Applying IFRS

IBOR reform

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EY

Building a better working world

Contents

What you need to know

- The IASB has completed its amendments to IFRS to facilitate IBOR Reform
- The main elements of the Phase 2 Amendments are that the effective interest rate on financial instruments must be adjusted, and hedge accounting will continue on transition to risk free rates, but only to the extent that the modifications made to financial instruments are those necessary to implement IBOR Reform and that the new basis for calculating cash flows is 'economically equivalent' to the previous basis
- There are also some significant new disclosure requirements
- IFRS 4 has been amended so that insurers who are still using IAS 39 will obtain the same reliefs as other entities
- IFRS 16 has also been amended to provide relief for the accounting by lessees for leases which refer to IBORs
- The effective date for the Phase 2 Amendments is 1 January 2021, but early adoption is permitted

1. Introduction

As a result of the reforms mandated by the Financial Stability Board following the financial crisis, regulators are pushing for benchmark InterBank Offered Rates (IBORs) such as LIBOR to be replaced by new 'official' benchmark rates, known as alternative Risk Free Rates (RFRs), a process hereinafter referred to as 'the Reform'. For instance, the new RFR for US dollars is the Secured Overnight Financing Rate (SOFR). Meanwhile, in the UK, the new official benchmark is the reformed Sterling Overnight Interest Average (SONIA) and panel banks will no longer be required to submit the quotes used to build LIBOR beyond the end of 2021. Such a change will affect future cash flows in both contractual floating rate financial instruments currently referenced to IBOR, and highly probable forecast transactions for which IBOR is designated as the hedged risk. This raises a number of accounting issues.

In 2018, the IASB added a project to its agenda to consider the financial reporting implications of the Reform. It identified two groups of accounting issues that could have financial reporting implications. These were:

- *Phase 1:* pre-replacement issues - issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an alternative RFR; and
- *Phase 2:* replacement issues - issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative RFR.

The IASB gave priority to the Phase 1 issues because they were more urgent and in September 2019 issued *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7* (the Phase 1 Amendments) to address them. The Phase 1 Amendments provided a number of temporary exceptions from applying specific hedge accounting requirements of both IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* (see section 4 below) but also added some additional disclosure requirements to IFRS 7 *Financial Instruments: Disclosures* (see section 6).

The Phase 1 Amendments were effective for accounting periods beginning on or after 1 January 2020 and early application was permitted.

In August 2020, the IASB issued *Interest Rate Benchmark Reform Phase 2, Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16* (the Phase 2 Amendments). The Phase 2 Amendments provide the following with respect to changes in financial instruments that are directly required by the Reform:

- A practical expedient when accounting for changes in the basis for determining the contractual cash flows of financial assets and liabilities, to allow the effective interest rate to be adjusted (see section 2)
- Reliefs from discontinuing hedge relationships (see section 4)
- Temporary relief from having to meet the separately identifiable requirement when an RFR instrument is designated as a hedge of a risk component (see section 4.2.2)
- Additional IFRS 7 disclosures (see section 6)

The Phase 2 Amendments also affected IFRS 16 *Leases* (see section 7) and IFRS 4 *Insurance Liabilities* (see section 8).

The Phase 2 Amendments are effective for annual periods beginning on or after 1 January 2021 and early application is permitted.

How we see it

Now that the Phase 2 Amendments have been finalised, entities must complete their assessment of the accounting implications of the scenarios they expect to encounter as they transition from IBORs to RFRs and accelerate their programmes to implement the new requirements. Where the Phase 2 Amendments introduce new areas of judgement, entities need to ensure they have appropriate accounting policies and governance in place. For the additional disclosures, entities must ensure they can gather and present the information required. Time is running out for entities considering early adopting the amendments for a December 2020 year end.

2. Changes in the basis for determining the contractual cash flows

In its Phase 2 Amendments the IASB has identified four ways that changes in the basis for determining the contractual cash flows of a financial instrument might be made in order to achieve IBOR reform[1]:

- By amending the contractual terms (for instance to replace a reference to an IBOR with a reference to an RFR)
- Through activation of an existing fallback clause in the contract
- Without amending the contractual terms, to change the way that an interest rate benchmark is calculated
- A hedging instrument may alternatively be changed as required by the Reform, not by amending the basis on which its contractual cash flows are calculated but, for instance, by closing out an existing IBOR-related derivative and replacing it with a new derivative with the same counterparty, on similar terms except referencing an RFR

The first two of these are relatively self-explanatory. The third stems initially from the decision made in Europe in 2019 to redefine the Euro OverNight Index Average (EONIA) as the Euro Short Term rate (ESTR) plus 8.5bp and also from the changes made in 2019 to how the Euro Interbank Offered Rate (Euribor) is calculated. The IASB believes that such changes were, in effect a modification.[2] Some constituents expressed concern in responding to the Exposure Draft for the Phase 2 Amendments (the Phase 2 ED) that this could create a precedent that might cause difficulties if a similar adjustment occurred outside of the scope of the Reform, when reliefs are not available. The IASB did not change the Amendments in this respect, although references to 'modification' have been removed from the final Phase 2 Amendments to IFRS 9 and reference is made instead to 'changes in the basis for determining contractual cash flows'. During discussions to finalise the Phase 2 Amendments, the IASB suggested it may initiate a project to clarify and improve the guidance on when modification of a financial instrument results in derecognition. This issue will, it is hoped, be considered again in that context.

The fourth method of making changes to the basis for determining contractual cash flows of an instrument, by replacing a hedging instrument as described, was added following responses to the Phase 2 ED. Many derivatives, especially those cleared through central clearing counterparties, may never be adjusted to achieve the Reform but, instead, be replaced by a new derivative on similar terms. (This is discussed in more detail in 2.2 below).

The first three of these types of changes to the basis for determining contractual cash flows may have an effect on how interest is recognised on financial instruments recorded at amortised cost or at fair value through other comprehensive income, and both the consequences and reliefs are discussed in 2.1 below. The fourth mainly affects hedge accounting (see section 4), but all four are relevant to the assessment as to whether the change to the basis for determining contractual cash flows results in derecognition (see 2.2).

[1] IFRS 9.5.4.6 and 6.9.2.
[2] IFRS 9.BC5.297 to 299.

2.1 Changes in the rate of interest

If an IBOR is amended to refer to an RFR, without the benefit of the amendments:

- First, the entity would have to assess whether the changes made to a financial instrument to achieve the Reform would lead to its derecognition (see also 2.2)
- Second, if the instrument is not derecognised and is recorded at amortised cost or at fair value through other comprehensive income, the entity would apply the requirements in paragraph 5.4.3 of IFRS 9 and recalculate the carrying amount of the financial instrument using the original effective interest rate (EIR), i.e., based on the IBOR before transition to the RFR

The second of these would mean that interest revenue or expense would continue to be recognised using an IBOR-based EIR over the remaining life of the instrument. The Board considered that, in the context of IBOR Reform, this outcome would not necessarily provide useful information to users of the financial statements, as the interest recognised would not reflect the economic effects of changes made to a financial instrument as a result of the Reform.[3]

Therefore, the Phase 2 Amendments require, as a practical expedient, for changes to cash flows that relate directly to the Reform to be treated as changes to a floating interest rate, i.e., the EIR is updated to reflect the change in an interest rate benchmark from IBOR to an RFR without adjusting the carrying amount. In effect, the change is treated as akin to a movement in the market rate of interest.[4]

The use of the practical expedient is subject to two conditions[5]:

- First, the change in the basis for determining contractual cash flows must be a direct consequence of the Reform
- Second, the new basis for determining the contractual cash flows must be 'economically equivalent' to the previous basis immediately preceding the change

Some respondents to the Phase 2 ED asked the question as to whether the reliefs are only available if, in the particular jurisdiction, the IBOR reform is mandated by laws or regulations. Consequently, they would not be available if, for example, financial instruments were modified only because of a concern that the IBOR may, in future, be discontinued or to align with global market developments. In the Phase 2 Amendments' Basis for Conclusions, the IASB has clarified that, while the changes must be a direct consequence of the Reform, the changes do not, in themselves, have to be mandatory.[6]

Examples of where changes would be 'economically equivalent' include[7]:

- The addition of a fixed spread to compensate for the basis difference between an existing IBOR and the alternative RFR. For example, the floating rate on a debt instrument for which the coupon was previously based on IBOR plus 100 basis points may be replaced with a coupon that is based on RFR plus 120 basis points, when the basis spread between IBOR and the RFR is 20 basis points. The basis difference arises mainly because the RFRs are overnight rates whereas LIBOR is a term rate, such as 3-month LIBOR

[3] IFRS 9.BC5.306.
[4] IFRS 9.5.4.7.
[5] IFRS 9.5.4.7.
[6] IFRS 9.BC5.313.
[7] IFRS 9.5.4.8.

- Changes to the reset period, reset dates or the number of days between coupon payment dates that are necessary to effect the Reform. For example, an interest rate previously based on a 3-month term IBOR rate paid quarterly may be replaced with one based on an RFR compounded over 3 months and paid quarterly, or an RFR compounded over one month and paid monthly
- The addition of a fallback provision that specifies the hierarchy of rates to be used in the event that the existing rate ceases to exist

However, the IASB regards 'economic equivalence' to be principles-based and the above list is not intended to be exhaustive. In the Basis for Conclusions it is also clarified that, while the notion of economic equivalence means that the interest rate will be substantially the same before and after the replacement, as long as the modifications are consistent with the above examples, there is no requirement to demonstrate this is the case through a quantitative analysis.[8]

It will be noticed that the addition of a fallback provision and the activation of a fallback provision are both treated in the Phase 2 Amendments as changes to the basis for determining contractual cash flows. This implies that if a financial instrument is, first, amended to add a fallback provision and, second, this provision is activated, then the Phase 2 practical expedient will be applied twice. However, applying the expedient, the accounting effects arise only on activation.

For many financial instruments, the changes needed to transition to an RFR will require negotiation between the two parties to the contract and it is possible that the agreed modifications may go further than those needed just to implement the Reform. After an entity applies the practical expedient to modifications to the financial instrument required by the Reform, it then separately assesses any further modifications that are not required by the Reform (e.g. a change in credit spread or a maturity date) to determine if they result in derecognition of the financial instrument (see 2.2 below). If they do not result in derecognition, an entity uses the updated EIR to adjust the carrying amount of the instrument and immediately recognises a modification gain or loss in profit or loss.[9]

These requirements are illustrated in Example 4 below.

How we see it

Because of the practical expedient, transition to RFRs will generally result in a change in the EIR for financial instruments recorded at amortised cost or at fair value through OCI. However, many financial instruments such as loans will need to be renegotiated bilaterally and entities will need to establish policies and procedures to identify any modifications over and above those required by the Reform and ensure that they are accounted for appropriately.

The term 'economically equivalent' is not defined in the Phase 2 Amendments. Whilst the IASB's intention is that the assessment should be predominately qualitative in nature, entities will need to develop an accounting policy and processes to ensure that the assessment can be carried out consistently in a suitably controlled manner. Associated with this, entities may wish to review how their existing accounting policy for modifications of financial instruments is determined and applied in practice.

[8] IFRS 9.BC5.315-317.
[9] IFRS 9.5.4.9.

2.2 Derecognition

The issue as to when a modification of a financial instrument might lead to its derecognition is specifically addressed in IFRS 9 only for financial liabilities and not for financial assets. The key requirement for financial liabilities is that a modification that results in a 'substantial change' in the expected cash flows will lead to the derecognition of the original liability and the recognition of a new one.[10] The Phase 2 Amendments apply this same principle to changes made to the basis for determining contractual cash flows of financial assets.

The Phase 2 Amendments only require an assessment of whether the derecognition criteria apply if changes are made to the financial instrument beyond those that qualify for the practical expedient (see 2.1 above). It follows that changes that do qualify for the practical expedient will not be regarded as sufficiently substantial that the instrument would be derecognised.[11]

However, after an entity applies the practical expedient, it must then separately assess any further changes that are not required by the Reform (e.g. a change in credit spread or a maturity date) to determine if they constitute such a substantial modification that they result in derecognition of the financial instrument.[12]

This principle appears to apply equally to the fourth method of changing the basis for determining contractual cash flows described at 2 above: the replacement of a derivative with the same counterparty. The IASB examined two scenarios. The first involves a pair of counterparties entering into two new derivatives, one derivative equal and offsetting the original IBOR-based derivative so as to close it out[13] with no gain or loss and a second derivative that references the RFR, but otherwise with the same terms as the original derivative so that it has an equivalent fair value.[14] Applying the derecognition guidance for liabilities[15], as this is an exchange with the same counterparty and does not constitute a 'substantial modification' of the original terms, the original derivative is treated as modified, rather than as derecognised with the recognition of a new derivative in its stead. In contrast, in the second scenario examined by the IASB, if the original derivative is closed out and the unrealised gain or loss settled in cash, and a new derivative is entered into on substantially different terms reflecting the current market rate, the first derivative would be treated as extinguished.[16]

It follows that it is possible that the new derivative might be entered into at a current market rate and yet the terms are not regarded as substantially different, and so the original derivative is not derecognised. However, even if the derivative is not derecognised, if the terms are sufficiently different that the fair value of the new derivative is not 'equivalent' to that of the original

[10] IFRS 9.3.3.2.
[11] IFRS 9.5.4.9
[12] IFRS 9.5.4.9.
[13] Using London Clearing House terminology, the derivatives would be closed out by being 'compressed.'
[14] IFRS 9.BC6.620 (a).
[15] IFRS 9.3.3.2.
[16] IFRS 9.BC6.620 (b).

derivative, any hedge relationship involving this derivative will need to be discontinued (see 4.2.1).

The IASB also clarified that novating an IBOR-based derivative to a new counterparty and subsequently amending the derivative with that counterparty to refer to an RFR, would (because of the novation) result in extinguishment of the original derivative.[17]

Application of the Amendments is illustrated in Examples 3 and 4 below in section 4.2.4.

How we see it

For any modifications that are made to a financial instrument that go beyond what is necessary to implement IBOR Reform, entities will need to assess whether they are sufficiently substantial that the instrument should be derecognised and a new one recognised in its stead. Similarly, if any hedging derivatives are closed out and replaced on current market terms, as described above, an assessment will need to be made as to whether the change in terms is substantial. The Amendments provide no further guidance on what level of modification would be viewed as substantial and this assessment will require judgement and the establishment of policies and processes to implement the assessment. While IFRS 9 states that a 10% change in the net present value of contractual cash flows of a liability would be considered substantial[18], it is recognised that the assessment should also have regard to qualitative factors, such as the introduction of new contractual features.[19]

[17] IFRS 9.BC6.621(d).
[18] IFRS 9.B3.3.6.
[19] See, for instance, the discussion on the restructuring of Greek Government bonds in the IFRIC Update September 2012.

3. Classification

3.1 Classification of financial assets

Any new financial assets, or any that have been derecognised and a new one recognised, because they have been subject to substantial modification (see 2.2 above) will need to be classified. A financial asset may only be accounted for at amortised cost or at fair value through other comprehensive income (FVOCI) if, at original recognition, the cash flows represent Solely Payment of Principal and Interest (SPPI).[20] As part of the IBOR Reform project, in October 2019,[1] the IASB considered whether, if IBORs are replaced with backward-looking term rates (such as a rate for the next six months based on the average overnight rate for the previous six months), this would cause instruments to fail the SPPI assessment. The IASB noted that there are no specific conditions or exceptions that would automatically disqualify contractual cash flows to be SPPI.
The focus on any assessment of interest should be on what the entity is being compensated for (i.e., whether the entity is receiving consideration for basic lending risks, costs and a profit margin). The IASB concluded that the current guidance in IFRS 9 provides an adequate basis to determine whether alternative benchmark rates are SPPI and that, provided the interest rate continues to reflect the time value of money and does not reflect other risks and features, the new instrument should pass the SPPI assessment.

Entities will, therefore, need to apply judgement in assessing whether there are any modifications to the time value of money element in replacement RFRs and, if there are, whether these modifications will cause a financial asset to fail the SPPI test.

Example 1 SPPI evaluation for SONIA
SONIA ("Sterling Over Night Indexed Average") is replacing sterling LIBOR as the risk-free rate for sterling loans. Whilst LIBOR is forward-looking, SONIA is backward-looking. SONIA is a daily rate and daily SONIA rates are compounded to determine the rate for an interest payment period such as three months. The interest to be paid is therefore only known at the end of the interest period. To facilitate timely payment of interest, it is useful for borrowers to know in advance what amount of interest is required to be paid. Therefore, the interest is determined five working days prior to the interest payment date, based on the compounded rate over a period starting and finishing five business days before the interest period begins and ends. In this instance, an entity may be able to assess from a qualitative perspective that there is no significant modification to the time value of money and, hence, the financial asset meets the SPPI criterion.

[20] IFRS 9.B4.1.7-26.

3.2 Separation of embedded derivatives

In October 2019, the IASB also considered in the context of its IBOR project, whether any amendment to IFRS 9 was required to clarify whether fallback provisions added as a result of the Reform should be separated from a host financial liability as an embedded derivative.

In the context of the Reform, fallbacks arise where the contractual terms of financial instruments contemplate the replacement of an established interest rate benchmark with an alternative interest rate benchmark. Such a contractual term could, for example, state that when the entity enacts IBOR reform for the financial instrument, the interest rate will change from 3-month Sterling LIBOR plus one hundred basis points, to Sterling Overnight Interest Average (SONIA) plus one hundred and twenty basis points.

The issue is only relevant for new financial liabilities and those that have been substantially modified such that a new financial instrument is recognised. If the economic terms of the financial instrument are affected by the fallback, there is a risk that it may not be closely related to the economic characteristics and risks of the host contract. Where this is the case, the fallback will need to be separated and accounted for as an embedded derivative.

In finalising the Phase 2 amendments, the IASB concluded that existing IFRS provides an adequate basis to determine the accounting for fallbacks that may arise in the context of interest rate benchmark reform. Applying the guidance in IFRS 9.B4.3.8(a), when a new financial liability is recognised, entities should assess whether the fallback could at least double the initial return and result in a rate of return that is at least twice what would be expected for a similar contract at the time the fallback takes effect. This assessment is often referred to as the 'double-double test'.

How we see it

The vast majority of fallbacks added in the context of the Reform should not require separation as an embedded derivative. This is because such fallbacks will normally be consistent with the financial instrument transitioning to an alternative RFR on an economically equivalent basis. When the fallback is triggered, application of the practical expedient results in the transition being reflected as a change to a market rate of interest. The fallback is therefore clearly and closely related to the debt host contract and should not be separated as an embedded derivative. The risk of it being necessary to separate an embedded derivative would probably be highest if the fallback requires a fixed, wide basis spread between IBOR and the RFR and the market interest rate is close to zero.

4. Hedge accounting

4.1 Phase 1 reliefs

The Phase 1 reliefs apply to all hedging relationships that are directly affected by uncertainties, due to the Reform, regarding the timing or amount of interest rate benchmark-based cash flows of the hedged item or hedging instrument (i.e. uncertainty about what the new benchmark will be and when it will take effect).[21] However, if the hedged item or hedging instrument is designated for risks other than just interest rate risk, the exceptions only apply to the interest rate benchmark-based cash flows. The relief does not, therefore, apply to net investment hedges, as the hedged item must have interest-based cash flows to be eligible.

Application of the reliefs is mandatory.[22] The first three reliefs for IFRS 9 provide for:

1. The assessment of whether a forecast transaction (or component thereof) is highly probable[23]
2. Assessing when to reclassify the amount in the cash flow hedge reserve to profit and loss[24]
3. The assessment of the economic relationship between the hedged item and the hedging instrument[25]

On application of each of these reliefs, it must be assumed that the benchmark on which the hedged cash flows are based (whether or not contractually specified) and/or, for relief three, the benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of the Reform.

Example 2: Application of Phase 1 relief for the Reform
Entity A is hedging an eight-year floating rate borrowing referenced to the 3-month US LIBOR, and it is known that any interest coupons payable after the loan has been renegotiated will not be determined with reference to US LIBOR, but according to the new RFR. The borrowing was previously designated in a cash flow hedge of 3m US LIBOR interest rate risk. There is still uncertainty, due to the Reform, about the timing or amount of interest rate benchmark-based cash flows of the loan and the associated hedging instrument. While that uncertainty exists, the Phase 1 Amendment requires Entity A to ignore that fact and assume the hedged interest coupons on the borrowing and associated hedging instrument will remain US LIBOR-based cash flows for the purpose of assessing and measuring effectiveness.

It is possible that the designated hedged item is an IBOR risk component of a financial instrument. To be an eligible risk component, it would have to be 'separately identifiable' and 'reliably measurable.[26] The fourth relief provides

[21] IFRS 9.6.8.1
[22] IFRS 9.7.1.8
[23] IFRS 9.6.8.4
[24] IFRS 9.6.8.5
[25] IFRS 9.6.8.6
[26] IFRS 9.6.3.7(a).

that, where a benchmark component of interest rate risk has been designated as the hedged item and it is affected by the Reform, the requirement that the risk component is separately identifiable need be met only at the inception of the hedging relationship.[27] Hence, as long as the IBOR was considered to be separately identifiable when the hedge relationship was first established, the IBOR will continue to qualify as a risk component even if the IBOR ceases to be separately identifiable. (The issue of whether a benchmark rate is separately identifiable is considered further in section 4.2.3 below).

For 'dynamic' or 'macro' hedging strategies (i.e., where hedging instruments and hedged items may be added to or removed from an open portfolio in a continuous hedging strategy, resulting in frequent de-designations and re-designations) the entity need only satisfy the separately identifiable requirement when hedged items are initially designated within the hedging relationship. The entity does not subsequently need to reassess this requirement for any hedged items that have been re-designated.[28]

However, the Phase 1 Amendments do not provide any relief from the requirement that changes in the fair value or cash flows of the risk component must be reliably measurable.[29]

The reliefs are intended to be narrow in their effect, such that other than the specific reliefs provided, the usual requirements within the IFRS 9 hedge accounting guidance must be applied. The Basis for Conclusions contains an example of where relief will not be available; benchmark-based cash flows cannot be assumed to still be highly probable if an entity decides not to issue forecast debt due to the uncertainties arising from the Reform.[30] Also, to the extent that a hedging instrument is altered so that its cash flows are based on an RFR, but the hedged item is still based on IBOR (or vice versa), there is no relief from measuring and recording any ineffectiveness that arises due to differences in their changes in fair value.[31]

4.1.2 End of Phase 1 reliefs

Reliefs one and two above cease to apply prospectively at the earlier of when the uncertainty arising from the Reform is no longer present with respect to the timing and amount of the IBOR-based cash flows of the hedged item, and:

- For relief one, when the hedging relationship that the hedged item is part of is discontinued
- For relief two, when the entire amount accumulated in the cash flow hedge reserve has been reclassified to profit and loss[32]

Relief three ceases prospectively, as follows:

- For a hedged item when the uncertainty arising from the Reform is no longer present with respect to the timing and amount of IBOR-based cash flows of the hedged item

[27] IFRS 9.6.8.7.
[28] IFRS 9.6.8.8.
[29] IFRS 9.BC6.575.
[30] IFRS 9.BC6.560.
[31] IFRS 9.BC6.567, BC6.568.
[32] IFRS 9.6.8.9, 6.8.10.

- For a hedging instrument, when the uncertainty arising from the Reform is no longer present with respect to the timing and amount of IBOR-based cash flows of the hedging instrument
- If the hedging relationship is discontinued before either of the two above events occur, at the date of discontinuation[33]

When an entity designates a group of items as the hedged item, the end of relief requirements would be applied prospectively to each individual item within the designated group of items.[34]

Relief four ceases either when the formal designation of the hedge relationship is amended, applying the Phase 2 relief (see 4.2 below) or when the hedging relationship is discontinued, applying the normal IFRS 9 discontinuation guidance. This means that until either of these occur, the risk component may continue to be designated, even if it is no longer separately identifiable. This is particularly relevant for fair value hedges as the hedged items will generally not need to be amended for the Reform.[35]

The reliefs will continue indefinitely in the absence of any of the events described above. The Basis for Conclusions sets out a number of different fact patterns, which could arise as contracts are amended in anticipation of the replacement of an interest rate benchmark, to illustrate when uncertainties due to the Reform will end.[36] The key message is that, in most cases, relief will only end when a contract is amended to specify both what the new benchmark will be and when it will take effect.

There could be situations in which the uncertainty for particular elements of a single hedging relationship could end at different times. For example, assume an entity is required to apply the relevant exceptions to both the hedged item and the hedging instrument, as will typically be the case for a cash flow hedge. If the hedging instrument in that hedging relationship is amended through market protocols covering all derivatives in that market, and will be based on an RFR such that the uncertainty about the timing and the amount of interest rate RFR-based cash flows of the hedging instrument is eliminated, the relevant exceptions would continue to apply to the hedged item, but would no longer apply to the hedging instrument.[37] The consequence of this is that any delay between the modification of the hedging instrument and the hedged item will introduce a new source of hedge ineffectiveness, specifically any changes in the basis risk between the RFR interest on the hedging instrument and the IBOR interest on the hedged item.

4.1.3 Phase 1 reliefs for IAS 39

As many entities remain under the hedge accounting requirements of IAS 39, Phase 1 Amendments were also made to IAS 39.[38] These are consistent with those for IFRS 9, but with the following differences:

- For the retrospective assessment of effectiveness, an entity may continue to apply hedge accounting to a hedging relationship for which effectiveness

[33] IFRS 9.6.8.11.
[34] IFRS 9.6.8.12.
[35] IFRS 9.6.8.13.
[36] IFRS 9.BC6.587-59.
[37] IFRS 9.BC6.594.
[38] IAS 39.102A-102N, 108G.

is outside of the 80–125% range during the period of uncertainty arising from the Reform. This applies to any hedge relationship affected by the uncertainties due to the Reform and is not restricted to the amount of ineffectiveness that can be directly attributed to the Reform.[39] The relief is, however, subject to satisfying the other conditions in paragraph 88 of IAS 39, including the prospective assessment that the hedge is expected to be highly effective (as amended below). This relief may be particularly important if there is a delay between when a hedging instrument is amended for the Reform and the amendment of the hedged item (or vice versa). Any actual ineffectiveness would need to be measured and recognised in the financial statements. This should be calculated based on how market participants would value the hedged items and hedging instruments and would include the effect of any increase in discount rates that the market requires due to the uncertainties arising from the Reform.[40]

- The Phase 1 relief from the retrospective 80–125% assessment ceases at the earlier of when there is no longer uncertainty with respect to the cash flows of both the hedged item and the hedging instrument, and when the hedging relationship is discontinued.[41]
- For the prospective assessment that a hedge is expected to be highly effective, it is assumed that the benchmark on which the hedged cash flows are based (whether or not it is contractually specified) and/or the benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of the Reform.[42]
- For a hedge of a benchmark portion (rather than a risk component under IFRS 9) of interest rate risk that is affected by the Reform, the requirement that the portion is separately identifiable need be met only at the inception of the hedge.[43]

4.2 Phase 2 hedge accounting amendments

As noted above, the Phase 1 Amendments only cover pre-replacement issues. The issues that affect financial reporting when an existing interest rate benchmark is replaced with an RFR, are addressed by Phase 2. Hedge relationships within the scope of Phase 2 are the same as those within the scope of Phase 1 (see 4.1).

The Phase 2 Amendments for IFRS 9 provide the following reliefs (the 'Phase 2 reliefs'):

1. Relief from discontinuing hedge relationships because of changes to hedge documentation required by the Reform (see 4.2.1 below)
2. Temporary relief from having to meet the separately identifiable requirement (see 4.2.2 below)

The Phase 2 reliefs can only be applied to hedge relationships including a financial asset or financial liability (including derivatives) for which contractual changes, or changes to cash flows are directly required by the Reform. Changes to contractual cash flows could change either in a way not originally specified on initial recognition, or as a result of activation of an existing contractual term

[39] IAS 39.BC250.
[40] IAS 39.102G.
[41] This was amended further in Phase 2 (IAS 39.102M).
[42] IAS 39.102F.
[43] IAS 39.102H.

such as a fallback clause.[44] As with the relief discussed at 2.1, above, changes are directly required by the Reform if, and only if, both of the following conditions are met:

- The change is necessary as a direct consequence of interest rate benchmark reform
- The new basis for determining the contractual cash flows is 'economically equivalent' to the previous basis (i.e., the basis immediately preceding the change)[45]

As already discussed in section 2 above, the Amendments include examples of the type of changes required by interest rate reform that are considered to be economically equivalent to the previous basis, as follows:

- The replacement of an existing interest rate with an RFR or effecting such a reform of an interest rate benchmark by changing the method used to calculate the interest rate benchmark, with the addition of a fixed spread to compensate for a basis difference between the existing interest rate benchmark and the RFR
- Changes to the reset period, reset dates, or the number of days between coupon payment dates that are necessary to effect the reform of an interest rate benchmark
- The addition of a fallback provision to the contractual terms of a financial asset or liability to enable any of the changes described above to be made[46]

4.2.1 Phase 2 reliefs from discontinuing hedge relationships

The Phase 2 amendments require that as and when an entity ceases to apply the Phase 1 reliefs to a hedging relationship (see 4.1.2 above), the entity must amend the formal designation of that hedging relationship to reflect the changes that are required by the Reform. The hedge designation must be amended by the end of the reporting period during which the applicable requirements cease to apply. The principle Phase 2 relief is that such changes to the hedge documentation do not result in the discontinuation of hedge accounting nor the designation of a new hedge relationship, as long as the only changes are those permitted by the Phase 2 Amendments. Permitted changes include redefining the hedged risk to reference an RFR and redefining the description of the hedging instruments and/or the hedged items to reflect the RFR. The amendments could include the addition of a fixed spread to compensate for the basis difference between the previous benchmark and the RFR, as described above.[47]

If changes are made in addition to the changes required by the Reform to the financial asset or financial liability designated in a hedging relationship, or to the designation of the hedging relationship, an entity must first apply the normal requirements in IFRS 9 to determine if those additional changes result in the discontinuation of hedge accounting. If the additional changes do not result in the discontinuation of hedge accounting, an entity must amend the formal designation of the hedging relationship[48].

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[44] See 2.1 above.
[45] IFRS 9.5.4.5 - 5.4.7.
[46] IFRS 9.5.4.8.
[47] IFRS 9.6.9.1, 6.9.3. 6.9.4.
[48] IFRS 9.6.9.5.

An example discussed in the Basis for Conclusions, is if an entity enters into a basis swap in order to mitigate ineffectiveness arising between different methods of compounding of RFRs for cash products and derivatives. The implication is that an amendment of the hedge relationship to encompass the addition of the basis swap could result in the discontinuation of the hedge relationship.[49] This is possibly because the addition of the basis swap is not strictly necessary to achieve IBOR Reform. Note that this is different from the use of a basis swap, as described below, to modify the contractual cash flows of a specific IBOR-based hedging instrument so as to be based on an RFR, where the hedge relationship will continue.

It is possible that a hedging instrument will be changed, as required by the Reform, not by amending the basis on which its contractual cash flows are calculated but by, for instance, terminating an existing IBOR-related derivative and replacing it with a new derivative with the same counterparty, referencing an RFR (see 2 above). Clarification was provided in the Phase 2 Amendments that in such situations the Phase 2 reliefs apply if and only if:

- The original hedging instrument is not derecognised, applying the usual accounting derecognition criteria (see 2.2 above)

  And

- The chosen approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument, as described above (see also 2.1)[50]

This means that, in order for the original hedge relationship to be regarded as continued, the fair value of the new RFR derivative at initial recognition must be equivalent to the fair value of the original derivative. It would not be possible to replace the older derivative with a new one at a market rate of interest unless it is substantially the same.[51]

Although this clarification will primarily apply to derivatives cleared by a central clearing counterparty, according to the Basis for Conclusions, it will also apply where the addition of a new basis swap, specific to a particular instrument, swaps the existing interest rate benchmark for that instrument to the RFR. This is viewed by the IASB as economically equivalent to modifying the contractual terms of the original instrument, as long as the basis swap is linked or coupled with the original derivative rather than being entered into at a portfolio level.[52]

Changes required by the Reform to be made to hedge designations and hedge documentation may be required at different times for different hedge relationships, and more than once for individual hedge relationships. For instance, for a cash flow hedge, it is possible that the hedge designation and documentation will need to be amended twice: once when the derivative is modified to refer to an RFR, and again when the hedged item is renegotiated to refer to an RFR. An entity must apply the relief from discontinuing hedge relationships on each occasion the criteria are met.[53]

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[49] IFRS 9.BC6.617.
[50] IFRS 9.6.9.2.
[51] IFRS 9.BC5.315.
[52] IFRS 9.BC6.620 (c).
[53] IFRS 9.6.9.3.

During the accounting period in which the hedge designation is amended to reference an RFR, the usual IFRS 9 requirements for accounting for changes in the fair value of the hedged item or hedging instrument apply, as follows:

- For fair value hedges, the hedging instrument and hedged item are remeasured based on the RFR.
- For cash flow hedges, the cash flow hedge reserve is remeasured, based on the RFR, to the lower of the cumulative gain or loss on the hedging instrument and the cumulative change in fair value of the hedged item.[54]

Any hedge ineffectiveness is recognised in profit and loss as normal. The IASB does not expect that there would be a significant change in fair value on transition, since that would imply that the amendments had not been made on an economically equivalent basis.[55]

When the hedged item is amended (or if the hedge has previously been discontinued, when the contractual cash flows of the previously designated item are modified), amounts accumulated in the cash flow hedge reserve are deemed to be based on the RFR. This results in the release of the cash flow hedge reserve to profit or loss in the same period or periods in which the hedged cash flows that are now based on the RFR affect profit or loss. To achieve this, a hypothetical derivative in a cash flow hedge may be updated, although any valuation adjustment on transition may need to be recognised in profit or loss in the period when the hedge documentation is amended. (This will be recorded as part of the normal recognition in other comprehensive income (OCI) of the lower of the cumulative gain or loss on the hedging instrument and the cumulative change in fair value of the hedged item).[56]

The Phase 2 Amendments also provide reliefs for items within a designated group of items (such as those forming part of a macro cash flow hedging strategy) that are amended for modifications directly required by the Reform. The reliefs allow the hedging strategy to remain and not be discontinued. As items within the hedged group transition at different times from IBORs to RFRs, they will be transferred to sub-groups of instruments that reference RFRs as the hedged risk. The existing IBOR would remain designated as the hedged risk for the other sub-group of hedged items, until they too are updated to reference the new RFR. At each transition, the hypothetical derivative for the sub-group will require updating. Each sub-group must meet the eligibility requirements for a group of items to be designated as a hedged item. However, the usual hedge accounting requirements must be applied to the hedge relationship in its entirety.[57]

The Phase 2 reliefs for accounting for cash flow hedges and groups of items provide exceptions only to the circumstances described and all the other qualifying criteria for hedge accounting must be applied.[58]

[54] IFRS 9.6.9.3.
[55] IFRS 9.BC6.626.
[56] IFRS 9.6.9.7, 6.9.8.
[57] IFRS 9.6.9.9- 6.9.10.
[58] IFRS 9.6.9.6.

4.2.2 Phase 2 temporary relief from having to meet the separately identifiable requirement

IFRS 9 requires that a risk component is not only reliably measurable, but also 'separately identifiable' to be eligible for hedge accounting. The Phase 2 Amendments provide temporary relief to entities from having to meet the separately identifiable requirement, when an RFR instrument is designated as a hedge of a risk component, both upon designation of a new hedge relationship, and for existing hedge relationships when changes required by the Reform are made to hedge designations and hedge documentation (see 4.2.1 above). The relief allows entities to assume that the separately identifiable requirement is met, provided the entity reasonably expects the RFR risk component to become separately identifiable within the next 24 months. The 24-month period applies to each RFR separately (i.e., it applies on a rate-by-rate basis) and starts from the date an entity designates the RFR as a risk component for the first time.

If an entity reasonably expects that an RFR will not be separately identifiable within 24 months after initial designation, the relief will end for that RFR. Hedge accounting should be discontinued prospectively from the date of that reassessment for all hedging relationships in which the RFR was designated as a risk component.[59]

In either of these cases, the hedge would have to be prospectively discontinued. Meanwhile, no relief is provided from the requirement for the risk component to be reliably measurable throughout the life of the hedging relationship.

The relief only applies for uncertainty arising directly from the Reform, as to whether an RFR risk component is separately identifiable. The relief is not available for hedging relationships where there is uncertainty whether the risk component is separately identifiable, but the uncertainty is not as a direct result of the Reform.

How we see it

The relief from having to satisfy the separately identifiable requirement should significantly ease the transition to RFRs by allowing hedging relationships to be designated and to continue, even before the new RFRs are fully established as market benchmarks. However, entities must ensure they are comfortable making the appropriate judgements at the time of transition and over the subsequent 24 months, while introducing suitable processes and governance to update their assessment.

4.2.3 Determination of whether an RFR is a separately identifiable risk component

Although the Phase 1 and 2 Amendments provide reliefs for the assessment of whether a non-contractually specified risk component is separately identifiable, and so can be designated as a hedged risk, they do not provide guidance on what is meant by 'separately identifiable'. Therefore, there should generally be no change in how this criterion is interpreted. There are, however, a couple of points made in the Phase 2 Amendments that may be relevant, first, for fair value hedges and, second, for cash flow hedges.

[59] IFRS 9.6.9.11, 6.9.12.

i) Fair value hedges

The first point is that, as the relief is provided only for 'separately identifiable' and not for 'reliably measurable', the two criteria are clearly different. It is to be expected that an RFR might become sufficiently liquid that it is reliably measurable, but without yet being separately identifiable.[60]

Whilst much of the pre-existing guidance in IFRS 9 on how to determine whether a risk component is separately identifiable or not was written primarily to permit hedging of components of non-financial items, one example appears particularly relevant for interest rate hedges, as follows:

"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. The price of fixed-rate debt instruments varies directly in response to changes in the benchmark as they happen. Consequently, Entity D may designate hedge relationships for the fixed rate debt instrument on a risk component basis for the benchmark interest rate risk[61]."

This paragraph is cited only as 'an example', so this should not be read as a list of criteria for a rate to qualify as separately identifiable. Nevertheless, this example could be read to imply that, for a benchmark interest rate to qualify as a risk component, it has to be the basis on which fixed rate debt instruments are frequently priced and floating ones frequently vary in rate, and that it would be insufficient for the rate to be used only in the swap market. At the time of writing, there have already been a number of SONIA-based bond issues and SONIA swaps already make up half the sterling swaps market by volume. It is possible that an entity might conclude that SONIA is already separately identifiable and, if not yet, will be within 24 months. In contrast, swaps referenced to (SOFR) (the chosen US dollar RFR) are far fewer in volume. Although it is not clear when or if it will form the basis on which fixed rate debt instruments are priced, there is an expectation that SOFR will become the reference index for many variable rate instruments. Further, the US dollar swap market is expected to move to be SOFR-based and, to that extent, SOFR will become a major interest rate benchmark and the main one used for hedging purposes. On this basis, given that the guidance in IFRS 9 is only 'an example', we expect that most entities applying IFRS 9 for hedge accounting purposes will conclude that SOFR will be separately measurable within 24 months.

Although the guidance in IFRS 9 as to the criterion for a risk component to be separately identifiable is very similar to that in IAS 39 for a risk portion, the wording is not exactly the same (see 4.2.6 below). The IASB never said that it had intended the application of 'separately identifiable' to interest rates to change on the application of IFRS 9, which could imply that if a benchmark risk portion was separately identifiable under IAS 39 then it would also be a separately identifiable risk component under IFRS 9. However, the guidance

[60] IFRS 9.B6.3.9.
[61] IFRS 9.B6.3.10(d).

in IFRS 9.B6.3.10(d) arguably provides a more restrictive interpretation of what constitutes a 'benchmark'. Further, if SOFR is already separately identifiable by virtue of being called a benchmark, that would make the 24-month exception largely unnecessary.

Meanwhile, the question arises as to whether it is still possible to designate LIBOR as a separately identifiable risk component. The answer is clearly 'yes' until the RFR becomes established and it is likely that after that, for a short while, LIBOR and the RFR will both be separately identifiable, as the market transitions from one benchmark rate to another.

ii) Cash flow hedges

The second point is that it is clear that the exception for identifying risk components in the Phase 1 and 2 Amendments apply to cash flow hedges as well as fair value hedges.[62] This leads to the question of whether it is possible to designate an RFR as a risk component of an IBOR floating rate debt instrument. The relevance of this question arises mainly where there is a mismatch in the timing of the amendment of a hedging derivative and the floating rate instrument that is the hedged item, so that the derivative is amended to refer to an RFR before the hedged item. The issue here is not whether, for instance, SONIA or SOFR will be separately identifiable as a component within 24 months, but whether it will ever be regarded as a separately identifiable component of a LIBOR-based floating rate.

In the deliberations on the Phase 2 Amendments regarding timing mismatches, it was suggested in a Staff Paper that hedge ineffectiveness could be minimised in the period before the hedged item is amended, by adjusting the hedged risk to the RFR rather than the contractual interest rate.[63] This might be read to endorse the possibility of designating an RFR component of IBOR (if it is expected to be separately identifiable within the next 24 months).

However, there is no specific guidance on this issue within the Phase 2 Amendments. Unlike fair value hedges, in the past there has been much less practice of designation of risk components in floating rate instruments, unless the risk was already contractually specified (e.g., LIBOR risk in a loan that was indexed to LIBOR). Also, the examples in both IFRS 9 and IAS 39 only address fair value hedges. Therefore, it is more difficult to draw on past precedent or practice to support designating an RFR as a component of LIBOR.

The case for SONIA as a component of sterling LIBOR is perhaps easier to make, since it can be thought of as 'overnight sterling LIBOR' and so 'a building block' of term LIBOR. SOFR, on the other hand, based on the repo rate, is somewhat different in nature from US dollar LIBOR. Practice will emerge on this issue and it is possible that the IASB or regulators may provide guidance on the topic, but, for the purpose of Example 4 below, it has been assumed that SOFR cannot be designated as a component of US dollar LIBOR.

[62] IFRS 9.BC6.647.
[63] See January Staff Paper 14A Paragraph 28.

4.2.4 Application of Phase 2 reliefs

The following two examples illustrate the key features of the Phase 2 Amendments:

Example 3: Application of Phase 2 relief to a fair value hedge
Company A has previously entered into an interest rate swap paying fixed 3% and receiving 3-month US dollar LIBOR. It had been designated in a hedge of the exposure to changes in fair value attributable to US dollar LIBOR, of cash flows equivalent to a 3% coupon plus principal of a 4% fixed US dollar asset. On 1 November 2020, 3-month US dollar LIBOR is 0.5% and SOFR is 0.2%, i.e., the basis difference between the two rates is 30 basis points. The swap is accordingly amended to pay fixed 2.7%, receive SOFR. The amendment of the derivative is not considered to be a substantial modification and so it is not derecognised.[64] The new swap is considered 'economically equivalent' to the old swap, since the only change has been to refer to SOFR instead of LIBOR and to adjust the spread based on the current market rates (see 2.1 above). As a result, the formal designation of the hedge is amended, and although the LIBOR hedged risk designation ends, the hedge continues, but with SOFR as the designated risk component (see 4.2.1 above). SOFR is expected to be a separately identifiable component of US dollar interest rates within 24 months, and therefore may now be designated as the hedged risk component (see 4 above). Consequently, the description of the hedge designation is amended to refer to the new hedging instrument and, the hedged item is amended to a hedge of changes in fair value attributable to SOFR, of the component of the 4% asset equivalent to a 2.7% coupon plus principal, (see 2.1 above). (An entity applying IAS 39 for hedge accounting must also update how hedge effectiveness will be assessed in future (see 4.2.5 below).) At the next period end, the swap is remeasured to its new fair value, based on SOFR, consistent with the normal hedge accounting requirements. This remeasurement will include any difference in fair value of the swap immediately before and after its modification, but as the derivative has been modified on an 'economically equivalent basis', the effect should be small. The asset is also adjusted for the difference in its fair value with respect to the designated hedged risk. This will include the difference in fair value between the 3% coupon plus principal discounted at 3-month US dollar LIBOR and the 2.7% coupon plus principal discounted at SOFR. This difference should also be small. Any net change of fair value on the amendment of the swap and of the designated hedged component, is recorded in profit or loss as part of the recorded hedge ineffectiveness for the period (see 4.2.1 above).

[64] IFRS 9.BC6.619.

Example 4: Application of Phase 2 relief to a cash flow hedge relationship

The initial fact pattern is the same as that in the Example 3 above, except that it is a cash flow hedge of the US dollar LIBOR risk of a US dollar LIBOR plus 20bp liability. Ineffectiveness has been assessed and measured using a hypothetical derivative on which Company A receives 3% fixed and pays 3-month US dollar LIBOR.

As in Example 3, on 1 November 2020, the derivative is amended to pay fixed 2.7%, receive SOFR. Again, the amendment of the derivative is not considered to be a substantial modification and so it is not derecognised. The main difference in this example is that the US dollar LIBOR borrowing will also need to be amended as part of IBOR reform, through bilateral negotiation, but it is assumed that this does not happen for several months.

The hedge documentation may need to be amended to describe the amended swap as the hedging instrument in a cash flow hedge of the US dollar LIBOR liability (see 4.2.1 above). Whether this will be necessary will depend on the specificity of the original hedge documentation. SOFR is expected to be a separately identifiable component of US dollar interest rates within 24 months. However, Company A does not consider SOFR will ever be a separately identifiable component of US dollar LIBOR (see 4.2.3 above). As a result, the hypothetical derivative is not amended at this time and continues to be based on LIBOR.

The original hedge relationship continues (see 4.2.1 above), and the amount recorded in the cash flow hedge reserve continues to be considered to be based on LIBOR as required by the Phase 1 Amendments.

At the end of each accounting period from when the swap is amended until the liability is also renegotiated, the cash flow hedge reserve is remeasured to the lower of:

- The cumulative gain or loss in fair value of the SOFR swap; and
- The cumulative gain or loss in fair value of the US dollar LIBOR hypothetical derivative.

Because the swap is valued based on SOFR and the liability based on LIBOR, this remeasurement will give rise to a degree of ineffectiveness which may need to be recorded in profit or loss. However, the entity considers that there is still an 'economic relationship' between SOFR and US dollar LIBOR, such that hedge accounting continues to be permitted. (An entity applying IAS 39 would be relieved from the 80-125% retrospective effectiveness assessment but would need to meet the prospective effectiveness assessment (see 4.2.5 below).)

The liability is renegotiated on 15 January 2021, when the basis difference between 3-month US dollar LIBOR and SOFR is 25 basis points. However, as part of the bilateral negotiation to amend the liability, the credit spread is also reduced by 6bp. The liability is accordingly amended to pay SOFR plus 39bp (where 39bp is the previous 20bp plus the current 3-month US dollar LIBOR-SOFR basis of 25bp, less the change in credit spread of 6bp).

Apart from the 6bp change in credit spread, the amendment is considered to be required as a direct consequence of the Reform and the new basis for determining the contractual flows is considered to be economically equivalent to the old basis (see 2.1 above). Applying the Phase 2 relief on modification of a financial instrument, the effective interest rate (EIR) on the liability is amended to SOFR plus 45bp (where 45bp is the previous 20bp plus the current 3-month LIBOR-SOFR basis of 25bp).

The 6bp change in credit spread is not considered to be a substantial modification of the liability, since quantitatively, the change in net present value discounted at the new EIR is less than 10% and the change is also judged to be not substantial from a qualitative perspective. Hence, the liability is not derecognised. The 6bp change in credit spread is however not covered by the Phase 2 relief and the net present value of the 6bp reduction, discounted at the revised EIR of SOFR plus 45bp, is recorded as an immediate credit to profit or loss.

The hedge documentation is amended for a second time (see 4.2.1 above). The Phase 1 relief requiring the hedged risk to continue to be based on LIBOR comes to an end (see 4.1.2 above), and the hedge is now documented as a cash flow hedge of the SOFR component of the SOFR plus 39bp liability. (An entity applying IAS 39 for hedge accounting will also need to update the hedge documentation for any change in how hedge effectiveness will be assessed (see 4.2.5 below)). Again, the amendment of the hedge documentation, to refer to the modified hedged item and the new designated risk component, does not constitute a discontinuation of the original hedging relationship (see 4.2.1 above). Hence, the amended hypothetical derivative does not need to be based on the current rate of SOFR. Instead it is amended to be a receive 2.75%, pay SOFR swap (where 2.75% is the previous 3% less the 25bp basis difference between 3-month US dollar LIBOR and SOFR when the hedge is amended).

The amount accumulated in the cash flow hedge reserve is now deemed to be based on SOFR (see 4.2.1 above). The cash flow hedge reserve is remeasured at the next period end, to the lower of:

- the cumulative gain or loss in fair value of the amended swap; and
- the cumulative gain or loss in fair value of the revised hypothetical derivative.

Note that because of the timing mismatch, the derivative (pay 2.70%, receive SOFR) and the hypothetical derivative (receive 2.75%, pay SOFR) have a different fixed rate, a degree of hedge ineffectiveness will arise:

- in this period, due mostly to a 'catch up' due to the difference in the fixed rates of the derivative and the hypothetical derivative and, hence, their fair values on redesignation; and

- in the future, as changes in the fair values of the derivative and the hypothetical derivative will not be the same. Going forward, although the entity considers that there is an 'economic relationship' between the derivative and the hypothetical derivative, for entities applying IAS 39, the level of ineffectiveness will need to be monitored to ensure that the hedge continues to qualify for accounting purposes as there is no relief from the 80/125% effectiveness requirements (see 4.2.5 below).

Because this is a cash flow hedge, the amount of ineffectiveness actually recorded will depend on whether the change in the fair value of the derivative is greater than that on the hypothetical derivative.

How we see it

Entities are recommended to ensure that there are as few mismatches as possible in the timing of the amendment of hedging instruments and hedged items, to minimise the level of recorded hedge ineffectiveness.

This may be especially challenging if an entity's swap traders do not know if a particular derivative is designated in a hedging relationship, as is more likely to be the case where a dynamic strategy is used or if derivatives are designated in 'proxy' hedges. Procedures would need to be established to help ensure that derivatives are not modified without first considering the accounting consequences.

4.2.5 Phase 2 amendments for IAS 39

As is the case for the Phase 1 amendments (see 4.2.1 above), the Phase 2 Amendments also include changes to IAS 39. The corresponding amendments to IAS 39 are consistent with those for IFRS 9, but with the following differences:

- IAS 39 is amended so that for the assessment of retrospective hedge effectiveness for fair value hedges, the cumulative fair value changes may be reset to zero when the exception to the retrospective assessment ends. This election is made separately for each hedging relationship (i.e., on a hedge-by-hedge basis). However, actual hedge ineffectiveness will continue to be measured and recognised in full in profit or loss[65]. This is amended from the Phase 2 ED, which had proposed to make resetting to zero compulsory.
- The Phase 2 amendments also clarify that changes to the method for assessing hedge effectiveness due to modifications required by IBOR reform, will not result in the discontinuation of hedge accounting.[66]

[65] IAS 39.102V.
[66] IAS 39.102P(d).

4.2.6 Determination of whether an RFR is a separately identifiable risk component under IAS 39

Similar to the Phase 1 and 2 Amendments for IFRS 9 (see 4.1.1 and 4.2.3 above), although the amendments to IAS 39 provide reliefs for the assessment of whether a non-contractually specified risk component is separately identifiable, and so can be designated as a hedged risk, they do not provide guidance on what is meant by 'separately identifiable'. Whilst the guidance in IFRS 9 that the criterion for a risk component to be separately identifiable is very similar to that in IAS 39 for a risk portion, the wording is not exactly the same. In particular, IAS 39 contains an additional example that was not carried forward into IFRS 9, as follows:

"... for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable."[67]

How we see it

Given the IAS 39 reference to 'risk-free or benchmark' as a separately identifiable component, it has been established practice to designate other benchmarks, such as the overnight interest rate swap rate (OIS). It is possible that those entities still applying IAS 39 will consider RFRs such as SONIA and SOFR as separately identifiable, on the basis that they are already benchmarks and SOFR is also (nearly) risk-free.

[67] IAS 39.AG99F(a).

5 Transition

5.1 Phase 1

The effective date of the Phase 1 Amendments is for annual periods beginning on or after 1 January 2020, although earlier application was permitted. The requirements must be applied retrospectively. However, the reliefs only apply to hedging relationships that existed at the beginning of the reporting period in which an entity first applies those requirements or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies those requirements. It follows that it is not possible to apply the requirements retrospectively to hedge relationships that were not previously designated as such.[68]

5.2 Phase 2

The Phase 2 Amendments are effective for annual periods beginning on or after 1 January 2021, with earlier application permitted (subject, of course, to any local endorsement procedures).[69] Application of the Phase 2 Amendments is mandatory, to ensure comparability.

Application is retrospective although, as is normal under IFRS, hedge relationships may not be designated retrospectively. However, discontinued hedging relationships must be reinstated if, and only if, the following conditions are met:

- The hedging relationship was discontinued solely due to changes required by the Reform, and therefore the entity would not have been required to discontinue that hedging relationship if the Phase 2 Amendments had been applied at that time

  And

- At the date of initial application of the Phase 2 Amendments, that discontinued hedge relationship continues to meet all the qualifying criteria for hedge accounting, after taking account of the Phase 2 Amendments[70]

Continuing to meet all the qualifying criteria will include the need for the risk management objective of the discontinued hedge relationship to remain unchanged. This is unlikely to be the case if either the hedged item or the hedging instrument has subsequently been designated in a new hedge relationship.

To the extent that application of the practical expedient would have resulted in a different accounting treatment to that applied by the entity for changes made prior to application of the Phase 2 Amendments to the basis for determining contractual cash flows, this will form part of the transition adjustment.

[68] IFRS 9.7.2.26(d).
[69] IFRS 9.7.1.10, IAS 39.108H.
[70] IFRS 9.7.2.36, 7.2.37, IAS 39.108I and 108.J.

An entity is not required to restate prior periods on application of the Phase 2 Amendments. It may do so but only if it is possible without the benefit of hindsight. If it does not restate prior periods, the entity must recognise any difference in carrying values as an adjustment to retained earnings (or other component of equity if appropriate) at the beginning of the annual reporting period that includes the initial date of application.[71]

How we see it

- Although relatively few hedging relationships may have been discontinued before the Phase 2 Amendments are implemented, the requirement to reinstate discontinued hedge relationships that meet the criteria may be operationally onerous. Each discontinued hedge relationship will need to be identified and assessed in order to determine whether the criteria are met or not. Further, for any relationships that do meet the criteria for reinstatement, calculation of retrospective hedge accounting entries may be challenging for accounting systems.
- It should be noted that while discontinued hedges must be reinstated if they meet the criteria, there is no equivalent requirement or ability to account retrospectively for hedge relationships that never qualified for hedge accounting in the first place.
- If hedges for which RFR instruments were designated as a hedge of a risk component have previously been discontinued and are reinstated, the 24-month period to which the separately identifiable relief applies, begins from the date of initial application of the Phase 2 Amendments. This may have the effect, in practice, of significantly shortening the 24-month window.
- Since, apart from the more complex rules on hedge accounting, the Phase 2 Amendments are applied retrospectively, entities may need to adjust the values of any financial instruments recorded at amortised cost that were amended prior to application.

5.3 End of Phase 2 reliefs

As instruments transition to RFRs, for a single benchmark interest rate there could be more than one change arising directly as a result of the Reform. The hedge accounting reliefs would not be restricted to one application, but will be applied each time a hedging relationship is modified as a direct result of the Reform. (However, the 24 month 'window' for assessing whether a risk component is separately identifiable does not reset). The Phase 2 reliefs will cease to apply once all changes have been made to financial instruments and hedging relationships, as required by the Reform.[72]

[71] IFRS 9.7.2.46, IAS 39.108K.
[72] IFRS 9. BC7.88.

6. Disclosures

6.1 Phase 1

Consequential amendments were also made by the Phase 1 Amendments to IFRS 7, requiring the following information to be disclosed in respect of hedging relationships to which the reliefs in IFRS 9 are applied[73]:

- The significant interest rate benchmarks to which the entity's hedging relationships are exposed
- The extent of the risk exposure the entity manages that is directly affected by the interest rate benchmark reform
- How the entity is managing the process to transition to alternative benchmark rates
- A description of significant assumptions or judgements the entity made in applying these paragraphs (for example, assumptions or judgements about when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows)
- The nominal amount of the hedging instruments in those hedging relationships

6.2 Phase 2

Consequential amendments were made by the Phase 2 Amendments to IFRS 7, to enable users of financial statements to understand the effect of interest rate benchmark reform on an entity's financial instruments and risk management strategy. As a result, entities should disclose information about:[74]

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

To meet these two objectives the following should be disclosed:[75]

- How the entity is managing the transition to alternative benchmark rates, its progress at the reporting date and the risks to which it is exposed arising from financial instruments because of the transition
- Disaggregated by significant interest rate benchmark subject to interest rate benchmark reform, quantitative information about financial instruments that have yet to transition to an alternative benchmark rate as at the end of the reporting period, showing separately:
  - Non-derivative financial assets
  - Non-derivative financial liabilities
  - Derivatives

    And

[73] IFRS 7.24H.
[74] IFRS 7.24I.
[75] IFRS 7.24J.

- If the risks described in the first objective above have resulted in changes to an entity's risk management strategy, a description of those changes

The quantitative disclosure excludes those financial instruments outstanding at the reporting date that will expire before transition. This disclosure, therefore, relates only to a subset of the total population of instruments referencing a significant interest rate benchmark subject to the Reform.[76]

The proposal in the Phase 2 ED to disclose the carrying value of non-derivative financial assets and financial liabilities, and the nominal value of derivatives, was replaced in the Phase 2 amendments with a more flexible approach. Entities may select the basis for the quantitative information they provide about financial instruments that have yet to transition to an alternative benchmark rate. Examples of approaches which could be followed, set out in the Basis for Conclusions to the amendments to IFRS 7, may include:

- The carrying amounts of non-derivative financial assets, the carrying amount of non-derivative financial liabilities and the nominal amount of derivatives
- The amounts related to recognised financial instruments (for example, the contractual par amount of non-derivative financial assets and non-derivative financial liabilities, and nominal amounts of derivatives)

  Or
- The amounts provided internally regarding these financial instruments to key management personnel of the entity (as defined in IAS 24), for example, the entity's board of directors or chief executive officer

This change is intended to reduce the incremental effort needed to provide the additional disclosure required by the Phase 2 Amendments, whilst still meeting the objective of the disclosure to provide relevant information on the entity's progress in implementing the Reform.[77]Entities must provide the Phase 2 IFRS 7 disclosures when they apply the Phase 2 Amendments to IFRS 9 and IAS 39 (or IFRS 4). It is clarified in the Basis for Conclusions that, on initial application, the new disclosures need not be provided for prior reporting periods unless the entity also restates prior periods for the effects of the Phase 2 Amendments to IFRS 9 and IAS 39 (or IFRS 4).[78]

6.3 Sources of hedge ineffectiveness

As discussed in 4.1.3 above, the Phase 1 Amendments provide relief under IAS 39 from the retrospective assessment of hedge effectiveness where effectiveness is outside the 80-125% range for any hedge relationships affected by IBOR reform. Also, 4.2.5 above discusses how the Phase 2 Amendments allow entities, for the purpose of the assessment of retrospective hedge effectiveness, to reset the cumulative fair value changes to zero. However, any actual hedge ineffectiveness continues to be recognised in full.
As a result of the Reform, the disclosures that entities provide in relation to hedge ineffectiveness may need to be revised or expanded.

For example, entities are required to disclose, by risk category, a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term.[79] Also when other sources of hedge ineffectiveness emerge in a hedging relationship, an entity is required to disclose those sources

[76] IFRS 7.BC35LLL.
[77] IFRS 7.BC35KKK.
[78] IFRS 7.BC35000.
[79] IFRS 7.23E.

by risk category and explain the resulting hedge ineffectiveness. As a consequence of IBOR reform and application of the Phase 1 and Phase 2 Amendments, entities may need to enhance these disclosures to include the additional interest rate risk related hedge ineffectiveness that may reasonably be expected to arise as financial instruments designated in hedging relationship are affected by the Reform.

6.4 Significant judgements

The Phase 2 ED included a requirement to provide a description of how an entity determined the base rate and relevant adjustments to that rate, including any significant judgements that it made to assess whether the conditions were met for applying the practical expedient described in 2.1 above. The key judgement relates to how entities assess whether transition has taken place on an 'economically equivalent' basis. Feedback on the Phase 2 ED identified that this disclosure would not be necessary because an entity is already required to disclose any significant judgements under IAS 1 *Presentation of Financial Statements*, paragraph 122. The IASB, therefore, did not include this requirement in the Phase 2 Amendments.[80]

In light of this, entities should consider whether the approach followed to make the assessment of economic equivalence represents a significant judgement that requires separate disclosure. Another example of a significant judgement for which disclosure may be required, would include the assessment of whether an RFR is separately identifiable, as described in 4.2.2 above.

6.5 Transition disclosures

The Phase 2 Amendments provide relief from having to meet some of the IAS 8 *Accounting Policies, Changes in Accounting estimates and Errors* disclosure requirements upon initial adoption.[81] Entities do not have to provide information for the current and prior period of the amount of the transitional adjustment on first adopting the Phase 2 Amendments for each financial statement line item affected and the impact on basic and diluted earnings per share.[82] However, an adjustment to opening retained earnings may, nonetheless, arise on adoption of the Phase 2 Amendments as discussed in 5.2 above, which must be recognised in opening retained earnings.

Whilst relief is provided from one of the IAS 8 transition disclosures, the other disclosures are still required. This includes the amount of any adjustment arising on transition relating to periods before the period of adoption, along with a description of the transitional provisions.[83]

[80] IFRS 7.BC35.MMM.
[81] IFRS 7.44H.
[82] IAS 8.28(f).
[83] IAS 8.28 (a) to (e) and (g) to (h).

How we see it

- The focus of the Phase 2 disclosures is to provide information that disaggregates the entity's exposure by significant interest rate benchmark. Inherent in this, there would appear to be no requirement to analyse the quantitative information by product type. However, if an entity considered that different products resulted in materially different risks in relation to IBOR reform, providing a disaggregation by product type would be consistent with the broader IFRS 7 disclosure principles.
- Although the IASB responded to preparers' concerns by making the Phase 2 quantitative disclosure requirements less onerous, they will still be a significant element of any IBOR Reform financial reporting project. Since the underlying information may have never previously been used for financial reporting purposes, entities need to ensure that the data is sufficiently complete and accurate to be capable of being audited and to meet regulatory requirements such as those of the Sarbanes Oxley Act. A number of banks have identified the disclosure requirements as a challenge and a hurdle to applying the Phase 2 Amendments early.

7. Amendments to IFRS 16 *Leases*

IFRS 16 has been amended to address situations where lease agreements specifically refer to an IBOR and will need to be amended to refer to an RFR.

To the extent that:

- The modification is necessary as a direct consequence of the Reform
- The new basis for determining lease payments is 'economically equivalent' to the previous basis (see 2.1, above)

lessees are required to remeasure their lease liabilities in similar fashion to any other change in estimate, rather than as a lease modification.[84] The amount of the remeasurement is recognised as an adjustment to the right-of-use asset.

If, in contrast, other changes to the lease are made at the same time, the normal modification rules in IFRS 16 apply, even to those modifications required by the Reform.[85]

The effective date is for annual reporting periods beginning on or after 1 January 2021. Early application is permitted. An entity is not required to restate comparative periods and may do so only if it is possible without the use of hindsight.[86]

[84] IFRS 16.104-105.
[85] IFRS 16.106.
[86] IFRS 16 C1B and C20C and D.

8. Amendments to IFRS 4 *Insurance Liabilities*

Those insurers who have elected to defer the implementation of IFRS 9 and so are still applying 'frozen' IAS 39 should account for amendments to financial instruments necessary to implement the Reform, by applying the amendments made to IFRS 9 in paragraphs 5.4.6-5.4.9 (see 2, above).[87] References to B5.4.5 of IFRS 9 should be read as referring to paragraph AG 7 of IAS 39 and references to 5.4.3 and B5.4.6 should be read as referring to AG 8.[88] This means that those insurers will obtain the same reliefs for assessing derecognition and resetting the EIR as other entities.

The effective date is for annual reporting periods beginning on or after 1 January 2021. Early application is permitted.[89] An entity is not required to restate comparative periods and may do so only if it is possible without the use of hindsight.[90]

Endnotes:

[1] *IASB Update*, October 2019 IASB staff paper 14B, Project IBOR Reform and its Effects on Financial Reporting—Phase 2, Paper topic: Accounting implications from derecognition of a modified financial instrument, pp.30-50.

[87] IFRS 4.20R.
[88] IFRS 4.20S.
[89] IFRS 4.50.
[90] IFRS 4.51.

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