Applying IFRS

IBOR reform

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Contents

1. Introduction 3
2. Changes in the basis for determining the contractual cash flows 6
2.1 Changes in the rate of interest 7
2.1.1 Direct consequences of the Reform 7
2.1.2 Economically equivalent 8
2.2 Derecognition 12
2.2.1 Modification of non-derivative financial instruments 12
2.2.2 Modification or replacement of derivative contracts 12
3. Classification 16
3.1 Classification of financial assets 16
3.2 Separation of embedded derivatives 18
4. Hedge accounting 19
4.1 Phase 1 reliefs 19
4.1.1 The Phase 1 reliefs for IFRS 9 19
4.1.2 End of Phase 1 reliefs for IFRS 9 21
4.1.3 Phase 1 reliefs for IAS 39 22
4.2 Phase 2 hedge accounting amendments 23
4.2.1 Phase 2 reliefs for IFRS 9 23
4.2.2 Phase 2 reliefs from discontinuing hedge relationships 24
4.2.3 Phase 2 relief for groups of items 26
4.2.4 Phase 2 temporary relief for designation of risk components 27
4.2.5 Determination of whether an RFR is a separately identifiable risk component 27
4.2.6 Determination of whether an RFR is a reliably measurable risk component 31
4.2.7 Phase 2 amendments for IAS 39 31
4.2.8 Determination of whether an RFR is a separately identifiable risk component under IAS 39 32
4.3. Application of Phase 2 reliefs 32
5 Transition 37
5.1 Phase 1 37
5.2 Phase 2 37
5.3 End of Phase 2 reliefs 38
6. Disclosures 39
6.1 Phase 1 39
6.1.1 The existing IFRS 7 disclosure requirements 40
6.2 Phase 2 41
6.2.1 Application to loan commitments 42
6.2.2 Level of detail for different categories 43
6.2.3 Exposures within the scope of the disclosure 43
6.3 Sources of hedge ineffectiveness 45
6.4 Significant judgements 45
6.5 Transition disclosures 45
6.6 Interim reporting 46
7. Amendments to IFRS 16 *Leases* 48
8. Amendments to IFRS 4 *Insurance Liabilities* 49

What you need to know

- The IASB has completed its amendments to IFRS to facilitate IBOR Reform
- The Phase 1 Amendments (effective for years beginning after 1 January 2020, but with early application permitted) primarily permit the continuation of hedge accounting for hedge relationships that reference IBORs that are expected to be replaced by IBOR Reform.
- The main elements of the Phase 2 Amendments (effective for years beginning after 1 January 2021, but with early application permitted) are that, to the extent that modifications are made to financial instruments that are necessary to implement IBOR Reform and the new basis for calculating cash flows is 'economically equivalent' to the previous basis,

  i) the effective interest rate on floating-rate financial instruments is adjusted,

  ii) hedge accounting will continue

- Both Phase 1 and Phase 2 introduce some significant new disclosure requirements
- IFRS 4 *Insurance Contracts* has been amended so that insurers who are still using IAS 39 *Financial Instruments: Recognition and Measurement* will obtain the same reliefs as other entities
- IFRS 16 *Leases* has also been amended to provide relief for the accounting by lessees for leases which refer to IBORs

1. Introduction

One of the reforms mandated by the Financial Stability Board following the financial crisis was to push 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 'IBOR Reform' or 'the Reform'.

For example, LIBOR, probably the most widely used benchmark published in several currencies, is expected to be discontinued post December 2021, as panel banks will no longer be required to submit the quotes used to construct it. On 18 November 2020, the ICE Benchmark Administration, the administrator of LIBOR, announced that it will consult on ceasing to publish Euro, Sterling, Swiss Franc and Yen LIBOR after the end of 2021. However, progress on transition has been slower for some rates such as US Dollar LIBOR. There has recently been suggestion that a mechanism may be developed to maintain US Dollar LIBOR beyond 2021 for so-called 'tough legacy' contracts, for which amendment would prove impossible by then.[1] Examples of IBORs which will be replaced by RFRs include: Hong Kong dollar OverNight Index Average (HONIA), Swiss Average Rate OverNight (SARON), Secured Overnight Financing Rate (SOFR) for US Dollars, Sterling OverNight Indexed Average (SONIA) and Tokyo OverNight Average (TONA) for Japanese Yen.

Meanwhile, the Euro Overnight interest Average (EONIA) is being replaced by the Euro Short Term-Rate (ESTR). Reforms to the Euro Interbank Offered Rate (EURIBOR) methodology were completed in 2019, but the long-term sustainability of EURIBOR depends on factors such as whether the panel of contributing banks continues to support it and whether or not there is sufficient activity in its underlying market. Consequently, robust fallbacks for EURIBOR will be needed and there are currently mixed views as to whether EURIBOR is in or outside the scope of the IFRS IBOR Reform Amendments.

The RFRs that have so far been introduced are overnight rates based on actual transactions and reflect the average of the interest rates that certain financial institutions pay to borrow overnight either on an unsecured basis (such as SONIA) or on secured overnight repurchase transactions (such as SOFR). The interest paid on an overnight RFR-based loan is calculated in arrears over a period, usually by compounding the daily rate. It is likely that at some point in the future 'term' RFRs will be developed in order to allow borrowers to know in advance the interest they will pay for a period, in a similar manner as for IBOR-based loans. An example would be the possible development of 3-month SOFR, i.e., the US Dollar benchmark rate that would be fixed in advance for a three month period.

[1] For instance, see the testimony by Randal K. Quarles, Vice Chairman of the US Federal Reserve, in 10 November 2020 to the US Senate Committee on Banking, while the UK's Financial Conduct Authority consulted in November 2020 on new powers. In each case, the regulator may mandate the continued publication of certain LIBORs and specify a methodology to calculate them.

On 23 October 2020, the International Swaps and Derivatives Association (ISDA) launched its IBOR fallback protocol and supplements, which are designed to address transition for those derivative contracts still outstanding on the permanent cessation of an IBOR. However, derivative market participants are encouraged to amend or close out existing IBOR contracts before then, without waiting to use the fallback mechanism.[2]

Applying the fallback, as IBORs are available in multiple tenors (such as 3-month or 6-month) and they include a bank's credit risk premium whereas the RFR is an overnight rate, the transition will include an adjustment to the previous derivative contract rate, based on the average historical spread between the relevant IBOR and the compounded RFR over the previous five years (see section 2.1.2). The ISDA spread adjustments and fallback rates are published daily by Bloomberg, for various IBOR tenors (such as 3-months and 12-months), to show what would be the fallback rate if it was triggered on that day. The fallback transition spread will become fixed on the cessation of the IBOR.

The Reform will also affect future cash flows on non-derivative floating rate financial instruments, such as bonds and loans, currently referenced to IBOR. These will need to be bilaterally renegotiated, as will other transactions that reference IBORs, such as some leases. In each country, working groups have been formed to issue recommendations and assist market participants in the transition from IBORs, including fallback language, possible replacement rates and the related spread adjustment methodologies for different types of loans.

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
- *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, The Board 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.

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[2] ISDA: Understanding IBOR Benchmark Fallbacks, October 2020

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 changes in respect of 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 require 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 4.2.4 and 5)
- 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 amendments to IFRS 4 are designed to allow insurers who are still applying IAS 39 to obtain the same reliefs as those provided by the amendments made to IFRS 9. Given the limited scope of the IFRS 4 amendments, this publication only provides references to IAS 39 in respect of hedge accounting, which is still applied by many entities.

The Phase 2 Amendments are effective for annual periods beginning on or after 1 January 2021 and early application is permitted (see section 5).

This publication is the second edition of a guide to how the Amendments will be applied in practice, drawing upon our experience of working with clients.

How we see it

Now that the Phase 2 Amendments have been finalised and fallback protocols, such as that developed by ISDA, have begun to be published, 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 compliant information. 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[3]:

- 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, by changing the way that an interest rate benchmark is calculated
- A hedging instrument may alternatively be changed as required by the Reform 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 or by combining the existing IBOR-related derivative with a new basis swap that swaps the existing referenced IBOR for the RFR.

The first two approaches are relatively self-explanatory. The third corresponds, for example, to the decision made in Europe in 2019 to redefine EONIA as ESTR plus 8.5bp and also to the changes made in 2019 to how EURIBOR is calculated. The IASB believes that changes in methods for calculating the interest rate may, in effect represent a modification of the contractual cash flows.[4] Some constituents expressed concern in response to the Exposure Draft for the Phase 2 Amendments (the Phase 2 ED) that general clarification on when modifications of contractual cash flows may occur could cause difficulties if a similar adjustment occurred outside of the scope of the Reform, when reliefs are not available. As a result, 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 modifications of financial assets. 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 above, 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 2.2.2 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).

[3] IFRS 9.5.4.6 and 6.9.2, as clarified by BC6.620 (a).
[4] 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
- 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, even though the IBOR may no longer be available 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.[5]

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.[6]

The use of the practical expedient is subject to two conditions[7]:

- 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

Each of these conditions is discussed, in turn, below.

It should be noted 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. Some 'hardwired' fallbacks specify two transitions, first to an overnight RFR and second, to a term RFR when it becomes available. Presumably, Phase 2 reliefs will be available for each transition.

2.1.1 Direct consequences of the Reform

There is limited guidance in the Phase 2 Amendments as to what changes for determining contractual cash flows would be a direct consequence of the Reform. In Phase 1, the IASB defined IBOR Reform as 'the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations of the Financial Stability Board's July 2014 report,

[5] IFRS 9.BC5.306.
[6] IFRS 9.5.4.7.
[7] IFRS 9.5.4.7.

'*Reforming Major interest Rate Benchmark*.'[8] IBOR Reform can, therefore, be read to encompass any replacement of references to an IBOR with a rate considered acceptable by local regulators, such as an RFR, and any related amendments necessary to implement the Reform, including those needed to achieve economic equivalence (see 2.1.2).

Some respondents to the Phase 2 ED asked the question as to whether the reliefs are only available if, in the particular jurisdiction, 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 due to reduced liquidity 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, they do not, in themselves, have to be mandatory.[9]

2.1.2 Economically equivalent

According to the Amendments, examples of where changes would be 'economically equivalent' include[10]:

1. 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 IBOR is a term rate, such as a 3-month IBOR, and so includes the credit risk of lending to banks over this period. Further, some RFRs, such as SOFR, are secured rates and so involve even less credit risk.
2. 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.
3. 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.

It will be clear from this list that 'economically equivalent' does not mean 'economically identical'. The IASB also makes it clear that it regards 'economic equivalence' to be principle-based and the above list is not intended to be exhaustive.[11] For instance, it would be consistent with these examples to include amendments to caps and floors so as to maintain their economic effect (see Example 1).

The Basis for Conclusions also clarifies 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 ("the entity would not be required to analyse whether the discounted present value of the cash flows of that financial

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[8] IFRS 9.6.8.2 and IAS 39.102B.
[9] IFRS 9.BC5.313.
[10] IFRS 9.5.4.8.
[11] IFRS 9.BC5.315 and 317.

instrument are substantially similar before and after the replacement").[12] Accordingly, the IASB set no 'bright lines' and an entity is required to apply judgement to assess whether circumstances meet the economic equivalence condition.

The challenges associated with determining an appropriate method for calculating the basis spread between RFRs and IBORs on transition are illustrated well by the process through which ISDA arrived at its derivative fallback protocol for the cessation of LIBOR. ISDA set out the following criteria:

i) minimising value transfer at the time the fallback is applied

ii) minimising any potential for manipulation

iii) eliminating or mitigating against the impact of market disruption at the time the fallback is applied

ISDA consulted on three possible approaches to set the spread, noting that they each satisfied these criteria to varying degrees:[13]

1. Arguably the most 'economically equivalent' approach, in that it would be present value neutral, would be to base the spread on the forward market view of the spread between the IBORs (for each tenor, such as 3-months or 6-months) and the RFR at the date of calibration. However, this approach would be complicated, and the necessary data is unlikely to be readily available. The forward approach would require a forward IBOR curve and a forward RFR curve for the term of all financial instruments and so potentially out to 40 or 50 years. This would require both an established RFR market as well as extensive market data, which does not currently exist.

2. The simplest approach would be what is termed the 'spot' method. This bases the spread adjustment on the spot spread between the relevant IBOR and the adjusted RFR on the day before the fallback provisions are triggered. This approach is likely to ensure that the current rate of interest is 'substantially the same'. Its disadvantages are not only that it does not reflect the market expectations on forward rates (and so will not be present value neutral on the date of calibration), but it is likely to be more volatile than a forward spread.

3. The majority of respondents to ISDA's consultation preferred what became the adopted approach, using the median historical spread between the relevant IBOR and the compounded RFR over the previous five years. It was recognised that this "is unlikely to be present value neutral on the calibration date because spot rates are unlikely to be consistent with forward rates and because the average historical market conditions may not match market expectations for future market conditions". However, it has two major advantages: first, it is less volatile than spot rates and captures the tendency of interest rates to fluctuate around a long-term mean and, hence, is likely to be a better approximation to the forward spread; and, second, it is based on readily available information.

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[12] IFRS 9.BC5.315-316.

[13] ISDA Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA definitions, Consultation on certain aspects of fallbacks July 2018.

It is likely that the ISDA methodology for determining the spread will be applied more broadly to the transition of many non-derivatives to RFRs.

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 to determine whether 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 an instrument not recorded at fair value through profit or loss, and immediately recognises a modification gain or loss in profit or loss.[14]

Examples of possible changes that would most likely not be viewed as economically equivalent, include:

i) Changes to the principal or notional value

ii) Changes in maturity and methods of repayment (such as a move from a bullet repayment to by instalment)

iii) Changes in credit spread to reflect changes in the credit quality of the obligor

iv) The addition or removal of caps and floors, prepayment and extension options

One particular area that may cause challenges is the introduction of, or adjustment of floors to financial instruments on transition to RFRs. This is especially relevant given that risk free interest rates are presently so close to zero or even negative. A simple example, where a floor is modified so as to give the same economic effect as before transition, is illustrated in Example 1. For more complex fact patterns, which might involve introducing a floor where none was present before, or resetting the floor so that the RFR cannot go below zero, and which may also involve an amendment to the spread or a cash compensation paid to the lender, the assessment will be more difficult. The Amendments provide only limited guidance, and this is an area where accepted practice has yet to develop, both as to whether the modification is considered to be required by the Reform and whether it is economically equivalent.

Perhaps the most challenging issue, however, is whether any cash settlement between the parties to a contract on transition, to compensate for the difference in fair value of a financial instrument, would automatically imply that the change is not economically equivalent. As already noted, 'economic equivalence' does not mean 'economically identical', and the guidance states that interest rates must be 'substantially similar', implying that there is a level of tolerance as to what changes would meet the criterion. As described in more detail in section 2.2.2, in the context of modification or replacement of derivatives, an example is included in the Basis for Conclusions where replacing a derivative with a new one on current market terms, with cash

[14] IFRS 9.5.4.9.

settlement for the difference in fair value, would not be regarded as economically equivalent. However, in this example, the contractual terms of the new at-market derivative are described as 'substantially different', which might possibly be read to mean that some cash settlement on transition may be acceptable as long as the future contractual terms remain substantially the same as those before transition. This is another area where practice has yet to develop and the application may require considerable judgement.

How we see it

In general, any transition that is economically equivalent is likely to share two main characteristics. First, the amendment should be designed to help ensure an equitable transition to an RFR for both parties to the contract. This will, in theory, most easily be demonstrated if the amendment is in accordance with an industry-accepted protocol designed with this objective.

Second, an economically equivalent transition should involve no significant change in a financial instrument's fair value. Therefore, any adjustment to the spread other than to reflect the difference between RFRs and IBORs on transition, or a payment by one party to the other, to compensate for a change in terms, may indicate that the terms are not economically equivalent and will require careful analysis.

Any approach would also have to be practical to apply and make use of data that is reliable and readily available. Because of limitations on the availability of data, it is likely that there will be more than one acceptable method for determining the spread between IBOR and an RFR. The types of approaches explored by ISDA and described above can, in theory, all result in transitions which are economically equivalent.

While approaches such as that developed by ISDA are based on quantitative analysis, as long as it can be demonstrated that the contractual terms will remain substantially the same, it will not normally be necessary to make a quantitative evaluation for each transition.

These requirements are illustrated in Example 1 below and also in Examples 6 and 7 in section 4.3.

Example 1 Application of the Phase 2 relief for amendment of a floor
Scenario 1: An existing short-term loan pays 3-month US dollar LIBOR plus 100 bp, with a floor of LIBOR = zero. It is restructured to pay SOFR plus 130 bp, when 30bp is determined to be the market basis difference between 3-month LIBOR and SOFR. The floor is amended to SOFR +30 bp = zero. The amendment of the instrument, including the floor, is a direct consequence of IBOR Reform and the new terms are assessed to be economically equivalent to the old ones, as the only adjustment is to replace 3-month LIBOR with SOFR plus the market basis difference, with an equivalent adjustment to the floor. Therefore, Phase 2 paragraph 5.4.7 relief is applied, the EIR is amended to SOFR plus 130 bp and there is no need to consider any other accounting consequences.

How we see it

Because of the practical expedient, transition to RFRs will generally result in a change in the EIR for floating-rate 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 avoid, or else 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.

2.2 Derecognition

2.2.1 Modification of non-derivative financial instruments

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.[15] There is no equivalent guidance in IFRS 9 for modifications of financial assets, although, in 2012, the IFRS Interpretations Committee, in discussing the restructuring of Greek Government Bonds, considered that it would be appropriate in that fact pattern to apply the guidance for financial liabilities, by analogy. This is an area which requires judgement and many entities will have already developed an appropriate accounting policy.

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 qualify for the practical expedient will not be regarded as sufficiently substantial that the instrument would be derecognised.[16]

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 would result in derecognition.[17]

2.2.2 Modification or replacement of derivative contracts

The fourth method of changing the basis for determining contractual cash flows has already been introduced at 2 above: the close-out and replacement of a derivative with the same counterparty and on the same terms, or the addition of a basis swap. As set out in the Basis for Conclusions, the IASB was concerned

[15] IFRS 9.3.3.2.
[16] IFRS 9.5.4.9 .
[17] IFRS 9.5.4.9.

that the substance of the arrangement should determine the accounting treatment, rather than its form and examined four scenarios.[18]

The first scenario involves the counterparties to an IBOR derivative entering into two new derivatives, one derivative equal and offsetting the original IBOR-based derivative so as to close it out 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.[19] According to the IASB's analysis, the counterparty to the new derivatives is the same as to the original derivative, the original derivative has not been derecognised and the terms of the alternative benchmark rate derivative are not substantially different from that of the original derivative. The Board, therefore, concluded that such an approach could be regarded as consistent with the changes required by the Reform and, hence, the Phase 2 hedge accounting reliefs will apply (see 4.2).

If the original derivative is not legally extinguished, this implies that all three derivatives - the original IBOR derivative and the two new ones - would need to be designated together as the hedging instrument. However, in practice, it is likely that the counterparties to the original derivative and the second one which closes it out, will chose to legally extinguish the two derivatives. The process for extinguishing derivatives cleared by a central clearing counterparty is known as 'compression'. In that case, applying the derecognition guidance for liabilities,[20] the original derivative may be treated as modified rather than as derecognised, since it is an exchange with the same counterparty and does not constitute a 'substantial modification' of the original terms. The relief criterion in paragraph 6.9.2(b), that the original hedging instrument is not derecognised, would, therefore, still be considered to be met. This approach would also be consistent with the IASB's focus on the substance rather than the legal form, given that it will make no difference to the subsequent net cash flows, whether or not the derivative is legally extinguished.

In contrast, in the second scenario examined by the IASB, the original IBOR derivative is terminated and the unrealised gain or loss settled in cash, and a new RFR derivative is entered into on substantially different terms reflecting the current market rate. Because the IBOR derivative has been extinguished and replaced with a new one on substantially different terms, the IASB considered that this is not consistent with the changes required by the Reform and so the Phase 2 hedge accounting reliefs will not apply. This analysis implies that the first derivative would be derecognised and the second one recognised in its place.[21]

In the third scenario, the entity enters into a new basis swap, specific to a particular derivative instrument, which 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.[22] The scenario does not specify whether the basis swap needs to be with the same

[18] IFRS 9 BC6.619.
[19] IFRS 9.BC6.620 (a).
[20] IFRS 9.3.3.2.
[21] IFRS 9.BC6.620 (b).
[22] IFRS 9.BC6.620 (c).

counterparty as the original derivative and it is unclear whether this should be assumed or whether the omission is deliberate.

If an entity enters into a new pair of swaps, traded at market rates with the same counterparty, one of which references the old benchmark and one the RFR, this would, in substance, have the same economic effect as a basis swap. In such a case, this might also be viewed as a modification of the original derivative. As with the basis swap in scenario 3, the two new swaps would have to be linked or coupled with the original derivative, and all three derivatives would need to be designated, together, as the hedging instrument.

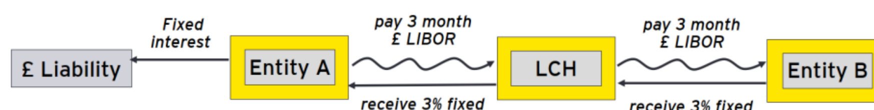
However, this fact pattern also looks very similar to scenario 2. The key differences with scenario 2 are that the original swap is not extinguished and the unrealised gain or loss is not settled in cash. Whether this is sufficient to distinguish this fact pattern from scenario 2 is currently unclear.

In its fourth scenario, the IASB 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 result in extinguishment of the original derivative.[23] This is because novation of a derivative would result in the derecognition of the original derivative. The Phase 2 hedge accounting reliefs will, therefore, not apply.

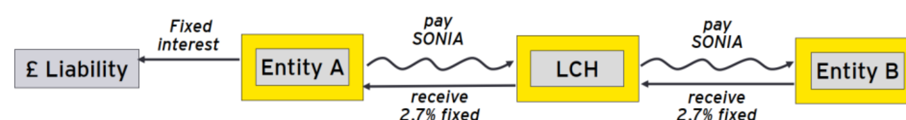
The process of modifying a derivative is illustrated in Example 2.

Example 2 Modification of a derivative

Entity A is a party to a swap (swap 1) with a notional value of £10 million and a remaining five years maturity on which, quarterly, it pays sterling 3-month LIBOR (fixed in advance at the beginning of the quarter) and receives 3% fixed. When first traded with Entity B, the swap was novated to the London Clearing House, which thereby serves as the swap counterparty to both A and B. A designates the swap as the hedging instrument in a fair value hedge of a fixed rate sterling liability.



In February 2021, Entities A and B choose to amend swap 1 in order to transition it to SONIA, at a time when the basis difference between 3-month LIBOR and overnight SONIA for this instrument is determined to be 30 basis points (see 2.1.2) . A and B enter into two new swaps, swap 2 with terms equal and opposite to those of swap 1, plus a new SONIA swap, swap 3. Swap 3 has the same notional value and remaining term to maturity as swap 1 but, A makes a quarterly payment of SONIA (compounded daily) and receives 2.7% fixed, where 2.7% is the original 3% less the 30bp basis difference.



[23] IFRS 9.BC6.621 (d).

Example 2 Modification of a derivative (continued)
Swaps 2 and 3 are novated to the LCH and A and B elect to compress the two offsetting LIBOR swaps (i.e., swaps 1 and 2). This gives rise to no profit or loss or net cash flow but legally extinguishes the two swaps. Because the net effect of the transaction is to exchange swap 1 with swap 3, with the LCH being the counterparty to both swaps, swap 1 is treated as modified by the exchange rather than derecognised. Also, and because the terms of swap 3 are economically equivalent to those of swap 1, this is considered to be a change in accordance with paragraph 6.9.2 of IFRS 9 and 102Q of IAS 39. Entity A modifies the hedge relationship so that the terms of the hedging instrument are those of the modified swap and, as made clear by paragraph 6.9.5 of IFRS 9 and 102T of IAS 39, this amendment does not constitute a discontinuation of the original hedge relationship nor the designation of a new one (see 4.2.1 below). The remainder of the process to amend the hedge designation is illustrated by Example 6.

Application of these Amendments is also illustrated in Examples 6 and 7 in section 4.3.

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 the instrument should be derecognised and a new one recognised instead. If the assessment is based on whether the terms are substantially different, then entities will need to develop a process to make this determination. The Amendments provide no further guidance on what level of modification would be viewed as substantial and this assessment will require judgement and possibly the refinement 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[24], it is recognised that the assessment should also have regard to qualitative factors, such as the introduction of new contractual features.

It is more complex to assess changes made to derivatives in hedging relationships. If they are merely modified, the test is whether the modification was a direct consequence of the Reform and executed on an economically equivalent basis. If this test is failed, the hedge relationship would need to dedesignated and redesignated. This is irrespective of whether or not the derivative is derecognised.

However, if the derivative is replaced with the same counterparty, then the test as to whether the Phase 2 hedge accounting reliefs apply is also whether the derivative has been closed out, without being derecognised. Consequently, the entity will need a policy to assess whether the original derivative is derecognised, in addition to whether a modification was a direct consequence of the Reform and executed on an economically equivalent basis.

[24] IFRS 9.B3.3.6.

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 to determine their accounting treatment. 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).[25]

As part of the IBOR Reform project, in October 2019[26], 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. Any assessment of interest should focus 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.

This principle is illustrated by two examples, for SONIA (Example 3) and Adjustable Rate Mortgages (Example 4).

Example 3 SPPI evaluation for SONIA
SONIA 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. As such, 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.

[25] IFRS 9.B4.1.7-26.
[26] *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.

Example 4 SPPI Evaluation for Adjustable Rate Mortgages (ARMs)
ARMs are US Dollar floating rate mortgages, that have historically been reset once a year, 45 days in advance of the period, and often based on LIBOR. After transition, it is recommended by the Alternative Reference Rates Committee (ARRC) that rates will be reset 45 days in advance, every six months, based on a 30-day compounded SOFR average plus a spread adjustment. The recommended spread adjustment is similar to that introduced by ISDA in its fallback for derivatives (see 2.1.2). It was not the intent of the ARRC to introduce features that deviate from the time value of money. Rather, it has sought to achieve the optimal lending terms, considering the needs of both issuers and investors. The market is familiar with a rate that is fixed in advance once a year and the frequency of reset has been amended to once every six months, in order to continue to provide certainty as to the next interest payment, and also to make the rate more responsive to changes in market rates. The rate is calculated 45 days in advance, consistent with previous practice, and given that there are, as yet, no term SOFR rates, the rate is based on overnight SOFR plus a spread adjustment. The 30-day average has been chosen to smooth out day-to-day SOFR volatility. Meanwhile, the spread adjustment is designed to reconcile SOFR (collateralised) to LIBOR (uncollateralised) and to capture the theoretical forward interest rate curve out to 6 months. On the basis that the lender is being compensated only for credit risk and the time value of money, with a profit margin, and based on the quantitative analysis perfomed by ARRC and published together with their recommendations to document their thought process[27], it can be assessed qualitatively that an ARM will satisfy the SPPI criterion and may be recorded by the lender at amortised cost or at fair value through OCI, depending on the IFRS 9 business model.

[27] Options for using SOFR in Adjustable Rate Mortgages, The Alternative Rates Committee, July 2019.

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 if 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 may involve basing the new rate of interest on the overnight RFR plus a spread or, as with US Adjustable Rate Mortgages, may be based on an average of the RFR determined over a period, and set in advance (see Example 4).

Given that the separation of embedded derivatives is only assessed when a financial liability is first recognised, 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 to financial liabilities 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.

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).[28] 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.

In this section, we first describe the reliefs for hedge accounting in accordance with IFRS 9. At section 4.1.3 below, we set out the differences for entities still applying IAS 39 for hedge accounting.

4.1.1 The Phase 1 reliefs for IFRS 9

Application of the reliefs is mandatory.[29] The first three reliefs for IFRS 9 provide for:

1. The assessment of whether a forecast transaction (or component thereof) is highly probable[30]
2. Assessing when to reclassify the amount in the cash flow hedge reserve to profit and loss[31]
3. The assessment of the economic relationship between the hedged item and the hedging instrument[32]

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.

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'.[33] The fourth relief provides 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.[34] 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 sections 4.2.4 and 5 below).

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[28] IFRS 9.6.8.1.
[29] IFRS 9.7.1.8.
[30] IFRS 9.6.8.4.
[31] IFRS 9.6.8.5.
[32] IFRS 9.6.8.6.
[33] IFRS 9.6.3.7(a).
[34] IFRS 9.6.8.7.

The Basis for Conclusions also clarifies that if IBOR cash flows have been designated as the hedged item in a cash flow hedge, the entity should continue to measure ineffectiveness based on the IBOR-based cash flows. However, the Basis for Conclusions also states that if the entity has chosen to measure changes in fair value of the IBOR cash flows using a 'hypothetical derivative', the hypothetical derivative should be measured using a market-based discount rate that reflects market participants' assumptions about the uncertainty arising from the Reform.[35] This would be consistent with the rate which market participants would apply to actual IBOR derivatives used as hedging instruments. Therefore, there should be no increase in hedge ineffectiveness.

Example 5: Application of Phase 1 relief
Entity A is hedging an eight-year floating rate borrowing referenced to 3-month US LIBOR, and it is known that any interest coupons payable after the loan has been amended to implement the Reform, 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. It is not yet known how the amendment will be achieved or when it will occur. Therefore, 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 the 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 purposes of assessing and measuring effectiveness.

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.[36]

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.[37]

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.[38] 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

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[35] IFRS 9.BC6.570.
[36] IFRS 9.6.8.8.
[37] IFRS 9.BC6.575.
[38] IFRS 9.BC6.560.

relief from measuring and recording any ineffectiveness that arises due to differences in their changes in fair value.[39]

4.1.2 End of Phase 1 reliefs for IFRS 9

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[40]

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
- 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[41]

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.[42]

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.[43]

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.[44] 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 when it will take effect.

Because the Phase 1 reliefs only cease to apply once there is no longer uncertainty over both which benchmark will apply and when it will be applied, it follows that agreement of a fallback arrangement will not in itself end the uncertainty and so does not bring an end to the Phase 1 relief, unless it specifies both the method and date of transition.

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[39] IFRS 9.BC6.567, BC6.568.
[40] IFRS 9.6.8.9, 6.8.10.
[41] IFRS 9.6.8.11.
[42] IFRS 9.6.8.12.
[43] IFRS 9.6.8.13.
[44] IFRS 9.BC6.587-59.

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 to be based on an RFR earlier than the hedged item, such that the uncertainty about the timing and the amount of RFR-based cash flows of the hedging instrument is eliminated, the relevant exceptions would no longer apply to the hedging instrument even though they would continue to apply to the hedged item.[45] The hedged item will therefore, by default, continue to be measured by reference to changes in IBOR, even though it is expected that it will be amended in the near term. The consequence of this is that any delay between the modification of the hedging instrument and the hedged item in a cash flow hedge will potentially 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. However, it may be possible to designate an RFR component of a LIBOR-based cash flow, which would help mitigate this risk (see 4.2.5).

This problem does not arise for fair value hedges, since the hedged instrument will not be amended as a result of the Reform and Phase 2 allows the designated hedged risk to be revised once the hedging instrument is amended (see 4.2).

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.[46] These are consistent with those for IFRS 9, as described at 4.1.1 and 4.1.2, but with the following differences:

- 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.[47] This relief ends under the same conditions as the IFRS 9 relief for the assessment of the economic relationship between the hedged item and the hedging instrument (see 4.1.2 above)
- For the retrospective assessment of effectiveness, an entity may continue to apply hedge accounting to a hedging relationship for which effectiveness 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.[48]

  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 above). The relief ceases at the earlier of when there is no longer uncertainty with respect to

[45] IFRS 9.BC6.594.
[46] IAS 39.102A-102N, 108G.
[47] IAS 39.102F.
[48] IAS 39.BC250.

the cash flows of both the hedged item and the hedging instrument, and when the hedging relationship is discontinued.[49]

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 still 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.[50]

- For a hedge of 'a benchmark portion' (similar to '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.[51]

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). As with section 4.1, we first describe the reliefs for hedge accounting under IFRS 9 and then in section 4.2.7 and 8 set out any differences for entities still applying IAS 39 for hedge accounting.

4.2.1 Phase 2 reliefs for IFRS 9

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 4.2.2 below)
2. Temporary relief from having to meet the separately identifiable requirement (see 4.2.4 and 5 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 such as a fallback clause.[52] 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)[53]

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[49] This was amended further in Phase 2 (IAS 39.102M).
[50] IAS 39.102G.
[51] IAS 39.102H.
[52] See 2.1 above.
[53] IFRS 9.5.4.5 - 5.4.7.

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[54]

4.2.2 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 a change required by the Reform is made to the hedged risk, hedged item or hedging instrument. 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.[55]

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, as mentioned, above without discontinuing the hedge relationship.[56]

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.[57] The reason is not clearly articulated but it is possibly because the addition of the basis swap is not strictly necessary to achieve IBOR Reform, but rather, is a subsequent addition to improve hedge effectiveness. Note that this is different from the use of a basis swap, as described below, to modify the

[54] IFRS 9.5.4.8.
[55] IFRS 9.6.9.1, 6.9.3. 6.9.4.
[56] IFRS 9.6.9.5.
[57] IFRS 9.BC6.617.

contractual cash flows of a specific IBOR-based hedging instrument so as to be based on an RFR, where the hedge relationship will continue.

As discussed in section 2, 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, closing out an existing IBOR-related derivative by entering into two new derivatives with the same counterparty, one that is equal and offsetting to the original derivative and another one on similar terms except referencing an RFR. 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.[58] Although this clarification will primarily apply to derivatives cleared by a central clearing counterparty, according to the Basis for Conclusions, as discussed at 2.2, the change can also be achieved by combining the existing IBOR-related derivative with a new basis swap that swaps the existing referenced IBOR for the RFR.

Clarification was also 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)[59]

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.[60]

The usual IFRS 9 requirements are applied for accounting for changes in the fair value of the hedging instrument and the hedged item. Therefore, they are measured at fair value as RFR-based or IBOR-based, depending on whether they have each been amended or not, except that, for cash flow hedges, the cash flow hedge reserve is remeasured to the lower of the cumulative gain or loss on the hedging instrument and the cumulative change in fair value of the hedged item.[61] When redesignating the hedge of a fixed-rate debt instrument, in order to be consistent with the continuation of the hedge, the component of the fixed cash flows designated as the hedged component should be adjusted to reflect the spread between RFR and IBOR. This is illustrated in Example 6.

58 IAS 39.BC250.
59 IFRS 9.6.9.2.
60 IFRS 9.6.9.3.
61 IFRS 9.6.9.3.

Meanwhile, if the change in fair value of the designated cash flows in a cash flow hedge is measured using a hypothetical derivative, after transition of the hedged financial instrument, the hypothetical derivative will be adjusted to reflect the RFR.

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.[62] However, if there is a mismatch in timing in the amendment of the hedging instrument or hedged item, this may give rise to some ineffectiveness for cash flow hedges (see Example 7).

When the hedged item is amended, amounts accumulated in the cash flow hedge reserve are deemed to be based on the RFR. The same applies for a hedge that has previously been discontinued, when the contractual cash flows of the previously designated item are modified. 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.[63]

4.2.3 Phase 2 relief for groups of items

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.[64]

Although the Amendments do not provide detailed guidance on how the relief for groups of items will work, we currently assume that:

i) If the hedged item was originally established as an 'open' portfolio, new hedging instruments and hedged items, whether they reference IBOR or RFRs, may be added to the groups as they are entered into

And

ii) At each transition, the hypothetical derivative for the sub-group will require updating

The entity must ensure that each sub-group continues to meet the normal requirements of IFRS 9 to be an eligible hedged item. If any sub-group fails to meet the requirement to be designated as a hedged item, the entity must discontinue hedge accounting for the hedge relationship in its entirety. Meanwhile, hedge ineffectiveness must be measured and recorded as normal for the hedge relationship in its entirety.[65]

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[62] IFRS 9.BC6.626.
[63] IFRS 9.6.9.7, 6.9.8.
[64] IFRS9.6.9.9
[65] IFRS 9.6.9.10.

4.2.4 Phase 2 temporary relief for designation of risk components

IFRS 9 requires that a risk component designated in a hedge relationship is both 'reliably measurable' and 'separately identifiable' to be eligible for hedge accounting.[66] 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 and 4.2.7 below). 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.[67]

The assessment of whether a risk component is separately identifiable is discussed further in section 4.2.5. Meanwhile, it must be stressed that no relief is provided from the requirement for the risk component to be *reliably measurable* throughout the life of the hedging relationship (see 4.2.6).

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 over 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 to make the appropriate judgements at the time of transition and over the subsequent 24 months, while introducing suitable processes and governance to update their assessment This judgement is discussed in more detail in the next section.

4.2.5 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

[66] IFRS 9.6.3.7(a).
[67] IFRS 9.6.9.11, 6.9.12.

points made in the Phase 2 Amendments that may be relevant, first, for fair value hedges and, second, for cash flow hedges.

i) Fair value hedges

The first point is that the relief is provided only for 'separately identifiable' and not for 'reliably measurable', and 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 within the hedged item such as a fixed-rate debt instrument.[68]

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 in direct 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."[69]

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 rate debt instruments frequently vary in rate, and that it would be insufficient for the rate to be used only in the swap market. Not only do SONIA swaps already make up half the sterling swaps market by volume, but in November 2019, it was claimed that "SONIA is now the norm in issuance of floating rate sterling bonds and securitisations".[70] Therefore, it is possible that an entity might conclude that SONIA is already separately identifiable and, if not yet, it will be within 24 months.

In contrast, swaps referenced to SOFR (the chosen US Dollar RFR) are far fewer in volume and there has been slower progress in the issue of SOFR-based cash instruments. However, although it is not clear when or if it will form the basis on which US Dollar fixed rate debt instruments are priced, as seen in the recommendations of the US Alternative Reference Rates Committee, 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 become SOFR-based and, to that extent, SOFR would become a major interest rate benchmark and the main one used for hedging purposes. On this basis, we

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[68] IFRS 9.B6.3.9.
[69] IFRS 9.B6.3.10(d).
[70] Speech delivered at the Risk.net LIBOR Summit 2019 by Edwin Shooling Latter, Director of Markets and Wholesale Policy at the UK's Financial Conduct Authority.

expect that most entities applying IFRS 9 for hedge accounting purposes would 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. IAS 39 mentions that, "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" (see 4.2.8 below). The IASB has 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 is considered identifiable under IAS 39 then it would also be a separately identifiable risk component under IFRS 9. However, the example in IFRS 9.B6.3.10(d) arguably provides a more detailed interpretation of what constitutes a 'benchmark'.

Meanwhile, the question also 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 made in the Phase 2 Amendments is that it is clear that the exception for identifying risk components apply to cash flow hedges as well as fair value hedges.[71] 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 form the basis of floating rate instruments within 24 months, but whether it may ever be regarded as a separately identifiable component of a *LIBOR-based* floating rate.

In the deliberations regarding timing mismatches in the Phase 2 Amendments, 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.[72] This might be read to endorse the possibility of designating an RFR component of IBOR. 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.

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[71] IFRS 9.BC6.647.
[72] See January Staff Paper 14A Paragraph 28.

The case for SONIA as a component of sterling LIBOR is perhaps easier to make, since it was first introduced in 1997 and SONIA can be thought of as 'overnight sterling LIBOR' and so 'a building block' of term LIBOR.[73] SOFR, however, which is based on the repo rate, is somewhat different in nature from US Dollar LIBOR. Overnight SOFR is also quite volatile and can, on occasion, exceed 3-month US Dollar LIBOR. Practice will emerge on this issue and it is possible that the IASB or regulators may provide guidance on the topic. For the purpose of Example 4 below, it has been assumed that SOFR cannot be designated as a component of US Dollar LIBOR.

iii) Term structure of separately identifiable risk components

The question has also arisen as to whether the separately identifiable criterion needs to be assessed separately depending on the maturity of the hedging instrument and the hedged item. For instance, would a hedge of a 30-year fixed rate bond be assessed separately from a hedge of a one-year bond, bearing in mind that there is likely to be far more activity in the market for shorter term instruments?

To use the IFRS 9 terminology, the separately identifiable assessment must be performed in the context of the market structure, and the structure of the interest rate market will always include a term structure. If it is determined that (for instance) SOFR is, or will be, separately identifiable, it follows that this is likely to be the case equally, whether SOFR is being used to hedge loans with (for example) six months, five years or ten years maturity. If bond prices are not aligned with SOFR swap rates, then there will always be an opportunity for arbitrage, to help bring the market in line.

If SOFR were only ever expected to be used as a short-term rate, it would raise the question as to what benchmark would be used instead for the longer maturity end of the market. And if some other benchmark were to be used for the longer maturity end of the market, it is likely that any entity that hedges a longer-term exposure would choose a derivative referenced to that longer-term benchmark rather than SOFR. Hence, in this case, the question as to whether SOFR can be separately identified for longer term maturities is unlikely to arise.

How we see it

Once an RFR is separately identifiable, it is likely to be so for any maturity. If another benchmark becomes established for certain maturities, the assessment of whether the RFR is separately identifiable is made for any maturity for which it is the benchmark. Should the market fragment in future, such that more than one benchmark emerges, serving different segments of the market, the continuing assessment required by paragraph 6.9.12 of the Amendments would be made separately for each segment of the market.

[73] When SONIA was reformed in 2018, so it could qualify as an RFR, the main changes were only to base it on a wider range of participants' transactions and to amend the volume-weighting methodology.

4.2.6 Determination of whether an RFR is a reliably measurable risk component

'Reliably measurable' is not defined further in IFRS 9 or in the IAS 39 hedge accounting guidance, but IAS 39 required that unquoted equity instruments that were not quoted in active markets to be recorded at cost if not 'reliably measurable'.[74] The guidance stated that the fair value would be reliably measurable if the range of variability of fair value measurements is not significant or the probabilities of the various estimates can be reasonably assessed and used when measuring fair value.[75] The standard went on to say that there are many situations where the range of variability for unquoted equity investments is likely not to be significant and that it is normally possible to measure reliably a financial asset acquired from a third party.[76] Given this guidance, 'reliably measurable' does not appear to be an especially high hurdle and it is likely that most derivatives referencing the RFRs will be considered reliably measurable once a market begins to develop.

4.2.7 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.[77] 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.[78]

One of the changes that may be required to the method for assessing hedge effectiveness is where the approach has previously been based on regression analysis and there are insufficient data points to enable this approach to be applied for the RFR. While the Amendment is not explicit on this issue, presumably regression could be replaced by another approach until sufficient data becomes available, at which point, the use of regression would resume, as long as this is documented as the strategy at the time the hedge relationship is adjusted.

[74] IAS 30.46 (c).
[75] IAS 39.AG80.
[76] IAS 39.AG81.
[77] IAS 39.102V.
[78] IAS 39.102P(d).

4.2.8 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 4.2.4 and 4.2.5 above), 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. However, again, the Amendments provide no new guidance on what is meant by 'separately identifiable'. As mentioned in section 4.2.5, whilst the guidance in IFRS 9 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 a simpler statement compared to the considerations included 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."[79]

How we see it

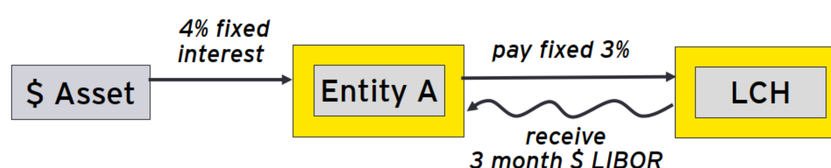
Given the IAS 39 reference to 'risk-free or benchmark' as a separately identifiable component, it has been established practice to designate other benchmarks, such as the overnight interest rate swap rate (OIS). It is possible that those entities still applying IAS 39 will consider RFRs such as SONIA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

4.3. Application of Phase 2 reliefs

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

Example 6: Application of Phase 2 relief to a fair value hedge

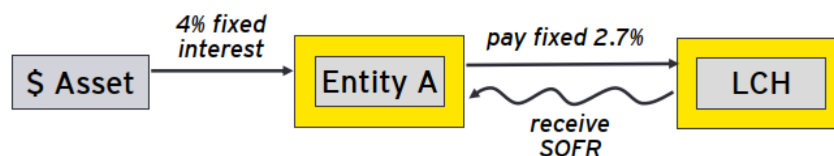
Company A has previously entered into an interest rate swap paying fixed 3% and receiving 3-month US dollar LIBOR. It had been designated in a hedge of the exposure to changes in fair value attributable to US dollar LIBOR, of cash flows equivalent to a 3% coupon plus principal of a 4% fixed US dollar asset.



79 IAS 39.AG99F(a).

Example 6: Application of Phase 2 relief to a fair value hedge (continued)

On 1 November 2020, when 3-month US dollar LIBOR is 0.5%, the basis difference between SOFR and LIBOR is determined to be 30 basis points. The swap is accordingly amended to pay fixed 2.7%, receive SOFR.



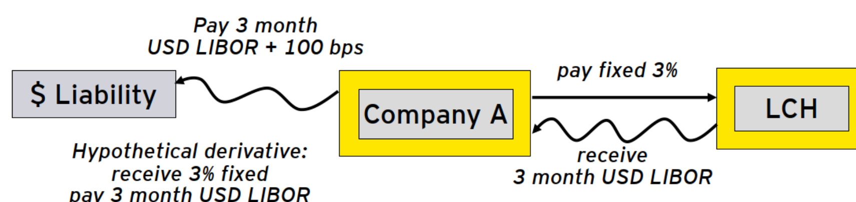
The new swap is considered 'economically equivalent' to the old swap, since the only change has been to refer to SOFR instead of LIBOR and to adjust the spread based on the current market rates (see 2.1 above). As a result, the formal designation of the hedging instrument is amended without discontinuing the hedge.

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 4.2.2 above). Consequently, the description of the hedged item is also 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, where 2.7% is the previous 3% less the 30 basis points spread. (An entity applying IAS 39 for hedge accounting must also update how hedge effectiveness will be assessed in future (see 4.2.7)).

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 4.2.2 above).

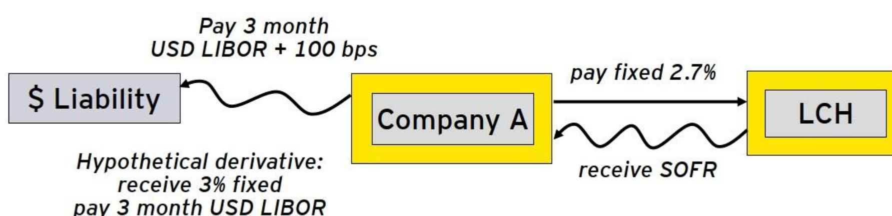
Example 7: Application of Phase 2 relief to a cash flow hedge relationship

The initial fact pattern is the same as that in Example 6, except that it is a cash flow hedge of the US dollar LIBOR risk of a US dollar LIBOR plus 100bp 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 6, on 1 November 2020, the derivative is amended to pay fixed 2.7%, receive SOFR. 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 will 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). 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 4.2.5 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 4.2.7).)

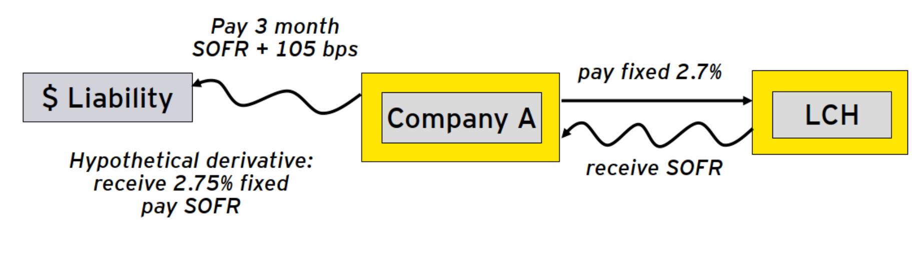
Example 7: Application of Phase 2 relief to a cash flow hedge relationship (continued)

The liability is renegotiated on 15 January 2021, when the basis difference between 3-month US dollar LIBOR and SOFR is determined to be 25 basis points. However, as part of the bilateral negotiation to amend the liability, the credit spread is also reduced by 20bp, due to an improvement in the borrower's credit quality. The liability is accordingly amended to pay SOFR plus 105bpbp (where 105bp is the previous 100bp plus the current 3-month US dollar LIBOR-SOFR basis of 25bp, less the change in credit spread of 20bp).

Apart from the 20bp 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 125bp (where 125bp is the previous 100bp plus the current 3-month LIBOR-SOFR basis of 25bp).

The 20bp 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 revised EIR of SOFR plus 125bp 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 20bp change in credit spread is not, however, covered by the Phase 2 relief and the net present value of the 20bp reduction, discounted at the revised EIR of SOFR plus 125bp, 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 and the hedge is now documented as a cash flow hedge of the SOFR component of the SOFR plus 105bp 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 4.2.7 above)). 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).



Example 7: Application of Phase 2 relief to a cash flow hedge relationship (continued)

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.

Hence, 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.

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 therefore arise:

- on transition, as 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, applying IFRS 9, the entity considers that there is an 'economic relationship' between the derivative and the hypothetical derivative, for entities applying IAS 39, the hedge must be assessed prospectively to be highly effective and the level of retrospective hedge ineffectiveness will need to be monitored to ensure that the hedge continues to qualify for accounting purposes as there is no longer any relief from the 80/125% effectiveness requirements (see 4.2.7 above).

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.

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 reliefs retrospectively to hedge relationships that were not previously designated as such.[80]

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).[81] 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.[82]

In practice, this means, for instance, that an entity cannot reinstate a hedging relationship that did not previously exist or was voluntarily de-designated, even if it could have met the conditions for hedge accounting and then failed as a direct consequence of IBOR reform.

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, such that the hedging instrument is no longer designated as a hedge of the same hedged item.

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.

[80] IFRS 9.7.2.26(d).
[81] IFRS 9.7.1.10, IAS 39.108H.
[82] IFRS 9.7.2.36, 7.2.37, IAS 39.108I and 108.J.

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 (see 4.2.4 and 4.2.5), begins from the date of initial application of the Phase 2 Amendments.

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.[83]

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. For instance, it will not be possible to reinstate a hedge relationship if the hedging instrument has already been designated as a hedge of a new hedged item. 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.
- Because the 24-month period to which the separately identifiable relief applies, begins from the date of initial application of the Phase 2 Amendments, reinstatement of hedging relationships may have the effect, in practice, of significantly shortening the 24-month window.

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 and starts from the date the entity designates the alternative benchmark rate as a non-contractually specified risk component for the first time.

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.[84]

[83] IFRS 9.7.2.46, IAS 39.108K.
[84] 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 are applied:[85]

- 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

The first, second and fifth of these requirements are illustrated in Example 8.

Example 8 Phase 1 quantitative disclosures

The table below indicates the nominal amount and weighted average maturity of derivatives in hedging relationships that will be affected by IBOR reform as financial instruments transition to RFRs, analysed by interest rate basis. The derivative hedging instruments provide a close approximation to the extent of the risk exposure the Bank manages through hedging relationships.

In $ million 31 December 2020	Nominal amount	Average maturity (years)
Interest rate swaps		
GBP LIBOR (3 months)	775	4.3
USD LIBOR (3 months)	906	5.3
USD LIBOR (6 months)	1,021	6.5
EUR LIBOR (3 months)	1,285	4.8
Other	522	5.3
	4,509	
Cross currency swaps		
GBP LIBOR (3 months) to USD IBOR $ (3 months)	460	4.7
	460	
	4,969	

[85] IFRS 7.24H.

Example 8 Phase 1 quantitative disclosures (continued)		
In $ million		
31 December 2020		
	Nominal amount	**Average maturity (years)**
Interest rate swaps		
GBP LIBOR (3 months)	864	4.4
US LIBOR (3 months)	1,105	5.2
US LIBOR (6 months)	1,110	6.6
EUR LIBOR (3 months)	1,474	4.7
Other	511	5.2
	5,064	
Cross currency swaps		
GBP LIBOR (3 months) to USD LIBOR $ (3 months)	750	4.6
	750	
	5,814	

Example 8 presents the significant IBORs, disaggregated by tenor. Whilst this is not a specific requirement of the Phase 1 Amendments, it arguably provides the most useful information on significant IBOR exposures.

The Phase 1 disclosures do not cease to be required once the Phase 2 Amendments are applied, although the population of instruments to be disclosed will decline over time as they transition to RFRs. The Phase 1 disclosures provide information on the hedging relationships that are still subject to the Phase 1 reliefs, which may continue to be used once the Phase 2 Amendments are applied.

6.1.1 The existing IFRS 7 disclosure requirements

An entity may apply only the Phase 1 Amendments and not the Phase 2 Amendments. This would be the case if for example an entity with a year end of 31 December 2020 chooses not to apply the Phase 2 Amendments early. However, the entity would also need to assess whether for its 31 December 2020 financial statements, its exposure to the risks posed by IBOR reform warrants disclosure under the general principles of IFRS 7. This requires that entities provide disclosures that enable users to evaluate:

- The significance of financial instruments for the entity's financial position and performance; and
- The nature and extent of risks arising from financial instruments to which the entity is exposed during the period, and how the entity manages those risks.[86]

If this is the case, qualitative and quantitative disclosure of the nature and extent of the risks arising from IBOR reform may need to be provided.[87] For the qualitative disclosure, this may include a description of the entity's project underway to manage the risk and transition the exposures from IBOR to RFRs.[88]

[86] IFRS 7.1.
[87] IFRS 7.31.
[88] IFRS 7.33.

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:[89]

- 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:[90]

- 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
- 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 disclosures provided by entities may exclude those exposures that are expected to expire or mature before the IBOR ceases. This is because for these instruments the entity would not consider itself to be exposed to the risks relating to IBOR Reform. This disclosure would, therefore, relate only to a subset of the total population of instruments referencing a significant interest rate benchmark subject to the Reform. However, if an entity wished to include these exposures, it may be justified as they could still be affected by IBOR Reform related risk, such as reduced liquidity in the IBOR before it expires or matures.[91]

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

[89] IFRS 7.24I.
[90] IFRS 7.24J.
[91] IFRS 7.BC35LLL.

- 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.[92] 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). The Basis for Conclusions clarifies 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).[93]

One of the concerns that banks have identified when preparing to provide these quantitative disclosures is that, while reports may be prepared for key management personnel and regulators on the instruments still subject to the Reform, the information may not be of the quality (in terms of completeness and accuracy) normally expected for disclosure in the audited financial statements. This is because, like any temporary reporting used to monitor a transition project, the information is built on a 'best effort basis' and was not intended to achieve the level of accuracy of the usual accounting disclosures.

A parallel can perhaps be drawn with the disclosure requirement in paragraph 30 of IAS 8 about new IFRSs that have been issued but are not yet effective, as both disclosures are temporary and deal with current known information about a future change. IAS 8.30 requires that an entity disclose "known or reasonably estimable information relevant to assessing the possible impact that application of the new IFRS will have on the entity's financial statements in the period of initial application." The objective of the Phase 2 disclosures is to reflect how the entity is implementing the Reform, a live and complex project.

It is also relevant that the IFRS Taxonomy amendments proposed to incorporate the new Phase 2 disclosure requirements, include a "text block" element in the proposed new table to address the 24J(b) requirements. This is to address the fact that the information can be disclosed in various ways. The proposed Taxonomy amendment also clarifies that the Board proposes to use text block elements for this disclosure of quantitative information because the disclosure requirements are not prescriptive about how the quantitative information should be provided. The amendments therefore permit an entity to choose the way in which it provides this quantitative information, for example, an entity can provide such information as an amount or a percentage accompanied by qualitative information to explain the context of the quantitative information.

6.2.1 Application to loan commitments

The Phase 2 Amendments describe that the quantitative disclosures should show separately non-derivative financial assets, non-derivative financial

[92] IFRS 7.BC35KKK.
[93] IFRS 7.BC35OOO.

liabilities and derivatives.[94] However, the disclosures do not relate just to these items, since the amendments to IFRS 7 are not restricted to just those financial instruments within the scope of IFRS 9.[95] Rather, the Phase 2 disclosures apply to all financial instruments within the scope of IFRS 7, which includes recognised and unrecognised financial instruments, some of which are outside the scope of IFRS 9.[96] Certain loan commitments, for example, are excluded from the scope of IFRS 9 (other than for the calculation of the expected credit loss) but are within the scope of IFRS 7 since they are still considered to be derivatives in nature.[97] As a result, loan commitments outside the scope of IFRS 9, should be included in the quantitative disclosures.

6.2.2 Level of detail for different categories

In terms of the level of granularity that should be provided in the quantitative information, there is no requirement to split the amounts into individual line items. It would, however, be permissible to include this additional level of detail if it provided useful information on the entity's exposure to the risks posed by IBOR reform, consistent with the disclosure objective of IFRS 7.[98]

6.2.3 Exposures within the scope of the disclosure

As IBOR reform progresses, some IBORs have been fully or partially reformed rather than being replaced. EURIBOR and the Canadian Overnight Repo Rate Average (CORRA) may be considered examples of such interest rates. As previously mentioned, there are varying views as to whether EURIBOR-based instruments should be included within the Phase 2 disclosures. However, if it subsequently transpires that further reform will be made to EURIBOR, it should be included within the Phase 2 disclosures until the reform is complete.

For some exposures, adding a fallback clause is intended to enable the contract to automatically switch to an RFR if the IBOR ceases to be available. Financial instruments for which this type of fallback clause is added will still need to be included within the Phase 2 disclosure until the IBOR has been replaced, either by the fallback being triggered or as a result of bilateral discussions between the parties to the contract.

The Phase 2 quantitative disclosure requirements are illustrated in Example 9. While this shows one way to comply with IFRS 7.24J(b), other approaches are possible. Judgement is required to define the best measure that reflects the entity's progress towards completing the Reform, considering that the Basis for Conclusions indicates that entities should make use of information that is already available to reduce the cost of providing the information. Entities should also consider whether the disclosure is sufficient to meet the objective of paragraph 24I(a) of IFRS 7, to provide information about the nature and the extent of risks to which the entity is exposed arising from financial instruments subject to IBOR Reform.

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[94] IFRS 7.24J(b).
[95] IFRS 7. 24I, IFRS 7.24J.
[96] IFRS 7.4.
[97] IFRS 9.BCZ2.2.
[98] IFRS 7.1.

Example 9 Phase 2 Quantitative Disclosures

In $ million 31 December 2020	Non derivative financial assets - carrying value	Non-derivative financial liabilities - carrying value	Derivatives Nominal amount[1]
GBP LIBOR (3 months)	1,272	1,984	1,975
USD LIBOR (3 months)	1,453	1,787	2,206
USD LIBOR (6 months)	1,306	1,430	2,221
EUR LIBOR (3 months)	854	926	2,585
Other	464	541	1,522
	10,359	14,289	20,023
Cross currency swaps			600
GBP LIBOR (3 months) to USD LIBOR $ (3 months)			600
	10,359	14,289	20,623

[1] *The IBOR exposures for derivative nominal amounts include loan commitments.*

The table of disclosures above presents the significant IBOR, disaggregated by tenor. Whilst this is not a specific requirement of the Phase 2 Amendments, it arguably provides the most useful information on significant IBOR exposures.

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, 4.2.7 above discusses how the Phase 2 Amendments allow entities, for the purpose of the IAS 39 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.[99] Also when other sources of hedge ineffectiveness emerge in a hedging relationship, an entity is required to disclose those sources by risk category and explain the resulting hedge ineffectiveness. Although there are no new specific disclosure requirements on this within the Phase 1 or Phase 2 Amendments, as a consequence of IBOR Reform and application of the 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 relationships are affected by the Reform.

6.4 Significant judgements

The Phase 2 ED included a requirement in relation to the modification of financial instruments and the conditions for applying the practical expedient to reset the EIR (see 2.1), 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. 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.[100]

In light of this, entities should still 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 expected to be separately identifiable, as described in 4.2.4 and 5 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.[101] 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

[99] IFRS 7.23E.
[100] IFRS 7.BC35.MMM.
[101] IFRS 7.44H.

statement line item affected and the impact on basic and diluted earnings per share.[102]

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 (as an adjustment to opening retained earnings), along with a description of the transitional provisions.[103]

Entities that do not apply the Phase 2 Amendments early, will need to meet the disclosure requirements for an IFRS that has been issued but is not yet effective. This disclosure must include known or reasonably estimable information relevant to assessing the possible impact that application of the Phase 2 Amendments will have on the entity's financial statements in the period of initial application.[104]

6.6 Interim reporting

Whether or not an entity chooses to apply early the Phase 2 Amendments may have an effect on the extent of disclosure they are required to provide in subsequent interim reports, prepared in accordance with IAS 34 *Interim Financial Reporting*.

For example, an entity may choose to apply early the Phase 2 Amendments for an annual period commencing before 1 January 2021, such as for a year ended 31 December 2020. The entity will present the full Phase 2 Amendments disclosures in their 2020 annual report. For subsequent interim reports in 2021 they are not required to update the disclosures except to the extent that the position as reported at year-end has significantly changed.[105] However, given that most of the transition to RFRs is expected to occur during 2021, it is quite likely that there will be significant change in some interim periods.

If an entity does not apply the Phase 2 Amendments early, it will be required to apply the full disclosures in each of their interim reports before the year end annual report.[106] Therefore, a decision not to apply early the Phase 2 Amendments has the potential for a requirement to repeat disclosures in the first year of application that may not be necessary if the Amendments had been applied early.

[102] IAS 8.28(f).
[103] IAS 8.28 (a) to (e) and (g) to (h).
[105] IAS 34.15.
[105] IAS 34.15.
[106] IAS 34.44.

How we see it

Although the IASB responded to preparers' concerns by making the Phase 2 quantitative disclosure requirements less onerous, by allowing entities to choose the basis for the quantitative information provided, production of these disclosures will still be a significant element of any IBOR Reform financial reporting project.

Phase 2 requires disclosure of information that disaggregates the entity's exposure by significant interest rate benchmark, which is subject to IBOR Reform, but there is no requirement to analyse the quantitative information further, for example, by product type. Nor is there a requirement to include within the disclosure those exposures indirectly affected by IBOR reform, for example, where a discount rate used by the entity in a valuation technique to calculate fair value is expected to change from IBOR to RFR. However, if the Bank considers that different product types, or some other subdivision of the information, represent materially different risks in relation to IBOR reform, then the provision of a further level of disaggregation would be consistent with the broader principles of IFRS 7 and the intention for this disclosure.

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)
- There are no further modifications other than those required by the Reform

Lessees are required to remeasure their lease liabilities in similar fashion to any other change in future lease payments resulting from a change in an index or a rate used to determine those payments in accordance with IFRS 16.42, rather than as a lease modification.[107]

Applying IFRS 16, modifying a lease contract to change the basis for determining the variable lease payments meets the definition of a lease modification, because a change in the calculation of the lease payments would change the original terms and conditions determining the consideration for the lease. Without the relief, IFRS 16 would require an entity to account for a lease modification by remeasuring the lease liability by discounting the revised lease payments using a revised discount rate (with an offsetting adjustment to the right of use asset). In the Board's view, reassessing the lessee's entire incremental borrowing rate when the modification is limited to what is required by the Reform would not reflect the economic effects of the modified lease. The practical expedient requires remeasurement of the lease liability using a discount rate that only reflects the change to the basis for determining the variable lease payments as required by the Reform.

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.[108] In contrast to the amendments for financial assets and financial liabilities in IFRS 9, the Board decided not to specify the order of accounting for lease modifications required by the Reform and other lease modifications. This is because the accounting outcome would not differ regardless of the order in which an entity accounts for lease modifications required by the Reform and other lease modifications.

For finance leases, a lessor is required to apply the requirements in IFRS 9 to a lease modification, so the amendments in paragraphs 5.4.5–5.4.9 of IFRS 9 would apply when those modifications are required by the Reform.

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.[109]

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[107] IFRS 16.104-105.
[108] IFRS 16.106.
[109] 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).[110] 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.[111] 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.[112] An entity is not required to restate comparative periods and may do so only if it is possible without the use of hindsight.[113]

[110] IFRS 4.20R.
[111] IFRS 4.20S.
[112] IFRS 4.50.
[113] IFRS 4.51.

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