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IFRS Developments

IBOR reform: publication of the phase one amendments and commencement of phase two

What you need to know

- The IASB has now completed phase one of its work to amend IFRS in response to the financial reporting challenges posed by IBOR reform.
- The amendments provide reliefs to allow hedge accounting to continue during the period of uncertainty before an IBOR is replaced.
- The IASB is now focusing on phase two of its project to deal with issues that may arise when an existing interest rate benchmark is replaced with an RFR.
- The IASB expects to discuss the phase two issues from October 2019 until February 2020.

Introduction

On 26 September 2019 the International Accounting Standards Board (IASB or the Board) published *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7* (the amendments). This brings to a conclusion phase one of the IASB's work to respond to the effects of Interbank Offered Rates (IBOR) reform on financial reporting.

The amendments provide temporary reliefs which enable hedge accounting to continue during the period of uncertainty before the replacement of an existing interest rate benchmark with an alternative nearly risk-free interest rate (an RFR).

With phase one completed, the IASB is now shifting its focus to consider those issues that could affect financial reporting when an existing interest rate benchmark is replaced with an RFR. This is referred to as phase two of the IASB's project. At its meeting on 25 September, the IASB tentatively agreed the list of phase two issues and the preliminary timetable of future meetings when they will be discussed. The IASB may add to the list of issues and revise the timetable as work on phase two progresses.

We provided background to the IASB's project in *IFRS Developments 144* and *145*, summarised the Exposure Draft in *IFRS Developments 148* and gave an update on the decisions taken by the IASB in August 2019 IASB in *IFRS Developments 151*.

The amendments to IFRS 9

For IFRS 9, the amendments include a number of reliefs, which apply to all hedging relationships that are directly affected by interest rate benchmark reform. A hedging relationship is affected if the reform gives rise to uncertainties about the timing and or amount of benchmark-based cash flows of the hedged item or the hedging instrument.

Building a better working world

Application of the reliefs is mandatory. The first three reliefs provide for:

1. The assessment of whether a forecast transaction (or component thereof) is highly probable

2. Assessing when to reclassify the amount in the cash flow hedge reserve to profit and loss

3. The assessment of the economic relationship between the hedged item and the hedging instrument

For each of these reliefs, it is 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 IBOR reform.

The fourth relief provides that, for a benchmark component of interest rate risk that is affected by IBOR reform, the requirement that the risk component is separately identifiable need be met only at the inception of the hedging relationship. Where hedging instruments and hedged items may be added to or removed from an open portfolio in a continuous hedging strategy, the separately identifiable requirement need only be met when hedged items are initially designated within the hedging relationship.

To the extent that a hedging instrument is altered so that its cash flows are based on an RFR, but the hedged item is still based on IBOR (or vice versa), there is no relief from measuring and recording any ineffectiveness that arises due to differences in their changes in fair value.

End of reliefs

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

- For relief one, when the hedging relationship that the hedged item is part of is discontinued; and

- For relief two, when the entire amount accumulated in the cash flow hedge reserve has been reclassified to profit and loss

Relief three will cease:

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

- For a hedging instrument, when the uncertainty arising from IBOR reform is no longer present with respect to the timing and amount of benchmark-based cash flows of the hedging instrument.

- If the hedging relationship is discontinued before either of the two above events occur, the relief will cease at the date of discontinuation.

When an entity designates a group of items as the hedged item, the requirements for when the reliefs cease are applied separately to each individual item within the designated group of items.

The reliefs continue indefinitely in the absence of any of the events described above.

Disclosure requirements

For hedging relationships to which the reliefs are applied, entities shall disclose:

a) The significant interest rate benchmarks to which the entity's hedging relationships are exposed
b) The extent of the risk exposure the entity manages that is directly affected by the interest rate benchmark reform
c) How the entity is managing the process to transition to RFRs
d) A description of the significant assumptions or judgements the entity had to make in applying the exceptions
e) The nominal amount of the hedging instruments in those hedging relationships

The amendments also provide an exemption from the disclosure requirements in IAS 8 *Accounting policies, changes in accounting estimates and errors*, paragraph 28-f. As a result, entities are not required on initial application of the amendments, to disclose for the current period and each prior period presented, the amount of any adjustment for each financial statement line item affected.

Effective date and transition

The effective date of the amendments is for annual periods beginning on or after 1 January 2020, with early application permitted. The requirements must be applied retrospectively. However, any hedge relationships that have previously been de-designated cannot be reinstated upon application, nor can any hedge relationships be designated with the benefit of hindsight.

The amendments to IAS 39

The corresponding amendments to IAS 39 F*inancial Instruments: Recognition and Measurement* are consistent with those for IFRS 9, but with the following differences:

- For the prospective assessment of hedge effectiveness, 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 IBOR reform.
- For the retrospective assessment of hedge effectiveness, to allow the hedge to pass the assessment even if the actual results of the hedge are temporarily outside the 80%-125% range, during the period of uncertainty arising from IBOR reform.
- For a hedge of a benchmark portion (rather than a risk component under IFRS 9) of interest rate risk that is affected by IBOR reform, the requirement that the portion is separately identifiable need be met only at the inception of the hedge.

Phase two issues

At its meeting on 25 September 2019, the IASB agreed the preliminary list of phase two issues:

- Classification and measurement
  - Whether a modification results in derecognition and, if not, how it should be accounted for
  - If changes to reset dates and compounding could affect the SPPI assessment
  - If the business model assessment would be affected when a modification triggers derecognition
  - Whether embedded derivatives may arise as a result of changes to reset dates and compounding periods for financial liabilities

- Hedge accounting
  - For hedge designations: whether a change to the hedged risk would trigger hedge accounting to be discontinued; whether flexible hedge designations could be permitted; and the effect if some assets within a loan portfolio transition to an RFR and others do not, along with consideration of applying other qualifying criteria to new hedging relationships.
  - For the end of relief in phase one: how this interacts with hedge designations under phase two; how amounts deferred in OCI should be recycled; and how the valuation adjustments on a hypothetical derivative and fair value hedge adjustment should be treated if a change in the hedged risk does not require discontinuation.
- Other IFRS standards: what are the potential implications for IAS 19 *Employee Benefits*, IFRS 16 *Leases*, and IFRS 17 *Insurance contracts*.
- Disclosures: whether additional disclosures should be developed.

It was suggested during the IASB's September meeting that the discussion for each topic will not necessarily result in an amendment to IFRS, as in certain cases it may only be necessary for the Board to clarify the accounting treatment it would expect under existing IFRS.

How we see it

We commend the IASB for completing phase one of its project to address the financial reporting challenges posed by IBOR reform. In finalising the amendments, the IASB has provided reliefs that are essential to mitigate the hedge accounting issues that could arise during the period of uncertainty before IBOR contracts are amended to new benchmark rates.

The IASB has, by assigning the topic a high priority and completing phase one within an accelerated timeframe, ensured there is a good chance of the amendments being endorsed by the EU in time for 2019 year-end reporting.

We are also pleased that the IASB is starting to consider the financial reporting issues that will arise once the transition to RFRs takes place. Given the outline timetable agreed by the IASB, it is possible that an exposure draft will be issued in April or May 2020, with the phase two amendments published as a final standard in Q3 2020 and available for 2020 year-ends.

As the transition from IBOR to RFRs is occurring at different times in different jurisdictions and for different financial instruments, entities may soon need to start amending contracts. We are concerned that the breadth of phase two issues the IASB has identified, coupled with the timeframe it has set itself to discuss them, may mean the solutions come too late for entities to address the accounting challenges that arise. Entities may be forced to delay their transition from IBORs to RFRs to avoid triggering the phase two accounting issues, which would slow the change global regulators have identified as necessary. The IASB must therefore ensure the momentum it has generated so far continues and attach the same urgency to resolving the phase two issues as it did to completing phase one. One possibility that we would recommend is to consider whether to divide the phase two list in two and to 'fast track' some of the more urgent issues.

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