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IFRS Developments

IBOR reform: IASB publishes phase two exposure draft

What you need to know

- On 9 April 2020 the IASB published an ED of proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 for phase two of its IBOR reform project.
- The ED has a 45-day comment period ending on 25 May 2020. This is a shorter period than usual, reflecting the urgency of the topic.
- The ED addresses the accounting issues that arise when financial instruments that reference IBORs transition to nearly RFRs.
- The proposed effective date is for annual periods beginning on or after 1 January 2021, but earlier application is permitted.

Introduction

On 9 April 2020 the International Accounting Standards Board (IASB or the Board) published an Exposure Draft, *Interest Rate Benchmark Reform – Phase 2, Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16* (the ED). Comments are to be received by 25 May 2020. The forty-five day comment period is shorter than normal for an exposure draft, reflecting the urgency of the topic and is the same length of time as was given for the phase one ED published in May 2019. In this publication, we summarise the proposals and provide our views.

Following the decision taken by global regulators to replace Interbank Offered Rates (IBORs) with alternative nearly risk-free rates (RFRs), in 2018, the IASB commenced work to address the effects of IBOR reform on financial reporting. The IASB divided its work into two phases:

- Phase one addressed issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an RFR.
- Phase two is focused on issues that affect financial reporting when an existing interest rate benchmark is replaced with an RFR.

The IASB completed phase one with the publication, in September 2019, of, *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7*. The ED contains the decisions taken by the IASB in phase two of its project since October 2020. Once the phase two amendments have been finalised, the IASB will have completed its project in response to IBOR reform.

For the background to the IASB's project, see our publications, *IFRS Developments 144* and *145;* we describe the phase one amendments in *IFRS Developments 152* and summarise the phase two decisions taken at Board meetings since October 2019 in *IFRS Developments 154, 156, 160 and 162*. These publications can be found at *www.ey.com/ifrs.*

1. Practical expedient for modifications

The ED includes a practical expedient to allow contractual changes, or changes to cash flows that are directly required by the reform, to be treated as changes to a floating interest rate, equivalent to a movement in a market rate of interest. Inherent in allowing the use of this practical expedient is the requirement that the transition from an IBOR benchmark rate to an RFR takes place on an economically equivalent basis with no value transfer having occurred.

Building a better working world

In applying this practical expedient, an entity is required to first identify and account for modifications to the instrument which relate directly to IBOR reform, by updating the effective interest rate (EIR) without adjusting the carrying amount. The ED includes examples of the type of modifications required by interest rate reform, to which the practical expedient is limited, as follows:

- The replacement of an existing interest rate with an alternative benchmark rate or effecting such a reform of an interest rate benchmark by changing the method used to calculate the interest rate benchmark
- The addition of a fixed spread to compensate for a basis difference between an existing interest rate benchmark and an alternative benchmark rate
- 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 fall-back provision to the contractual terms of a financial asset or liability to enable any of the changes described above to be made

Any other modifications to the financial instrument that may be made at the same time, such as a change in the credit spread or maturity date, are assessed. If they are not substantial, the updated EIR should be used to recalculate the carrying amount of the financial instrument, with any modification gain or loss recognised in profit or loss. No changes are proposed to the existing requirements in IFRS to determine whether or not modifications are substantial and result in derecognition.

The practical expedient would also be applied by entities applying IFRS 4 *Insurance Contracts* that are using the exemption from IFRS 9 *Financial Instruments* and for IFRS 16 *Leases* to lease modifications required by IBOR reform. Whilst the IASB is considering providing relief under IFRS 16 for changes to lease terms in direct response to Covid-19, this is not expected to affect the proposals in the ED.

2. Relief from discontinuing hedging relationships

Changes to hedge documentation

The ED proposes to allow changes required by IBOR reform to be made to hedge designations and hedge documentation under both IFRS 9 and IAS 39 without resulting in the discontinuation of hedge accounting. 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.

Consistent with this, the ED proposes that IAS 39 should be amended to 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.

Remeasurement on transition to an RFR

At the time the hedge designation is amended to reference an RFR:

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

Amounts accumulated in the cash flow hedge reserve

The ED proposes that when the hedged item is amended (or if the hedge has previously been discontinued, when the contractual cash flows of the previously designated item are modified), amounts accumulated in the cash flow hedge reserve are deemed to be based on the RFR. This results in the release of the cash flow hedge reserve to profit or loss in the same period or periods in which the hedged cash flows that are based on the RFR affect profit or loss. To achieve this, a hypothetical derivative in a cash flow hedge may be updated, although any valuation adjustment on transition is recognised immediately in profit or loss.

IAS 39 assessment of retrospective hedge effectiveness

The phase one reliefs are amended to end when there is no longer uncertainty with respect to the cash flows of both the hedged item **and** the hedging instrument.

IAS 39 will also be amended so that for the assessment of retrospective hedge effectiveness, cumulative fair value changes will reset to zero when the exception to the retrospective assessment ends. However, actual hedge ineffectiveness will continue to be measured and recognised in full in profit or loss.

Hedges of groups of items

The ED proposes 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 IBOR 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. At each transition, the hypothetical derivative for the subgroup will require updating.

3. Separately identifiable risk components

IFRS 9 and IAS 39 require that a risk component (or a designated portion) is separately identifiable to be eligible for hedge accounting. The ED proposes to 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. The relief allows entities upon designation of the hedge, 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 twenty-four months. The relief ends at the earlier of:

- Twenty-four months after the initial designation of the RFR component, or
- When the entity becomes reasonably certain that the risk component will not be separately identifiable within twenty-four months after initial designation

In either of these cases, the hedge would have to be prospectively discontinued. No relief is provided from the requirement for the risk component to be reliably measurable throughout the life of the hedging relationship. Any hedge ineffectiveness would be recognised in profit and loss as normal.

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

4. Additional disclosures

The ED proposes to amend *IFRS 7 Financial Instruments: Disclosures* to include the following additional disclosures:

- How the entity is managing the transition to RFRs, its progress and the risks arising from the transition
- Disaggregated by each significant IBOR benchmark, the carrying amount of non-derivative financial assets and liabilities, and the nominal value of derivatives that continue to reference IBORs subject to reform
- For each RFR, an explanation of how the entity has determined the base rate and relevant adjustments to that rate, including any significant judgements,

to assess whether modifications have been made on an economically equivalent basis, to determine if derecognition is required

- Whether IBOR reform has given rise to any changes to the entity's risk management strategy, a description of the changes and of how the entity is managing those risks

5. Multiple application and end of the phase two 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 IBOR reform. The reliefs would not be restricted to one application, but could be applied each time a hedging relationship is modified as a direct result of IBOR reform.

The phase two reliefs will cease to apply once all changes have been made to financial instruments and hedging relationships, as required by IBOR reform.

6. Effective date and transition requirements

The ED proposes that the phase two amendments will be effective for annual periods beginning on or after 1 January 2021, with earlier application permitted. Application is retrospective and hedging relationships must be reinstated once an entity first applies the phase two amendments if the following applies:

- The hedging relationship was discontinued solely due to changes required by IBOR reform
- The hedging relationship would not have been discontinued if the phase two reliefs had been available

An entity is not required to restate prior periods. Application of the phase two reliefs will be mandatory to ensure comparability.

How we see it

The practical expedient requires that the transition to RFRs is made on an *economically equivalent* basis. This is a new term which is not defined elsewhere in IFRS. Entities will need to consider how they will apply it in practice.

The relief from having to satisfy the separately identifiable requirement should significantly ease the transition to RFRs by allowing hedging relationships to continue. However, entities must ensure they are comfortable making the appropriate judgements at the time of transition, over the subsequent 24 months and have suitable processes and governance to update their assessment.

The need to reinstate discontinued hedges may appear onerous, requiring entities to maintain two sets of hedge accounting records. However, entities should aim to manage their programmes so that financial instruments only transition to RFRs once the amendments are available. Provided phase two is finalised before the end of 2020, this should not unduly delay the transition to RFRs.

For the phase two disclosures, entities should start to consider how to gather and present the necessary information. Given the importance global regulators continue to place on ensuring that IBOR reform progresses, entities would be well advised to ensure their disclosures are as complete and transparent as possible.

Now that the ED has been published, it is important for entities to carefully assess the precise wording of the proposals. Entities should think through in detail the implications for the various scenarios likely to be encountered as they transition from IBORs to RFRs. This will allow them to identify feedback for the IASB that should help ensure the phase two reliefs are clear, sufficient and operable.

The IASB is re-prioritising its work plan in response to Covid-19. Given the continued importance of IBOR reform, no delay is currently expected in finalising the phase two amendments.

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