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IFRS Developments

IBOR reform: IASB discusses phase two hedge accounting issues

What you need to know

- At its December meeting, the IASB made further progress in phase two of its project to amend IFRS in response to the financial reporting challenges posed by IBOR reform.
- The IASB agreed solutions to address the phase two issues associated with the hedge accounting arising on transition to RFRs.
- In January, the IASB will discuss the end of the phase one reliefs, other IFRS standards and disclosures.

Introduction

At its meeting on 11 December 2019, the International Accounting Standards Board (IASB or the Board) made significant further progress in its project to address the financial reporting issues associated with IBOR reform. In this publication, we summarise the tentative decisions taken and provide our view of how we see it.

Following the decision taken by global regulators to replace Interbank Offered Rates (IBORs) with replacement benchmark interest rates or 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 alternative nearly risk-free interest rate.
- 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, of *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7*. In October, the IASB reached tentative conclusions on the phase two issues relating to classification and measurement. At its December meeting, the IASB reached tentative decisions on the phase two issues associated with hedge accounting on transition to RFRs.

We provide background to the IASB's project in *IFRS Developments 144* and *145*, we describe the phase one amendments in *IFRS Developments 152* and summarise the phase two tentative decisions on classification and measurement in *IFRS Developments 154*. These publications can be found at www.ey.com/ifrs.

Determining whether a modification should trigger a hedging relationship to be discontinued

At its December meeting, the IASB reached tentative decisions on whether modifications to financial instruments should trigger hedge accounting to be discontinued. The IASB decided that no change is required to the existing requirements for whether hedge accounting should be discontinued following:

- A substantial modification that results in derecognition of the hedged item and / or the hedging instrument

  Or

- A modification that did not result in derecognition and that is not directly required by IBOR reform

This is consistent with the decisions reached at the October meeting, that no change is required for the existing IFRS requirements to determine whether a modification not directly required by IBOR reform results in derecognition.

Changes to hedge documentation and effectiveness testing arising as a result of modifications required by IBOR reform

The IASB tentatively agreed that existing hedging relationships should continue if they are subject to modifications that are directly required by IBOR reform. This avoids entities having to discontinue hedges as a result of IBOR reform and prevents them in future from having to recognise increased volatility in profit or loss for cash flow hedges, as would otherwise be the case under existing IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Classification and Measurement*.

For modifications that are directly required by IBOR reform, the Board agreed that IFRS 9 and IAS 39 should be amended to allow changes to be made to hedge documentation without resulting in the discontinuation of hedge accounting, including:

- Redefining the hedged risk to make reference to an RFR
- Redefining the description of the hedging instruments and / or the hedged items to reflect the RFR

Consistent with this decision, the IASB tentatively also agreed 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.

Treatment of valuation adjustments due to modifications directly required by the reform

The IASB tentatively decided that any valuation adjustments arising from modifications due directly to IBOR reform shall be recognised immediately in profit or loss as they occur and should not be deferred nor recognised as an adjustment to opening retained earnings on initial application of the amendments. Therefore, no exceptions will be provided from the current requirements in IFRS 9 and IAS 39, which would require entities to measure and recognise:

- For a fair value hedge, any valuation adjustments arising when the hedge documentation is updated to reflect the transition to an RFR as the new hedged risk

- For the hypothetical derivative in a cash flow hedge, any hedge ineffectiveness arising from a modification to the hedged item that is directly required by the reform
- For derivatives designated as the hedging instruments, any valuation adjustments arising when they are amended to replace IBOR with an RFR

Immediate recognition in profit or loss of any valuation adjustments on transition to RFRs would be consistent with the phase one reliefs, which require any hedge ineffectiveness to be recognised in full in profit or loss. The Board's tentative decisions are intended to report the economic effects of any amendments to hedging relationships, that arise as a result of IBOR reform, as transparently as possible.

Hedges of a group of items

The IASB tentatively decided that changes should be made to IFRS 9 and IAS 39 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 changes agreed will allow the hedging strategy to remain and not be discontinued as items within the hedged group transition from IBORs to RFRs. IFRS 9 and IAS 39 will be changed to require the following:

- The hedge documentation will be amended to define the hedged items by way of two subgroups within the designated group of items, one referencing the original IBOR and the other the RFR.
- Hedge effectiveness will be tested separately for each subgroup of items designated in the hedging relationship. IBOR and RFR items will be assessed for hedge effectiveness within the same subgroup like-for-like against similar items. This will help prevent hedges from failing hedge effectiveness due to the transition of items in the group from IBORs to RFRs.
- The IBOR and RFR items will be separated into different subgroups, but will be considered to still form parts of the original single hedging relationship. The hedging relationship would therefore remain in place and not have to be discontinued as the transition to RFRs occurs.
- For groups of items designated as hedges under IAS 39, those referencing IBOR and RFRs will be treated as if they share similar risk characteristics. This change is necessary because IAS 39 requires that any items designated as a group for hedge accounting should share similar characteristics.

In practice, it may be necessary to establish more than two subgroups, if for example, a single IBOR transitions to more than one RFR. The implications of this possibility will be considered further at the IASB's January meeting.

The hypothetical derivatives for each subgroup will require updating each time instruments transition from IBORs to RFRs.

IAS 39 fair value hedge accounting for a portfolio of interest rate risk

The IASB tentatively agreed to amend IAS 39 so that when entities change the hedged risk to an RFR in the hedging documentation, it is assumed that all items in the portfolio of financial assets or financial liabilities share the risk being hedged. This relief ensures that, as instruments included within this type of hedging relationship transition from IBOR to RFRs, the condition in IAS 39 that they share the risk being hedged, will continue to be met.

Next steps

Having tentatively concluded on these hedge accounting issues, the IASB will next consider the effects on hedge accounting once the phase one reliefs end. These discussions are scheduled to take place during January 2020.

Also, at the January meeting, other IFRS standards are due to be considered, along with any new issues identified and additional disclosures required as a result of the phase two amendments.

How we see it

The decisions taken at the December meeting should substantially resolve the hedge accounting issues that will arise once financial instruments transition to RFRs. We note that the decisions taken by the Board are tentative and can only be considered final once phase two of the IASB's project is complete.

We welcome the reliefs which allow changes to be made to hedge documentation for modifications directly required by IBOR reform. This avoids the discontinuation of hedge accounting as hedging relationships transition to RFRs.

For hedges of a group of items, entities will need to ensure their operational processes are capable of updating the subgroups and amending the corresponding hypothetical derivatives as the transition from IBOR to RFRs progresses.

With the progress made at the December meeting, the IASB is on track to publish an exposure draft by the end of the first quarter of 2020. If, as with phase one, the comment period for the phase two exposure draft is limited to forty-five days, it should be possible for the IASB to publish the final phase two amendments during the third quarter.

The timing for when the phase two amendments are finalised is important because entities are likely to accelerate their plans during 2020 to complete the transition from IBORs to RFRs, especially during the second half of the year. Entities will need the phase two reliefs to have been finalised (and, if applicable, endorsed) before the transition proceeds.

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