

Snapshot: *Interest Rate Benchmark Reform—Phase 2*

This Snapshot provides an overview of the Exposure Draft *Interest Rate Benchmark Reform—Phase 2* published by the International Accounting Standards Board (Board).

The Board's objective	To assist companies in providing useful information to investors about the effects of interest rate benchmark reform on financial statements.
Project stage	This is Phase 2 of the Board's project on interest rate benchmark reform. ¹ The proposals in the Exposure Draft address issues affecting financial statements when changes are made to contractual cash flows and hedging relationships as a result of interest rate benchmark reform.
Next steps	<p>The Board will consider feedback on the proposals in the Exposure Draft in developing amendments to:</p> <ul style="list-style-type: none"> • IFRS 9 <i>Financial Instruments</i>; • IAS 39 <i>Financial Instruments: Recognition and Measurement</i>; • IFRS 7 <i>Financial Instruments: Disclosures</i>; • IFRS 4 <i>Insurance Contracts</i>; and • IFRS 16 <i>Leases</i>. <p>The Board aims to issue the final amendments in 2020.</p>
Comment deadline	25 May 2020.

¹ The Project Summary on Phase 1 of the project is available at <https://www.ifrs.org/-/media/project/ibor-reform/interest-rate-benchmark-reform-project-summary.pdf?la=en>.

Background

What is interest rate benchmark reform?

Interest rate benchmarks such as interbank offered rates (IBORs) play an important role in global financial markets and index a variety of financial products ranging from mortgages to derivatives worth trillions of dollars and of other currencies.

Market developments have undermined the reliability of some benchmarks. In 2014 the Financial Stability Board published a report setting out recommendations to reform some major benchmarks.² Since then, public authorities in many jurisdictions have made progress towards replacing benchmarks with alternative, nearly risk-free rates based to a greater extent on transaction data.

We refer to this specific market-wide reform of an interest rate benchmark, including the replacement of IBOR with an alternative benchmark rate, as interest rate benchmark reform (the reform). Jurisdictions have their own timelines for completing the reform, but there is an expectation that some major interest rate benchmarks will cease to be published by the end of 2021.

Why a two-phase project?

In 2018 the Board decided to add a project to its work plan to consider the financial reporting implications of the reform and identified two groups of accounting issues that could affect financial reporting. These are:

- pre-replacement issues—issues affecting financial reporting in the period during which there is uncertainty about contractual cash flows arising from the reform (addressed by Phase 1 amendments); and
- replacement issues—issues affecting financial reporting when changes are made to contractual cash flows and hedging relationships as a result of the reform (to be addressed by Phase 2 amendments).

The Board considered the pre-replacement issues to be more urgent and also addressed hedge accounting requirements as a priority in the first phase of the project.

What did the Phase 1 amendments cover?

The Board amended IFRS 9 and IAS 39 in September 2019 to provide temporary exceptions to specific hedge accounting requirements and added related disclosure requirements to IFRS 7. Companies would apply these specific hedge accounting requirements assuming the reform has not changed the interest rate benchmark. Applying these exceptions, companies would not be required to discontinue hedge accounting solely because of the uncertainty arising from the reform.

IFRS 9 allows companies, when they first apply the Standard, to continue applying the hedge accounting requirements of IAS 39 instead of IFRS 9.

Many companies—financial institutions in particular—have elected to continue to apply hedge accounting according to IAS 39 rather than to IFRS 9. For this reason, the Board amended both IFRS 9 and IAS 39 in Phase 1.

² The report is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

What is the Board proposing in Phase 2 of this project?

The proposals in the Board's Exposure Draft address the accounting issues that arise from the replacement of interest rate benchmarks; and, given that the use of such benchmarks is extensive and global, the Board expects the proposals to affect many companies.

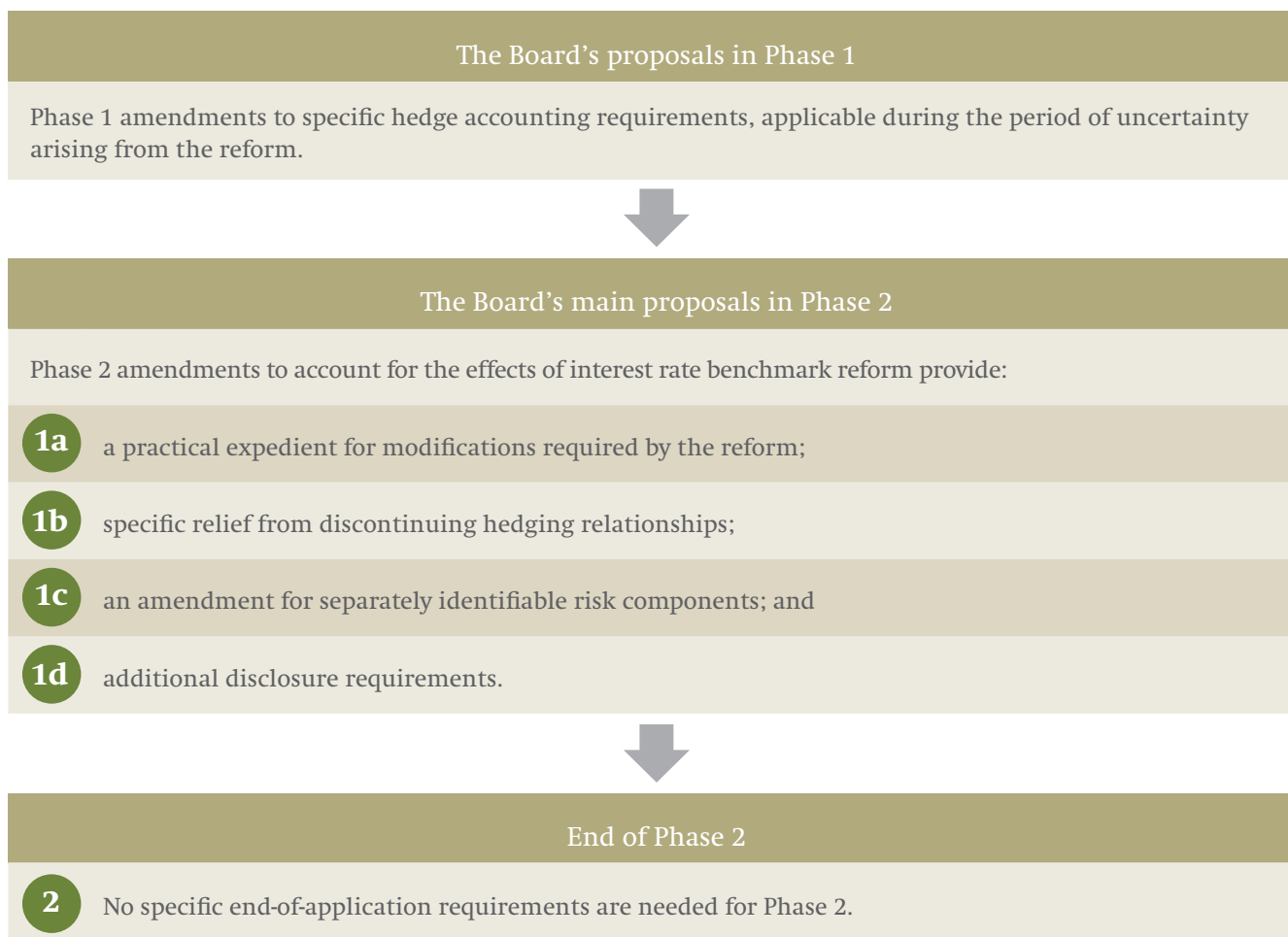
Phase 2 of the Board's project considers, as a priority, the effects of the reform on a company's financial statements that arise when, for example, an interest rate benchmark used to calculate interest on a financial asset is replaced with an alternative benchmark rate.

The Board proposes amendments to specific requirements in IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 relating to:

- modifications of financial assets and financial liabilities and lease liabilities;
- hedge accounting; and
- disclosures.

The proposed amendments apply to changes to financial instruments and hedging relationships required by the reform.

The Board's main proposals in Phase 2 in the context of the overall interest rate benchmark reform project are set out in the illustration on this page.



1a Practical expedient for modifications

What is the issue?

Applying IFRS 9, a company assesses whether a modification of a financial asset or financial liability results in derecognition of the financial asset or financial liability.

If it does not result in derecognition, a modification gain or loss is determined by recalculating the carrying amount of the financial instrument using the original effective interest rate (EIR) to discount the modified cash flows. A company immediately recognises any modification gain or loss in profit or loss.

In the absence of any relief, a company would apply this requirement to a modification required by the reform.

For the purposes of the Exposure Draft, a modification is considered to be required by the reform only if:

- (a) it is required as a direct consequence of the reform; and
- (b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis.

Such a modification can arise even if the contractual terms of the financial instrument are not amended but the basis for determining contractual cash flows changes.

What is the Board proposing?

- A practical expedient for modifications required by the reform—a company would not derecognise the financial asset or financial liability. Modifications required by the reform would be accounted for by updating the EIR to reflect, for example, the change in an interest rate benchmark from IBOR to an alternative benchmark rate.
- This practical expedient would also apply to changes in estimates of future cash payments or receipts as a result of the activation of an existing contractual clause (for example, the triggering of a fallback clause³).
- After a company applies the practical expedient to modifications required by the reform it would separately assess modifications not required by the reform to determine if they result in derecognition of a financial instrument. If they do not result in derecognition, a company would adjust the carrying amount of a financial instrument and immediately recognise any modification gain or loss in profit or loss.
- Amendments to IFRS 4 to require insurers applying the temporary exemption from IFRS 9 to apply the practical expedient for modifications required by the reform.
- Amendments to IFRS 16 to require lessees to use a similar practical expedient to account for lease modifications required by the reform.

Comparing IBOR to an alternative nearly risk-free rate

- If IBOR is replaced with an alternative benchmark rate, this alternative benchmark rate would generally be a nearly risk-free rate (RFR) which is lower than IBOR.
- To account for the economic basis difference between IBOR and RFR, a fixed spread may be added to the RFR.
- Such a fixed-spread adjustment is an example of a change that would be considered a modification required by the reform.

IBOR

- term rate
- forward-looking
- includes a component for bank credit risk and other factors

≈

RFR

- overnight rate
- based on historic transactions

+

fixed spread

³ A fallback clause refers to a contractual provision that sets out how to identify a replacement rate if an interest rate benchmark is no longer available.

1b Specific relief from discontinuing hedging relationships

What is the issue?

A company changes its hedge designations and hedge documentation when it changes a designated hedged risk or changes the basis for determining contractual cash flows for a financial asset or a financial liability designated in a hedging relationship.

To reflect the reform, a company would update its hedge documentation by:

- designating an alternative benchmark rate as a hedged risk;
- amending the description of the hedging instrument or the hedged item to refer to an alternative benchmark rate; or
- amending the description of how it will assess hedge effectiveness.

Generally, under both IFRS 9 and IAS 39, amending the formal designation of a hedging relationship would result in discontinuing the hedging relationship.

Without relief from these and some other requirements in IFRS 9 and IAS 39, companies would be required to discontinue hedge accounting solely due to changes required by the reform.

However, discontinuing hedge accounting solely due to changes required by the reform would not reflect the economic effects of the changes and would not provide useful information to investors.

What is the Board proposing?

- Amending hedge accounting requirements so that changes to hedge designations and hedge documentation required by the reform would not result in discontinuation of hedge accounting. For a company to continue applying hedge accounting, its amended hedging relationships would still be required to meet all other qualifying criteria.
- Requiring the amounts accumulated in the cash flow hedge reserve to be deemed to be based on the alternative benchmark rate when there is a change in the basis for determining the contractual cash flows.
- For the purposes of the IAS 39 retrospective assessment of hedge effectiveness, requiring a company to reset the cumulative fair value changes of the hedged item and hedging instrument to zero immediately after ceasing to apply the Phase 1 relief. The cumulative fair value changes would therefore be ignored and would not affect the assessment going forward. However, the usual measurement requirements would apply.
- Amending specific requirements for applying hedge accounting to groups of items to reflect the expectation that hedged items within the group may be changed at different times.

Hedged items and hedging instruments would continue to be measured in accordance with IFRS 9 and IAS 39. Therefore any measurement differences arising from amending the formal designation of a hedging relationship required by the reform would be recognised as hedge ineffectiveness in the financial statements.

Doing so would be consistent with accounting for such amendments as the continuation of the hedging relationship and reflects the economic effects of the reform.

1c Separately identifiable risk components

What is the issue?

A company may designate an item in its entirety or a component of an item as a hedged item in a hedging relationship. Despite some differences, both IFRS 9 and IAS 39 require a risk component (or a portion) to be separately identifiable to be eligible for hedge accounting.

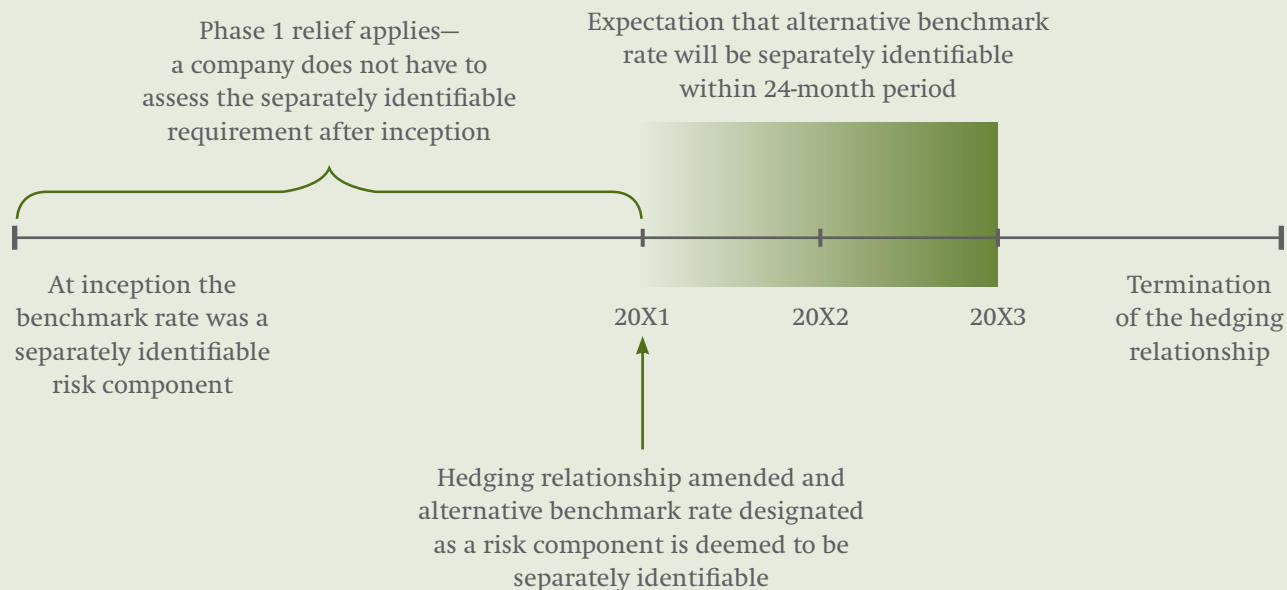
When hedging relationships are amended as a result of the reform or new hedging relationships are designated, an alternative benchmark rate designated as a non-contractually specified risk component may not meet the 'separately identifiable requirement'. This is because a particular market for financial instruments referenced to an alternative benchmark rate might not yet be sufficiently developed.

What is the Board proposing?

The Board is proposing that an alternative benchmark rate be deemed a separately identifiable risk component if a company reasonably expects it to meet the separately identifiable requirement within 24 months of the date it is designated as a non-contractually specified risk component. The risk component would be deemed separately identifiable for the entire 24 months unless a company reasonably expects it not to be separately identifiable within that period. It must however be reliably measurable to qualify for hedge accounting.

Applying the proposed amendment

Assume a company designates the IBOR component of a fixed-rate financial liability as the hedged item in a fair value hedge. Phase 1 relief required a company to assess the separately identifiable requirement at the inception of the hedging relationship only. Phase 1 relief ends when changes to the hedging relationship required by the reform are made. In 20X1 the hedging relationship is amended and the alternative benchmark rate is designated as a risk component.



1d Disclosure requirements

What is the issue?

In considering the need for additional disclosure requirements, the Board balanced the benefits of providing useful information to investors about the effects of the reform on a company's financial statements with a company's costs for providing that information.

Although companies are required to provide some information about the reform when applying disclosure requirements such as those in IFRS 7, some useful information may not be captured by current disclosure requirements.

What is the Board proposing?

The Board is proposing that a company be required to make additional disclosures in its financial statements so that investors can better understand the reform's effects on that company.

Objectives of the disclosures

Provide disclosures that enable investors to understand:

- the nature and extent of risks arising from interest rate benchmark reform to which a company is exposed, and how it manages those risks; and
- a company's progress in completing the transition from interest rate benchmarks to alternative benchmark rates, and how it is managing the transition.

Achieving the objectives

To achieve these two objectives, a company would disclose:

- how it is managing the transition to alternative benchmark rates, the progress made at the reporting date, and the risks arising from the transition;
- the carrying amount of non-derivative financial instruments and the nominal amount of derivatives that continue to reference interest rate benchmarks subject to the reform, disaggregated by significant interest rate benchmark;
- for each significant alternative benchmark rate to which a company is exposed, a description of how it determined the base rate and relevant adjustments to that rate, including a description of significant judgements to assess whether the modifications were required by the reform; and
- to the extent that the reform has resulted in changes to a company's risk management strategy, a description of those changes and how it is managing those risks.

2 End of the application of Phase 2

What is the issue?

Unlike the Phase 1 amendments, which are applied during the period of uncertainty arising from the reform, the proposed amendments in Phase 2 would be applied at the point when changes to financial instruments or hedging relationships occur as a result of the reform. Therefore, by design, the application of these proposed amendments has a natural end.

The Board considered whether any specific end-of-application requirements were needed.

What is the Board proposing?

The Board did not propose any specific end-of-application requirements, because it tentatively decided that the proposed amendments can only be applied when changes are made to financial instruments and hedging relationships as required by the reform.

Can the proposed amendments be applied more than once?

In limited cases, a company might apply the proposed amendments more than once to each financial instrument or component of a hedging relationship.

This could be the case, for example, when a central authority in its capacity as the administrator of an interest rate benchmark undertakes a multi-step process to replace an interest rate benchmark with an alternative benchmark rate. A company would be required to apply the proposed amendments to each change to the basis for determining the contractual cash flows of the instrument that is required by the reform.

Similarly, more than one amendment to the formal designation of the hedging relationship may be necessary to reflect changes required by the reform. This could be the case, for example, if a company makes changes required by the reform to the hedging instrument and hedged item at different dates.

Transition and effective date

Transition

The Board has proposed that a company retrospectively apply the proposals in the Exposure Draft without being required to restate comparative information.

A company is therefore required to reinstate a hedging relationship that was discontinued before it first applied the proposed amendments only if:

- it discontinued a hedging relationship solely due to changes required by the reform; and
- that hedging relationship would not have been required to be discontinued if the proposed amendments had been applied at that time.

Effective date

The Board proposes that the amendments would apply for annual reporting periods beginning on or after 1 January 2021. Earlier application would be permitted. The proposed effective date reflects the urgency of the replacement issues.

The proposed amendments are mandatory. The Board considered, but decided against voluntary application. Voluntary application of these amendments could lead to selective application to achieve specific accounting results. Voluntary application could also reduce the comparability of the information that each company provides in its financial statements.

Proposals	Which IFRS Standards would be affected?				
	IAS 39 <i>Financial Instruments: Recognition and Measurement</i>	IFRS 7 <i>Financial Instruments: Disclosures</i>	IFRS 9 <i>Financial Instruments</i>	IFRS 4 <i>Insurance Contracts</i>	IFRS 16 <i>Leases</i>
1a Practical expedient for modifications			✓	✓	✓
1b Relief from discontinuing hedging relationships	✓		✓		
1c Separately identifiable risk components	✓		✓		
1d Disclosure requirements		✓			

Further information

The deadline for comments on the Exposure Draft is 25 May 2020

Respondents are invited to answer any or all of the questions in the Exposure Draft and to comment on any other matter that the Board should consider when finalising the amendments. Comments can be submitted on our 'Open for comment documents' page at www.ifrs.org/projects/open-for-comment/

Stay informed

To stay up to date with the latest developments in this project and to sign up for email alerts, please visit <https://www.ifrs.org/projects/work-plan/ibor-reform-and-its-effects-on-financial-reporting-phase-2/>

Exposure Draft package

The Exposure Draft package includes:

- the Board's detailed proposals, in the format of draft amendments to IFRS Standards;
- the Basis for Conclusions on the Exposure Draft which summarises how the Board developed its proposals; and
- questions for respondents.

This document

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