

IFRS Developments

IBOR reform: the IASB's proposals, part 3.

What you need to know

- ▶ On 3 May 2019 the IASB published an ED of proposed amendments to IFRS 9 and IAS 39 providing relief to allow hedge accounting to continue despite the uncertainties resulting from transition from IBOR to RFRs.
- ▶ The ED has a 45-day comment period ending on 17 June 2019. This is a shorter period than usual, reflecting the urgency of the topic.
- ▶ The IASB has not yet considered what reliefs may be required for financial reporting issues that might affect financial reporting when transitions from IBOR to RFRs take place

Introduction

On 3 May 2019 the International Accounting Standards Board (IASB or the Board) published an Exposure Draft, *Interest Rate Benchmark Reform, Proposed amendments to IFRS 9 and IAS 39* (the ED). Comments are to be received by 17 June 2019, which is forty-five days after publication of the ED. This is a shorter comment period than normal for an exposure draft, reflecting the urgency of the topic.

The ED presents for comment the decisions taken by the IASB to date as part of its project responding to the effects of Interbank Offered Rates (IBOR) reform on financial reporting. The IASB has divided the project into two phases:

- ▶ Phase one addresses issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an alternative virtually risk-free interest rate (an RFR).
- ▶ Phase two will focus on issues that might affect financial reporting when an existing interest rate benchmark is replaced with an RFR.

The ED is the next key step in phase one of the IASB's project and contains the proposed amendments to IFRS 9 *Financial instruments* and IAS 39 *Financial Instruments: Recognition and Measurement*, following the tentative decisions reached by the IASB at the meetings in February and March 2019.

In our *IFRS Developments 144* and *145*, we summarised the tentative decisions taken at these meetings and provided some background to the IBOR reforms. The IASB has not yet started to consider the issues arising from phase two of its project. Here we summarise the proposals in the ED and share our preliminary views.

The proposed amendments to IFRS 9

The ED proposes temporary exceptions from applying specific hedge accounting requirements.

For IFRS 9, the proposed amendments include a number of reliefs. The reliefs apply to all hedging relationships of interest rate risk that are affected by IBOR 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.

Application of the reliefs will be 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.

The reliefs are intended to be narrow in their effect. 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 a liability is repaid early due to the uncertainties arising from IBOR reform. 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 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.

The reliefs will continue indefinitely in the absence of any of the events described above. The Basis for Conclusions of the amendment sets out a number of different fact patterns, which could arise as contracts are amended in anticipation of IBOR reform, to illustrate when uncertainties due to IBOR reform will end. The key message appears to be that, in most cases, relief will only end when a contract is amended to specify both what the new benchmark will be and when it will take effect.

Disclosure considerations

Consistent with IFRS 7 *Financial Instruments: Disclosures*, separate information must be disclosed for hedging relationships to which any of the reliefs are applied. This information will include quantitative information for hedging instruments and hedged items on the carrying amount, change in fair value, nominal amount, for fair value hedges the carrying amount of the hedged item, and the accumulated amount of fair value hedge adjustments and the cash flow hedge reserve.

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, the Basis for Conclusions to the ED clarifies that 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 proposed amendments to IAS 39

The corresponding amendments to IAS 39 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 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.

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How we see it

The publication of the ED represents a significant milestone in the IASB's response to the financial reporting challenges arising from IBOR reform. We commend the IASB for prioritising this important topic and progressing their work to this stage.

The ED should successfully address many of the hedge accounting issues that have been identified as potentially problematic during the period before contracts are amended to new benchmark rates. Whilst there are some additional clarifications that the proposals would benefit from to enhance their clarity, these are relatively minor and our initial view is that the IASB has made good progress towards achieving its objective for the amendments.

However, it is now important for the IASB to turn its attention to phase two of the project and consider the financial reporting issues that will arise once the transitions to RFRs take place. The transition from IBOR to RFRs will likely occur at different times in different jurisdictions and for different financial instruments. There is a concern that contracts will begin to be amended before phase two is concluded. For instance, without reliefs that will hopefully be made available by phase two, any amounts in other comprehensive income for a cash flow hedge based on IBOR must be recycled to profit or loss as soon as IBOR uncertainty ends. Also, if the IASB can substantially address the questions posed by the second phase of IBOR reform, it will help provide entities with confidence on the financial reporting consequences and so help smooth the transition from IBOR to RFRs.