

Applying IFRS IBOR Reform

Updated May 2021

Contents

1. Introduction	3
1.1 Background	3
1.2 IFRS Amendments	5
2. Changes in the basis for determining the contractual cash flows	7
2.1 Changes in the rate of interest	8
2.1.1 Direct consequences of the Reform	9
2.1.2 Economically equivalent	10
2.2 Derecognition	14
2.2.1 Modification of financial instruments	15
2.2.2 Modification or replacement of derivative contracts	16
3. Classification	19
3.1 Classification of financial assets	19
3.2 Separation of embedded derivatives	21
4. Hedge accounting	22
4.1 Phase 1 reliefs	22
4.1.1 The Phase 1 reliefs for IFRS 9	22
4.1.2 End of Phase 1 reliefs for IFRS 9	24
4.1.3 Phase 1 reliefs for IAS 39	26
4.2 Phase 2 hedge accounting amendments	27
4.2.1 Phase 2 reliefs for IFRS 9	27
4.2.2 Phase 2 reliefs from discontinuing hedge relationships	27
4.2.3 Phase 2 relief for groups of items	31
4.2.4 Phase 2 temporary relief for designation of risk components	32
4.2.5 Determination of whether an RFR is a separately identifiable risk component	33
4.2.6 Determination of whether an RFR is a reliably measurable risk component	36
4.2.7 Phase 2 amendments for IAS 39	36
4.2.8 Determination of whether an RFR is a separately identifiable risk component under IAS 39	37
4.3. Application of Phase 2 reliefs	38
4.3.1. Fair value hedges	38
4.3.2 Cash flow hedges	41
5 Transition	45
5.1 Phase 1	45
5.2 Phase 2	45
5.3 End of Phase 2 reliefs	47
6. Disclosures	48
6.1 Phase 1	48
6.1.1 The existing IFRS 7 disclosure requirements	49
6.2 Phase 2	50
6.2.1 Application to loan commitments	52
6.2.2 Level of detail for different categories	52
6.2.3 Exposures within the scope of the disclosure	52
6.3 Sources of hedge ineffectiveness	55
6.4 Significant judgements	55
6.5 Transition disclosures	56
6.6 Interim reporting	56
7. Amendments to IFRS 16 <i>Leases</i>	58
8. Amendments to IFRS 4 <i>Insurance Liabilities</i>	59

What you need to know

- ▶ The Phase 1 Amendments (effective for years beginning after 1 January 2020, but with early application permitted) primarily permit the continuation of hedge accounting for hedge relationships that reference IBORs that are expected to be replaced by IBOR Reform.
- ▶ The main elements of the Phase 2 Amendments (effective for years beginning after 1 January 2021, but with early application permitted) are that, to the extent that modifications are made to financial instruments that are necessary to implement IBOR Reform and the new basis for calculating cash flows is 'economically equivalent' to the previous basis,
 - i) the effective interest rate (EIR) on floating-rate financial instruments is adjusted,
 - ii) the formal designation of hedge relationships is amended and hedge accounting will continue.
- ▶ To the extent that any additional modifications are made to financial instruments, it will be necessary to assess whether they would lead to the instrument's derecognition. If not:
 - i) For floating rate instruments not recorded at fair value through profit or loss, the net present value of the additional modification (discounted at the revised EIR) is recorded in profit or loss.
 - ii) Hedge accounting will only continue as long as the hedge is not required to be discontinued, applying the normal hedge accounting rules. If the hedge continues, the formal designation is amended, but there may in future be additional hedge ineffectiveness.
- ▶ This is the third edition of this publication. The main amendments and additions since the previous version reflect that the ISDA fallback spreads were fixed in March and it has been confirmed that non-US dollar LIBORs will cease to be published after December of this year. Also, it reflects new practical issues that have emerged as entities transition to the new RFRs.
- ▶ Both Phase 1 and Phase 2 introduce some significant new disclosure requirements
- ▶ IFRS 4 *Insurance Contracts* has been amended so that insurers who are still using IAS 39 *Financial Instruments: Recognition and Measurement* will obtain the same reliefs as other entities
- ▶ IFRS 16 *Leases* has also been amended to provide relief for the accounting by lessees for leases which refer to IBORs

1. Introduction

1.1 Background

One of the reforms mandated by the Financial Stability Board following the financial crisis was to push for benchmark InterBank Offered Rates (IBORs), such as LIBOR, to be replaced by new 'official' benchmark rates, known as alternative Risk Free Rates (RFRs), a process hereinafter referred to as 'IBOR Reform' or 'the Reform'.

Examples of RFRs that will replace IBORs include: Hong Kong dollar OverNight Index Average (HONIA), Swiss Average Rate OverNight (SARON), Secured Overnight Financing Rate (SOFR) for US dollar, Sterling OverNight Indexed Average (SONIA) and Tokyo OverNight Average (TONA) for Japanese Yen.

Non-US dollar LIBORs will no longer be published after the end of 2021 ...

In March 2021, the ICE Benchmark Administration (the administrator of LIBOR), in conjunction with the UK's Financial Conduct Authority (FCA) announced that it will stop publishing the following LIBOR settings based on submissions from panel banks, after 31 December 2021: all GBP, EUR, CHF and JPY LIBOR settings and the one-week and two-month USD LIBOR settings. All remaining USD LIBOR settings (i.e., the overnight and the one-, three-, six- and 12-month settings) will cease to be published based on panel bank submissions after 30 June 2023.

... but synthetic LIBORs may be published to manage tough legacy contracts.

The FCA, which regulates LIBOR, has indicated that it will consult in Q2 2021 on requiring the ICE Benchmark Administration to continue publishing certain LIBOR settings (i.e., one-, three- and six- months settings for GBP, JPY and USD) on a non-representative, 'synthetic' basis for some future period beyond the dates noted above¹. However, the FCA noted that these synthetic LIBORs are not for use in new contracts, but are intended to help reduce disruption for certain contracts that are particularly difficult to amend (often referred to as 'tough legacy' contracts).

Meanwhile, the Euro Overnight interest Average (EONIA) is being replaced by the Euro Short Term-Rate (ESTR). Reforms to the Euro Interbank Offered Rate (EURIBOR) methodology were completed in 2019, but the long-term sustainability of EURIBOR depends on factors such as whether the panel of contributing banks continues to support it and whether or not there is sufficient activity in its underlying market. Consequently, appropriate fallbacks for EURIBOR will be needed and there are currently mixed views as to whether EURIBOR is still in or outside the scope of the IFRS IBOR Reform Amendments.

The RFRs that have so far been introduced are overnight rates based on actual transactions and reflect the average of the interest rates that certain financial institutions pay to borrow overnight either on an unsecured basis (such as SONIA) or on secured overnight repurchase transactions (such as SOFR). The interest paid on an overnight RFR-based loan is calculated in arrears over a period, usually by compounding the daily rate. It is expected that at some point in the future, 'term' RFRs will be developed for use in certain circumstances, to allow borrowers to know in advance the interest they will pay for a period, in a

¹ This would involve using proposed new powers which are included in the Financial Services Bill as proposed amendments to the UK Benchmarks Regulation (BMR).

similar manner as for IBOR-based loans. An example would be the possible development of 3-month SOFR, i.e., the US dollar benchmark rate that would be fixed in advance for a three month period. While there is currently no specific timeframe on when term SOFR rates might be developed, the Alternative Reference Rates Committee in the USA has set a goal of having a robust, IOSCO-compliant, forward-looking term rate produced by a private administrator that could be used in commercial contracts. This will be permitted once the SOFR derivatives markets that the term rate would be based on have grown to sufficient depth.

On 23 October 2020, the International Swaps and Derivatives Association (ISDA) published its IBOR fallback protocol and supplements, which are designed to address transition for those derivative contracts still outstanding on the permanent cessation of an IBOR. However, derivative market participants are encouraged to amend or close out existing IBOR contracts before then, without waiting to use the fallback mechanism.²

Applying the ISDA fallbacks, as IBORs are available in multiple tenors (such as 3-month or 6-month) and they include a bank's credit risk premium for that period, whereas the RFR is an overnight rate, the transition will include an adjustment to the previous derivative contract rate, based on the average historical spread between the relevant IBOR and the compounded RFR over the previous five years (see section 2.1.2). These spreads are sometimes referred to as Credit Adjustment Spreads ('CAS'). The ISDA fallback spread adjustments became fixed on 5 March 2021.³ These include:

- ▶ USD 3-months 26.161bp
- ▶ Sterling 3-months 11.93bp
- ▶ Sterling 6-months 27.66bp
- ▶ Japanese Yen 3-months 8.35bp

It is likely that the synthetic IBOR rates for tough legacy contracts, that cannot easily be transitioned, will be calculated based on the RFR plus the ISDA spread.

Also during 2020, derivative clearing houses such as the Chicago Mercantile Exchange and the London Clearing House adopted RFRs as discount rates to value LIBOR derivatives. It should be stressed that amending the reference rate for derivative contracts does not affect their credit risk. Consequently, for uncollateralised derivatives, unless compensating changes are also made to the calculation of the Credit Valuation Adjustment (CVA), it does not follow that there will be a reduction in the discount rates used to value them.

The Reform will also affect future cash flows on non-derivative floating rate financial instruments, such as bonds and loans, currently referenced to IBOR. These will need to be bilaterally renegotiated, as will other transactions that reference IBORs, such as some leases. In each country, working groups have been formed to issue recommendations and assist market participants in the transition from IBORs, including fallback language, possible replacement rates and the related spread adjustment methodologies for different types of loans.

² ISDA: Understanding IBOR Benchmark Fallbacks, October 2020

³ These are published by Bloomberg.

1.2 IFRS Amendments

In 2018, the IASB added a project to its agenda to consider the financial reporting implications of the Reform. It identified two groups of accounting issues that could have financial reporting implications. These were:

- ▶ *Phase 1:* pre-replacement issues - issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an alternative RFR
- ▶ *Phase 2:* replacement issues - issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative RFR.

The IASB gave priority to the Phase 1 issues because they were more urgent and in September 2019, The Board issued *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7* (the Phase 1 Amendments) to address them. The Phase 1 Amendments provided a number of temporary exceptions from applying specific hedge accounting requirements of both IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* (see section 4 below), but also added some additional disclosure requirements to IFRS 7 *Financial Instruments: Disclosures* (see section 6).

The Phase 1 Amendments were effective for accounting periods beginning on or after 1 January 2020 and early application was permitted.

In August 2020, the IASB issued *Interest Rate Benchmark Reform Phase 2, Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16* (the Phase 2 Amendments). The Phase 2 Amendments provide the following changes in respect of financial instruments that are directly required by the Reform:

- ▶ A practical expedient when accounting for changes in the basis for determining the contractual cash flows of financial assets and liabilities, to require the effective interest rate to be adjusted (see section 2)
- ▶ Reliefs from discontinuing hedge relationships (see section 4)
- ▶ Temporary relief from having to meet the separately identifiable requirement when an RFR instrument is designated as a hedge of a risk component (see sections 4.2.4 and 5)
- ▶ Additional IFRS 7 disclosures (see section 6)

The Phase 2 Amendments also affected IFRS 16 *Leases* (see section 7) and IFRS 4 *Insurance Liabilities* (see section 8). The amendments to IFRS 4 are designed to allow insurers who are still applying IAS 39 to obtain the same reliefs as those provided by the amendments made to IFRS 9. Given the limited scope of the IFRS 4 amendments, this publication only provides references to IAS 39 in respect of hedge accounting, which is still applied by many entities.

The Phase 2 Amendments are effective for annual periods beginning on or after 1 January 2021 and early application is permitted (see section 5).

The IASB Amendments are mandatory for annual periods beginning on or after 1 January 2021.

This publication is the third edition of a guide to how the Amendments will be applied in practice, drawing upon our experience of working with clients.

How we see it

Now that the IFRS Amendments have been finalised and fallback protocols and transition basis spreads, such as those developed by ISDA, have begun to be published, entities need to complete their assessment of the accounting implications of the scenarios they expect to encounter as they transition from IBORs to RFRs and accelerate their programmes to implement the new requirements. The work required to negotiate the new terms for loans (especially where there are multiple parties to the contract such as syndicated loans) and to amend derivative valuation models may be substantial. Where the Phase 2 Amendments introduce new areas of judgement, entities need to ensure they have appropriate accounting policies and governance in place. For the additional disclosures, entities must ensure they can gather and present compliant information.

While most non-US dollar LIBORs will transition to RFRs during 2021, other IBORs (such as the Johannesburg InterBank Average Rate (JIBAR)) may transition at some further date in the future. The IFRS Amendments will apply on an instrument-by-instrument basis, and it is possible that, for some IBORs, application of Phase 2 will not happen until a number of years in the future.

2. Changes in the basis for determining the contractual cash flows

In its Phase 2 Amendments the IASB has identified four ways that changes in the basis for determining the contractual cash flows of a financial instrument might be made in order to achieve IBOR Reform⁴:

- ▶ By amending the contractual terms (for instance, to replace a reference to an IBOR with a reference to an RFR)
- ▶ Through activation of an existing fallback clause in the contract
- ▶ Without amending the contractual terms, by changing the way that an interest rate benchmark is calculated
- ▶ A hedging instrument may alternatively be changed as required by the Reform by closing out an existing IBOR-related derivative and replacing it with a new derivative with the same counterparty, on similar terms except referencing an RFR, or by combining the existing IBOR-related derivative with a new basis swap that swaps the existing referenced IBOR for the RFR.

The first two approaches are relatively self-explanatory. The third corresponds, for example, to the decision made in Europe in 2019 to redefine EONIA as ESTR plus 8.5bp and also to the changes made in 2019 to how EURIBOR is calculated. The IASB believes that changes in methods for calculating the interest rate may, in effect, represent a modification of the contractual cash flows.⁵ Some constituents expressed concern in response to the Exposure Draft for the Phase 2 Amendments (the Phase 2 ED) that general clarification on when modifications of contractual cash flows may occur could cause difficulties if a similar adjustment occurred outside of the scope of the Reform, when reliefs are not available. As a result, references to 'modification' have been removed from the final Phase 2 Amendments to IFRS 9 and reference is made instead to 'changes in the basis for determining contractual cash flows'. During discussions to finalise the Phase 2 Amendments, the IASB suggested it may initiate a project to clarify and improve the guidance on modifications of financial assets. This issue will, it is hoped, be considered again in that context.

The fourth method of making changes to the basis for determining contractual cash flows of an instrument, by replacing a hedging instrument, as described above, was added following responses to the Phase 2 ED. Many derivatives, especially those cleared through central clearing counterparties, may never be adjusted to achieve the Reform but, instead, be replaced by a new derivative on similar terms. (This is discussed in more detail in 2.2.2 below).

For all four changes, an entity needs to assess whether they are a direct consequence of the reform and result in economically equivalent new contractual cash flows.

If yes, then the reliefs applicable for the adjustment of the EIR (as described in section 2.1.) and for the continuation of hedging relationships (as described in section 4.2.2.) must be applied.

⁴ IFRS 9.5.4.6 and 6.9.2, as clarified by BC6.620 (a).

⁵ IFRS 9.BC5.297 to 299.

If the changes are not a direct consequence of the reform or do not result in economically equivalent contractual cash flows, it is first necessary to assess if the changes require the derecognition of the original instrument, as described in section 2.2.

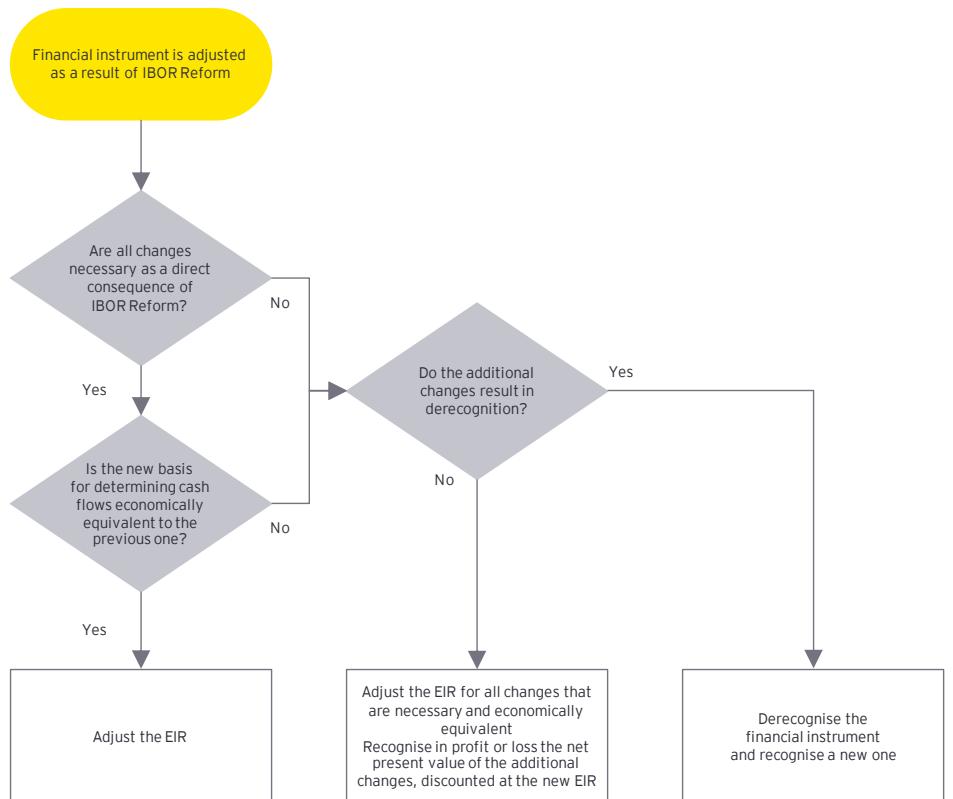
If derecognition is required, then the reliefs applicable to the EIR and the continuation of hedging relationships are not available.

If derecognition is not required by the changes, then the reliefs may be partially applicable:

- ▶ A modification gain or loss may need to be recognised after revising the EIR for instruments involving an EIR, as described in section 2.1.
- ▶ A hedging relationship may still continue, as described in section 4.2.2.

2.1 Changes in the rate of interest

The requirements are summarised in the following flow chart:



This section covers the application of the relief applicable to instruments with an EIR. However, because the two conditions required to apply this relief (i.e., the changes are a direct consequence of the Reform and the changes result in economically equivalent contractual cash flows) are the same as for the relief allowing the continuation of hedging relationships, the clarifications provided in this section on these two conditions are also applicable for the purpose of assessing continuation of hedging relationships (as further discussed in section 4.2.2.)

If an IBOR is amended to refer to an RFR, without the benefit of the amendments:

- ▶ First, the entity would have to assess whether the changes made to a financial instrument to achieve the Reform would lead to its derecognition
- ▶ Second, if the instrument is not derecognised and is recorded at amortised cost or at fair value through other comprehensive income, the entity would apply the requirements in paragraph 5.4.3 of IFRS 9 and recalculate the carrying amount of the financial instrument using the original effective interest rate (EIR), i.e., based on the IBOR before transition to the RFR.

The second of these would mean that interest revenue or expense would continue to be recognised using an IBOR-based EIR over the remaining life of the instrument, even though the IBOR may no longer be available. The Board considered that, in this context, this outcome would not necessarily provide useful information to users of the financial statements, as the interest recognised would not reflect the economic effects of changes made to a financial instrument as a result of the Reform.⁶

The IASB Phase 2 Amendments require changes to contractual cash flows due directly to the Reform to be treated as changes in a floating rate, if they meet two conditions.

Therefore, the Phase 2 Amendments require, as a practical expedient, for changes to cash flows that relate directly to the Reform to be treated as changes to a floating interest rate, i.e., the EIR is updated to reflect the change in an interest rate benchmark from IBOR to an RFR without adjusting the carrying amount. In effect, the change is treated as akin to a movement in the market rate of interest.⁷

The use of the practical expedient is subject to two conditions⁸:

- ▶ First, the change in the basis for determining contractual cash flows must be a 'direct consequence of the Reform'
- ▶ Second, the new basis for determining the contractual cash flows must be 'economically equivalent' to the previous basis immediately preceding the change

Each of these conditions is discussed, in turn, below.

It should be noted that the addition of a fallback provision and the activation of a fallback provision are both treated in the Phase 2 Amendments as changes to the basis for determining contractual cash flows. This implies that if a financial instrument is, first, amended to add a fallback provision and, second, this provision is activated, then the Phase 2 practical expedient will be applied twice. However, applying the expedient, the accounting effects arise only on activation. Some 'hardwired' fallbacks specify two transitions, first to an overnight RFR and second, to a term RFR when it becomes available. Presumably, Phase 2 reliefs will be available for each transition.

2.1.1 Direct consequences of the Reform

There is limited guidance in the Phase 2 Amendments as to what changes for determining contractual cash flows would be a direct consequence of the Reform. In Phase 1, the IASB defined IBOR Reform as 'the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations of the Financial Stability Board's July 2014 report, *'Reforming Major interest Rate Benchmark.'*⁹ IBOR Reform can, therefore, be read to encompass any replacement of references to an IBOR with a rate

⁶ IFRS 9.BC5.306.

⁷ IFRS 9.5.4.7.

⁸ IFRS 9.5.4.7.

⁹ IFRS 9.6.8.2 and IAS 39.102B.

considered acceptable by local regulators, such as an RFR, and any related amendments necessary to implement the Reform, including those needed to achieve economic equivalence (see 2.1.2).

Some respondents to the Phase 2 ED asked the question as to whether the reliefs are only available if, in the particular jurisdiction, IBOR Reform is mandated by laws or regulations. Consequently, they would not be available if, for example, financial instruments were modified only because of a concern that the IBOR may, in future, be discontinued due to reduced liquidity or to align with global market developments. In the Phase 2 Amendments' Basis for Conclusions, the IASB has clarified that, while the changes must be a direct consequence of the Reform, they do not, in themselves, have to be mandatory.¹⁰

2.1.2 Economically equivalent

According to the Amendments, examples of where changes would be 'economically equivalent' include¹¹:

1. The addition of a fixed spread (i.e., a CAS) to compensate for the basis difference between an existing IBOR and the alternative RFR. For example, the floating rate on a debt instrument for which the coupon was previously based on IBOR plus 100 basis points may be replaced with a coupon that is based on RFR plus 120 basis points, when the basis spread between IBOR and the RFR is 20 basis points. The basis difference arises mainly because the RFRs are overnight rates whereas IBOR is a term rate, such as a 3-month IBOR, and so includes the credit risk of lending to banks over this period. Further, some RFRs, such as SOFR, are secured rates and so involve even less credit risk.
2. Changes to the reset period, reset dates or the number of days between coupon payment dates that are necessary to effect the Reform. For example, an interest rate previously based on a 3-month term IBOR rate paid quarterly may be replaced with one based on an RFR compounded over 3 months and paid quarterly, or an RFR compounded over one month and paid monthly.
3. The addition of a fallback provision that specifies the hierarchy of rates to be used in the event that the existing rate ceases to exist.

It will be clear from this list that 'economically equivalent' does not mean 'economically identical'. The IASB also makes it clear that it regards 'economic equivalence' to be principle-based and the above list is not intended to be exhaustive.¹² For instance, it would be consistent with these examples to include amendments to caps and floors so as to maintain their economic effect (see Example 1).

The Basis for Conclusions also clarifies that, while the notion of economic equivalence means that the interest rate will be substantially the same before and after the replacement, as long as the changes are consistent with the above examples, there is no requirement to demonstrate this is the case through a quantitative analysis ("the entity would not be required to analyse whether the discounted present value of the cash flows of that financial instrument are

¹⁰ IFRS 9.BC5.313.

¹¹ IFRS 9.5.4.8.

¹² IFRS 9.BC5.315 and 317.

substantially similar before and after the replacement").¹³ Accordingly, the IASB set no 'bright lines' and an entity is required to apply judgement to assess whether circumstances meet the economic equivalence condition.

The challenges associated with determining an appropriate method for calculating the basis spread between RFRs and IBORs on transition are illustrated well by the process through which ISDA arrived at its derivative fallback protocol for the cessation of LIBOR. ISDA set out the following criteria:

- i) minimising value transfer at the time the fallback is applied
- ii) minimising any potential for manipulation
- iii) eliminating or mitigating against the impact of market disruption at the time the fallback is applied

ISDA consulted on three possible approaches to set the spread, noting that they each satisfied these criteria to varying degrees:¹⁴

1. Arguably the most 'economically equivalent' approach, in that it would be present value neutral, would be to base the spread on the forward market view of the spread between the IBORs (for each tenor, such as 3-months or 6-months) and the RFR at the date of calibration. However, this approach would be complicated, and the necessary data is unlikely to be readily available. The forward approach would require a forward IBOR curve and a forward RFR curve for the term of all financial instruments and so potentially out to 40 or 50 years. This would require both an established RFR market as well as extensive market data, which does not currently exist.
2. The simplest approach would be what is termed the 'spot' method. This bases the spread adjustment on the spot spread between the relevant IBOR and the adjusted RFR on the day before the fallback provisions are triggered. This approach is likely to ensure that the current rate of interest is 'substantially the same'. Its disadvantages are not only that it does not reflect the market expectations on forward rates (and so will not be present value neutral on the date of calibration), but it is likely to be more volatile than a forward spread.
3. The majority of respondents to ISDA's consultation preferred what became the adopted approach, using the median historical spread between the relevant IBOR and the compounded RFR over the previous five years. It was recognised that this "is unlikely to be present value neutral on the calibration date because spot rates are unlikely to be consistent with forward rates and because the average historical market conditions may not match market expectations for future market conditions". However, it has two major advantages: first, it is less volatile than spot rates and captures the tendency of interest rates to fluctuate around a long-term mean and, hence, is likely to be a better approximation to the forward spread; and, second, it is based on readily available information.

¹³ IFRS 9.BC5.315-316.

¹⁴ ISDA Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA definitions, Consultation on certain aspects of fallbacks July 2018.

It is likely that the ISDA methodology for determining the spread will be applied more broadly to the transition of many non-derivatives to RFRs. As has already been mentioned in Section 1, the ISDA fallback spreads were 'fixed' on 5 March 2021.

For many financial instruments, the changes needed to transition to an RFR will require negotiation between the two parties to the contract and it is possible that the agreed modifications may go further than those needed just to implement the Reform. After an entity applies the practical expedient to modifications to the financial instrument required by the Reform, it then separately assesses any further modifications that are not required by the Reform to determine whether they result in derecognition of the financial instrument (see 2.2 below). If they do not result in derecognition, an entity uses the updated EIR to adjust the carrying amount of an instrument not recorded at fair value through profit or loss, and immediately recognises a modification gain or loss in profit or loss.¹⁵

Examples of possible changes that would most likely not be viewed as economically equivalent, include:

- ▶ Changes to the principal or notional value
- ▶ Changes in maturity and methods of repayment (such as a move from a bullet repayment to by instalment)
- ▶ Changes in credit spread to reflect changes in the credit quality of the obligor
- ▶ The addition or removal of caps and floors, prepayment and extension options

The introduction of, or amendments to, floors to floating rates could be challenging.

One particular area that may cause challenges is the introduction of, or adjustment of floors to financial instruments on transition to RFRs. This is especially relevant given that risk free interest rates are presently so close to zero or even negative. A simple example, where a floor is modified so as to give the same economic effect as before transition, is illustrated in Example 1. For more complex fact patterns, which might involve introducing a floor where none was present before, or resetting the floor so that the RFR cannot go below zero, and which may also involve an amendment to the spread or a cash compensation paid to the lender, the assessment will be more difficult. The analysis will depend on whether the modification is considered to be required by the Reform and whether the effect is economically equivalent. The addition of a floor is unlikely to be viewed as economically equivalent unless the likelihood of the floor being activated is insignificant. The Amendments provide only limited guidance, and this is an area where accepted practice has yet to develop.

Another challenging issue is whether any cash settlement between the parties to a contract on transition, to compensate for the difference in fair value of a financial instrument, would automatically imply that the change is not economically equivalent. As already noted, 'economic equivalence' does not mean 'economically identical', and the guidance states that interest rates must be 'substantially similar', implying that there is a level of tolerance as to what changes would meet the criterion. As described in more detail in section 2.2.2,

¹⁵ IFRS 9.5.4.9.

in the context of modification or replacement of derivatives, an example is included in the Basis for Conclusions where replacing a derivative with a new one on current market terms, with cash settlement for the difference in fair value, would not be regarded as economically equivalent. However, in this example, the contractual terms of the new at-market derivative are described as 'substantially different'. In contrast, another example regarded as economically equivalent involves no cash settlement and the replacement of the original derivative with an off market derivative with identical terms other than the replacement RFR. A situation involving some cash settlement could fall between these two extremes, provided the amount of cash settlement is judged to be relatively small. When considered against the contractual cash flows of the original instrument, the new instrument could arguably still be considered economically equivalent. This is an area where practice is developing and the application may require considerable judgement, especially when considering derivatives.

These requirements are illustrated in Example 1 below and also in Examples 6 to 8 in section 4.3.

Example 1 Application of the Phase 2 relief for amendment of a floor

An existing short-term loan pays 3-month US dollar LIBOR + 100 bp, with a floor of LIBOR = zero. It is restructured to pay SOFR + 126bp, when 26bp is determined to be the market basis difference between 3-month LIBOR and SOFR. (26bp is based on the ISDA fallback spread although rounded to simplify the example). The floor is amended to SOFR + 26bp = zero. Both before and after transition, including the credit spread, the loan has an effective floor of 100bp.¹⁶

The amendment of the instrument, including the floor, is a direct consequence of IBOR Reform and the new terms are assessed to be economically equivalent to the old ones, as the only adjustment is to replace 3-month LIBOR with SOFR plus the market basis difference, with an equivalent adjustment to the floor and the difference in volatility between the two floors is considered negligible. Therefore, Phase 2 paragraph 5.4.7 relief is applied, the EIR is amended to SOFR + 126bp and there is no need to consider any other accounting consequences.

¹⁶ In practice, there might also be a further minor adjustment to the spread to reflect the difference in volatility of an RFR-based floor compared to an IBOR-based floor, but this is ignored for the purpose of this example.

How we see it

Because of the practical expedient, transition to RFRs will generally result in a change in the EIR for floating-rate financial instruments recorded at amortised cost or at fair value through OCI. However, many financial instruments such as loans will need to be renegotiated bilaterally and entities will need to establish policies and procedures to avoid, or else identify, any modifications over and above those required by the Reform and to ensure that they are accounted for appropriately.

The term 'economically equivalent' is not defined in the Phase 2 Amendments. Whilst the IASB's intention is that the assessment should be predominantly qualitative in nature, entities will need to develop an accounting policy and processes to ensure that the assessment can be carried out consistently in a suitably controlled manner. Associated with this, entities may wish to review how their existing accounting policy for modifications of financial instruments is determined and applied in practice.

In general, any transition that is economically equivalent is likely to share three main characteristics.

- ▶ The new basis for determining contractual cash flows should be qualitatively similar to the previous one.
- ▶ The amendment should be designed to help ensure an equitable transition to an RFR for both parties to the contract. This will, in theory, most easily be demonstrated if the amendment is in accordance with an industry-accepted protocol designed with this objective.
- ▶ An economically equivalent transition should involve no significant change in a financial instrument's fair value. Therefore, any adjustment to the spread other than to reflect the difference between RFRs and IBORs on transition, or a payment by one party to the other, to compensate for a change in terms, which is not small when compared to the original contractual cash flows, may indicate that the terms are not economically equivalent and will require careful analysis.

Any approach to adjust the spread would also have to be practical to apply and make use of data that is reliable and readily available. Because of limitations on the availability of data, it is likely that there will be more than one acceptable method for determining the spread between IBOR and an RFR. The types of approaches explored by ISDA and described above can, in theory, all result in transitions which are economically equivalent.

While approaches such as that developed by ISDA are based on quantitative analysis, as long as it can be demonstrated that the contractual terms will remain substantially the same, it will not normally be necessary to make a quantitative evaluation for each transition.

2.2 Derecognition

It is possible that amendments made to financial instruments on transition to RFRs may lead to their derecognition and the recognition of a new instrument. Assessing whether derecognition is required may have a significant consequence for their accounting treatment. For a financial instrument that is

not measured at fair value through profit or loss, the possible outcomes of this assessment include a profit or loss on derecognition, the classification of the new instrument, the measurement of the EIR, and its staging if subject to the expected credit loss impairment requirements. Meanwhile, for all financial instruments, including derivatives, the derecognition assessment may be critical for the continuation or discontinuance of hedge accounting.

2.2.1 Modification of financial instruments

The issue as to when a modification of a financial instrument might lead to its derecognition is specifically addressed in IFRS 9 only for financial liabilities and not for financial assets. The key requirement for financial liabilities is that a modification that results in a 'substantial change' in the expected cash flows will lead to the derecognition of the original liability and the recognition of a new one.¹⁷ There is no equivalent guidance in IFRS 9 for modifications of financial assets, although, in 2012, the IFRS Interpretations Committee, in discussing the restructuring of Greek Government Bonds, considered that it would be appropriate in that fact pattern to apply the guidance for financial liabilities, by analogy.¹⁸ This is an area which requires judgement and many entities will have already developed an appropriate accounting policy.

There is no need to assess derecognition if changes to a financial instrument meet two conditions.

The Phase 2 Amendments only require an assessment of whether the derecognition criteria apply if changes are made to the financial instrument beyond those that qualify for the practical expedient (see 2.1 above). This will be the case if:

- ▶ The change in the basis for determining contractual cash flows is a direct consequence of the Reform
- ▶ The new basis for determining the contractual cash flows is economically equivalent to the previous basis immediately preceding the change

It follows that changes that qualify for the practical expedient will not be regarded as sufficiently substantial that the instrument would be derecognised.¹⁹

How we see it

For any changes that are made to a financial instrument that go beyond what is necessary to implement IBOR Reform, entities will need to assess whether the instrument should be derecognised and a new one recognised instead. The Amendments provide no further guidance on what level of modification would be viewed as sufficiently substantial as to lead to derecognition and this assessment will require judgement and possibly the refinement of existing policies and processes to implement the assessment. While IFRS 9 states that a 10% change in the net present value of contractual cash flows of a liability would be considered substantial²⁰, it is recognised that the assessment should also have regard to qualitative factors, such as the introduction of new contractual features.

¹⁷ IFRS 9.3.3.2.

¹⁸ IAS 8.11.

¹⁹ IFRS 9.5.4.9 .

²⁰ IFRS 9.B3.3.6.

2.2.2 Modification or replacement of derivative contracts

The fourth method of changing the basis for determining contractual cash flows has already been introduced at 2 above: the close-out and replacement of a derivative with the same counterparty and on the same terms, or the addition of a basis swap. As set out in the Basis for Conclusions, the IASB was concerned that the substance of the arrangement should determine the accounting treatment, rather than its form and examined four scenarios.²¹

The first scenario involves the counterparties to an IBOR derivative entering into two new derivatives, one derivative equal and offsetting the original IBOR-based derivative so as to close it out with no gain or loss and a second derivative that references the RFR, but otherwise with the same terms as the original derivative so that it has an equivalent fair value.²² According to the IASB's analysis, the counterparty to the new derivatives is the same as to the original derivative, the original derivative has not been derecognised and the terms of the alternative benchmark rate derivative are not substantially different from that of the original derivative. The Board, therefore, concluded that such an approach could be regarded as consistent with the changes required by the Reform and, hence, the Phase 2 hedge accounting reliefs will apply (see 4.2).

If the original derivative is not legally extinguished, this implies that all three derivatives - the original IBOR derivative and the two new ones - would need to be designated together as the hedging instrument. However, in practice, it is likely that the counterparties to the original derivative and the second one which closes it out, will choose to legally extinguish the two derivatives. The process for extinguishing derivatives cleared by a central clearing counterparty is known as 'compression'. In that case, applying the derecognition guidance for liabilities,²³ the original derivative may be treated as modified rather than as derecognised, since it is an exchange with the same counterparty and does not constitute a 'substantial modification' of the original terms. The relief criterion in paragraph 6.9.2(b), that the original hedging instrument is not derecognised, would, therefore, be considered to be met. This approach would also be consistent with the IASB's focus on the substance rather than the legal form, given that it will make no difference to the subsequent net cash flows, whether or not the derivative is legally extinguished.

In contrast, in the second scenario examined by the IASB, the original IBOR derivative is terminated and the unrealised gain or loss settled in cash, and a new RFR derivative is entered into on substantially different terms reflecting the current market rate. Because the IBOR derivative has been extinguished and replaced with a new one on substantially different terms, the IASB considered that this is not consistent with the changes required by the Reform and so the Phase 2 hedge accounting relief on continuation of the hedging relationship will not apply. This analysis implies that the first derivative would be derecognised and the second one recognised in its place.²⁴

²¹ IFRS 9 BC6.619.

²² IFRS 9.BC6.620 (a).

²³ IFRS 9.3.3.2.

²⁴ IFRS 9.BC6.620 (b).

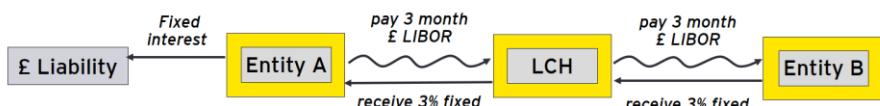
In the third scenario, the entity enters into a new basis swap, specific to a particular derivative instrument, which swaps the existing interest rate benchmark for that instrument to the RFR. This is viewed by the IASB as economically equivalent to modifying the contractual terms of the original instrument, as long as the basis swap is linked or coupled with the original derivative rather than being entered into at a portfolio level.²⁵ The scenario does not specify whether the basis swap needs to be with the same counterparty as the original derivative and it is unclear whether this should be assumed or whether the omission is deliberate.

In a fourth scenario considered by the IASB, it clarified that novating an IBOR-based derivative to a new counterparty and subsequently amending the derivative with that counterparty to refer to an RFR, would result in extinguishment of the original derivative.²⁶ This is because novation of a derivative would result in the derecognition of the original derivative. The Phase 2 hedge accounting reliefs will, therefore, not apply.

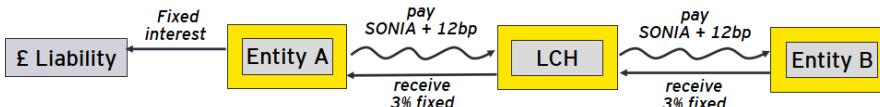
The process of modifying a derivative is illustrated in Example 2.

Example 2 Modification of a derivative

Entity A is a party to a swap (swap 1) with a notional value of £10 million and a remaining five years maturity on which, quarterly, it pays sterling 3-month LIBOR (fixed in advance at the beginning of the quarter) and receives 3% fixed. When first traded with Entity B, the swap was novated to the London Clearing House (LCH), which thereby serves as the swap counterparty to both A and B. A designates the swap as the hedging instrument in a fair value hedge of a fixed rate sterling liability.



In October 2021, Entities A and B choose to amend swap 1 in order to transition it to SONIA, at a time when the basis difference between 3-month LIBOR and overnight SONIA for this instrument is determined to be 12 basis points (based on the ISDA fallback protocol, although rounded to simplify the example) (see 2.1.2) . A and B enter into two new swaps, swap 2 with terms equal and opposite to those of swap 1, plus a new SONIA swap, swap 3. Swap 3 has the same notional value and remaining term to maturity as swap 1 and continues to pays 3% fixed, but A makes a quarterly payment of SONIA + 12bp (compounded daily).



²⁵ IFRS 9.BC6.621 (d).

²⁶ IFRS 9.BC6.621 (d).

Example 2 Modification of a derivative (continued)

Swaps 2 and 3 are novated to the LCH and A and B elect to compress the two offsetting LIBOR swaps (i.e., swaps 1 and 2). This gives rise to no profit or loss or net cash flow but legally extinguishes the two swaps. Because the net effect of the transaction is to exchange swap 1 with swap 3, with the LCH being the counterparty to both swaps, swap 1 is treated as modified by the exchange rather than derecognised. Consequently, the replacement qualifies to be assessed as to whether hedge accounting can continue, as described in section 4.2.2.

How we see it

The first two scenarios for the replacement of swaps discussed in the Basis for Conclusions are intended to represent two ends of a spectrum. The first illustrates where the terms of the new RFR derivative are the same as the old IBOR one, except that it now references the RFR with the addition of an appropriate spread, while in the second scenario, the terms are substantially different. It follows that there may be intermediate fact patterns, where the derivative may be amended more than is strictly necessary to transition to the RFR, without the terms being substantially different. Hence, the derivative will still not be derecognised. Assessing whether the terms are substantially different will require the development of policies and processes to make the assessment and the application of judgement.

3. Classification

3.1 Classification of financial assets

Any new financial assets, or any that have been derecognised and a new one recognised because they have been subject to substantial modification (see 2.2 above), will need to be classified to determine their accounting treatment. A financial asset may only be accounted for at amortised cost or at fair value through other comprehensive income (FVOCI) if, at original recognition, the cash flows represent Solely Payment of Principal and Interest (SPPI).²⁷

As part of the IBOR Reform project, in October 2019²⁸, the IASB considered whether, if IBORs are replaced with backward-looking term rates (such as a rate for the next six months based on the average overnight rate for the previous six months), this would cause instruments to fail the SPPI assessment.

The IASB noted that there are no specific conditions or exceptions that would automatically disqualify contractual cash flows to be SPPI. Any assessment of interest should focus on what the entity is being compensated for (i.e., whether the entity is receiving consideration for basic lending risks, costs and a profit margin). The IASB concluded that the current guidance in IFRS 9 provides an adequate basis to determine whether alternative benchmark rates are SPPI and that, provided the interest rate continues to reflect the time value of money and does not reflect other risks and features, the new instrument should pass the SPPI assessment.

Entities will, therefore, need to apply judgement in assessing whether there are any modifications to the time value of money element in replacement RFRs and, if there are, whether these modifications will cause a financial asset to fail the SPPI test.

This principle is illustrated by two examples, for SONIA (Example 3) and Adjustable Rate Mortgages (Example 4).

Example 3 SPPI evaluation for SONIA

SONIA is replacing sterling LIBOR as the risk-free rate for sterling loans. Whilst LIBOR is forward-looking, SONIA is backward-looking. SONIA is a daily rate and daily SONIA rates are compounded to determine the rate for an interest payment period such as three months. The interest to be paid is, therefore, only known at the end of the interest period. To facilitate timely payment of interest, it is useful for borrowers to know in advance what amount of interest is required to be paid. As such, the interest is determined five working days prior to the interest payment date, based on the compounded rate over a period starting and finishing five business days before the interest period begins and ends. In this instance, an entity may be able to assess from a qualitative perspective that there is no significant modification to the time value of money and, hence, the financial asset meets the SPPI criterion.

²⁷ IFRS 9.B4.1.7-26.

²⁸ IASB Update, October 2019, IASB staff paper 14B, Project IBOR Reform and its Effects on Financial Reporting—Phase 2, Paper topic: Accounting implications from derecognition of a modified financial instrument, pp.30-50.

Example 4 SPPI Evaluation for Adjustable Rate Mortgages (ARMs)

ARMs are US dollar floating rate mortgages, that have historically been reset once a year, 45 days in advance of the period, and often based on LIBOR. After transition, it is recommended by the Alternative Reference Rates Committee (ARRC) that rates will be reset 45 days in advance, every six months, based on a 30-day compounded SOFR average plus a spread adjustment. The recommended spread adjustment is similar to that introduced by ISDA in its fallback for derivatives (see 2.1.2).

It was not the intent of the ARRC to introduce features that deviate from the time value of money. Rather, it has sought to achieve the optimal lending terms, considering the needs of both issuers and investors. The market is familiar with a rate that is fixed in advance once a year and the frequency of reset has been amended to once every six months, in order to continue to provide certainty as to the next interest payment, and also to make the rate more responsive to changes in market rates. The rate is calculated 45 days in advance, consistent with previous practice, and given that there are, as yet, no term SOFR rates, the rate is based on overnight SOFR plus a spread adjustment. The 30-day average has been chosen to smooth out day-to-day SOFR volatility. Meanwhile, the spread adjustment is designed to reconcile SOFR (collateralised) to LIBOR (uncollateralised) and to capture the theoretical forward interest rate curve out to 6 months.

On the basis that the lender is being compensated only for credit risk and the time value of money, with a profit margin, and based on the quantitative analysis performed by the ARRC and published together with their recommendations to document their thought process²⁹, it can be assessed qualitatively that an ARM will satisfy the SPPI criterion and may be recorded by the lender at amortised cost or at fair value through OCI, depending on the IFRS 9 business model.

²⁹ Options for using SOFR in Adjustable Rate Mortgages, The Alternative Rates Committee, July 2019.

3.2 Separation of embedded derivatives

In October 2019, the IASB also considered in the context of its IBOR project, whether any amendment to IFRS 9 was required to clarify if fallback provisions added as a result of the Reform should be separated from a host financial liability as an embedded derivative.

In the context of the Reform, fallbacks arise where the contractual terms of financial instruments contemplate the replacement of an established interest rate benchmark with an alternative interest rate benchmark. Such a contractual term may involve basing the new rate of interest on the overnight RFR plus a spread or, as with US Adjustable Rate Mortgages, may be based on an average of the RFR determined over a period, and set in advance (see Example 4).

Given that the separation of embedded derivatives is only assessed when a financial liability is first recognised, the issue is only relevant for new financial liabilities and those that have been substantially modified such that a new financial instrument is recognised. If the economic terms of the financial instrument are affected by the fallback, there is a risk that it may not be closely related to the economic characteristics and risks of the host contract. Where this is the case, the fallback will need to be separated and accounted for as an embedded derivative.

In finalising the Phase 2 amendments, the IASB concluded that existing IFRS provides an adequate basis to determine the accounting for fallbacks that may arise in the context of interest rate benchmark reform. Applying the guidance in IFRS 9.B4.3.8(a), when a new financial liability is recognised, entities should assess whether the fallback could at least double the initial return and result in a rate of return that is at least twice what would be expected for a similar contract at the time the fallback takes effect. This assessment is often referred to as the 'double-double test'.

How we see it

The vast majority of fallbacks added to financial liabilities in the context of the Reform should not require separation as an embedded derivative. This is because such fallbacks will normally be consistent with the financial instrument transitioning to an alternative RFR on an economically equivalent basis. When the fallback is triggered, application of the practical expedient results in the transition being reflected as a change to a market rate of interest. The fallback is, therefore, clearly and closely related to the debt host contract and should not be separated as an embedded derivative.

4. Hedge accounting

4.1 Phase 1 reliefs

The Phase 1 reliefs apply to all hedging relationships that are directly affected by uncertainties due to the Reform, regarding the timing or amount of interest rate benchmark-based cash flows of the hedged item or hedging instrument (i.e., uncertainty about what the new benchmark will be and when it will take effect).³⁰ However, if the hedged item or hedging instrument is designated for risks other than just interest rate risk, the exceptions only apply to the interest rate benchmark-based cash flows. The relief does not, therefore, apply to net investment hedges, as the hedged item must have interest-based cash flows to be eligible.

In this section, we first describe the reliefs for hedge accounting in accordance with IFRS 9. At section 4.1.3 below, we set out the differences for entities still applying IAS 39 for hedge accounting.

4.1.1 *The Phase 1 reliefs for IFRS 9*

The Phase 1 reliefs address the uncertainties caused by IBOR Reform.

Application of the reliefs is mandatory.³¹ The first three reliefs for IFRS 9 provide for:

1. The assessment of whether a forecast transaction (or component thereof) is highly probable³²
2. Assessing when to reclassify the amount in the cash flow hedge reserve to profit and loss³³
3. The assessment of the economic relationship between the hedged item and the hedging instrument³⁴

On application of each of these reliefs, it must be 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 the Reform.

It is possible that the designated hedged item is an IBOR risk component of a financial instrument. To be an eligible risk component, it would have to be 'separately identifiable' and 'reliably measurable'.³⁵ The fourth relief provides that, where a benchmark component of interest rate risk has been designated as the hedged item and it is affected by the Reform, the requirement that the risk component is separately identifiable need be met only at the inception of the hedging relationship.³⁶ Hence, as long as the IBOR was considered to be separately identifiable when the hedge relationship was first established, the IBOR will continue to qualify as a risk component even if the IBOR ceases to be separately identifiable. (The issue of whether a benchmark rate is separately identifiable is considered further in sections 4.2.4 and 5 below).

³⁰ IFRS 9.6.8.1.

³¹ IFRS 9.7.1.8.

³² IFRS 9.6.8.4.

³³ IFRS 9.6.8.5.

³⁴ IFRS 9.6.8.6.

³⁵ IFRS 9.6.3.7(a).

³⁶ IFRS 9.6.8.7.

The Basis for Conclusions also clarifies that if IBOR cash flows have been designated as the hedged item in a cash flow hedge, the entity should continue to measure ineffectiveness based on the IBOR-based cash flows. However, the Basis for Conclusions also states that if the entity has chosen to measure changes in fair value of the IBOR cash flows using a 'hypothetical derivative', the hypothetical derivative should be measured using a market-based discount rate that reflects market participants' assumptions about the uncertainty arising from the Reform.³⁷ This would be consistent with the rate which market participants would apply to actual IBOR derivatives used as hedging instruments. Therefore, there should be no increase in hedge ineffectiveness.

Example 5: Application of Phase 1 relief

Entity A is hedging an eight-year floating rate borrowing referenced to 3-month US LIBOR, and it is known that any interest coupons payable after the loan has been amended to implement the Reform, will not be determined with reference to US LIBOR, but according to the new RFR. The borrowing was previously designated in a cash flow hedge of 3-month US LIBOR interest rate risk. It is not yet known how the amendment will be achieved or when it will occur. Therefore, there is still uncertainty due to the Reform about the timing or amount of interest rate benchmark-based cash flows of the loan and the associated hedging instrument. While the uncertainty exists, the Phase 1 Amendment requires Entity A to ignore that fact and assume the hedged interest coupons on the borrowing and associated hedging instrument will remain US LIBOR-based cash flows for the purposes of assessing and measuring effectiveness.

For 'dynamic' or 'macro' hedging strategies (i.e., where hedging instruments and hedged items may be added to or removed from an open portfolio in a continuous hedging strategy, resulting in frequent de-designations and re-designations) the entity need only satisfy the separately identifiable requirement when hedged items are initially designated within the hedging relationship. The entity does not subsequently need to reassess this requirement for any hedged items that have been re-designated.³⁸

However, the Phase 1 Amendments do not provide any relief from the requirement that changes in the fair value or cash flows of the risk component must be reliably measurable.³⁹

The reliefs are intended to be narrow in their effect, such that other than the specific reliefs provided, the usual requirements within the IFRS 9 hedge accounting guidance must be applied. 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 an entity decides not to issue forecast debt due to the uncertainties arising from the Reform.⁴⁰ 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.⁴¹

³⁷ IFRS 9.BC6.570.

³⁸ IFRS 9.6.8.8.

³⁹ IFRS 9.BC6.575.

⁴⁰ IFRS 9.BC6.560.

⁴¹ IFRS 9.BC6.567, BC6.568.

4.1.2 End of Phase 1 reliefs for IFRS 9

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

- ▶ For relief one, when the hedging relationship that the hedged item is part of is discontinued
- ▶ For relief two, when the entire amount accumulated in the cash flow hedge reserve has been reclassified to profit and loss⁴²

Relief three ceases prospectively, as follows:

- ▶ For a hedged item when the uncertainty arising from the Reform is no longer present with respect to the timing and amount of IBOR-based cash flows of the hedged item
- ▶ For a hedging instrument, when the uncertainty arising from the Reform is no longer present with respect to the timing and amount of IBOR-based cash flows of the hedging instrument
- ▶ If the hedging relationship is discontinued before either of the two above events occur, at the date of discontinuation⁴³

When an entity designates a group of items as the hedged item, the end of relief requirements would be applied prospectively to each individual item within the designated group of items.⁴⁴

Relief four ceases either when the formal designation of the hedge relationship is amended, applying the Phase 2 relief (see 4.2 below) or when the hedging relationship is discontinued, applying the normal IFRS 9 discontinuation guidance. This means that until either of these occur, the risk component may continue to be designated, even if it is no longer separately identifiable. This is particularly relevant for fair value hedges as the hedged items will generally not need to be amended for the Reform.⁴⁵

The reliefs will continue indefinitely in the absence of any of the events described above. The Basis for Conclusions sets out a number of different fact patterns, which could arise as contracts are amended in anticipation of the replacement of an interest rate benchmark, to illustrate when uncertainties due to the Reform will end.⁴⁶ The key message is 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. As already mentioned, as the relief is applied on a contract-by-contract basis, for some IBORs, such as JIBAR, the uncertainty may continue for a number of years.

Because the Phase 1 reliefs only cease to apply once there is no longer uncertainty over both which benchmark will apply and when it will be applied, it follows that agreement of a fallback arrangement will not in itself end the uncertainty and so does not bring an end to the Phase 1 relief, unless it specifies both the method and date of transition.

⁴² IFRS 9.6.8.9, 6.8.10.

⁴³ IFRS 9.6.8.11.

⁴⁴ IFRS 9.6.8.12.

⁴⁵ IFRS 9.6.8.13.

⁴⁶ IFRS 9.BC6.587-59.

Because the FCA has announced that most LIBOR settings will cease at the end of 2021 and ISDA has now fixed the basis spreads that will be applied to the RFR on transition under the fallback protocol (see Section 1), the question arises as to whether there remains any uncertainty with respect to the amount or timing of IBOR Reform, and hence whether Phase 1 has now ended. As noted in IFRS 7.24H(d), deciding whether there remains uncertainty is a judgement that entities will need to make and disclose if the effect is material. In making this judgement the following factors are relevant:

- ▶ If the hedged item is floating rate but is not subject to the ISDA transition protocol and will require bilateral negotiation, there is still uncertainty as to amount and timing
- ▶ While the LIBORs will cease to be published based on the panel bank submissions after 31 December 2021, the FCA has stated that it may bring the date forward if there is insufficient market liquidity
- ▶ Meanwhile, as mentioned earlier, the FCA may still require the ICE Benchmark Administration to continue publishing certain LIBOR settings (i.e., one-, three- and six- months settings for GBP, JPY and USD) on a non-representative, 'synthetic' basis for some future period beyond December 2021 to help deal with 'tough legacy' contracts
- ▶ Entities may also choose to transition earlier than the date of cessation and the London Clearing House (LCH) in its circular of 18 March 2021 reiterated its recommendation that its members transition cleared derivatives ahead of the fallback date, in which case they are not obliged to use the ISDA fallback spread

And

- ▶ The market spread between the RFR and LIBOR may fluctuate for cashflows that will occur prior to the date of cessation

Whether or not it is judged that Phase 1 has ended, it is possible that estimates of the fixed spread that will be applied on transition to RFRs will already be reflected in the market's valuation of IBOR-based instruments. These have converged, to a significant extent, on the ISDA fallback spreads although, at the time of writing, this is more evident for certain currencies, e.g., sterling, than for others such as US dollars.

There could be situations in which the uncertainty for particular elements of a single hedging relationship could end at different times. For example, assume an entity is required to apply the relevant exceptions to both the hedged item and the hedging instrument, as will typically be the case for a cash flow hedge. If the hedging instrument in that hedging relationship is amended to be based on an RFR earlier than the hedged item, such that the uncertainty about the timing and the amount of RFR-based cash flows of the hedging instrument is eliminated, the relevant exceptions would no longer apply to the hedging instrument even though they would continue to apply to the hedged item.⁴⁷ The hedged item will therefore, by default, continue to be measured by reference to changes in IBOR, even though it is expected that it will be amended in the near term. The consequence of this is that any delay between the modification of the hedging instrument and the hedged item in a cash flow hedge will potentially introduce a new source of hedge ineffectiveness, specifically any changes in

⁴⁷ IFRS 9.BC6.594.

the basis risk between the RFR interest on the hedging instrument and the IBOR interest on the hedged item. However, now that the ISDA fallback spreads have been fixed, and so quotations of IBOR indices and the new RFRs are expected to converge on them, the effect of this may be small.

This problem does not arise for fair value hedges, since the hedged instrument will not be amended as a result of the Reform and Phase 2 allows the designated hedged risk to be revised when the hedging instrument is amended (see 4.2).

4.1.3 Phase 1 reliefs for IAS 39

As many entities remain under the hedge accounting requirements of IAS 39, Phase 1 Amendments were also made to IAS 39.⁴⁸ These are consistent with those for IFRS 9, as described at 4.1.1 and 4.1.2, but with the following differences:

- ▶ For the prospective assessment that a hedge is expected to be highly effective, 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 the Reform.⁴⁹ This relief ends under the same conditions as the IFRS 9 relief for the assessment of the economic relationship between the hedged item and the hedging instrument (see 4.1.2 above)
- ▶ For the retrospective assessment of effectiveness, an entity may continue to apply hedge accounting to a hedging relationship for which effectiveness is outside of the 80–125% range during the period of uncertainty arising from the Reform. This applies to any hedge relationship affected by the uncertainties due to the Reform and is not restricted to the amount of ineffectiveness that can be directly attributed to the Reform.⁵⁰

The relief is, however, subject to satisfying the other conditions in paragraph 88 of IAS 39, including the prospective assessment that the hedge is expected to be highly effective (as amended above). The relief ceases at the earlier of when there is no longer uncertainty with respect to the cash flows of both the hedged item and the hedging instrument, and when the hedging relationship is discontinued.⁵¹

This relief may be particularly important if there is a delay between when a hedging instrument is amended for the Reform and the amendment of the hedged item (or vice versa). Any actual ineffectiveness would still need to be measured and recognised in the financial statements. This should be calculated based on how market participants would value the hedged items and hedging instruments and would include the effect of any increase in discount rates that the market requires due to the uncertainties arising from the Reform.⁵² However, as the ISDA fallback spreads have now been fixed, the effect of this may be small.

- ▶ For a hedge of ‘a benchmark portion’ (similar to ‘a risk component’ under IFRS 9) of interest rate risk that is affected by the Reform, the requirement

⁴⁸ IAS 39.102A-102N, 108G.

⁴⁹ IAS 39.102F.

⁵⁰ IAS 39.BC250.

⁵¹ This was amended further in Phase 2 (IAS 39.102M).

⁵² IAS 39.102G.

Phase 2 helps ensure continuity of hedge accounting.

that the portion is separately identifiable need be met only at the inception of the hedge.⁵³

4.2 Phase 2 hedge accounting amendments

As noted above, the Phase 1 Amendments only cover pre-replacement issues. The issues that affect financial reporting when an existing interest rate benchmark is replaced with an RFR, are addressed by Phase 2. Hedge relationships within the scope of Phase 2 are the same as those within the scope of Phase 1 (see 4.1). As with section 4.1, we first describe the reliefs for hedge accounting under IFRS 9 and then in section 4.2.7 and 8 set out any differences for entities still applying IAS 39 for hedge accounting.

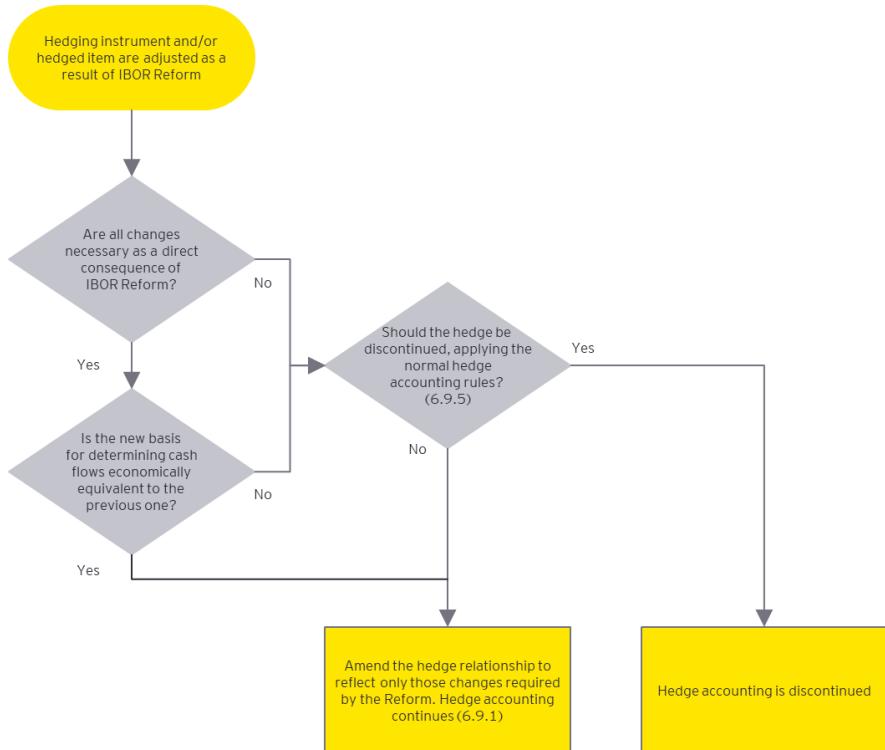
4.2.1 Phase 2 reliefs for IFRS 9

The Phase 2 Amendments for IFRS 9 provide the following reliefs (the 'Phase 2 reliefs'):

1. Relief from discontinuing hedge relationships because of changes to hedge documentation required by the Reform (see 4.2.2 below)
2. Temporary relief from having to meet the 'separately identifiable' requirement (see 4.2.4 and 5 below)

4.2.2 Phase 2 reliefs from discontinuing hedge relationships

The application of the Phase 2 reliefs is summarised in the following flow chart:



The Phase 2 Amendments require that as and when an entity ceases to apply the Phase 1 reliefs to a hedging relationship (see 4.1.2 above), the entity must amend the formal designation of that hedging relationship to reflect the changes that are required by the Reform. However, the hedge designation need not be amended immediately. It must be amended by the end of the reporting period during which a change required by the Reform is made to the

⁵³ IAS 39.102H.

The hedge accounting relief is dependent on two conditions.

hedged risk, hedged item or hedging instrument. Such an amendment does not constitute a discontinuation of the hedge relationship.⁵⁴

For this purpose, 'the end of the reporting period' should be given its normal interpretation as the end of an interim reporting period if an entity or group of which the entity is a member, publishes IAS 34 interim financial statements.

These amendments to the hedge designation covered by the Phase 2 relief are restricted to one or more of the following:

- ▶ Designating an RFR as the hedged risk
- ▶ Amending the description of the hedged item, including any designated portion of the cash flows or fair value of the hedged item
- ▶ Amending the description of the hedging instrument⁵⁵

The changes must be directly required by the Reform, which means that both of the following conditions must be met:

- ▶ The changes must be necessary as a direct consequence of interest rate benchmark reform
- ▶ The new basis for determining the contractual cash flows is 'economically equivalent' to the previous basis (i.e., the basis immediately preceding the change)⁵⁶

As already discussed in section 2 above, the Amendments include examples of the type of changes required by interest rate reform that are considered to be economically equivalent to the previous basis, as follows:

- ▶ The replacement of an existing interest rate with an RFR or effecting such a reform of an interest rate benchmark by changing the method used to calculate the interest rate benchmark, with the addition of a fixed spread to compensate for a basis difference between the existing interest rate benchmark and the RFR
- ▶ 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 fallback provision to the contractual terms of a financial asset or liability to enable any of the changes described above to be made⁵⁷

The above guidance is reasonably straight forward to apply if the changes made to hedged items or hedging instruments are only those necessary to achieve IBOR Reform and so made on an economically equivalent basis. If changes are made to a financial asset or liability (including a derivative) designated in a hedging relationship, or to the designation of the hedging relationship, beyond those required by the Reform, the Amendments require that an entity must first apply the normal requirements in IFRS 9 to determine if those additional changes would result in the discontinuation of the hedge relationship. If the additional changes do not result in the discontinuation of hedge accounting, an entity must amend the formal designation of the hedging relationship, as described above, without discontinuing the hedge relationship.⁵⁸

⁵⁴ IFRS 9.6.9.1 and 6.9.4.

⁵⁵ IFRS 9.6.9.1.

⁵⁶ IFRS 9. 6.9.1 and 5.4.5 - 5.4.7.

⁵⁷ IFRS 9.5.4.8.

⁵⁸ IFRS 9.6.9.5.

As already set out in 2.1.2 above, examples of possible changes that would most likely not be viewed as economically equivalent, and hence not required by the Reform, would include:

- ▶ Changes to the principal or notional value
- ▶ Changes in maturity and methods of repayment (such as a move from a bullet repayment to by instalment)
- ▶ Changes in credit spread to reflect changes in the credit quality of the obligor
- ▶ The addition or removal of caps and floors, prepayment and extension options

If changes are made other than those directly required by the Reform or that would not be economically equivalent, hedge continuity must be assessed by applying the normal hedge accounting requirements.

Such additional changes must, therefore, be assessed to determine if, applying the normal IFRS 9 requirements, they would lead to the discontinuation of the hedge. According to IFRS 9, apart from when there is a change in the risk management objective, hedges are discontinued only when the qualifying criteria are no longer met, i.e., if:

- ▶ The hedging instrument or hedged item are no longer eligible for hedge accounting
- ▶ There is no longer an economic relationship between the hedged item and the hedging instrument
- ▶ The effect of credit risk dominates the value changes that result from the economic relationship

Or,

- ▶ The hedged item or hedging instrument is derecognised⁵⁹

It is likely that the most challenging of these criteria in the context of IBOR Reform is the last: whether the hedged item or hedging instrument is derecognised (see section 2).

If the hedge relationship is not discontinued, the hedge relationship is amended to: i) designate an RFR as the hedged risk; ii) amend the description of the hedged item, including any designated portion of the cash flows or fair value of the hedged item; and/or iii) amend the description of the hedging instrument⁶⁰, in each case, to the extent required by the Reform. This means that any changes that are made to the hedging instrument or hedged item beyond those required by IBOR Reform will need to be included in the ongoing measurement of hedge ineffectiveness. This is illustrated by Example 7 in 4.3.2.

As discussed in section 2.2 in the context of derecognition, it is possible that a hedging instrument will be changed by entering into two new derivatives with the same counterparty, one that is equal and offsetting to the original derivative and another one on similar terms except referencing an RFR. This is most likely to arise for derivatives cleared by a central clearing counterparty.

⁵⁹ IFRS 9.6.5.6 and 6.4.1.

⁶⁰ IFRS9.6.9.5 and 6.9.1.

Phase 2 hedge accounting relief is obtained in this situation as long as two criteria are met:

- i) The original derivative is not derecognised, as outlined earlier at 2.2.2
- ii) The change is made on an economically equivalent basis

The examples contained in the Basis for Conclusions have already been introduced at 2.2.2, in the context of derecognition. Although they provide guidance on whether or not an approach would be regarded as consistent with the changes required by the Reform, they do not specify whether the conclusion is driven primarily by the assessment of derecognition, or of economic equivalence, or both. In scenario (a), replacement of an original IBOR-based derivative by an RFR-based derivative on 'similar terms' is considered to meet both these criteria whereas it is implied that in scenario (b) the replacement on 'substantially different terms' causes neither criteria to be met. It is, therefore, unclear whether there may be fact patterns that avoid derecognition, but still fail economic equivalence.

Also, as already discussed in the context of derecognition, the examples are intended to represent two ends of a spectrum. It would, therefore, be possible to apply the Phase 2 reliefs to fact patterns that involve a less substantial difference in terms. However, no guidance is provided as to how much change would be permitted before the derivative would be derecognised or the terms would no longer be regarded as economically equivalent. As a result, this is an area where judgement needs to be applied.

In another scenario examined by the IASB, the entity enters into a new basis swap, specific to a particular derivative instrument, which swaps the existing interest rate benchmark for that instrument to the RFR. This is viewed by the IASB as economically equivalent to modifying the contractual terms of the original instrument, as long as the basis swap is linked or coupled with the original derivative rather than being entered into at a portfolio level.⁶¹ The scenario does not specify whether the basis swap needs to be with the same counterparty as the original derivative but this is probably assumed.

In contrast, in a further example discussed in the Basis for Conclusions, an entity enters into a basis swap in order to mitigate ineffectiveness arising between different methods of compounding of RFRs for cash products and derivatives. (A possible scenario is if the cash products and derivatives transition to RFRs on a slightly different basis, thus, introducing a new source of potential hedge ineffectiveness). The implication is that an amendment of the hedge relationship to encompass the addition of this basis swap would result in the discontinuation of the hedge relationship.⁶² The reason is not clearly articulated, but it is possibly because the addition of the basis swap is not strictly necessary to achieve IBOR Reform, rather, is a subsequent addition to improve hedge effectiveness.

⁶¹ IFRS 9.BC6.620 (c).

⁶² IFRS 9.BC6.617.

Changes to hedge designations and hedge documentation required by the Reform may need to be made at different times for different hedge relationships, and more than once for individual hedge relationships. For instance, for a cash flow hedge, it is possible that the hedge designation and documentation will need to be amended twice: once when the derivative is modified to refer to an RFR; and again when the hedged item is renegotiated to refer to an RFR. An entity must apply the relief from discontinuing hedge relationships on each occasion the criteria are met.⁶³

The usual IFRS 9 requirements are applied for accounting for changes in the fair value of the hedging instrument and the hedged item. Therefore, they are measured at fair value as RFR-based or IBOR-based, depending on whether they have each been amended or not, except that, for cash flow hedges, the cash flow hedge reserve is remeasured to the lower of the cumulative gain or loss on the hedging instrument and the cumulative change in fair value of the hedged item.⁶⁴ When redesignating the hedge of a fixed-rate debt instrument, in order to be consistent with the continuation of the hedge, the component of the fixed cash flows designated as the hedged component should be adjusted to reflect the spread between RFR and IBOR. This is illustrated in Example 6.

Meanwhile, if the change in fair value of the designated cash flows in a cash flow hedge is measured using a hypothetical derivative, after transition of the hedged financial instrument, the hypothetical derivative will be adjusted to reflect the RFR (see Example 8).

Any hedge ineffectiveness is recognised in profit and loss, as normal. The IASB does not expect that there would be a significant change in fair value on transition, since that would imply that the amendments had not been made on an economically equivalent basis.⁶⁵ However, if there is a mismatch in timing in the amendment of the hedging instrument or hedged item, this may give rise to some ineffectiveness for cash flow hedges (see Example 8).

When the hedged item is amended, amounts accumulated in the cash flow hedge reserve are deemed to be based on the RFR. The same applies for a hedge that has previously been discontinued, when the contractual cash flows of the previously designated item are modified. 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 now based on the RFR affect profit or loss.⁶⁶

4.2.3 Phase 2 relief for groups of items

The Phase 2 Amendments also provide 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 the 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. The existing IBOR would remain designated as the hedged risk

⁶³ IFRS 9.6.9.3.

⁶⁴ IFRS 9.6.9.3.

⁶⁵ IFRS 9.BC6.626.

⁶⁶ IFRS 9.6.9.7, 6.9.8.

for the other sub-group of hedged items, until they too are updated to reference the new RFR.⁶⁷

Although the Amendments do not provide detailed guidance on how the relief for groups of items will work, we currently assume that:

- i) If the hedged item was originally established as an 'open' portfolio, new hedging instruments and hedged items, whether they reference IBOR or RFRs, may be added to the groups as they are entered into
And
- ii) At each transition, the hypothetical derivative for the sub-group will require updating

The entity must ensure that each sub-group continues to meet the normal requirements of IFRS 9 to be an eligible hedged item. If any sub-group fails to meet the requirement to be designated as a hedged item, the entity must discontinue hedge accounting for the hedge relationship in its entirety.

Meanwhile, hedge ineffectiveness must be measured and recorded as normal for the hedge relationship in its entirety.⁶⁸

4.2.4 Phase 2 temporary relief for designation of risk components

IFRS 9 requires that a risk component designated in a hedge relationship is both 'reliably measurable' and 'separately identifiable' to be eligible for hedge accounting.⁶⁹ The Phase 2 Amendments 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, both upon designation of a new hedge relationship and for existing hedge relationships when changes required by the Reform are made to hedge designations and hedge documentation (see 4.2.1 above and 4.2.7 below). The relief allows entities 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 24 months. The 24-month period applies to each RFR separately (i.e., it applies on a rate-by-rate basis) and starts from the date an entity designates the RFR as a risk component for the first time.

If an entity reasonably expects that an RFR will not be separately identifiable within 24 months after initial designation, the relief will end for that RFR. Hedge accounting should be discontinued prospectively from the date of that reassessment for all hedging relationships in which the RFR was designated as a risk component.⁷⁰

The assessment of whether a risk component is separately identifiable is discussed further in section 4.2.5. Meanwhile, it must be stressed that no relief is provided from the requirement for the risk component to be *reliably measurable* throughout the life of the hedging relationship (see 4.2.6).

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

⁶⁷ IFRS9.6.9.9

⁶⁸ IFRS 9.6.9.10.

⁶⁹ IFRS 9.6.3.7(a).

⁷⁰ IFRS 9.6.9.11, 6.9.12.

An RFR may be designated as a risk component as long as it is reliably measurable and is expected to be separately identifiable within the context of the market structure within the next 24 months.

How we see it

The relief from having to satisfy the separately identifiable requirement should significantly ease the transition to RFRs by allowing hedging relationships to be designated and to continue, even before the new RFRs are fully established as market benchmarks. However, entities must ensure they are comfortable to make the appropriate judgements at the time of transition and over the subsequent 24 months, while introducing suitable processes and governance to update their assessment. This judgement is discussed in more detail in the next section.

4.2.5 Determination of whether an RFR is a separately identifiable risk component

Although the Phase 1 and 2 Amendments provide reliefs for the assessment of whether a non-contractually specified risk component is separately identifiable, and so can be designated as a hedged risk, they do not provide guidance on what is meant by 'separately identifiable'. Therefore, there should generally be no change in how this criterion is interpreted. There are, however, a couple of points made in the Phase 2 Amendments that may be relevant, first, for fair value hedges and, second, for cash flow hedges.

i) Fair value hedges

The first point is that the relief is provided only for 'separately identifiable' and not for 'reliably measurable', and so, the two criteria are clearly different. It is to be expected that an RFR might become sufficiently liquid that it is reliably measurable, but without yet being separately identifiable within the hedged item such as a fixed-rate debt instrument.⁷¹

Whilst much of the pre-existing guidance in IFRS 9 on how to determine whether or not a risk component is separately identifiable, was written primarily to permit hedging of components of non-financial items, one example appears particularly relevant for interest rate hedges, as follows:

"Entity D holds a fixed-rate debt instrument. This instrument is issued in an environment with a market in which a large variety of similar debt instruments are compared by their spreads to a benchmark rate (for example, LIBOR) and variable rate instruments in that environment are typically indexed to that benchmark rate. Interest rate swaps are frequently used to manage interest rate risk on the basis of that benchmark rate. The price of fixed-rate debt instruments varies in direct response to changes in the benchmark as they happen. Consequently, Entity D may designate hedge relationships for the fixed rate debt instrument on a risk component basis for the benchmark interest rate risk."⁷²

This paragraph is cited only as 'an example', so this should not be read as a list of criteria for a rate to qualify as separately identifiable. Nevertheless, this example could be read to imply that, for a benchmark interest rate to qualify as a risk component, it has to be the basis on which fixed rate debt instruments are frequently priced and floating rate debt instruments frequently vary in rate,

⁷¹ IFRS 9.B6.3.9.

⁷² IFRS 9.B6.3.10(d).

and that it would be insufficient for the rate to be used only in the swap market. Not only do SONIA swaps already make up half the sterling swaps market by volume, but in November 2019, it was claimed that “SONIA is now the norm in issuance of floating rate sterling bonds and securitisations”.⁷³ Therefore, it is possible that an entity might conclude that SONIA is already separately identifiable and, if not yet, it will be within 24 months.

Swaps referenced to SOFR (the chosen US dollar RFR) make up a far lower percentage of the total US dollar swaps traded, and there has been slower progress in the issue of SOFR-based cash instruments. However, as seen in the recommendations of the US Alternative Reference Rates Committee, there is an expectation that SOFR will become the reference index for many variable rate instruments. Further, the US dollar swap market is expected to move to become SOFR-based and, to that extent, SOFR would become a major interest rate benchmark and the main one used for hedging purposes. On this basis, we expect that most entities applying IFRS 9 for hedge accounting purposes would conclude that SOFR will be separately identifiable within 24 months.

Although the guidance in IFRS 9 as to the criterion for a risk component to be separately identifiable is very similar to that in IAS 39 for a risk portion, the wording is not exactly the same. IAS 39 mentions that, “for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable” (see 4.2.8 below). The IASB has never said that it had intended the application of ‘separately identifiable’ to interest rates to change on the application of IFRS 9, which could imply that if a benchmark risk portion is considered identifiable under IAS 39 then it would also be a separately identifiable risk component under IFRS 9. However, the example in IFRS 9.B6.3.10(d) arguably provides a more detailed interpretation of what constitutes a ‘benchmark’.

Meanwhile, the question also arises as to whether it is still possible to designate LIBOR as a separately identifiable risk component. The answer is clearly ‘yes’ until the RFR becomes established and it is likely that after that, for a short while, LIBOR and the RFR will both be separately identifiable, as the market transitions from one benchmark rate to another.

ii) Cash flow hedges

The second point made in the Phase 2 Amendments is that it is clear that the exception for identifying risk components apply to cash flow hedges as well as fair value hedges.⁷⁴ This leads to the question of whether it is possible to designate an RFR as a risk component of an IBOR floating rate debt instrument. The relevance of this question arises mainly where there is a mismatch in the timing of the amendment of a hedging derivative and the floating rate instrument that is the hedged item, so that the derivative is amended to refer to an RFR before the hedged item. The issue here is not whether, for instance, the RFR will form the basis of floating rate instruments within 24 months, but

⁷³ Speech delivered at the Risk.net LIBOR Summit 2019 by Edwin Shooling Latter, Director of Markets and Wholesale Policy at the UK's Financial Conduct Authority.

⁷⁴ IFRS 9.BC6.647.

whether it may ever be regarded as a separately identifiable component of an *IBOR-based* floating rate.

In the deliberations regarding timing mismatches in the Phase 2 Amendments, it was suggested in a Staff Paper that hedge ineffectiveness could be minimised in the period before the hedged item is amended, by adjusting the hedged risk to the RFR rather than the contractual interest rate.⁷⁵ This might be read to endorse the possibility of designating an RFR component of IBOR. However, there is no specific guidance on this issue within the Phase 2 Amendments. Unlike fair value hedges, in the past there has been much less practice of designation of risk components in floating rate instruments, unless the risk was already contractually specified (e.g., LIBOR risk in a loan that was indexed to LIBOR). Also, the examples in both IFRS 9 and IAS 39 only address fair value hedges. Therefore, it is more difficult to draw on past precedent or practice to support designating an RFR as a component of LIBOR.

The case for SONIA as a component of sterling LIBOR is perhaps easier to make, since it was first introduced in 1997 and SONIA can be thought of as 'overnight sterling LIBOR' and so 'a building block' of term LIBOR.⁷⁶ SOFR, however, which is based on the repo rate, is somewhat different in nature from US dollar LIBOR. Overnight SOFR is also quite volatile and can, on occasion, exceed 3-month US dollar LIBOR.

However, if, as expected, 'tough legacy' financial instruments are dealt with by creating 'synthetic' IBORs, by redefining IBORs to be the RFRs plus the ISDA fallback spreads, then it would follow that the RFR will become a benchmark component of IBOR.

For the purpose of Example 8 below, it has been assumed that SOFR cannot be designated as a component of US dollar LIBOR.

iii) Term structure of separately identifiable risk components

The question has also arisen as to whether the separately identifiable criterion needs to be assessed separately depending on the maturity of the hedging instrument and the hedged item. For instance, would a hedge of a 30-year fixed rate bond be assessed separately from a hedge of a one-year bond, bearing in mind that there is likely to be far more activity in the market for shorter term instruments?

To use the IFRS 9 terminology, the separately identifiable assessment must be performed in the context of the market structure, and the structure of the interest rate market will always include a term structure. If it is determined that (for instance) SOFR is, or will be, separately identifiable, it follows that this is likely to be the case equally, whether SOFR is being used to hedge loans with (for example) six months, five years or ten years maturity. If bond prices are not aligned with SOFR swap rates, then there will always be an opportunity for arbitrage, to help bring the market in line.

⁷⁵ See January 2020 Staff Paper 14A Paragraph 28.

⁷⁶ When SONIA was reformed in 2018, so it could qualify as an RFR, the main changes were only to base it on a wider range of participants' transactions and to amend the volume-weighting methodology.

If SOFR were only ever expected to be used as a short-term rate, it would raise the question as to what benchmark would be used instead for the longer maturity end of the market. And if some other benchmark were to be used for the longer maturity end of the market, it is likely that any entity that hedges a longer-term exposure would choose a derivative referenced to that longer-term benchmark rather than SOFR. Hence, in this case, the question as to whether SOFR can be separately identified for longer term maturities is unlikely to arise.

How we see it

Once an RFR is separately identifiable, it is likely to be so for any maturity. If another benchmark becomes established for certain maturities, the assessment of whether the RFR is separately identifiable is made for any maturity for which it is the benchmark. Should the market fragment in future, such that more than one benchmark emerges, serving different segments of the market, the continuing assessment required by paragraph 6.9.12 of the Amendments would be made separately for each segment of the market.

4.2.6 Determination of whether an RFR is a reliably measurable risk component

'Reliably measurable' is not defined further in IFRS 9 or in the IAS 39 hedge accounting guidance, but IAS 39 required that unquoted equity instruments that were not quoted in active markets to be recorded at cost if not 'reliably measurable'.⁷⁷ The guidance stated that the fair value would be reliably measurable if the range of variability of fair value measurements is not significant or the probabilities of the various estimates can be reasonably assessed and used when measuring fair value.⁷⁸ The standard went on to say that there are many situations where the range of variability for unquoted equity investments is likely not to be significant and that it is normally possible to measure reliably a financial asset acquired from a third party.⁷⁹ Given this guidance, 'reliably measurable' does not appear to be an especially high hurdle and it is likely that most derivatives referencing the RFRs will be considered reliably measurable once a market begins to develop.

4.2.7 Phase 2 amendments for IAS 39

As is the case for the Phase 1 amendments (see 4.2.1 above), the Phase 2 Amendments also include changes to IAS 39. The corresponding amendments to IAS 39 are consistent with those for IFRS 9, but with the following differences:

- IAS 39 is amended so that for the assessment of retrospective hedge effectiveness for fair value hedges, the cumulative fair value changes may be reset to zero when the exception to the retrospective assessment ends. This election is made separately for each hedging relationship (i.e., on a hedge-by-hedge basis). However, actual hedge ineffectiveness will continue to be measured and recognised in full in profit or loss.⁸⁰ This is amended from the Phase 2 ED, which had proposed to make resetting to zero compulsory.

⁷⁷ IAS 30.46 (c).

⁷⁸ IAS 39.AG80.

⁷⁹ IAS 39.AG81.

⁸⁰ IAS 39.102V.

- The Phase 2 amendments also 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.⁸¹

One of the changes that may be required to the method for assessing hedge effectiveness is where the approach has previously been based on regression analysis and there are insufficient data points to enable this approach to be applied for the RFR. While the Amendment is not explicit on this issue, presumably regression could be replaced by another approach until sufficient data becomes available, at which point, the use of regression would resume, as long as this is documented as the strategy at the time the hedge relationship is adjusted.

As discussed at 4.2.2 in the context of IFRS 9, if a hedged item, or hedging instrument is amended to transition from IBOR to an RFR, but changes are made in addition to those required by IBOR Reform to obtain the Phase 2 hedge accounting reliefs, it is necessary to assess, first, whether the additional changes result in the discontinuation of hedge accounting, applying the normal hedge accounting requirements. Under IAS 39, one of the criteria for continuing hedge accounting is that the hedge is expected to be highly effective. As a consequence, it will be necessary to assess whether any additional changes made on transition to an RFR mean that the hedge is no longer expected to be highly effective. If this is the case, hedge accounting must be discontinued and Phase 2 hedge accounting relief is not available.

4.2.8 Determination of whether an RFR is a separately identifiable risk component under IAS 39

Similar to the Phase 1 and 2 Amendments for IFRS 9 (see 4.1.1 and 4.2.4 and 4.2.5 above), the amendments to IAS 39 provide reliefs for the assessment of whether a non-contractually specified risk component is separately identifiable, and so can be designated as a hedged risk. However, again, the Amendments provide no new guidance on what is meant by 'separately identifiable'. As mentioned in section 4.2.5, whilst the guidance in IFRS 9 for a risk component to be separately identifiable is very similar to that in IAS 39 for a risk portion, the wording is not exactly the same. In particular, IAS 39 contains a simpler statement compared to the considerations included into IFRS 9, as follows:

"... for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable."⁸²

How we see it

Given the IAS 39 reference to 'risk-free or benchmark' as a separately identifiable component, it has been established practice to designate other benchmarks, such as the overnight interest rate swap rate (OIS). It is possible that those entities still applying IAS 39 will consider RFRs such as SONIA and SOFR as already separately identifiable, on the basis that they are already viewed by regulators as benchmarks and SOFR is also (nearly) risk-free.

⁸¹ IAS 39.102P(d).

⁸² IAS 39.AG99F(a).

4.3. Application of Phase 2 reliefs

4.3.1. *Fair value hedges*

Since the hedged item will have a fixed rate, it will not need to be amended as part of IBOR Reform. Hence, Phase 1 ends when there is no longer uncertainty as to the timing and amount of the hedging instrument. This is expected to occur when the hedging instrument is amended as required by the Reform, at which point, Phase 2 will apply. At that time, it will also be necessary to amend the designated hedged risk.

A hedging derivative could be amended in one of two main ways; the transition basis spread could be added either to the floating leg of the derivative or subtracted from the fixed leg. For example, if a hedging swap had been pay 3% fixed, receive 3-month US dollar LIBOR, when the transition basis difference is considered to be 26bp, it would be acceptable for the amended derivative to be pay 3%, receive SOFR + 26bp or, alternatively, pay 2.74%, receive SOFR (where 2.74% is 3.0% - 26bp).

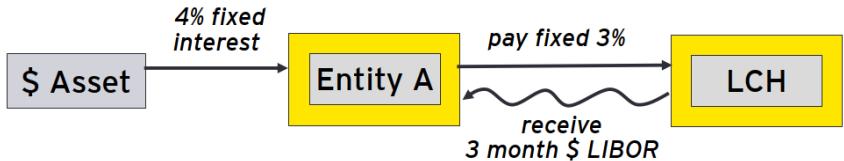
As has already been mentioned in Section 1, changing the derivative's reference should not require a change in the discount rate used to measure it. The discount rate should reflect the credit risk of the counterparty and this will not have changed just because of IBOR Reform. IBOR-based derivatives that are fully collateralised are already discounted at overnight rates, such as the RFRs. In contrast, it would be inappropriate to move to a risk-free discount rate for uncollateralised trades (i.e., if they have previously been discounted at IBOR, then it would follow that they should now be discounted at the RFR plus the transition spread) unless compensating changes are also made to the way that Credit Valuation Adjustments (CVAs) are calculated, such that there is no net impact on their valuation,

Whether the derivative is amended to pay 3%, receive SOFR + 26bp, or to pay 2.74%, receive SOFR, the designated hedged risk would most likely be revised to be a fair value hedge of a 2.74% component of the hedged item for changes in SOFR. Meanwhile, the discount rate used to measure the hedged risk would change from LIBOR to SOFR. The cumulative change in fair value of a 2.74% component of a fixed rate debt for changes in SOFR (discounted using SOFR) should be more or less the same value as the previously recorded change in fair value of a 3% component for changes in 3-month US dollar LIBOR (discounted using LIBOR), so there should be only a small change in value, if any, to be recorded in profit or loss.

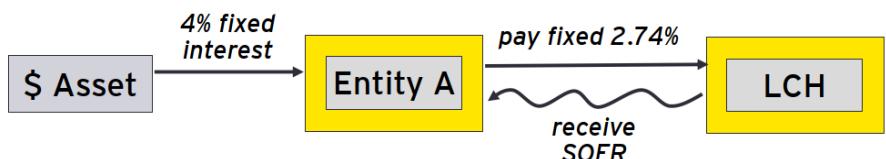
The following two examples illustrate the key features of the Phase 2 Amendments for fair value hedges, the first where the derivative is amended on an economically equivalent basis and the second where it is determined that it is not.

Example 6: Application of Phase 2 relief to a fair value hedge

Company A has previously entered into an interest rate swap paying fixed 3% and receiving 3-month US dollar LIBOR. It had been designated in a hedge of the exposure to changes in fair value attributable to US dollar LIBOR, of cash flows equivalent to a 3% coupon plus principal of a 4% fixed US dollar asset.



On 1 November 2021, the basis difference between SOFR and LIBOR is determined to be 26 basis points (based on the ISDA fallback, rounded to simplify the example). The swap is accordingly amended to pay fixed 2.74%, receive SOFR.



The new swap is considered 'economically equivalent' to the old swap, since the only change has been to refer to SOFR instead of LIBOR and to adjust the spread based on the current market rates (see 2.1 above). As a result, the formal designation of the hedging instrument is amended without discontinuing the hedge.

SOFR is expected to be a separately identifiable component of US dollar interest rates within 24 months and, therefore, may now be designated as the hedged risk component (see 4.2.2 above). Consequently, the description of the hedged item is also amended to a hedge of changes in fair value attributable to SOFR, of the component of the 4% asset equivalent to a 2.74% coupon plus principal, where 2.74% is the previous 3% less the 26 basis points spread. (An entity applying IAS 39 for hedge accounting must also update how hedge effectiveness will be assessed in future (see 4.2.7)).

At the next period end, the swap is remeasured to its new fair value, based on SOFR, consistent with the normal hedge accounting requirements. This remeasurement will include any difference in fair value of the swap immediately before and after its modification, but as the derivative has been modified on an 'economically equivalent basis', the effect should be small. The asset is also adjusted for the difference in its fair value with respect to the designated hedged risk. This will include the difference in fair value between the 3% coupon plus principal discounted at 3-month US dollar LIBOR and the 2.74% coupon plus principal discounted at SOFR. This difference should also be small. Any net change of fair value on the amendment of the swap and of the designated hedged component, is recorded in profit or loss as part of the recorded hedge ineffectiveness for the period (see 4.2.2 above).

Example 7: Application of Phase 2 relief to a fair value hedge where the swap is amended to reflect the current market rate of interest

Entity A is a party to a swap with a notional value of £10 million and a remaining five years maturity on which, quarterly, it pays sterling 3-month LIBOR (fixed in advance at the beginning of the quarter) and receives 3% fixed. The swap has been designated as a fair value hedge of a 3% component of a 4% fixed liability for changes in LIBOR.

On 1 November 2021, when the market rate for a five-year SONIA swap is 2.7%, the swap is amended to refer to SONIA at a time when the basis difference between 3-month LIBOR and SONIA is considered to be 12bp. However, rather than amend the swap to receive 2.88% and pay SONIA, which would be economically equivalent, the swap is amended to reflect the current market rate of interest, so that Entity A receives 2.7% and pays SONIA. The present value of the net 18bp difference between the fixed and floating rates on the old and new swaps (3% - 2.7% - 12bp) is settled in cash. The entity determines that:

- i) The new swap is not economically equivalent to the old one, due to the net 18bp change in the fixed interest payments.
- ii) However, the revised contractual cash flows are not substantially different, as would give rise to the swap's derecognition.
- iii) Hence, applying paragraph 6.9.5, as all the other IFRS 9 hedge accounting criteria are considered to still be met, the hedge relationship is not discontinued.

As a consequence, the entity amends the hedge relationship to reflect the changes, that is, to be a fair value hedge of the SONIA risk of a net 2.88% (3% - 12bp) fixed rate component of the 4% fixed rate liability, but using a receive 2.7%, pay SONIA swap. It is not possible to amend the hedged item to be a 2.7% fixed rate component, because the hedged item may only be amended to reflect changes required by the Reform. However, the cumulative change in fair value of a 2.88% component of a fixed rate debt for changes in SONIA should be more or less the same value as the previously recorded change in fair value of a 3% component for changes in 3-month sterling LIBOR, so there should be only a small change in value, if any, to be recorded in profit or loss.

The future different sensitivity of the fair values of the 2.88% component and the 2.7% swap to changes in SONIA will be an additional source of ongoing hedge ineffectiveness. Meanwhile, the reduction in the swap's fixed rate will, over time, be compensated, in profit or loss, by fair value changes as the swap reverts to a nil fair value at maturity.

4.3.2 Cash flow hedges

For a cash flow hedge, both the hedging instrument and the hedged item are likely to be required to be amended as required by the Reform. It is possible that they will be amended at different times and it is also possible that they will be amended on different bases, so that, for instance, the hedging instrument transitions using the ISDA protocol, whereas the basis of transition for the hedged item depends on bilateral negotiation. Phase 1 will end for each of the hedging instrument and the hedged item when there is no uncertainty of timing or amount, which could be at different times, while Phase 2 may need to be applied more than once, when each of the hedging instrument and hedged item are amended.

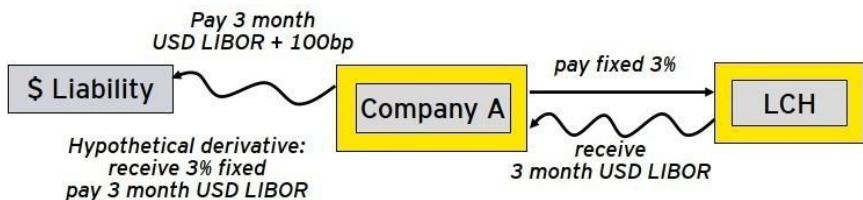
In general, the method of designating the hedged risk and, hence, a hypothetical derivative should not change, just because of IBOR Reform, beyond what is strictly required by the Reform. Accordingly, if prior to transition, the designated hedged risk was the variability of IBOR cash flows, the new designated risk would be the variability of RFR plus the transition spread cash flows, as this would be economically equivalent. This is also likely to result in no gain or loss to be recorded on revising the hypothetical derivative and should not lead to any increase in future hedge ineffectiveness if the spread is calculated using the ISDA fallback protocol and the hedging instrument is amended in the same manner.

Alternatively, if the previously designated hedged risk was the variability of all the cash flows of the hedged item, then going forward, any hypothetical derivative would need to reflect the actual transition spread on the hedged item as negotiated between the parties. If this results in a change in the fair value of the hedged item, this may give rise to a profit or loss when the hypothetical derivative is amended. Also, if the transition spread on the hedged item differs from that on the hedging instrument, this difference in spread may also introduce a new ongoing source of hedge ineffectiveness.

The following example illustrates the application of Phase 2 to a cash flow hedge.

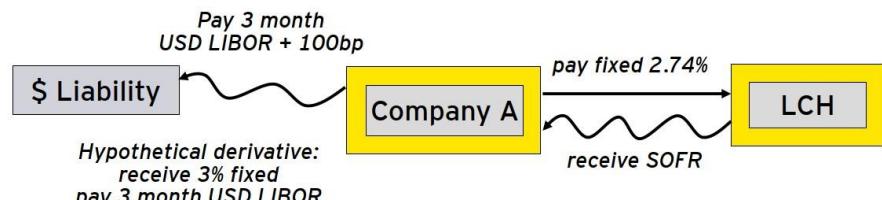
Example 8: Application of Phase 2 relief to a cash flow hedge relationship

The initial fact pattern is the same as that in Example 6, except that it is a cash flow hedge of the US dollar LIBOR risk of a US dollar LIBOR plus 100bp liability. Ineffectiveness has been assessed and measured using a hypothetical derivative on which Company A receives 3% fixed and pays 3-month US dollar LIBOR.



As in Example 6, on 1 November 2021, the derivative is amended to pay fixed 2.74%, receive SOFR. The main difference in this example is that the US dollar LIBOR borrowing will also need to be amended as part of IBOR reform, through bilateral negotiation, but it is assumed that this does not happen for several months.

The hedge documentation will need to be amended to describe the amended swap as the hedging instrument in a cash flow hedge of the US dollar LIBOR liability (see 4.2.1 above). SOFR is expected to be a separately identifiable component of US dollar interest rates within 24 months. However, Company A does not consider SOFR will ever be a separately identifiable component of US dollar LIBOR (see 4.2.5 above). As a result, the hypothetical derivative is not amended at this time and continues to be based on LIBOR.



The original hedge relationship continues (see 4.2.1 above), and the amount recorded in the cash flow hedge reserve continues to be based on LIBOR as required by the Phase 1 Amendments.

Because the swap is valued based on SOFR and the liability based on LIBOR, this remeasurement will give rise to a degree of ineffectiveness which may need to be recorded in profit or loss. However, given that the ISDA protocol transition spread has now been fixed, this is likely to be very small. The entity considers that there is still an 'economic relationship' between SOFR and US dollar LIBOR, such that hedge accounting continues to be permitted. (An entity applying IAS 39 would be relieved from the 80-125% retrospective effectiveness assessment, but would need to meet the prospective effectiveness assessment (see 4.2.7).)

At the end of each accounting period from when the swap is amended until the liability is also renegotiated, the cash flow hedge reserve is remeasured to the lower of:

Example 8: Application of Phase 2 relief to a cash flow hedge relationship (continued)

- ▶ The cumulative gain or loss in fair value of the SOFR swap (which will include gains or losses accumulated prior to the swap's transition); and
- ▶ The cumulative gain or loss in fair value of the US dollar LIBOR hypothetical derivative.

The liability is renegotiated on 1 December 2021, when the basis difference between 3-month US dollar LIBOR and SOFR is agreed to be 25 basis points, based on observable US LIBOR and SOFR swap quotations at that date. However, as part of the bilateral negotiation to amend the liability, the credit spread is also reduced by 20bp, due to an improvement in the borrower's credit quality. The liability is accordingly amended to pay SOFR + 105bp (where 105bp is the previous 100bp plus the current 3-month US dollar LIBOR-SOFR basis of 25bp, less the change in credit spread of 20bp).

Apart from the 20bp change in credit spread, the amendment is considered to be required as a direct consequence of the Reform and the new basis for determining the contractual flows is considered to be economically equivalent to the old basis (see 2.1 above).

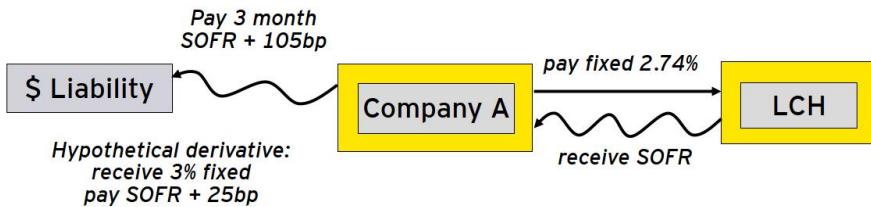
The 20bp change in credit spread is not considered to be a substantial modification of the liability, since quantitatively, the change in net present value discounted at the revised EIR of SOFR +125bp is less than 10% and the change is also judged to be not substantial from a qualitative perspective. Hence, the liability is not derecognised.

Applying the Phase 2 relief on modification of a financial instrument, the effective interest rate (EIR) on the liability is amended to SOFR + 125bp (where 125bp is the previous 100bp plus the current 3-month LIBOR-SOFR basis of 25bp).

The 20bp change in credit spread is not, however, covered by the Phase 2 relief and the net present value of the 20bp reduction, discounted at the revised EIR of SOFR plus 125bp, is recorded as an immediate credit to profit or loss.

The hedge documentation is amended for a second time (see 4.2.1 above). The Phase 1 relief requiring the hedged risk to continue to be based on LIBOR comes to an end and the hedge is now documented as a cash flow hedge of the SOFR component of the SOFR + 105bp liability. (An entity applying IAS 39 for hedge accounting will also need to update the hedge documentation for any change in how hedge effectiveness will be assessed (see 4.2.7 above)). Again, the amendment of the hedge documentation, to refer to the modified hedged item and the new designated risk component, does not constitute a discontinuation of the original hedging relationship (see 4.2.1 above). Hence, the amended hypothetical derivative is not based on the current rate of SOFR. Instead it is amended to be a receive 3%, pay SOFR + 25bp swap.

Example 8: Application of Phase 2 relief to a cash flow hedge relationship (continued)



The amount accumulated in the cash flow hedge reserve is now deemed to be based on SOFR (see 4.2.1 above).

Note that because of the timing mismatch, the derivative (pay 2.74%, receive SOFR) and the hypothetical derivative (receive 3.0%, pay SOFR + 25bp) have a 1bp different net cash flow. A small degree of hedge ineffectiveness will, therefore, arise in the future, as changes in the fair values of the derivative and the hypothetical derivative will not be the same.

However, applying IFRS 9, the entity considers that there is still an 'economic relationship' between the derivative and the hypothetical derivative going forward. For entities applying IAS 39, the hedge must be assessed prospectively to be highly effective and the level of retrospective hedge ineffectiveness will need to be monitored to ensure that the hedge continues to qualify for accounting purposes as there is no longer any relief from the 80/125% effectiveness requirements (see 4.2.7 above).

The cash flow hedge reserve is remeasured at the next period end, to the lower of:

- ▶ the cumulative gain or loss in fair value of the amended swap; and
- ▶ the cumulative gain or loss in fair value of the revised hypothetical derivative.

Hence, the amount of ineffectiveness actually recorded will depend on whether the change in the fair value of the derivative is greater than that on the hypothetical derivative.

How we see it

Entities are recommended to ensure that there are as few mismatches as possible in the timing of the amendment of hedging instruments and hedged items, to minimise the level of recorded hedge ineffectiveness. For those IBORs due to cease at the end of 2021, now that the ISDA fallback spreads have been fixed, this may no longer be a major concern. This is because market spreads are expected to converge on the ISDA fallbacks. But for those IBORs that will not cease so soon, such as certain US dollar LIBOR settings, there may still be some variability in the market spread between LIBOR and SOFR over the next year.

Ensuring that the hedged item and hedging instrument transition at a similar time may be especially challenging if an entity's swap traders do not know if a particular derivative is designated in a hedging relationship, as is more likely to be the case where a dynamic strategy is used or if derivatives are designated in 'proxy' hedges. Procedures would need to be established to help ensure that derivatives are not modified without first considering the accounting consequences.

5 Transition

5.1 Phase 1

The effective date of the Phase 1 Amendments was for annual periods beginning on or after 1 January 2020, although earlier application was permitted. The requirements had to be applied retrospectively. However, the reliefs only applied to hedging relationships that existed at the beginning of the reporting period in which an entity first applies those requirements or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies those requirements. It follows that it was not possible to apply the reliefs retrospectively to hedge relationships that were not previously designated as such.⁸³

5.2 Phase 2

The Phase 2 Amendments are effective for annual periods beginning on or after 1 January 2021, with earlier application permitted (subject, of course, to any local endorsement procedures).⁸⁴ Application of the Phase 2 Amendments is mandatory, to ensure comparability.

Application is retrospective although, as is normal under IFRS, hedge relationships may not be designated retrospectively. However, discontinued hedging relationships must be reinstated if, and only if, the following conditions are met:

- ▶ The hedging relationship was discontinued solely due to changes required by the Reform, and, therefore, the entity would not have been required to discontinue that hedging relationship if the Phase 2 Amendments had been applied at that time

And

- ▶ At the date of initial application of the Phase 2 Amendments, that discontinued hedge relationship continues to meet all the qualifying criteria for hedge accounting, after taking account of the Phase 2 Amendments.⁸⁵

In practice, this means, for instance, that an entity cannot reinstate a hedging relationship that did not previously exist or was voluntarily de-designated, even if it could have met the conditions for hedge accounting and then failed as a direct consequence of IBOR Reform.

Continuing to meet all the qualifying criteria will include the need for the risk management objective of the discontinued hedge relationship to remain unchanged. This is unlikely to be the case if either the hedged item or the hedging instrument has subsequently been designated in a new hedge relationship, such that the hedging instrument is no longer designated as a hedge of the same hedged item.

⁸³ IFRS 9.7.2.26(d).

⁸⁴ IFRS 9.7.1.10, IAS 39.108H.

⁸⁵ IFRS 9.7.2.36, 7.2.37, IAS 39.108I and 108.J.

To the extent that application of the practical expedient would have resulted in a different accounting treatment to that applied by the entity for changes made prior to application of the Phase 2 Amendments to the basis for determining contractual cash flows, this will form part of the transition adjustment.

If hedges for which RFR instruments were designated as a hedge of a risk component have previously been discontinued and are reinstated, the 24-month period to which the separately identifiable relief applies (see 4.2.4 and 4.2.5), begins from the date of initial application of the Phase 2 Amendments.

An entity is not required to restate prior periods on application of the Phase 2 Amendments. It may do so, but only if it is possible without the benefit of hindsight. If it does not restate prior periods, the entity must recognise any difference in carrying values as an adjustment to retained earnings (or other component of equity, if appropriate) at the beginning of the annual reporting period that includes the initial date of application.⁸⁶

How we see it

- ▶ Although relatively few hedging relationships may have been discontinued before the Phase 2 Amendments are implemented, the requirement to reinstate discontinued hedge relationships that meet the criteria may be operationally onerous. Each discontinued hedge relationship will need to be identified and assessed in order to determine whether the criteria are met or not. For instance, it will not be possible to reinstate a hedge relationship if the hedging instrument has already been designated as a hedge of a new hedged item. Further, for any relationships that do meet the criteria for reinstatement, calculation of retrospective hedge accounting entries may be challenging for accounting systems.
- ▶ It should be noted that while discontinued hedges must be reinstated if they meet the criteria, there is no equivalent requirement or ability to account retrospectively for hedge relationships that never qualified for hedge accounting in the first place.
- ▶ Because the 24-month period to which the separately identifiable relief applies, begins from the date of initial application of the Phase 2 Amendments, reinstatement of hedging relationships may have the effect, in practice, of significantly shortening the 24-month window.
- ▶ Entities must carefully track the timing for when the phase one reliefs end and the phase two reliefs apply. Different IBORs will transition to RFRs at different times, with some IBORs on a timetable that is set (e.g. LIBORs) and others for which it is not yet known (e.g. JIBAR). Entities will have similar instruments referencing the same IBOR that transition at different times depending on whether they do so via fallback or bilateral negotiation. The need to ensure the appropriate reliefs are correctly applied at the right time to individual financial instruments, presents entities with a potentially complex additional financial reporting challenge and corresponding control risk.

⁸⁶ IFRS 9.7.2.46, IAS 39.108K.

5.3 End of Phase 2 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 the Reform. The hedge accounting reliefs would not be restricted to one application but will be applied each time a hedging relationship is modified as a direct result of the Reform. However, the 24 month 'window' for assessing whether a risk component is separately identifiable does not reset and starts from the date the entity designates the alternative benchmark rate as a non-contractually specified risk component for the first time.

The Phase 2 reliefs will cease to apply once all changes have been made to financial instruments and hedging relationships, as required by the Reform.⁸⁷

⁸⁷ IFRS 9. BC7.88.

The IFRS Amendments require some new disclosures.

6. Disclosures

6.1 Phase 1

Consequential amendments were also made by the Phase 1 Amendments to IFRS 7, requiring the following information to be disclosed in respect of hedging relationships to which the reliefs are applied:⁸⁸

- ▶ The significant interest rate benchmarks to which the entity's hedging relationships are exposed
- ▶ The extent of the risk exposure the entity manages that is directly affected by the interest rate benchmark reform
- ▶ How the entity is managing the process to transition to alternative benchmark rates
- ▶ A description of significant assumptions or judgements the entity made in applying these paragraphs (for example, assumptions or judgements about when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows)
- ▶ The nominal amount of the hedging instruments in those hedging relationships

The first, second and fifth of these requirements are illustrated in Example 9.

Example 9 Phase 1 quantitative disclosures

The table below indicates the nominal amount and weighted average maturity of derivatives in hedging relationships that will be affected by IBOR reform as financial instruments transition to RFRs, analysed by interest rate basis. The derivative hedging instruments provide a close approximation to the extent of the risk exposure the Bank manages through hedging relationships.

	Nominal amount	Average maturity (years)
Interest rate swaps		
GBP LIBOR (3 months)	775	4.3
USD LIBOR (3 months)	906	5.3
USD LIBOR (6 months)	1,021	6.5
EUR LIBOR (3 months)	1,285	4.8
Other	522	5.3
	<hr/> 4,509	
Cross currency swaps		
GBP LIBOR (3 months) to USD IBOR \$ (3 months)	460	4.7
	<hr/> 460	
	<hr/> <u>4,969</u>	

⁸⁸ IFRS 7.24H.

Example 9 Phase 1 quantitative disclosures (continued)

In \$ million	Nominal amount	Average maturity (years)
31 December 2020		
Interest rate swaps		
GBP LIBOR (3 months)	864	4.4
US LIBOR (3 months)	1,105	5.2
US LIBOR (6 months)	1,110	6.6
EUR LIBOR (3 months)	1,474	4.7
Other	511	5.2
	<hr/> 5,064	
Cross currency swaps		
GBP LIBOR (3 months) to USD LIBOR \$ (3 months)	750	4.6
	<hr/> 750	
	<u>5,814</u>	

Example 9 presents the significant IBORs, disaggregated by tenor. Whilst this is not a specific requirement of the Phase 1 Amendments, it arguably provides the most useful information on significant IBOR exposures.

The Phase 1 disclosures do not cease to be required once the Phase 2 Amendments begin to be applied, although the population of instruments to be disclosed will decline over time as they transition to RFRs. The Phase 1 disclosures provide information on the hedging relationships that are still subject to the Phase 1 reliefs.

6.1.1 The existing IFRS 7 disclosure requirements

An entity may apply only the Phase 1 Amendments and not the Phase 2 Amendments. This would be the case if for example an entity with a year end of 31 December 2020 chose not to apply the Phase 2 Amendments early. However, the entity would also need to assess whether its exposure to the risks posed by IBOR reform warrants disclosure under the general principles of IFRS 7. This requires that entities provide disclosures that enable users to evaluate:

- ▶ The significance of financial instruments for the entity's financial position and performance; and
- ▶ The nature and extent of risks arising from financial instruments to which the entity is exposed during the period, and how the entity manages those risks.⁸⁹

If this is the case, qualitative and quantitative disclosure of the nature and extent of the risks arising from IBOR reform may need to be provided.⁹⁰ For the qualitative disclosure, this may include a description of the entity's project underway to manage the risk and transition the exposures from IBOR to RFRs.⁹¹

⁸⁹ IFRS 7.1.

⁹⁰ IFRS 7.31.

⁹¹ IFRS 7.33.

6.2 Phase 2

Consequential amendments were made by the Phase 2 Amendments to IFRS 7, to enable users of financial statements to understand the effect of interest rate benchmark reform on an entity's financial instruments and risk management strategy. As a result, entities should disclose information about:⁹²

- ▶ The nature and extent of risks to which the entity is exposed arising from financial instruments subject to interest rate benchmark reform, and how the entity manages those risks
- ▶ Their progress in completing the transition to alternative benchmark rates, and how the entity is managing that transition

To meet these two objectives, the following should be disclosed:⁹³

- ▶ How the entity is managing the transition to alternative benchmark rates, its progress at the reporting date and the risks to which it is exposed arising from financial instruments because of the transition
- ▶ Disaggregated by significant interest rate benchmark subject to interest rate benchmark reform, quantitative information about financial instruments that have yet to transition to an alternative benchmark rate as at the end of the reporting period, showing separately:
 - ▶ Non-derivative financial assets
 - ▶ Non-derivative financial liabilities
 - ▶ Derivatives

And

- ▶ If the risks described in the first objective above have resulted in changes to an entity's risk management strategy, a description of those changes

The quantitative disclosures provided by entities may exclude those exposures that are expected to expire or mature before the IBOR ceases. This is because for these instruments the entity would not consider itself to be exposed to the risks relating to IBOR Reform. This disclosure would, therefore, relate only to a subset of the total population of instruments referencing a significant interest rate benchmark subject to the Reform. However, if an entity wished to include these exposures, it may be justified as they could still be affected by IBOR Reform related risk, such as reduced liquidity in the IBOR before it expires or matures.⁹⁴

The proposal in the Phase 2 ED to disclose the carrying value of non-derivative financial assets and financial liabilities, and the nominal value of derivatives, was replaced in the Phase 2 amendments with a more flexible approach. Entities may select the basis for the quantitative information they provide about financial instruments that have yet to transition to an alternative benchmark rate. Examples of approaches which could be followed, set out in the Basis for Conclusions to the amendments to IFRS 7, may include:

- ▶ The carrying amounts of non-derivative financial assets, the carrying amount of non-derivative financial liabilities and the nominal amount of derivatives

⁹² IFRS 7.24I.

⁹³ IFRS 7.24J.

⁹⁴ IFRS 7.BC35LLL.

- ▶ The amounts related to recognised financial instruments (for example, the contractual par amount of non-derivative financial assets and non-derivative financial liabilities, and nominal amounts of derivatives)

Or

- ▶ The amounts provided internally regarding these financial instruments to key management personnel of the entity (as defined in IAS 24), for example, the entity's board of directors or chief executive officer

This change is intended to reduce the incremental effort needed to provide the additional disclosure required by the Phase 2 Amendments, whilst still meeting the objective of the disclosure to provide relevant information on the entity's progress in implementing the Reform.⁹⁵ Entities must provide the Phase 2 IFRS 7 disclosures when they apply the Phase 2 Amendments to IFRS 9 and IAS 39 (or IFRS 4). The Basis for Conclusions clarifies that, on initial application, the new disclosures need not be provided for prior reporting periods unless the entity also restates prior periods for the effects of the Phase 2 Amendments to IFRS 9 and IAS 39 (or IFRS 4).⁹⁶

One of the concerns that banks have identified when preparing to provide these quantitative disclosures is that, while reports may be prepared for key management personnel and regulators on the instruments still subject to the Reform, the information may not be of the quality (in terms of completeness and accuracy) normally expected for disclosure in the audited financial statements. This is because, like any temporary reporting used to monitor a transition project, the information is built on a 'best effort basis' and was not intended to achieve the level of accuracy of the usual accounting disclosures.

A parallel can perhaps be drawn with the disclosure requirement in paragraph 30 of IAS 8 about new IFRSs that have been issued but are not yet effective, as both disclosures are temporary and deal with current known information about a future change. IAS 8.30 requires that an entity disclose "known or reasonably estimable information relevant to assessing the possible impact that application of the new IFRS will have on the entity's financial statements in the period of initial application." The objective of the Phase 2 disclosures is to reflect how the entity is implementing the Reform, a live and complex project.

It is also relevant that the IFRS Taxonomy amendments proposed to incorporate the new Phase 2 disclosure requirements, include a "text block" element in the proposed new table to address the 24J(b) requirements. This is to address the fact that the information can be disclosed in various ways. The proposed Taxonomy amendment also clarifies that the Board proposes to use text block elements for this disclosure of quantitative information because the disclosure requirements are not prescriptive about how the quantitative information should be provided. The amendments, therefore, permit an entity to choose the way in which it provides this quantitative information, for example, an entity can provide such information as an amount or a percentage accompanied by qualitative information to explain the context of the quantitative information.

For entities that adopted the Phase 2 amendments for their December 2020 year-end financial statements, a variety of approaches were used to provide the quantitative disclosures. For derivatives, the information presented included notional values, fair values and both in combination. For non-derivatives, book values or nominal values were used. Once other entities start applying the Phase 2 amendments during 2021, other approaches can be expected.

⁹⁵ IFRS 7.BC35KKK.

⁹⁶ IFRS 7.BC35000.

6.2.1 Application to loan commitments

The Phase 2 Amendments describe that the quantitative disclosures should show separately non-derivative financial assets, non-derivative financial liabilities and derivatives.⁹⁷ However, the disclosures do not relate just to these items, since the amendments to IFRS 7 are not restricted to just those financial instruments within the scope of IFRS 9.⁹⁸ Rather, the Phase 2 disclosures apply to all financial instruments within the scope of IFRS 7, which includes recognised and unrecognised financial instruments, some of which are outside the scope of IFRS 9.⁹⁹ Certain loan commitments, for example, are excluded from the scope of IFRS 9 (other than for the calculation of the expected credit loss) but are within the scope of IFRS 7 since they are still considered to be derivatives in nature.¹⁰⁰ As a result, loan commitments outside the scope of IFRS 9, should be included in the quantitative disclosures, where their relevance for the IBOR Reform programme is material.

6.2.2 Level of detail for different categories

In terms of the level of granularity that should be provided in the quantitative information, there is no requirement to split the amounts into individual line items. It would, however, be permissible to include this additional level of detail if it provided useful information on the entity's exposure to the risks posed by IBOR reform, consistent with the disclosure objective of IFRS 7.¹⁰¹

6.2.3 Exposures within the scope of the disclosure

As IBOR reform progresses, some IBORs have been fully or partially reformed rather than being replaced. EURIBOR and the Canadian Overnight Repo Rate Average (CORRA) may be considered examples of such interest rates. As previously mentioned, there are varying views as to whether EURIBOR-based instruments should be included within the Phase 2 disclosures. However, if it subsequently transpires that further reform will be made to EURIBOR, it should be included within the Phase 2 disclosures until the reform is complete.

For some exposures, adding a fallback clause is intended to enable the contract to automatically switch to an RFR if the IBOR ceases to be available. Financial instruments for which this type of fallback clause is added will still need to be included within the Phase 2 disclosure until the IBOR has been replaced, either by the fallback being triggered or as a result of bilateral discussions between the parties to the contract.

The Phase 2 quantitative disclosure requirements are illustrated in Example 9. While this shows one way to comply with IFRS 7.24J(b), other approaches are possible. Judgement is required to define the best measure that reflects the entity's progress towards completing the Reform, considering that the Basis for Conclusions indicates that entities should make use of information that is already available to reduce the cost of providing the information. Entities should also consider whether the disclosure is sufficient to meet the objective of paragraph 24I(a) of IFRS 7, to provide information about the nature and the extent of risks to which the entity is exposed arising from financial instruments subject to IBOR Reform.

⁹⁷ IFRS 7.24J(b).

⁹⁸ IFRS 7. 24I, IFRS 7.24J.

⁹⁹ IFRS 7.4.

¹⁰⁰ IFRS 9.BCZ2.2.

¹⁰¹ IFRS 7.1.

Example 10 Phase 2 Quantitative Disclosures, EY's Good Bank 2020

In \$ million
31 December 2020

	Non derivative financial assets - carrying value	Non-derivative financial liabilities - carrying value	Derivatives Nominal amount¹
GBP LIBOR (3 months)	1,272	1,984	1,975
USD LIBOR (3 months)	1,453	1,787	2,206
USD LIBOR (6 months)	1,306	1,430	2,221
EUR LIBOR (3 months)	854	926	2,585
Other	464	541	1,522
	<u>10,359</u>	<u>14,289</u>	<u>20,023</u>
Cross currency swaps			<u>600</u>
GBP LIBOR (3 months) to USD LIBOR \$ (3 months)			<u>600</u>
	<u><u>10,359</u></u>	<u><u>14,289</u></u>	<u><u>20,623</u></u>

¹ The IBOR exposures for derivative nominal amounts include loan commitments.

The table of disclosures above presents the significant IBOR, disaggregated by tenor. Whilst this is not a specific requirement of the Phase 2 Amendments, it arguably provides the most useful information on significant IBOR exposures.

Example 11 Phase 2 quantitative disclosures, NatWest Group, 2020 Annual Report, page 291

The table below provides an overview of IBOR related exposure by currency and nature of financial instruments. Non-derivative financial instruments are presented on the basis of their carrying amounts excluding expected credit losses while derivative financial instruments are presented on the basis of their notional amount.

	Rates subject to IBOR reform				Balances not subject to IBOR reform £m	Expected credit losses £m	Total £m
	GBP LIBOR £m	USD IBOR (1) £m	EUR IBOR £m	Other IBOR £m			
Trading assets	75	60	348	1	68,506	—	68,990
Loans to banks - amortised cost	23	82	101	—	6,751	(2)	6,955
Loans to customers - amortised cost	39,858	5,289	4,950	234	316,200	(5,987)	360,544
Other financial assets	2,847	303	370	71	51,568	(11)	55,148
Bank deposits	—	—	—	—	20,606	—	20,606
Customer deposits	—	—	—	4	431,735	—	431,739
Trading liabilities	54	301	269	2	71,630	—	72,256
Other financial liabilities	1,116	9,792	5,902	146	28,856	—	45,812
Subordinated liabilities	8	1,286	438	—	8,230	—	9,962
Loan commitments (2)	25,616	9,228	7,176	682	79,220	—	121,922
Derivatives notional (£bn)	1,407.5	1,368.8	2,358.8	289.6	8,622.1	—	14,046.8

Notes:

(1) USD LIBOR is now expected to convert to alternative risk free rates in mid-2023 subject to consultation.

(2) Certain loan commitments are multi-currency facilities. Where these are fully undrawn, they are allocated to the principal currency of the facility. Where the facilities are partly drawn, the remaining loan commitment is allocated to the currency with the largest drawn amount.

Included within the table above for derivatives were currency swaps with corresponding legs also subject to IBOR reform of GBP LIBOR of £5.2 billion with USD IBOR £2.0 billion, EUR IBOR £2.9 billion and Other IBOR £0.3 billion. Currency swaps of USD IBOR of £231.7 billion with GBP LIBOR £98.5 billion, EUR IBOR £85.8 billion and Other IBOR £47.4 billion. Currency swaps of EUR IBOR of £5.1 billion with GBP LIBOR £2.3 billion, USD IBOR £1.8 billion and Other IBOR £1.0 billion. Currency swaps of Other IBOR of £2.2 billion with EUR IBOR £0.7 billion, USD IBOR £1.2 billion and Other IBOR £0.3 billion.

Additionally, included above are basis swaps for GBP LIBOR of £97.0 billion, USD IBOR of £ 81.0 billion, EUR IBOR of £49.0 billion and Other IBOR of £10.0 billion.

Example 12 Phase 2 quantitative disclosures, Barclays, 2020 Annual Report, page 369

The following table summarises the significant exposures impacted by interest rate benchmark reform as at 31 December 2020:

	GBP LIBOR £m	USD LIBOR £m	JPY LIBOR £m	CHF LIBOR £m	Others £m	Total £m
Non-derivative financial assets						
Loans and advances at amortised cost	30,179	18,109	173	18	1,725	50,204
Reverse repurchase agreements and other similar secured lending	–	334	–	–	–	334
Financial assets at fair value through the income statement	3,496	6,373	–	283	209	10,361
Financial assets at fair value through other comprehensive income	186	114	–	–	8	308
Non-derivative financial assets	33,861	24,930	173	301	1,942	61,207
Non-derivative financial liabilities						
Debt securities in issue	(1,023)	(10,718)	(1,201)	–	–	(12,942)
Subordinated liabilities	(71)	(1,592)	–	–	–	(1,663)
Financial liabilities designated at fair value	(149)	(1,273)	(759)	–	(139)	(2,320)
Non-derivative financial liabilities	(1,243)	(13,583)	(1,960)	–	(139)	(16,925)
Equity						
Other equity instruments	(3,500)	(3,131)	–	–	–	(6,631)
Standby facilities, credit lines and other commitments	18,944	74,011	–	74	15,951	108,980

The table above represents the exposures to interest rate benchmark reform by balance sheet account, which have yet to transition. The exposure disclosed is for positions with contractual maturities after 31 December 2021. Balances reported at amortised cost are disclosed at their gross carrying value and do not include any expected credit losses that may be held against them. Balances reported at fair value are disclosed at their fair value on the balance sheet date.

The Group also has exposure to interest rate benchmark reform in respect of its cash collateral balances across some of its Credit Support Annex agreements, predominantly in EONIA. This exposure is not included within the table above due to its short dated nature.

	GBP LIBOR £m	USD LIBOR £m	EONIA £m	JPY LIBOR £m	CHF LIBOR £m	Others £m	Total £m
Derivative notional contract amount							
OTC interest rate derivatives	592,827	2,832,802	457,844	754,206	25,681	41,782	4,705,142
OTC interest rate derivatives – cleared by central counterparty	1,684,553	2,891,029	638,202	1,091,479	119,382	198,113	6,622,758
Exchange traded interest rate derivatives	300,182	333,705	–	–	2,494	–	636,381
OTC foreign exchange derivatives	155,285	589,334	–	93,108	31,257	1,921	870,905
OTC equity and stock index derivatives	1,845	7,946	544	1,929	491	2,141	14,896
Derivative notional contract amount	2,734,692	6,654,816	1,096,590	1,940,722	179,305	243,957	12,850,082

The table above represents the derivative exposures to interest rate benchmark reform, which have yet to transition. The exposure disclosed is for positions with contractual maturities after 31 December 2021. Derivatives are reported by using the notional contract amount and where derivatives have both pay and receive legs with exposure to benchmark reform such as cross currency swaps, the notional contract amount is disclosed for both legs. As at 31 December 2020, there were £264bn of cross currency swaps where both the pay and receive legs are impacted by interest rate benchmark reform.

The Group also had £28bn of Barclays issued debt retained by the group, impacted by the interest rate benchmark reform, predominately in GBP and USD LIBOR.

6.3 Sources of hedge ineffectiveness

As discussed in 4.1.3 above, the Phase 1 Amendments provide relief under IAS 39 from the retrospective assessment of hedge effectiveness where effectiveness is outside the 80-125% range for any hedge relationships affected by IBOR reform. Also, 4.2.7 above discusses how the Phase 2 Amendments allow entities, for the purpose of the IAS 39 assessment of retrospective hedge effectiveness, to reset the cumulative fair value changes to zero. However, any actual hedge ineffectiveness continues to be recognised in full. As a result of the Reform, the disclosures that entities provide in relation to hedge ineffectiveness may need to be revised or expanded.

For example, entities are required to disclose, by risk category, a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term.¹⁰² Also when other sources of hedge ineffectiveness emerge in a hedging relationship, an entity is required to disclose those sources by risk category and explain the resulting hedge ineffectiveness. Although there are no new specific disclosure requirements on this within the Phase 1 or Phase 2 Amendments, as a consequence of IBOR Reform and application of the Amendments, entities may need to enhance these disclosures to include the additional interest rate risk related hedge ineffectiveness that may reasonably be expected to arise as financial instruments designated in hedging relationships are affected by the Reform.

6.4 Significant judgements

The Phase 2 ED included a requirement in relation to the modification of financial instruments and the conditions for applying the practical expedient to reset the EIR (see 2.1), to provide a description of how an entity determined the base rate and relevant adjustments to that rate, including any significant judgements that it made to assess whether the conditions were met. The key judgement relates to how entities assess whether transition has taken place on an 'economically equivalent' basis. Feedback on the Phase 2 ED identified that this disclosure would not be necessary because an entity is already required to disclose any significant judgements under IAS 1 *Presentation of Financial Statements*, paragraph 122. The IASB, therefore, did not include this requirement in the Phase 2 Amendments.¹⁰³

In light of this, entities should still consider whether the approach followed to make the assessment of economic equivalence represents a significant judgement that requires separate disclosure.

Another example of a significant judgement for which disclosure may be required, would include the assessment of whether an RFR is expected to be separately identifiable, as described in 4.2.4 and 5 above.

¹⁰² IFRS 7.23E.

¹⁰³ IFRS 7.BC35.MMM.

6.5 Transition disclosures

The Phase 2 Amendments provide relief from having to meet some of the IAS 8 *Accounting Policies, Changes in Accounting estimates and Errors* disclosure requirements upon initial adoption.¹⁰⁴ Entities do not have to provide information for the current and prior period of the amount of the transitional adjustment on first adopting the Phase 2 Amendments for each financial statement line item affected and the impact on basic and diluted earnings per share.¹⁰⁵

Whilst relief is provided from one of the IAS 8 transition disclosures, the other disclosures are still required. This includes the amount of any adjustment arising on transition relating to periods before the period of adoption (as an adjustment to opening retained earnings), along with a description of the transitional provisions.¹⁰⁶

Entities that do not apply the Phase 2 Amendments early, will need to meet the disclosure requirements for an IFRS that has been issued but is not yet effective. This disclosure must include known or reasonably estimable information relevant to assessing the possible impact that application of the Phase 2 Amendments will have on the entity's financial statements in the period of initial application.¹⁰⁷

6.6 Interim reporting

Whether or not an entity chooses to apply early the Phase 2 Amendments may have an effect on the extent of disclosure they are required to provide in subsequent interim reports, prepared in accordance with IAS 34 *Interim Financial Reporting*.

For example, an entity may have chosen to apply early the Phase 2 Amendments for an annual period commencing before 1 January 2021, such as for a year ended 31 December 2020. The entity will have presented the full Phase 2 Amendments disclosures in their 2020 annual report. For subsequent interim reports in 2021 they are not required to update the disclosures except to the extent that the position as reported at year-end has significantly changed.¹⁰⁸ However, given that much of the transition to RFRs is expected to occur during 2021, it is quite likely that there will be significant change in some interim periods.

If an entity has not applied the Phase 2 Amendments early, the question arises as to whether it will be required to apply the full disclosures in an interim report before its year-end annual report. To do so would appear consistent with the IASB's aim to provide information to users of the reports, especially as, for some entities, Phase 2 may largely start and end within 2021. Therefore, a decision not to apply early the Phase 2 Amendments has the potential for a requirement to make disclosures in an interim report in the first year of application that may not be necessary if the Amendments had been applied early.

¹⁰⁴ IFRS 7.44H.

¹⁰⁵ IAS 8.28(f).

¹⁰⁶ IAS 8.28 (a) to (e) and (g) to (h).

¹⁰⁸ IAS 34.15.

¹⁰⁸ IAS 34.15.

How we see it

Although the IASB responded to preparers' concerns by making the Phase 2 quantitative disclosure requirements less onerous, by allowing entities to choose the basis for the quantitative information provided, production of these disclosures will still be a significant element of any IBOR Reform financial reporting project.

Phase 2 requires disclosure of information that disaggregates the entity's exposure by significant interest rate benchmark, which is subject to IBOR Reform, but there is no requirement to analyse the quantitative information further, for example, by product type. Nor is there a requirement to include within the disclosure those exposures indirectly affected by IBOR reform, for example, where a discount rate used by the entity in a valuation technique to calculate fair value is expected to change from IBOR to RFR. However, if the Bank considers that different product types, or some other subdivision of the information, represent materially different risks in relation to IBOR reform, then the provision of a further level of disaggregation would be consistent with the broader principles of IFRS 7 and the intention for this disclosure.

7. Amendments to IFRS 16 Leases

If a lease agreement refers to an IBOR, then lessees should remeasure their lease liabilities when the agreement is amended, as with a change in an index or rate.

IFRS 16 has been amended to address situations where lease agreements specifically refer to an IBOR and will need to be amended to refer to an RFR.

To the extent that:

- ▶ The modification is necessary as a direct consequence of the Reform
- ▶ The new basis for determining lease payments is 'economically equivalent' to the previous basis (see 2.1, above)
- ▶ There are no further modifications other than those required by the Reform

Lessees are required to remeasure their lease liabilities in similar fashion to any other change in future lease payments resulting from a change in an index or a rate used to determine those payments in accordance with IFRS 16.42, rather than as a lease modification.¹⁰⁹

Applying IFRS 16, modifying a lease contract to change the basis for determining the variable lease payments meets the definition of a lease modification, because a change in the calculation of the lease payments would change the original terms and conditions determining the consideration for the lease. Without the relief, IFRS 16 would require an entity to account for a lease modification by remeasuring the lease liability by discounting the revised lease payments using a revised discount rate (with an offsetting adjustment to the right of use asset). In the Board's view, reassessing the lessee's entire incremental borrowing rate when the modification is limited to what is required by the Reform would not reflect the economic effects of the modified lease. The practical expedient requires remeasurement of the lease liability using a discount rate that only reflects the change to the basis for determining the variable lease payments as required by the Reform.

If, in contrast, other changes to the lease are made at the same time, the normal modification rules in IFRS 16 apply, even to those modifications required by the Reform.¹¹⁰ In contrast to the amendments for financial assets and financial liabilities in IFRS 9, the Board decided not to specify the order of accounting for lease modifications required by the Reform and other lease modifications. This is because the accounting outcome would not differ regardless of the order in which an entity accounts for lease modifications required by the Reform and other lease modifications.

For finance leases, a lessor is required to apply the requirements in IFRS 9 to a lease modification, so the amendments in paragraphs 5.4.5–5.4.9 of IFRS 9 would apply when those modifications are required by the Reform.

The effective date is for annual reporting periods beginning on or after 1 January 2021. Early application is permitted. An entity is not required to restate comparative periods and may do so only if it is possible without the use of hindsight.¹¹¹

¹⁰⁹ IFRS 16.104-105.

¹¹⁰ IFRS 16.106.

¹¹¹ IFRS 16 C1B and C20C and D.

8. Amendments to IFRS 4 *Insurance Liabilities*

Those insurers who have elected to defer the implementation of IFRS 9 and so are still applying 'frozen' IAS 39 should account for amendments to financial instruments necessary to implement the Reform, by applying the amendments made to IFRS 9 in paragraphs 5.4.6-5.4.9 (see 2, above).¹¹² References to B5.4.5 of IFRS 9 should be read as referring to paragraph AG 7 of IAS 39 and references to 5.4.3 and B5.4.6 should be read as referring to AG 8.¹¹³ This means that those insurers will obtain the same reliefs for assessing derecognition and resetting the EIR as other entities.

The effective date is for annual reporting periods beginning on or after 1 January 2021. Early application is permitted.¹¹⁴ An entity is not required to restate comparative periods and may do so only if it is possible without the use of hindsight.¹¹⁵

¹¹² IFRS 4.20R.

¹¹³ IFRS 4.20S.

¹¹⁴ IFRS 4.50.

¹¹⁵ IFRS 4.51.

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

About EY's International Financial Reporting Standards Group

A global set of accounting standards provides the global economy with one measure to assess and compare the performance of companies. For companies applying or transitioning to International Financial Reporting Standards (IFRS), authoritative and timely guidance is essential as the standards continue to change. The impact stretches beyond accounting and reporting to the key business decisions you make. We have developed extensive global resources – people and knowledge – to support our clients applying IFRS and to help our client teams. Because we understand that you need a tailored service as much as consistent methodologies, we work to give you the benefit of our deep subject matter knowledge, our broad sector experience and the latest insights from our work worldwide.

© 2021 EYGM Limited.
All Rights Reserved.

EYG No. 004196-21Gbl
ED None

EY-000129616.indd (UK) 05/21.
Artwork by Creative Services Group London.



In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, legal or other professional advice. Please refer to your advisors for specific advice.

This publication contains copyright material of the IFRS® Foundation in respect of which all rights are reserved. Reproduced by EY with the permission of the IFRS Foundation. No permission granted to third parties to reproduce or distribute. For full access to IFRS Standards and the work of the IFRS Foundation please visit <http://eifrs.ifrs.org>