

## IFRS Developments

# IBOR reform: finalisation of phase one

### What you need to know

- ▶ The IASB has confirmed the amendments to IFRS 9 and IAS 39 as proposed in its May 2019 ED on Interest Rate Benchmark Reform.
- ▶ It has agreed to provide relief for the IAS 39 retrospective effectiveness assessment.
- ▶ It has also agreed to address/clarify two issues that arise in hedges of groups of items, to extend the relief to certain foreign currency hedges and to simplify the disclosure requirements.
- ▶ The final amendments are planned to be issued in September 2019.

### Introduction

On 3 May 2019 the International Accounting Standards Board (IASB or the Board) published an Exposure Draft, *Interest Rate Benchmark Reform, Proposed amendments to IFRS 9 Financial instruments and IAS 39 Financial instruments* (the ED). The ED presented for comment the decisions taken so far by the IASB in phase one of its project responding to the effects of Interbank Offered Rates (IBOR) reform on financial reporting. The IASB had previously divided the project into two phases:

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

We summarised the ED in our *IFRS Developments, issue 148* and provided background to the project in *IFRS Developments, issues 144 and 145*.

Following responses by constituents to the ED, the Board met on 28 August 2019 to confirm its proposals and agree some additional amendments.

## Confirmation of the ED proposals

The IASB confirmed the following reliefs proposed in the ED, which we summarised in our *IFRS Developments, issue 148*:

1. The assessment of whether a forecast transaction (or component thereof) is highly probable
2. Assessing when to reclassify the amount in the cash flow hedge reserve to profit and loss
3. For IFRS 9, the assessment of the economic relationship between the hedged item and the hedging instrument and for the IAS 39 prospective assessment

For each of these reliefs, it is assumed that the benchmark on which the hedged cash flows are based (whether or not contractually specified) and/or, for relief three, the benchmark on which the cash flows of the hedging instrument are based, will not be altered as a result of IBOR reform.

The effective date of the amendments is for annual periods beginning on or after 1 January 2020, with early application permitted. The requirements must be applied retrospectively. However, it was clarified in the August meeting that the reliefs would apply to hedging relationships in existence as of the date of first application.

## The IASB's further amendments

At its August meeting, the IASB made the following additional decisions:

1. To provide an exception for the IAS 39 paragraph AG105 (b) retrospective assessment, to allow the hedge to pass the assessment even if the actual results of the hedge are temporarily outside the 80%-125% range, during the period of uncertainty arising from IBOR reform. The application of this new exception will be mandatory. All other hedge accounting requirements, including the amended prospective assessment requirements, would need to be met and any actual ineffectiveness would 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. This would include the effect of any increase in discount rates that the market would require due to the uncertainties arising from IBOR reform.
2. To provide relief from the separately identifiable requirement for hedging strategies in which hedged items are designated and re-designated, such as in 'macro hedges'. The ED proposed that a non-contractually specific risk component only has to satisfy the IFRS 9 paragraph 6.3.7 (a) 'separate identifiability' requirement at inception of the hedging relationship. However, where hedging instruments and hedged items may be added to or removed from an open portfolio in a continuous hedging strategy, entities have to de-designate and re-designate hedging relationships at regular intervals. If each re-designation is considered to represent the inception of a new hedging relationship, the exception as proposed in the ED would have given limited benefit. The amended relief requires the entity to satisfy the separately identifiable requirement only when hedged items are initially designated within the hedging relationship. The entity would not subsequently need to reassess this requirement for any hedged items that have been re-designated. The exception is mandatory for all such hedges directly affected by the reform.

3. To clarify when IBOR relief ceases to apply to a group of items designated as the hedged item. According to the ED, the proposed exceptions for the 'highly probable' and 'prospective assessment' requirements end when uncertainty regarding the timing and the amount of benchmark-based cash flows is no longer present. Respondents asked for clarification, for hedges of groups of items, whether this assessment should be performed on an individual instrument basis, or on a group basis (so that uncertainty would not end for any item in the group until the last item in the group has been amended to the new benchmark rate). The new amendment will state that, when an entity designates a group of items as the hedged item, the end of application requirement should apply to each individual item within the designated group of items.
4. To clarify that the proposed reliefs will apply to hedging relationships where interest rate risk is not the only hedged risk being designated. This could apply when both interest rate risk and another risk, such as foreign currency risk, are designated hedged risks. The amendment will clarify that the reliefs apply to all hedging relationships that are directly affected by uncertainties about the timing or amount of interest rate benchmark-based cash flows of the hedged item or hedging instrument due to IBOR reform. However, if the hedged item or hedging instrument is designated for risks other than just interest rate risk, the proposed exceptions only apply to the interest rate benchmark-based cash flows. It was also clarified at the Board meeting that the hedged item must have interest-based cash flows and so relief would not apply, for instance, to net investment hedges.
5. To exempt entities from the disclosure requirements in paragraph 28-f of IAS 8 *Accounting policies, changes in accounting estimates and errors* upon the initial application of the amendments and to simplify the disclosure requirements, as originally set out in the ED. Informal outreach conducted with users has revealed that users mainly want to understand the extent to which an entity's hedging relationships are within the scope of the exceptions. They also want qualitative disclosures of significant assumptions and judgements and how the uncertainties are affecting the entity's risk management strategies. The revised, more targeted disclosures will now contain:
  - a. A description of the significant interest rate benchmarks to which the entity's hedging relationships are exposed
  - b. An explanation of how the entity is managing its transition to RFRs
  - c. An explanation of significant assumptions or judgements the entity had to make in applying the exceptions
  - d. The nominal amount of the hedging instruments and the extent of risk exposures that are affected by IBOR reform

The Board agreed not to re-expose the amendments and gave permission to make the amendments to the standards, with the expectation that the final amendments will be issued in September 2019.

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**How we see it**

The completion of phase one of the project is an important milestone and we commend the IASB for making this topic a priority and issuing amendments so that there is a reasonable chance that they can be endorsed by the EU before year end.

The amendments should address the hedge accounting issues that have been identified as potentially problematic during the period before contracts are amended to new benchmark rates.

However, it is now important for the IASB to turn its attention to phase two of the project and consider the financial reporting issues that will arise once the transitions to RFRs take place. The transition from IBOR to RFRs is occurring at different times in different jurisdictions and for different financial instruments and contracts will have begun to be amended before phase two is concluded. Depending on how IBOR is replaced in different jurisdictions, one of the concerns is that without the reliefs that will hopefully be made available by phase two, there is a risk that amounts in other comprehensive income for a cash flow hedge based on IBOR may have to be recycled to profit or loss once IBOR uncertainty ends. If the IASB can substantially address the questions posed by the second phase of IBOR reform, it will help smooth the transition from IBOR to RFRs.