Applying IFRS

IBOR reform

Updated December 2021

Building a better working world

Contents

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 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.
- 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
- This publication was first issued in October 2020. It was subsequently updated in December 2020 and May 2021 to reflect further developments in IBOR reform and the resulting accounting considerations.
- This fourth edition of the publication contains updates covering:
  - The announcement of synthetic LIBORs and when they take effect once LIBORs cease
  - The central conversion process being run by certain central clearing houses such as the London Clearing House
  - The end of uncertainty and when the phase 1 reliefs end
  - How and when the phase 2 reliefs are applied including when the hedging documentation and EIR should be updated
  - The phase 1 and phase 2 disclosures required as at 31 December 2021

1. Introduction

1.1 Background

IBOR Reform is ongoing. So far, 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 cease to be published after the end of 2021 …

In March 2021, the Intercontinental Exchange (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 will be published for some LIBORs to help manage tough legacy contracts.

The FCA, which regulates LIBOR, confirmed on 29 September 2021 that 'synthetic' LIBOR will continue to be published for one-month, three-month and six-month sterling and yen LIBOR until 31 December 2022. The FCA has indicated that it will not compel publication of Yen LIBOR thereafter, but the position for GBP LIBOR is currently unclear. The synthetic LIBOR will be based on forward looking term versions of the relevant RFR plus the ISDA fallback spread adjustment (see below). However, the FCA has stressed that these synthetic LIBORs do not meet the conditions of the Benchmark Regulation, are not for use in new contracts and are intended to help reduce disruption for certain contracts that are particularly difficult to amend (often referred to as 'tough legacy') to help ensure an orderly wind-down[1].

Meanwhile, the Euro Overnight interest Average (EONIA) has, in effect, been replaced by the Euro Short-Term Rate (€STR) and publication of EONIA is due to cease on 3 January 2022[2]. Reforms to the Euro Interbank Offered Rate (EURIBOR) methodology were completed in 2019. The long-term sustainability of the different EURIBOR maturities will depend on factors such as whether the panel of contributing banks continues to support them and whether or not there is sufficient activity in its underlying market. Consequently, there may be mixed views as to whether some EURIBOR maturities are still in scope of the IFRS IBOR Reform Amendments.

The RFRs that were originally introduced are overnight rates based on actual transactions and reflected 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. Term RFRs, based on the forward market for overnight RFRs, are now becoming available for use in certain circumstances, which allow borrowers to know in advance the interest they will pay for a period, in a similar manner to IBOR-based

[1] Further arrangements for the orderly wind-down of LIBOR at end-2021, FCA, 29 September 2021.
[2] EONIA is now defined as €STR +8.5bp.

loans. On 29 July 2021, the US Alternative Reference Rates Committee (ARRC) formally recommended the use of the 1-month, 3-month and 6-month SOFR Term Rates administered by the Chicago Mercantile Exchange (CME) Group.[3] One-month, three-month, 6-month and twelve-month forward looking term SONIA Reference Rates also became available from the beginning of 2021. References in this publication to SOFR and SONIA are to overnight rates unless indicated otherwise.

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.[4]

IBORs, fixed in advance for a period (such as 3-months or 6-months), include a bank's credit risk premium for that period. However, the RFRs are designed to exclude all but overnight credit risk and SOFR is based on secured lending rates. Hence, applying the ISDA Fallbacks, the transition will include a spread adjustment to the previous derivative floating rate, which takes effect from when the period for the current LIBOR fixing comes to an end. The same approach will be used for derivatives that transition with the central clearing houses. The ISDA fallback spread adjustments, sometimes referred to as Credit Adjustment Spreads (CAS) are based on the average historical spread between the relevant IBOR and the compounded RFR over the previous five years (see section 2.1.2 below). The ISDA spread adjustments became fixed on 5 March 2021.[5] These include:

ISDA fixed its fallback credit spread adjustments in March 2021.

- USD 3-months 26.161bp
- Sterling 3-months 11.93bp
- Sterling 6-months 27.66bp
- Japanese Yen 3-months 0.835bp

Also, during 2020, derivative clearing houses such as the Chicago Mercantile Exchange and the London Clearing House (LCH) 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 also affects 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

[3] ARRC Formally Recommends Term SOFR, 29 July 2021.
[4] Understanding IBOR Benchmark Fallbacks, ISDA, October 2020.
[5] IBOR Fallbacks – Technical Notice – Spread Fixing Event for LIBOR, Bloomberg, 5 March 2021.

rates and the related spread adjustment methodologies for different types of loans.

How we see it

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 execute their programmes to implement the new requirements before the IBORs cease. 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.

1.2 IFRS amendments

The IASB's project to address the financial reporting implications of IBOR reform was split into two phases.

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

- *Phase 1*
  Pre-replacement issues – those 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), and also added some additional disclosure requirements to IFRS 7 *Financial Instruments: Disclosures* (see section 6 below).

The IASB Phase 1 Amendments were effective for periods beginning on or after 1 January 2020 with early application permitted.

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 affected 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 below)
- Reliefs from discontinuing hedge relationships (see section 4 below)
- 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 below)
- Additional IFRS 7 disclosures (see section 6 below)

How we see it

The Phase 2 Amendments introduce additional areas of judgement, for which 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.

The IASB Phase 2 Amendments are mandatory for annual periods beginning on or after 1 January 2021.

The Phase 2 Amendments also affect IFRS 16 *Leases* (see section 7 below) and IFRS 4 *Insurance Liabilities* (see section 8 below). 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 below).

How we see it

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

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 Reform: *[IFRS 9.5.4.6, IFRS 9.6.9.2, IFRS 9.BC6.620(a)]*

- 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. *[IFRS 9.BC5.297, IFRS 9.BC.298, IFRS 9.BC.299]*. However, the Phase 2 Amendments use the phrase, 'changes in the basis for determining contractual cash flows' instead of 'modification of the contractual cash flows', so as not to imply that the Phase 2 Amendments provide guidance on the treatment of those modifications that occur outside of the scope of the Reform. The IASB has identified the general model of modifications to contractual cash flows as a topic to be considered as part of the Post Implementation Review of IFRS 9.[6]

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 2.3 below).

Entities need to assess whether changes are a direct consequence of the Reform and result in economically equivalent new contractual cash flows.

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 below) and for the continuation of hedging relationships (as described in section 4.2.2 below) must be applied.

[6] Request for Information - Post-implementation Review - IFRS 9 *Financial Instruments, Classification and Measurement*, Section 6 - Modifications to contractual cash flows, IASB, September 2021.

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 below.

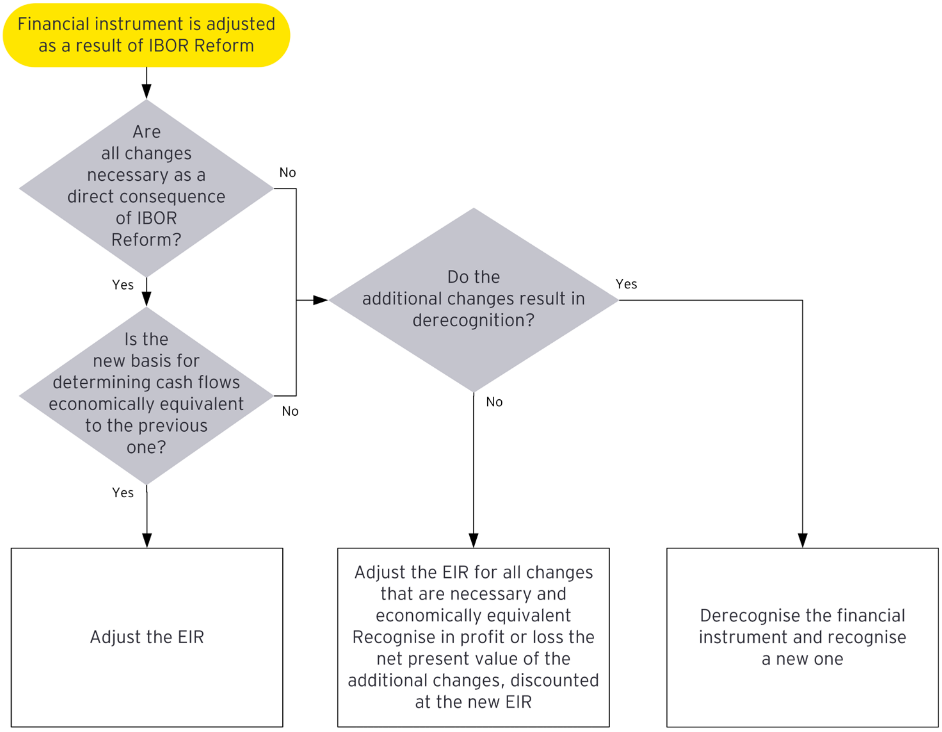
If derecognition is required, then the reliefs applicable to the EIR and the continuation of hedging relationships are not available.

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 below.
- A hedging relationship may still continue, as described in section 4.2.2 below.

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 the continuation of hedging relationships (as further discussed in section 4.2.2 below).

- 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. *[IFRS 9.BC5.306]*.

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.

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. *[IFRS 9.5.4.7]*.

The use of the practical expedient is subject to two conditions: *[IFRS 9.5.4.7]*.

- First, the change in the basis for determining contractual cash flows must be 'necessary as a direct consequence of interest rate benchmark 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.

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.

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*.' *[IFRS 9.6.8.2, IAS 39.102B]*. IBOR Reform can, therefore, be read to encompass any replacement of references to an IBOR with a rate 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. *[IFRS 9.BC5.313]*.

2.1.2 Economically equivalent

The Phase 2 Amendments provide examples of where changes would be 'economically equivalent': *[IFRS 9.5.4.8]*

Extract from IFRS 9
5.4.8 Examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis (ie the basis immediately preceding the change) are: (a) the replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an alternative benchmark rate - or the implementation of such a reform of an interest rate benchmark by altering the method used to calculate the interest rate benchmark - with the addition of a fixed spread necessary to compensate for the basis difference between the existing interest rate benchmark and the alternative benchmark rate; (b) changes to the reset period, reset dates, or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and (c) the addition of a fallback provision to the contractual terms of a financial asset or financial liability to enable any change described in (a) and (b) above to be implemented.

Economically equivalent' does not mean 'economically identical'. The IASB regards 'economic equivalence' to be principle-based.

It will be clear from the list above 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. *[IFRS 9.BC5.315, IFRS 9.BC5.317]*. For instance, it would be consistent with these examples to include amendments to caps and floors so as to maintain their economic effect (see Illustration 2-1). It would also be consistent with the examples for transition to a synthetic LIBOR such as those defined by the FCA (see 1.1 above), to be considered as economically equivalent.

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 substantially similar before and after the replacement"). *[IFRS 9.BC5.315, IFRS 9.BC5.316]*. Accordingly, the IASB set no 'bright lines' and an entity is required to apply judgement to assess whether circumstances meet the economic equivalence condition.

How we see it

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.

2.1.3 ISDA fallback spread

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:[7]

[7] Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA definitions, Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW, ISDA, July 2018.

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.

The ISDA methodology for determining the spread may be applied by entities more broadly to the transition of many non-derivatives to RFRs, e.g., it can provide a starting point in bilateral negotiations to amend a contract. As has already been mentioned in Section 1, the ISDA fallback spreads were ‘fixed’ on 5 March 2021.

How we see it

Any approach to adjust the spread on transition to an RFR would have to be practical to apply and make use of data that is reliable and readily available. Limitations on the availability of data are likely to mean 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 can, in theory, result in transitions which are economically equivalent.

When using approaches such as those developed by ISDA that are based on rigorous quantitative analysis, it should not be necessary to make a quantitative evaluation of the economic equivalence on an instrument-by-instrument basis.

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 within interest income or expense. *[IFRS 9.5.4.9]*.

Extract from IFRS 9

5.4.9 If changes are made to a financial asset or financial liability in addition to changes to the basis for determining the contractual cash flows required by interest rate benchmark reform, an entity shall first apply the practical expedient in paragraph 5.4.7 to the changes required by interest rate benchmark reform. The entity shall then apply the applicable requirements in this Standard to any additional changes to which the practical expedient does not apply. If the additional change does not result in the derecognition of the financial asset or financial liability, the entity shall apply paragraph 5.4.3 or paragraph B5.4.6, as applicable, to account for that additional change. If the additional change results in the derecognition of the financial asset or financial liability, the entity shall apply the derecognition requirements.

An entity first applies the practical expedient to a change that is required by IBOR Reform and then applies the normal requirements in IFRS 9 to those changes to which the practical expedient does not apply.

Application of these requirements means an entity first applies the practical expedient to a change that is required by IBOR Reform (i.e., a change that meets both the conditions in paragraph 5.4.6) and then applies the normal requirements in IFRS 9 to those changes to which the practical expedient does not apply.

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 instalments)
- 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

In many cases, an instrument will transition on a date that is different to the fixing date when the contractual cash flows are scheduled to periodically reset to the current floating rate. Therefore, at the time of transition, an instrument will often, in effect, be a combination of a fixed rate instrument until the end of the previous fixing period and a floating rate instrument for all future fixings. IBOR Reform affects only the future fixings, which following transition will reference the new RFR. For the instrument to transition on an economically equivalent basis, any cash flows remaining from the final IBOR fixing before transition, will normally continue until the next scheduled fixing takes place, which will reference the RFR.

How we see it

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.

2.1.4 Addition of and adjustment to floors and caps

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 shown in Illustration 2-1.

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.

These requirements are shown in Illustration 2-1 below and also in Illustrations 4-2 to 4-4 in section 4.3 below.

Illustration 2-1:	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.[8]

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.

2.1.5 Cash settlement

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 2.3 below, 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. Therefore, a transition involving some cash settlement may still be viewed as economically equivalent provided that it is relatively small when considered against the contractual cash flows of the original instrument.

This is an area where practice is developing, and the application may require judgement.

[8] 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.

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 new instruments. 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

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

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. *[IFRS 9.3.3.2]*. 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 to analogise, at least to some extent, to those requirements in IFRS 9 applying to modifications and exchanges of financial liabilities[9]. This is an area which requires judgement, and many entities will have already developed an appropriate accounting policy.

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. *[IFRS 9.5.4.9]*

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.

[9] IFRIC Update, September 2012, IAS 39 Financial Instruments: Recognition and Measurement–Derecognition of financial instruments upon modification.

How we see it

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 substantial. *[IFRS 9.B3.3.6]*, it is recognised that the assessment should also have regard to qualitative factors, such as the introduction of new contractual features.

If a derivative is closed out and replaced with a counterparty on the same terms, the substance of the arrangement shall determine its accounting treatment, rather than its legal form.

2.3 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. *[IFRS 9 BC6.619]*.

2.3.1 Two new derivatives, one equal and offsetting the original derivative

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. *[IFRS 9.BC6.620 (a)]*. 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 financial liabilities, *[IFRS 9.3.3.2]*, 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.

2.3.2 Derivative replaced with a new derivative

It would give the same result as that described above, if on transition an existing swap is legally terminated and at the same time, a new interest rate swap is entered into, in which all terms and conditions remain unchanged, other than the new RFR which replaces the IBOR. Notably, the terms of the new instrument may not contain a fixed spread adjustment (similar to the CAS referred to above), which would, therefore, contribute to the new derivative being off market. Derecognition of the original derivative would not be required if, similar to the scenario described in 2.3.1 above, the conditions to derecognise a financial liability have not been met as the terms are not substantially different.

By 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. *[IFRS 9.BC6.620 (b)]*.

2.3.3 New basis swap linked to the derivative

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. *[IFRS 9.BC6.620 (c)]*. 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.

2.3.4 Novation to a new counterparty and amendment of the derivative

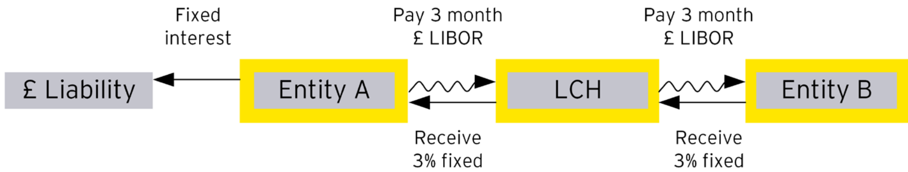
Novating an IBOR-based derivative to a new counterparty and subsequently amending the derivative to refer to an RFR, would result in extinguishment of the original derivative.

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. *[IFRS 9.BC6.620 (d)]*. 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.

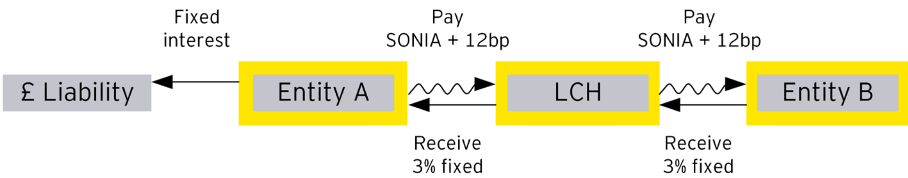
The process of modifying a derivative is shown in Illustration 2-2.

Illustration 2-2: 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 year 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 pay 3% fixed, but starting from the next quarterly fixing date, A makes a quarterly payment of SONIA + 12bp (compounded daily).



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 below.

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. 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.

2.3.5 Transition by central clearing houses

A further complexity can arise when entities agree that instruments will reference IBOR until the cessation date, but for operational reasons, they convert the instruments prior to cessation date. The LCH will operationally convert all bookings for LIBOR swaps to RFRs prior to cessation date.

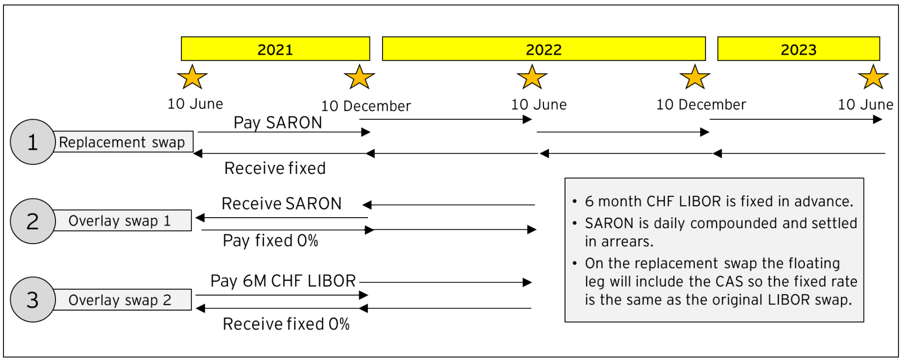
For example, the LCH will change all CHF LIBOR swap bookings to SARON on 4 December 2021, but the swaps will continue to reference CHF LIBOR until 31 December 2021. This means that, for CHF LIBOR swaps with a fixing date from 4 December to 31 December, the final LIBOR fixing between the date of conversion and the date of transition will be retained. Retaining this final LIBOR fixing will help ensure that the transition is economically equivalent. To help make this operational, the LCH will replace each LIBOR swap with three separate 'bookings', which, in combination, achieve this result, as shown in the illustration below.

Illustration 2-3: LCH transition of LIBOR swaps

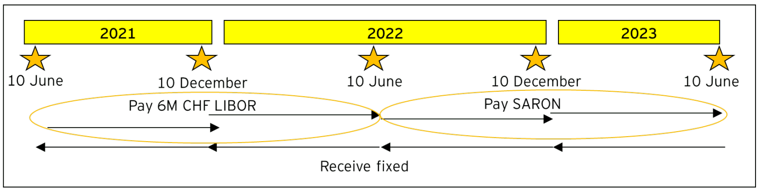
Consider a swap with a two-year term pay 6-month CHF LIBOR, receive fixed

- First transacted on 10 June 2021 and maturing on 10 June 2023
- Fixing dates on 10 December and 10 June annually

Upon conversion on 4 December 2021, three bookings are made:



The overall effect from the combination of the three bookings is as reflected in the diagram below:



How we see it

Consistent with the guidance set out in the Phase 2 Amendments, the three new bookings would be viewed together as a continuation of the original LIBOR swap, which will be treated as modified rather than derecognised. The LCH has received legal advice that the three new bookings have no contractual effect and do not alter or amend the legal rights and obligations under the original derivative, which supports considering them together as a continuation of the original swap.

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 initial recognition, the cash flows represent Solely Payment of Principal and Interest (SPPI). *[IFRS 9.B4.1.7 - IFRS 9.B4.1.26]*.

The IASB concluded 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.

As part of the IBOR Reform project, in October 2019[10], 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 (Illustration 3-1) and Adjustable Rate Mortgages (Illustration 3-2).

Illustration 3-1: 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.

[10] *IASB Update*, October 2019, IASB Staff Paper 14B, IBOR Reform and its Effects on Financial Reporting—Phase 2, Accounting implications from derecognition of a modified financial instrument, paragraphs 30 to 50.

Illustration 3-2: 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 term SOFR rates were not available when the ARRC issued their recommendations and will take some time to become well established, 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 process[11], 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.

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 Illustration 3-2).

[11] Options for using SOFR in Adjustable Rate Mortgages, The Alternative Reference Rates Committee, July 2019.

When a new financial liability is recognised, entities should assess whether the fallback passes the 'double-double test.

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 significantly modified. 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

Extract from IFRS 9
6.8.1 An entity shall apply paragraphs 6.8.4–6.8.12 and paragraphs 7.1.8 and 7.2.26(d) to all hedging relationships directly affected by interest rate benchmark reform. These paragraphs apply only to such hedging relationships. A hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about: (a) the interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk; and/or (b) the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument.

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

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).*[IFRS 9.6.8.1]*. 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

Application of the reliefs is mandatory. *[IFRS 9.7.1.8]*. The first three reliefs for IFRS 9 provide for:

1. The assessment of whether a forecast transaction (or component thereof) is highly probable *[IFRS 9.6.8.4]*
2. Assessing when to reclassify the amount in the cash flow hedge reserve to profit and loss *[IFRS 9.6.8.5]*
3. The assessment of the economic relationship between the hedged item and the hedging instrument *[IFRS 9.6.8.6]*

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'. *[IFRS 9.6.3.7(a)]*. 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. *[IFRS 9.6.8.7]*. 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 section 5 below).

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. *[IFRS 9.BC6.570]*. 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.

Illustration 4-1: 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. *[IFRS 9.6.8.8.]*.

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. *[IFRS 9.BC6.575]*.

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. *[IFRS9.BC6.560]*. 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. *[IFRS 9.BC6.567, IFRS 9. 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 loss *[IFRS 9.6.8.9, IFRS9.6.8.10]*

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 discontinuation *[IFRS 9.6.8.11]*

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. *[IFRS 9.6.8.12]*

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. *[IFRS 9.6.8.13]*

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

In most cases, the Phase 1 relief will only end when a contract is amended to specify both what the new benchmark will be and when it will take effect, and the spread adjustment that will be applied.

uncertainties due to the Reform will end. [IFRS 9.BC6.587 - IFRS 9.BC6.593]. 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, and the spread adjustment that will be applied. 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.

As the Phase 1 reliefs only cease to apply when there is no longer uncertainty over the benchmark that will apply, when it will be applied, and the change to the spread, 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.

The FCA announced in March 2021 that most LIBOR settings will cease at the end of 2021 and ISDA fixed the basis spreads that will be applied to the RFR on transition under the fallback protocol (see Section 1). This raises the question 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. Similarly, entities may decide to bilaterally negotiate the terms of transition so as to override the terms of the fallback.
- As mentioned earlier, the FCA will still require the ICE Benchmark Administration to continue publishing certain LIBOR settings (i.e., one-, three- and six- months settings for GBP and JPY) on a non-representative, 'synthetic' basis for 12-months beyond December 2021 (and potentially further for GBP) 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.
- Although it may be known when derivatives will transition and the RFR and spread adjustment that will be applied, there may be an additional adjustment at the transition date, to reflect any further differences in market fair value.

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. *[IFRS 9.BC6.594]*. 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 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. *[IAS 39.102A - IAS 39.102N, IAS 39.108G]*. These are consistent with those for IFRS 9, as described at 4.1.1 and 4.1.2 above, 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. *[IAS 39.102F]*. 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. *[IAS 39.BC250]*.

  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. *[IAS 39.102M]*.

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. *[IAS 39.102G]*. 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 that the portion is separately identifiable need be met only at the inception of the hedge. *[IAS 39.102H]*.

4.2 Phase 2 hedge accounting amendments

The Phase 2 reliefs help ensure continuity of hedge accounting.

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 above, we first describe the reliefs for hedge accounting under IFRS 9 and then in sections 4.2.7 and 4.2.8 below set out any differences for entities still applying IAS 39 for hedge accounting.

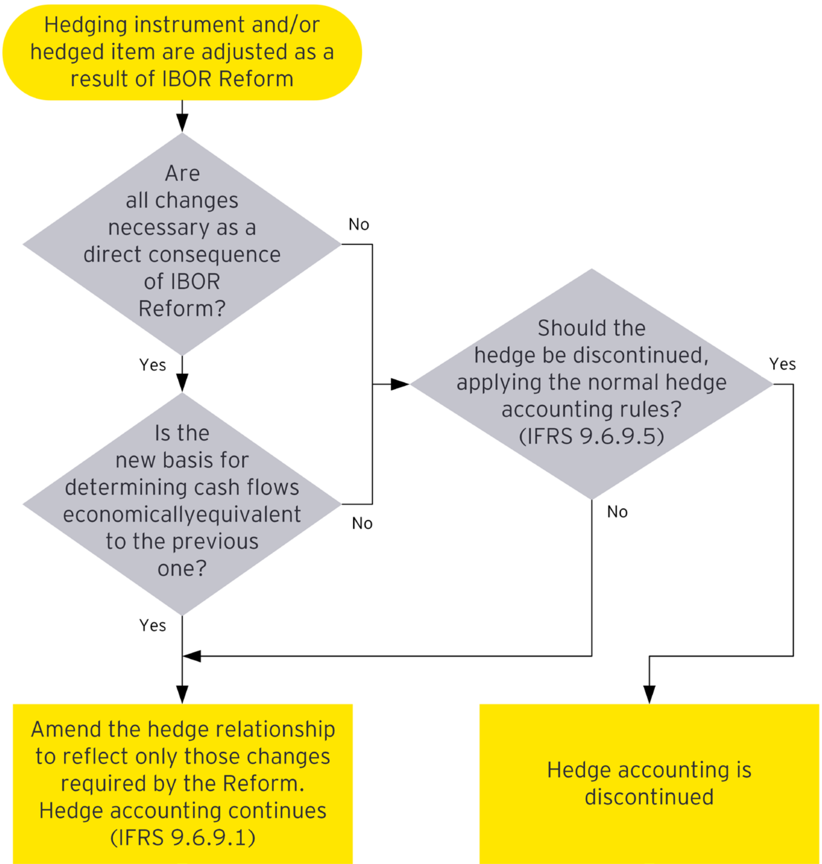
4.2.1 Phase 2 reliefs for IFRS 9

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 4.2.5 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 hedge accounting relief is dependent on two conditions.

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 hedged risk, hedged item or hedging instrument. Such an amendment does not constitute a discontinuation of the hedge relationship. *[IFRS 9.6.9.1, IFRS 9.6.9.4]*.

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 interim financial statements in accordance with IAS 34 *Interim Financial Reporting*.

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 instrument *[IFRS 9.6.9.1]*

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) *[IFRS 9. 6.9.1, IFRS 9. 5.4.5, IFRS 9.5.4.6, IFRS 9. 5.4.7]*

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 made *[IFRS 9.5.4.8]*

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.

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. *[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

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 derecognised *[IFRS 9.6.5.6, IFRS 9.6.4.1]*

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

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 instrument *[IFRS 9.6.9.5, IFRS 9.6.9.1]*, 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 Illustration 4-3 in 4.3.2.

As discussed in section 2.2 above 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.

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 2.3

ii) The change is made on an economically equivalent basis

The examples contained in the Basis for Conclusions have already been introduced in section 2.3, 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 criterion 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. *[IFRS 9.BC6.620 (c)]* 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. *[IFRS 9.BC6.617]*. 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 it is a subsequent addition to improve hedge effectiveness.

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. *[IFRS 9.6.9.3]*

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. *[IFRS 9.6.9.3]* 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 shown in Illustration 4-2.

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 Illustration 4-4).

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. *[IFRS 9.BC6.626]*. 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 Illustration 4-4).

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. *[IFRS 9.6.9.7, IFRS 9.6.9.8]*.

Extract from IFRS 9

Cash flow hedges

6.9.7 For the purpose of applying paragraph 6.5.11, at the point when an entity amends the description of a hedged item as required in paragraph 6.9.1(b), the amount accumulated in the cash flow hedge reserve shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

6.9.8 For a discontinued hedging relationship, when the interest rate benchmark on which the hedged future cash flows had been based is changed as required by interest rate benchmark reform, for the purpose of applying paragraph 6.5.12 in order to determine whether the hedged future cash flows are expected to occur, the amount accumulated in the cash flow hedge reserve for that hedging relationship shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

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 for the other sub-group of hedged items, until they too are updated to reference the new RFR. *[IFRS9.6.9.9]*.

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. *[IFRS 9.6.9.10]*

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. *[IFRS 9.6.3.7(a)]*. 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.

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.

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. *[IFRS 9.6.9.11, IFRS 9.6.9.12]*

The assessment of whether a risk component is separately identifiable is discussed further in section 4.2.5 below. 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 below).

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.

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

Relief is provided only for 'separately identifiable' and not for 'reliably measurable.

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. *[IFRS 9.B6.3.9]*.

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 in the extract below:

Extract from IFRS 9	
B6.3.10(d)	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.

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, and that it would be insufficient for the rate to be used only in the swap market. Not only do SONIA swaps make up more than 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".[12] An entity might therefore 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) have until recently made 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 applies to cash flow hedges as well as fair value hedges. *[IFRS 9.BC6.647]* 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 whether it may ever be regarded as a separately identifiable component of an *IBOR-based* floating rate.

12 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.

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.[13] 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.[14] SOFR, however, which is based on overnight borrowing in the US Treasury repo market, 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, since, ‘tough legacy’ financial instruments are being dealt with by creating ‘synthetic’ IBORs, by redefining some GBP and JPY LIBORs to be based on the term version of the RFRs plus the ISDA fallback spreads, then it would follow that the RFR will become a benchmark component of the corresponding synthetic LIBOR.

For the purpose of Illustration 4-4 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.

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[13] IASB Staff Paper 14A, IBOR reform and its Effects on Financial Reporting – Phase 2, End of application – Phase 1 exceptions, paragraph 28.
[14] 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.

Synthetic LIBORs, once available, will be set by reference to the term version of the corresponding RFR plus a CAS. It should therefore follow that the RFR will become a separately identifiable risk component of the synthetic LIBOR. This will be relevant where a RFR derivative is designated as a hedge of a synthetic LIBOR exposure.

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'. *[IAS 39.46 (c)]*. 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. *[IAS 39.AG80]*. 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. *[IAS 39.AG81]*. 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.

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 4.1.3 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. *[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. *[IAS 39.102P(d)]*.

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, 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 above, 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."
[IAS 39.AG99F(a)].

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.

4.3. Application of Phase 2 reliefs

4.3.1. Fair value hedges

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.

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. This would include when the hedging derivative transitions to referencing an RFR, either through a centrally managed conversion process such as that run by the LCH, or the completion of bilateral negotiations to amend the derivative. At that time, Phase 2 will apply and 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). In the examples below, for the hedging derivative the transition basis adjustment has been made to the floating leg, as the LCH have advised they will follow this approach for interest rate swaps they transition[15].

The hedge is likely to need to be redesignated once the contractual terms of the hedging instrument are amended.

Whether or not the transition basis spread is added to the floating leg or deducted from the fixed leg, the amendment would take effect from the date of the first reset of the floating leg to SOFR (or other RFR as appropriate). For the purposes of hedge accounting, the hedge is likely to need to be redesignated earlier, since once the contractual terms of the hedging instrument are amended, there will no longer be any uncertainty as to the timing and amount of IBOR-based cash flows.

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. (The advantage of designating the 2.74% component for changes in SOFR rather than a 3% component for changes in SOFR +

[15] *Managing the Transition to RFRs, SwapClear's Approach to the Conversion Process*. London Clearing House, 4 November 2021.

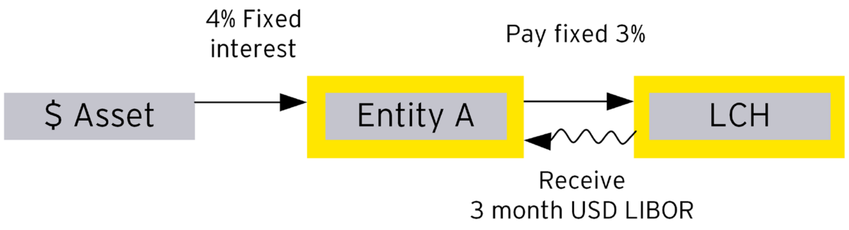
26bp, is that the former is much easier to calculate and apply, especially subsequent to transition when all new hedges will be designated for changes in SOFR-flat, i.e., with no spread adjustment).

Meanwhile, the discount rate used to measure the hedged risk would change from LIBOR to SOFR. On transition, 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.

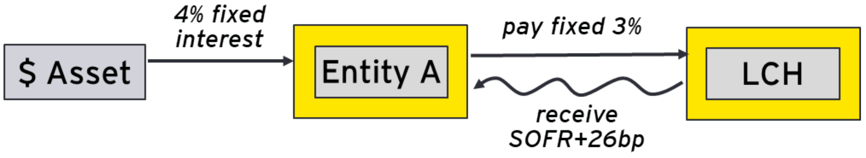
The following two examples illustrate the key features of the Phase 2 Amendments for fair value hedges, the first where the derivative is amended on an economically equivalent basis and the second where it is determined that it is not.

Illustration 4-2: 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 (fixed in advance at the beginning of the quarter). 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 3%, receive SOFR+26bps, effective from the first time the floating leg resets to 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 floating 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.

Illustration 4-2: Application of Phase 2 relief to a fair value 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 when the derivative transitions 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).

Illustration 4-3: 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 3% and pay SONIA+12bp, 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, effective from the first time the floating leg resets to SOFR. 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 combined 18bp change in the interest payments (12bp added to the floating pay leg and 30bp subtracted from the fixed receive leg). ii) However, the revised contractual cash flows are not substantially different, so do not give rise to the swap's derecognition.

Illustration 4-3:	Application of Phase 2 relief to a fair value hedge where the swap is amended to reflect the current market rate of interest

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 on transition.

The 2.88% component and the 2.7% swap will have fair values with different sensitivities to changes in SONIA, which 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 cash flow hedges, 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.

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.

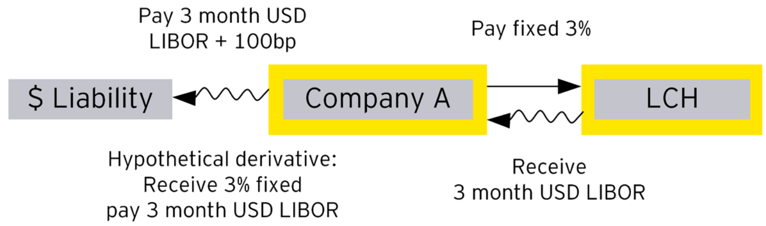
In general, the method of designating the hedged risk and, hence, a hypothetical derivative should not change, just because of IBOR Reform, beyond what is strictly required by the Reform. Accordingly, if prior to transition, the designated hedged risk was the variability of IBOR cash flows, the new designated 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.

Illustration 4-4: Application of Phase 2 relief to a cash flow hedge relationship

The initial fact pattern is the same as that in Illustration 4-2, 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 (fixed in advance at the beginning of the quarter).



As in Illustration 4-2, on 1 November 2021, the derivative is amended to pay fixed 3%, receive SOFR+26bp, effective from the first SOFR fixing date. 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 at the time the derivative is amended, it is assumed that this may not happen for some time, potentially several months.

At this point 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.

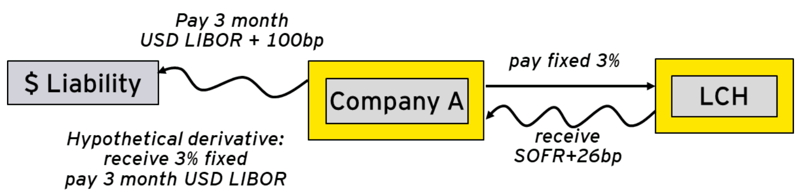


Illustration 4-4: Application of Phase 2 relief to a cash flow hedge relationship

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+26bp 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 relatively 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:

- 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.

One month after the derivative is amended, 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), with effect from the first time that the floating leg resets to SOFR.

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).

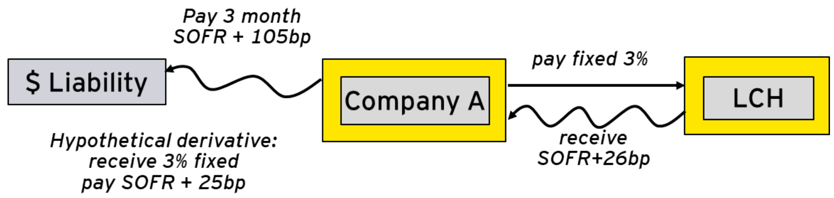
The 20bp change in credit spread is not considered to be a substantial modification of the liability, since quantitatively, the change in net present value discounted at the revised EIR of SOFR +125bp is less than 10% and the change is also judged to be not substantial from a qualitative perspective.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

Illustration 4-4: Application of Phase 2 relief to a cash flow hedge relationship

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 now 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 + CAS 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.



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 3%, receive SOFR+26bp) 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.

Illustration 4-4: Application of Phase 2 relief to a cash flow hedge relationship
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. However, this may no longer be a major concern for those IBORs due to cease at the end of 2021, now that the ISDA fallback spreads have been fixed. This is because market spreads have largely converged 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 during the period until the LIBOR ceases. Hedging relationships where the hedged item transitions to synthetic LIBOR may subsequently transition to an RFR, which would require the hedging relationship to be updated for each transition.

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. *[IFRS 9.7.2.26(d)]*.

Extract from IFRS 9

7.2.26 As an exception to prospective application of the hedge accounting requirements of this Standard, an entity:

(a) ...

(d) shall apply the requirements in Section 6.8 retrospectively. This retrospective application applies only to those 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.

5.2 Phase 2

The Phase 2 Amendments are effective for annual periods beginning on or after 1 January 2021, with earlier application permitted. *[IFRS 9.7.1.10, IAS 39.108H]*. Application of the Phase 2 Amendments is mandatory, to ensure comparability.

Application of the Phase 2 reliefs is retrospective although, as is normal under IFRS, hedge relationships may not be designated retrospectively.

Application is retrospective although, as is normal under IFRS, hedge relationships may not be designated retrospectively. However, discontinued hedging relationships must be reinstated in certain circumstances as described below. *[IFRS 9.7.2.43, IFRS 9.7.2.44, IFRS 9.7.2.45, IAS 39.108I, IAS 39.108.J]*.

Extract from IFRS 9

7.2.43 An entity shall apply *Interest Rate Benchmark Reform—Phase 2* retrospectively in accordance with IAS 8, except as specified in paragraphs 7.2.37–7.2.39.

7.2.44 An entity shall designate a new hedge accounting relationship (for example, as described in paragraph 6.9.13) only prospectively (i.e., an entity is prohibited from designating a new hedge accounting relationship in prior periods). However, an entity shall reinstate a

Extract from IFRS 9
discontinued hedging relationship if and only if the following conditions are met: (a) the entity had discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and the entity would not have been required to discontinue that hedging relationship if these amendments had been applied at that time; and (b) at the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments), that discontinued hedging relationship meets the qualifying criteria for hedge accounting (after taking into account these amendments). 7.2.45 If, in applying paragraph 7.2.44, an entity reinstates a discontinued hedging relationship, the entity shall read references in paragraphs 6.9.11 and 6.9.12 to the date the alternative benchmark rate is designated as a non-contractually specified risk component for the first time as referring to the date of initial application of these amendments (i.e., the 24-month period for that alternative benchmark rate designated as a non-contractually specified risk component begins from the date of initial application of these amendments).

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.

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.

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. *[IFRS 9.7.2.46, IAS 39.108K]*.

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.

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. *[IFRS 9.BC7.88]*.

How we see it

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 IBORs 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 requirements.

The IFRS amendments require some additional disclosures.

6. Disclosures

6.1 Phase 1

Consequential amendments were made by the Phase 1 Amendments to IFRS 7, as shown below. *[IFRS 7.24H]*.

Extract from IFRS 7

Uncertainty arising from interest rate benchmark reform

24H For hedging relationships to which an entity applies the exceptions set out in paragraphs 6.8.4–6.8.12 of IFRS 9 or paragraphs 102D–102N of IAS 39, an entity shall disclose:

(a) the significant interest rate benchmarks to which the entity's hedging relationships are exposed;

(b) the extent of the risk exposure the entity manages that is directly affected by the interest rate benchmark reform;

(c) how the entity is managing the process to transition to alternative benchmark rates;

(d) 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); and

(e) the nominal amount of the hedging instruments in those hedging relationships.

The first, second and fifth of these requirements are illustrated in Practical example 6-1 below:

Practical example 6-1: Standard Chartered plc 2020 Annual Report **UK**

Notes to the financial statements [extract]

Note 14. Derivative financial instruments [extract]

Interest rate benchmark reform [extract]

As at 31 December 2020, the following populations of derivative instruments designated in fair value or cash flow hedge accounting relationships were linked to IBOR reference rates:

	Fair value hedges		Cash flow hedges			
	Notional designated up to 31 December 2021 $million	Notional designated beyond 31 December 2021 $million	Notional designated up to 31 December 2021 $million	Notional designated beyond 31 December 2021 $million	Total $million	Weighted average exposure Years
Interest rate swaps						
USD LIBOR	9,454	36,024	345	2,733	48,556	3.2
GBP LIBOR	268	1,720	89	–	2,077	10.9
JPY LIBOR	552	1,785	–	–	2,337	3.0
SGD SOR	360	123	–	–	483	1.2
	10,634	39,652	434	2,733	53,453	3.5
Cross currency swaps						
USD LIBOR vs Fixed rate foreign currency	2,221	1,915	–	–	4,136	1.3
Total notional of hedging instruments in scope of IFRS amendments as at 31 December 2020	12,855	41,567	434	2,733	57,589	3.4

Practical example 6-1: Standard Chartered plc 2020 Annual Report — UK

	Fair value hedges		Cash flow hedges			
	Notional designated up to 31 December 2021 $million	Notional designated beyond 31 December 2021 $million	Notional designated up to 31 December 2021 $million	Notional designated beyond 31 December 2021 $million	Total $million	Weighted average exposure Years
Interest rate swaps						
USD LIBOR	26,159	25,622	950	2,559	55,290	2.7
GBP LIBOR	613	4,049	–	–	4,662	5.5
JPY LIBOR	1,429	569	–	–	1,998	2.4
SGD SOR	563	132	–	–	695	1.7
	28,764	30,372	950	2,559	62,645	2.9
Cross currency swaps						
USD LIBOR vs Fixed rate foreign currency	6,216	2,189	–	–	8,405	2.7
Total notional of hedging instruments in scope of IFRS amendments as at 31 December 2019	34,980	32,561	950	2,559	71,050	2.9

The Group's primary exposure is to USD LIBOR due to the extent of fixed rate debt security assets and issued notes denominated in USD that are designated in fair value hedge relationships. Where fixed rate instruments are in other currencies cross currency swaps are used to achieve an equivalent floating USD exposure.

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.

6.2 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. *[IFRS 7.24I, IFRS 7.24J]*.

Extract from IFRS 7

Additional disclosures related to interest rate benchmark reform

24I 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, an entity shall disclose information about:

(a) 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 these risks; and

(b) the entity's progress in completing the transition to alternative benchmark rates, and how the entity is managing the transition.

Extract from IFRS 7

24J To meet the objectives in paragraph 24I, an entity shall disclose:

(a) 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;

(b) 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:

(i) non-derivative financial assets;

(ii) non-derivative financial liabilities; and

(iii) derivatives; and

(c) if the risks identified in paragraph 24J(a) have resulted in changes to an entity's risk management strategy (see paragraph 22A), a description of these 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. *[IFRS 7.BC35LLL]*.

Entities may select the basis for the quantitative information they provide about financial instruments that have yet to transition to an alternative benchmark rate.

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
- 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 *Related Party Disclosures*), 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. *[IFRS 7.BC35KKK]*. 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). *[IFRS 7.BC35OOO]*.

One of the concerns that some entities, banks in particular, 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 be drawn, perhaps, with the disclosure requirement in paragraph 30 of IAS 8 for 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 amendments to the IFRS Taxonomy 2021, which incorporate the Phase 2 Amendments' disclosures, include a "text block" element in the table to address the IFRS 9.24J(b) requirements. This is to address the fact that the information can be disclosed in various ways. The Taxonomy reflects that the Board permits the use of text block elements for the disclosure of quantitative information because the disclosure requirements are not prescriptive about how the quantitative information should be provided. The Phase 2 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. For entities that apply the Phase 2 amendments for the first time for their December 2021 year-end, other approaches can be expected.

6.2.1 Disclosure for instruments which have not transitioned

The Phase 2 Amendments require disclosure at the end of the reporting period of exposures which are still to transition from IBOR to RFR *[IFRS 7.24J(b)].* The FCA in its announcement on 5 March 2021,[16] confirmed that twenty-six of the thirty-five LIBOR settings 'will cease immediately after':

- 31 December 2021 for twenty-four of the LIBORs, and
- 30 June 2023 for two USD LIBORs (overnight and twelve month)

For the nine remaining LIBORs, the FCA confirmed on 29 September 2021, that publication would continue on a synthetic basis from 1 January 2022 using a new methodology to help ensure an orderly wind-down.[17]

'Transition' is not defined by the Phase 1 or Phase 2 amendments. Therefore, determining which exposures should be included in the disclosure is a matter of judgment. In making this judgement, entities should consider the Phase 2 Amendments' disclosure objective, which requires entities to disclose the nature and extent of risks arising from financial instruments subject to IBOR reform *[IFRS 7.24I].*

Instruments may be changed from IBOR to RFR in a series of steps, each of which may represent a 'transition' and be eligible for the reliefs which the Phase 2 amendments provide, depending on the specific facts and circumstances. Transition dates for the application of the relief for resetting the effective interest rate are also likely to be different from the transition dates for applying the hedge accounting reliefs. These steps could potentially include the following situations: when a fall-back is added; when an entity decides to use the fallback; when bilateral negotiation is completed; when exposures are automatically converted by a central clearing house such as the LCH; when an IBOR ceases to be published; when a fallback is activated or the first time the floating rate of an instrument resets to an RFR. Entities should determine at the reporting date, the stage their exposures have reached in the transition from IBOR to RFR and they should disclose those exposures which they consider still present a risk arising from IBOR Reform.

Entities should disclose any significant judgements made in the determination, in order to meet the objectives of IFRS 7.24I (see 6.4 below). For example, if an entity includes in its disclosure, IBOR exposures with fall-back provisions which will convert to an RFR immediately after the reporting date (e.g., 31 December 2021), we would generally expect adequate disclosure of this circumstance, including if no further changes are expected to these exposures/contracts due to IBOR Reform. This would include a quantification of those exposures separately from others for which either such fall-backs have not yet been agreed or else will not take effect immediately after the reporting date, e.g., the fallbacks relate to IBORs that will not cease for some time, such as those USD LIBORs that cease after 30 June 2023 or other local IBORs for which a timetable for their replacement has not yet been set. This would provide more meaningful

[16] FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks, 5 March 2021.
[17] Further arrangements for the orderly wind-down of LIBOR at end-2021, 29 September 2021.

information to users about the nature and extent of the risks arising from these financial instruments.

6.2.2 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. *[IFRS 7.24J(b)]*. 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. *[IFRS 7. 24I, IFRS 7.24J]*. 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. *[IFRS 7.4]*. 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. *[IFRS 9.BCZ2.2]*. 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.

6.2.3 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 balance sheet 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. *[IFRS 7.1]*

Similarly, there is no requirement to analyse the quantitative information 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.

How we see it

If the entity 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.

6.2.4 Exposures that reference a new rate but for which further transition may occur

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.

Some LIBORs will be made available on a synthetic basis to help deal with tough legacy exposures by allowing them more time to run-off. The synthetic LIBORs will not be used for new transactions. The FCA state that whilst the synthetic LIBORs are calculated using a new methodology, they do not meet the requirements of the Benchmarks Regulation[18]. Since exposures referencing synthetic LIBORs do not reference a reformed benchmark interest rate, it would appear reasonable for them to still be included in the Phase 2 disclosures. If an entity's exposure to synthetic LIBORs is material, they may require separate disclosure to distinguish between synthetic LIBOR exposures that:

- The entity expects will transition to RFRs
- Are expected to mature whilst the synthetic LIBOR remains available
- Are not expected to transition to RFRs

The Phase 2 quantitative disclosure requirements are shown in Illustration 6-1. While this shows one way to comply with IFRS 7.24J(b), other approaches are possible.

How we see it

Judgement is required to define the best measures to reflect the entity's progress towards completing IBOR 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.

6.2.5 Phase 2 disclosure: Illustrations and examples

Illustration 6-1: Phase 2 Quantitative Disclosures, EY's Good Bank 2021

Notes to the Financial Statements [extract]

Note 48.4.3.1 IBOR reform [extract]

The table below shows the Bank's exposure at the year end to significant IBORs subject to reform that have yet to transition to RFRs as at the current year end, and those exposures which transitioned immediately after the current year end. The tables exclude exposures to IBOR that will expire before transition is required.

[18] Financial Conduct Authority, 29 September 2021, 'Further arrangements for the orderly wind-down of LIBOR at end-2021.

Illustration 6-1: Phase 2 Quantitative Disclosures, EY's Good Bank 2021

In $ million 31 December 2021	Non derivative financial assets – carrying value	Non-derivative financial liabilities – carrying value	Derivatives Nominal amount[1]
Goodland* IBOR $ (1 month)	1,247	1,610	1,474
Goodland IBOR $ (2 months)	1,459	1,545	1,800
Goodland IBOR $ (3 months)	1,181	1,266	1,340
GBP LIBOR (3 months)	1,62	984	1,275
USD LIBOR (3 months)	453	887	906
USD LIBOR (6 months)	306	430	8,22
EUR LIBOR (3 months)	854	426	685
Other	464	541	562
	6,126	7,689	8,864
Cross currency swaps			460
GBP LIBOR (3 months) to USD LIBOR $ (3 months)			460
	6,126	**7,689**	**9,324**

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

Included within the table above are exposures at 31 December 2021 that transitioned from IBORs to RFRs on 1 January 2022, which are shown in the table below. LIBOR USD (3 months) will transition immediately after 30 June 2023. The transition date for Goodland IBORs has not yet been determined.

In $ million 31 December 2021	Non-derivative financial assets - carrying value	Non-derivative financial liabilities carrying value	Derivatives Nominal amount[1]
LIBOR GBP (3 months)	102	894	1,275
LIBOR USD (2 months)	453	887	906
LIBOR EUR (1 month)	854	426	685
Other	264	441	262
	1,673	**2,648**	**3,128**
Cross currency swaps LIBOR GBP (3 months) to Goodland IBOR $ (3 months)			460
	1,673	**2,648**	**3,588**

Exposures at 31 December 2021 that transitioned from LIBOR GBP (3 months) to synthetic LIBOR GBP (3 months) on 1 January 2022, comprise non-derivative financial assets of $60m and non-derivative financial liabilities of $90m.

**Goodland is a fictional country created for EY's Good Bank publication*

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.

Practical Example 6-2: NatWest Group plc, 2020 Annual Report **UK**

Notes to the consolidated financial statements [extract]

Note 11 Financial instruments – classification [extract]

Interest rate benchmark reform [extract]

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	Expected credit losses	Total
	GBP LIBOR £m	USD IBOR (1) £m	EUR IBOR £m	Other IBOR £m	£m	£m	£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 £2.3billion, 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.

Practical Example 6-3: Barclays Plc 2020 Annual Report — UK

Notes to the financial statements [extract]

Note 41 Interest rate benchmark reform [extract]

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. *[IFRS 7.23E]*. 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

When applying the Phase 1 and Phase 2 amendments, entities may be required to make various judgements in order to apply the reliefs and produce the disclosures. Separate disclosure of any significant judgements should be provided in line with the requirements of IAS 1 *Presentation of Financial Statements*, paragraph 122. Since this disclosure requirement is already established in IFRS, the IASB did not specify additional disclosures for significant judgments when finalising the IBOR Reform amendments. *[IFRS 7.BC35.MMM]*.

Significant judgements which could arise for which entities would be required to provide disclosure may include (but are not limited to) the following:

- How entities assess whether transition has taken place on an 'economically equivalent' basis. This is discussed further in section 2 above.
- To determine when the Phase 1 reliefs should end, entities will need to assess whether there remains any uncertainty with respect to the amount or timing of IBOR Reform. This is discussed further in section 4.1.2 above.
- The assessment of whether an RFR is expected to be separately identifiable, as described in 4.2.4 and 4.2.5 above.
- To determine which exposures should be included in the Phase 2 Amendments' quantitative disclosures, entities will need to identify those exposures which have not transitioned and continue to present a risk arising from IBOR Reform, as discussed in 6.2.1 above.

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. *[IFRS 7.44H]* 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. *[IAS 8.28(f)]*.

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. *[IAS 8.28 (a) - IAS 8.28 (e), IAS 8.28 (g) - IAS 8.28 (h)]*.

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.

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.

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. *[IAS 34.15]*. 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.

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.

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. *[IFRS 16.104, IFRS 16.105]*

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. *[IFRS 16.106]*. 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. *[IFRS 16.C1B, IFRS 16.C20C, IFRS 16.C20D]*

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 9.5.4.6 to IFRS 9.5.4.9 (see 2, above). *[IFRS 4.20R]* References to IFRS 9.B5.4.5 should be read as referring to IAS 39.AG 7 and references to IFRS 9.5.4.3 and IFRS 9.B5.4.6 should be read as referring to IAS 39.AG 8. *[IFRS 4.20S]*. 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. *[IFRS 4.50]*. An entity is not required to restate comparative periods and may do so only if it is possible without the use of hindsight. *[IFRS 4.51]*

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ED None

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