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IFRS Developments

IBOR reform: IASB discusses remaining phase two issues

What you need to know

- At its February meeting, the IASB completed its discussions on phase two of its project to amend IFRS in response to the financial reporting challenges posed by IBOR reform.
- The IASB agreed how risk components would be designated upon transition to RFRs including the reliefs that would apply and how long they must remain in place.
- The IASB will mandate the application where the reliefs are applicable.
- The effective date is for annual periods beginning on or after 1 January 2021, but earlier application is permitted. Hedges which have previously failed as a direct result of IBOR reform must be reinstated.
- Work will now proceed on the exposure draft, with the expectation that it will be published in April 2020 with a forty-five day comment period.

Introduction

At its meeting on 26 February 2020, the International Accounting Standards Board (IASB or the Board) discussed the final topics in phase two of its project to address the financial reporting issues associated with IBOR reform. In this publication, we summarise the tentative decisions taken and provide our views.

Following the decision taken by global regulators to replace Interbank Offered Rates (IBORs) with alternative nearly risk-free rates (RFRs). In 2018, the IASB commenced work to address the effects of IBOR reform on financial reporting. The IASB divided its work into two phases:

- Phase one addressed issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an RFR.
- Phase two is focused on issues that affect financial reporting when an existing interest rate benchmark is replaced with an RFR.

The IASB completed phase one with publication, in September 2019, of *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7*. The IASB started considering the phase two issues in October and continued its deliberations at its meetings in December 2019 and January 2020. With the tentative decisions reached in February, the IASB has now discussed all the phase two issues and the staff are proceeding to produce the Exposure Draft (ED), which is expected to be published in April.

For the background to the IASB's project, see our publications, *IFRS Developments 144* and *145;* we describe the phase one amendments in *IFRS Developments 152* and summarise the earlier phase two tentative decisions in *IFRS Developments Issues 154, 156 and 160*. These publications can be found at www.ey.com/ifrs.

Building a better working world

1. Modification of financial instruments

At the meeting in October, the IASB tentatively decided to add a clarification to IFRS 9 *Financial Instruments*, that even in the absence of an amendment to the contractual terms of a financial instrument, a change in the basis on which the contractual cash flows are determined that alters what was originally anticipated, constitutes a modification. An example would be the transition from the Euro Overnight Index Average (EONIA) to €STR in October 2019, or possible future changes to how EURIBOR is constructed.

Since the October meeting, it has been identified that this amendment could have far reaching effects, which require time to identify and assess. In view of the need to complete the phase two amendments within an accelerated time frame, the IASB agreed to limit the amendment to extend the definition of modification only to those changes to contractual cash flows which occur directly as a result of IBOR reform. The wider implications of a change to the definition of 'modification', which applies in all circumstances will be considered, as a separate project, once the IASB's IBOR reform project is complete.

2. Hedges of risk components – separately identifiable requirement

While IFRS 9 uses the term 'risk component' and IAS 39 uses 'designated portion', in this section, we will use 'risk component' to refer to the terms used in each standard, as the IASB believes the concepts to be equivalent.

End of phase one relief

The phase one amendments provide relief that a non-contractually specified IBOR risk component designated as the hedged risk, need only meet the 'separately identifiable' requirement at the inception of the hedging relationship. This means that if, in the period preceding the transition from IBORs to RFRs, entities can no longer demonstrate for a hedging relationship that the hedged risk component remains separately identifiable, relief is given from having to discontinue the hedge. The designated risk component would, however, still have to be reliably measurable, implying that there would need to be a sufficiently liquid market in RFR instruments to enable a term structure to be created.

Unlike the specific end of application requirements for the other reliefs set out in phase one, no end date was set for the 'specifically identifiable' relief, pending the development of phase two. Now that phase two has been tentatively agreed, at the February meeting, the Board decided the relief should cease to apply at the earlier of:

- When changes to the hedging relationship are made for the hedged risk to reflect modifications directly required by IBOR reform; and
- When the hedging relationship is discontinued.

Designation of an RFR as a risk component

As instruments transition from IBORs to RFRs, there may be a period when it is not possible to demonstrate that a non-contractually specified RFR risk component is separately identifiable within the context of the market structure. This may be because variable rate payments are not yet typically indexed to the RFR, fixed rate instruments are not yet priced by comparison to the RFR and most interest rate swaps do not yet reference the RFR. Where this is the case, the RFR may be ineligible to be designated as a hedged risk, which would discourage entities from progressing the transition of their instruments from IBORs to RFRs and from entering into new hedges of RFR risk components.

The IASB, therefore, tentatively agreed in February to 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. The relief allows entities upon designation of the hedge, 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 twenty-four months. The relief ends at the earlier of:

- Twenty-four months after the initial designation of the RFR component, or
- When the entity becomes reasonably certain that the risk component will not be separately identifiable by twenty-four months after initial designation

In either of these cases, the hedge would have to be prospectively discontinued.

When the RFR risk component is designated, entities would need to exercise judgement to assess whether they can apply, and may continue to apply, the relief. Also, no relief is provided from the requirement for the risk component to be reliably measurable throughout the life of the hedging relationship. Any hedge ineffectiveness would be recognised in profit and loss as normal.

The relief will only apply for uncertainty arising directly from IBOR reform, as to whether an RFR risk component is separately identifiable. The relief will not be available for hedging relationships where there is uncertainty whether the risk component is separately identifiable, but the uncertainty is not as a direct result of IBOR reform. Availability of the relief will end once IBOR reform is complete and RFRs have become established as a market benchmark. The relief will not be available to mitigate other causes of illiquidity in benchmark interest rate markets that may arise in future.

3. Multiple application of 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 IBOR reform. An example could be instruments that reference EONIA, for which, as discussed above, the methodology for setting the benchmark changed during 2019 to reference €STR plus a fixed spread, with a further transition expected to replace contractual references to EONIA with €STR. The reliefs would not be restricted to one application for each benchmark, but could be applied each time a hedging relationship is modified as a direct result of IBOR reform. The same principle is expected to apply to the phase two modification reliefs agreed in October 2019.

4. Mandatory application

If entities have instruments affected by the phase two issues, the Board tentatively decided that application of the reliefs will be mandatory rather than voluntary. This is consistent with the approach followed for the phase one amendments, whereby entities are required to apply the reliefs to all hedging relationships directly affected by IBOR reform. This helps to ensure that the reporting of the effects of IBOR reform will be consistent and comparable between entities.

5. Effective date and transition requirements

It was agreed that the phase two amendments will be effective for annual periods beginning on or after 1 January 2021, with earlier application permitted.

Given the pace at which IBOR reform is expected to progress during the remainder of 2020, there is a reasonable likelihood that hedges may be discontinued, for accounting purposes, as a direct result of IBOR reform before the phase two reliefs are available for entities to apply. The IASB tentatively decided that such hedging relationships will be reinstated once an entity first applies the phase two amendments. This will only apply if the entity can demonstrate that the hedging relationship would not have been discontinued if the phase two reliefs had been available.

For those hedging relationships discontinued in prior periods, entities will adjust opening retained earnings for the effect of the reinstatement at the beginning of the period when the phase two amendments are adopted. Earlier reporting periods will not be restated.

This relief is intended to ensure that entities are not discouraged from progressing their efforts to transition instruments from IBORs to RFRs due to the accounting consequences of having to discontinue hedging relationships during the period until the phase two reliefs are available. For example, hedges may be terminated due to changes to the hedge documentation that are necessary on transition from an IBOR to an RFR, even though for economic and risk management purposes, the hedges remain effective. The relief therefore means that this type of purely accounting consequence arising from IBOR reform will be short lived and reversed upon adoption of the phase two amendments. Since the reinstatement is mandatory for all affected hedges, entities will not be able to selectively reinstate some discontinued hedges and not others.

Next steps

Having now completed the phase two discussions, the IASB is now developing the ED which is expected to be published in April. It was agreed the ED will have a comment period of forty-five days.

How we see it

We believe that the separately identifiable relief will apply in three situations where either an IBOR hedging instrument has been modified to refer to an RFR, or a new RFR-based hedging instrument is entered into, and they are designated as a hedge of an RFR component:

- The hedged item is a fixed rate debt instrument
- The hedged item is an existing IBOR-based instrument
- The hedged item is a highly probable acquisition or issue of a debt instrument

The third category will include not only where the instrument is expected to be fixed rate, or floating rate based on IBOR or an RFR, but also when it is expected to be floating rate and it is currently uncertain whether it will initially be based on an IBOR or an RFR.

The twenty-four month period over which the separately identifiable relief must be applied, introduces a new type of accounting judgement. To start applying the relief, entities must, at initial designation, be reasonably certain that by the end of the relief period, the RFR will become separately identifiable. Entities may then only cease to apply the relief if they are reasonably certain the RFR will ***not*** become separately identifiable before the end of the relief period. The requirement to be reasonably certain sets a high bar for entities both commencing and ceasing to apply the relief. This relief will also require entities to have a clear understanding of what is meant by separately identifiable.

For all hedging relationships that are discontinued as a direct result of IBOR reform before the phase two reliefs are available, entities must ensure that as well as reporting them on a discontinued basis, additional accounting records are retained as if the hedges had continued, so that they can be reinstated once the phase two amendments are applied.

Now that the Board has completed its discussion of the phase two issues, affected entities can make more concrete plans to transition to RFRs. As is always the case, it will be important to have regard to the precise wording of the ED once it is issued. However, by carefully thinking through the implications of the proposed reliefs for the various scenarios that are likely to be encountered, entities will be better placed to respond to the IASB on whether the reliefs as set out in the ED are clear, sufficient and operable.

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ED None