Issue 174 / September 2020

IFRS Developments

IASB completes its IBOR reform programme

What you need to know

- On 27 August 2020 the IASB published amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 for phase two of its IBOR reform project.
- The amendments address the accounting issues that arise when financial instruments that reference IBORs transition to nearly RFRs.
- The effective date is for annual periods beginning on or after 1 January 2021, but earlier application is permitted.
- Publication of the phase two amendments completes the IASB's work to amend IFRS in response to IBOR reform.

Introduction

On 27 August 2020, the International Accounting Standards Board (IASB or the Board) published *Interest Rate Benchmark Reform – Phase 2, Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16* (the amendments). In this publication, we summarise the amendments, highlight the main changes since the Exposure Draft (the ED) 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 focused on issues that affect financial reporting when an existing interest rate benchmark is replaced with an RFR.

The IASB completed phase one with the publication, in September 2019, of *Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7*. The phase two ED was published in April 2020 and the IASB discussed the comments received at its Board meetings in June and July. Now the phase two amendments have been finalised, the IASB has completed its work in response to IBOR reform.

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*, we summarised the phase two ED in *IFRS Developments 165* and the IASB's responses at its June meeting in *IFRS Developments 172*. These publications can be found at www.ey.com/ifrs.

1. Practical expedient for modifications

The amendments include a practical expedient to require contractual changes, or changes to cash flows that are directly required by the reform, to be treated as changes to a floating interest rate, equivalent to a movement in a market rate of interest. Inherent in allowing the use of this practical expedient is the requirement that the transition from an IBOR benchmark rate to an RFR takes place on an economically equivalent basis with no value transfer having occurred.

In applying the practical expedient, an entity is required to first identify and account for modifications to the instrument which relate directly to IBOR reform,

Building a better working world

by updating the effective interest rate (EIR) without adjusting the carrying amount. The amendments include examples of the type of modifications required by interest rate reform, to which the practical expedient is limited by the following:

- The replacement of an existing interest rate with an alternative benchmark rate or effecting such a reform of an interest rate benchmark by changing the method used to calculate the interest rate benchmark
- The addition of a fixed spread to compensate for a basis difference between an existing interest rate benchmark and an alternative benchmark rate
- Changes to the reset period, reset dates, or the number of days between coupon payment dates, to effect the reform of an interest rate benchmark
- The addition of a fall-back provision to the contractual terms of a financial asset or liability to enable any of the changes described above to be made

Any other modifications made at the same time, such as a change in the credit spread or maturity date, are assessed. If they are substantial, the instrument is derecognised. If they are not substantial, the updated EIR is used to recalculate the carrying amount of the financial instrument, with any modification gain or loss recognised in profit or loss.

The practical expedient is also required for entities applying IFRS 4 *Insurance Contracts* that are using the exemption from IFRS 9 *Financial Instruments* (and therefore, apply *IAS 39 Financial Instruments: Recognition and Measurement*) and for IFRS 16 *Leases*, to lease modifications required by IBOR reform.

2. Relief from discontinuing hedging relationships

Changes to hedge designation

The amendments permit changes required by IBOR reform to be made to hedge designations and hedge documentation under both IFRS 9 and IAS 39 without the hedging relationship being discontinued. Permitted changes include redefining the hedged risk to reference an RFR and redefining the description of the hedging instruments and/or the hedged items to reflect the RFR.

Following feedback received on the ED, hedge designations must also be updated if derivatives are closed out and replaced on the same terms, but referencing an RFR, as long as the original hedging instrument is not derecognised. The Basis for Conclusions implies that if the replacement derivative is entered into with the same counterparty, on an economically equivalent basis to the original derivative, then the change is unlikely to be a substantial modification and so would not lead to derecognition. The relief also applies if the original derivative is retained and a basis swap from IBOR risk into RFR is entered into, provided the basis swap can be individually linked to the original derivative.

The amendments to IAS 39 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.

Feedback to the ED noted that entities could face operational challenges from having to change hedging designations on the date they transition to RFRs. The amendments, therefore, allow entities until the end of the reporting period during which a modification required by IBOR reform is made, to complete the changes.

Remeasurement on transition to an RFR

The ED included proposals for the treatment of gains and losses arising on financial instruments at the time the hedge designation is amended to reference an RFR.

When discussing feedback received on the ED, the IASB concluded that IFRS 9 and IAS 39 already deal appropriately with any gains or losses that could arise on transition, through the normal requirements to measure and recognise hedge ineffectiveness. As a result, the ED's specific proposals in this area were removed.

Amounts accumulated in the cash flow hedge reserve

The amendments require that when the description of the hedged item is amended (or if the hedge has previously been discontinued, when the contractual cash flows of the previously designated item are modified), amounts accumulated in the cash flow hedge reserve are deemed to be based on the RFR. 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 based on the RFR affect profit or loss. To achieve this, a hypothetical derivative in a cash flow hedge may be updated.

IAS 39 assessment of retrospective hedge effectiveness

The phase one reliefs have been amended to end when there is no longer uncertainty with respect to the cash flows of both the hedged item **and** the hedging instrument.

IAS 39 has also been amended so that for the assessment of retrospective hedge effectiveness, entities may elect on a hedge-by-hedge basis, to reset the cumulative fair value changes to zero when the exception to the retrospective assessment ends. The ED proposed that all hedges should be reset, but feedback highlighted this could increase ineffectiveness in some cases. Hence, the amendments allow entities to elect the relief for individual hedges. Any hedge ineffectiveness will continue to be measured and recognised in full in profit or loss.

Hedges of groups of items

The amendments provide relief 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 IBOR 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. At each transition, the hypothetical derivative for the subgroup will require updating.

Multiple application and end of phase two reliefs

As instruments transition to RFRs, a hedging relationship may need to be modified more than once. The phase two reliefs apply each time a hedging relationship is modified as a direct result of IBOR reform.

The phase two reliefs cease to apply once all changes have been made to financial instruments and hedging relationships, as required by IBOR reform.

3. Separately identifiable risk components

IFRS 9 and IAS 39 require that a risk component (or a designated portion) is 'separately identifiable' to be eligible for hedge accounting. The 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. 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. In the final amendments, the relief applies to each RFR on a rate-by-rate basis and starts when the entity first designates the RFR as a non-contractually specified risk component. Material on this topic in the ED's Basis for Conclusions that could be read to interpret what is meant by 'separately identifiable', has been removed in the amendments.

The relief ends at the earlier of:

- Twenty-four months after the initial designation of the RFR component: or
- When the entity reasonably expects that the risk component will not be separately identifiable within twenty-four months after initial designation.

In either of these cases, the hedge would be prospectively discontinued. 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 is recognised in profit and loss as normal.

The relief as to whether an RFR risk component is separately identifiable, only applies for uncertainty arising directly from IBOR reform. The relief is not available for hedging relationships where there is uncertainty that is not as a direct result of IBOR reform.

If on first applying the amendments, the entity reinstates a previously discontinued hedging relationship of a risk component (see 5 below), the twenty-four month period for the RFR, starts from the date the entity initially applies the amendments.

4. Additional disclosures

IFRS 7 Financial Instruments: Disclosures includes the following additions:

- How the entity is managing the transition to RFRs, its progress and the risks to which it is exposed arising from financial instruments due to IBOR reform
- Disaggregated by each significant IBOR benchmark, quantitative information about financial instruments that have yet to transition to RFRs
- If IBOR reform has given rise to changes in the entity's risk management strategy, a description of these changes

Feedback on the ED noted that the quantitative disclosures could be operationally burdensome to provide. As such, the amendments allow entities to select the basis for the disclosure, which could include using management information.

5. Effective date and transition requirements

The amendments are mandatory and effective for annual periods beginning on or after 1 January 2021, with earlier application permitted. Application is retrospective and hedging relationships must be reinstated once an entity first applies the amendments if the hedging relationship was discontinued solely due to changes required by IBOR reform and it would not have been discontinued if the phase two amendments had been applied at that time. An entity is not required to restate prior periods.

Feedback on the ED identified that reinstating some hedges could be inappropriate. To address this, at the beginning of the reporting period in which the amendments are first applied, the discontinued hedging relationship being reinstated must meet the qualifying criteria for hedge accounting, after taking into account the phase two amendments.

How we see it

The publication of the phase two amendments completes the IASB's response to the call for IBOR reform. Together with the phase one amendments published in 2019, the IASB has delivered a comprehensive suite of changes to IFRS which substantially mitigate the effects of IBOR reform on financial reporting.

Now that the amendments have been finalised, entities must complete their assessment of the accounting implications of the scenarios they expect to encounter as they transition from IBORs to RFRs and their programmes to implement the new requirements. Where the amendments introduce new areas of judgement, entities need to ensure they have appropriate accounting policies and governance in place. For the additional disclosures, entities must ensure they can gather and present the information required. Time is running out for entities considering early adopting the amendments for a December 2020 year end.

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

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

EYG No. 006164-20Gbl
ED None