STAFF PAPER

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Project	**IBOR Reform and its Effects on Financial Reporting**
Paper topic	Voluntary application and end of relief

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Introduction

1. This paper follows on from the discussions at the February 2019 Board meeting concerning issues affecting financial reporting leading up to IBOR reform. The purpose of this paper is to address the two issues raised at the February Board meeting:

    (a) whether an entity should have a choice in applying the proposed relief; and

    (b) the end of relief.

2. This paper is structured as follows:

    (a) Summary of staff recommendations (paragraph 3);

    (b) Background (paragraphs 4–8);

    (c) Applicability of relief (paragraphs 9 – 12)

    (d) Mandatory versus voluntary application of the proposed relief (paragraphs 13–28);

    (e) End of relief (paragraphs 29–47);

    (f) End of relief – Other Areas (paragraphs 48-57)

    (g) Appendix A – Extracts from the February 2019 Agenda Paper 14 *Issues leading up to IBOR reform* (paragraphs A1–A4).

Summary of staff recommendations

3. In this paper the staff recommend that:

   (a) the application of the relief should be mandatory as it addresses concerns around arbitrary discontinuation of hedge accounting and would be consistent with the Board's decision to prohibit voluntary discontinuation of hedge accounting in IFRS 9.

   (b) entities should stop applying the proposed relief at the earlier of:

      (i) when the uncertainty regarding the timing and amount of the resulting cash flows is no longer present; and

      (ii) the termination of the hedging relationship.

   (c) End of relief, prior to the termination of the hedge relationship, prior to termination of the hedge relationship is not applicable for separately identifiable risk component.

Background

4. At its February 2019 meeting, the Board agreed to amend IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* to address certain concerns related to uncertainties arising from IBOR reform that might affect financial reporting before the reform is enacted. Specifically, the Board tentatively decided that:

   (a) the 'highly probable' requirement should be amended such that, when assessing the likelihood that a forecast transaction will occur, an entity can assume the IBOR-based contractual terms will remain unchanged;

   (b) the prospective assessments in IFRS 9 and IAS 39 should be amended, such that, an entity could base such assessments on existing contractual cash flows from the hedging instrument and the hedged item; and

   (c) an entity should be allowed to continue hedge accounting when a non-contractually specified IBOR risk component meets the separately identifiable requirement at the inception of the hedging relationship. In addition, the Board tentatively decided that relief should not be provided for risk components that are not separately identifiable at the inception of a hedging relationship.

5. At the same meeting, the staff clarified the proposed amendments are not intended to provide relief from all consequences arising from IBOR reform, especially those that may arise due to an actual change in the economics of a financial instrument. The Board also emphasised that the underlying economics of a transaction affected by IBOR reform should continue to be reflected in financial reporting as required by the relevant IFRS Standards.

6. The staff re-iterate that just because an entity applies the relief, it does not mean a hedging relationship would always be accounted for as a continuing relationship. The proposals aim to provide relief from uncertainties around the general conditions (timing and specifics) of the potential replacement of IBOR for with alternative Risk-free-rate (RFR). Other effects from IBOR reform on hedge accounting requirements are not within the scope of the relief. Said differently, the relief focuses on three requirements as outlined in paragraph 4 and, to apply hedge accounting, an entity would still need to satisfy all other hedge accounting qualifying criteria, which remain unchanged.

7. At its February 2019 meeting, the Board requested the staff to further explore the following topics:

   (a) Mandatory versus voluntary application of the proposed relief; and

   (b) End of the proposed relief.

8. These are further discussed in the proceeding paragraphs of this paper.

Applicability of Relief

9. The staff would clarify that there could be instances where the relief is not applicable in the first place. For example, if a particular jurisdiction has decided there is no need for IBOR reform, then there is no uncertainty regarding the amount and timing of cash flows and therefore, relief is not applicable.

10. Furthermore, there are instances where one aspect of the relief may not be applicable. For example, if an entity designates an RFR-based hedged item against an IBOR-based derivative (ie hedging instrument), then the entity could apply the

relief to the prospective assessments because the future cash flows arising from the hedging instrument is unknown (ie these could be either IBOR or RFR-based), assuming the relationship meets the other hedge accounting requirements. However, the entity does not need the relief for the highly probable assessment and therefore should not apply that aspect of relief because there is no uncertainty regarding how IBOR reform will impact the cash flows of the hedged item. This would also be the case for the relief applicable to non-contractually specified components if the entity does not designate non-contractually specified components[1].

11. Also, for the avoidance of doubt the staff highlight that both new and existing hedges can qualify for relief depending upon the facts and circumstances.

Staff view

12. As stated in paragraphs 9 – 11, the relief may not be applicable in all instances and furthermore, certain aspects of relief may be applicable whereas others not depending upon the facts and circumstances.

Question for the Board

Question for the Board
1) Does the Board have any questions or comments regarding the applicability of relief?

Mandatory versus voluntary application of the proposed relief

13. IFRS 9 and IAS 39 do not mandate the use of hedge accounting. Provided the set of qualifying criteria in IFRS 9 and IAS 39 are met, the application of hedge

[1] Regarding risk components, the Board tentatively decided that relief should not be provided for risk components that are not separately identifiable at the inception of a hedging relationship.

accounting is voluntary. Considering the Board's tentative decision to amend IFRS 9 and IAS 39 to provide relief from the effects of uncertainties around the general conditions (timing and specifics) of IBOR reform,[2] for those entities applying hedge accounting, the question that follows is whether the application of such relief should be mandatory or voluntary.

14. The staff have considered the following alternative approaches regarding whether application should be mandatory or voluntary, assuming relief is applicable in the first place:

    (a) Approach A: voluntary application on a relationship-by-relationship basis (ie entities could make an election to apply the relief to a specific hedging relationship or group of hedging relationships of interest rate risk);

    (b) Approach B: voluntary application to all hedging relationships (ie entities could elect to apply the relief to all hedging relationships of interest rate risk); and

    (c) Approach C: mandatory application (ie entities must apply the relief to all hedging relationships of interest rate risk).

Approach A: voluntary application on a relationship-by-relationship basis

15. Under this approach, entities applying hedge accounting would have a choice to apply the proposed relief on a relationship-by-relationship basis. This means that an entity could elect to apply the relief to a specific relationship or group of hedging relationships affected by uncertainties around the general conditions (timing and specifics) of IBOR reform.

16. Since hedge accounting is voluntary, one could argue that applying the proposed relief should also be voluntary. This would allow entities to elect not to apply the relief in situations when, for example, a comprehensive review of all hedging instruments and hedged items potentially affected by IBOR reform would not be cost effective. Electing not to apply the relief could lead to discontinuation of

[2] For further information, refer to the February 2019 IASB Update.

hedge accounting and reclassification of the cash flow hedge reserve or amortisation of the fair value adjustment to profit or loss.

17. However, while hedge accounting is voluntary, IFRS 9 and IAS 39 have specific requirements that mandate how to reflect those hedges in financial reporting. For example, specific requirements exist regarding how the effective portion of a hedge should affect the statement of profit or loss (ie the IFRS Standards stipulate how the amount accumulated in other comprehensive income, in the case of cash flow hedges, and the fair value adjustment recorded on the balance sheet, in the case of fair value hedges, should affect profit or loss). As such, even though the application of hedge accounting is voluntary, how an entity reflects their hedges in financial reporting if they chose to apply hedge accounting is governed by strict requirements. Therefore, allowing voluntary application of the relief would be inconsistent with these requirements of hedge accounting as it could result in outcomes that are in conflict with the stipulations mentioned above.

18. In addition, the staff is concerned that the application of the relief on a relationship-by-relationship basis could provide opportunities for structuring. This would allow entities to elect not to apply the relief to specific hedging relationships solely to achieve an accounting outcome that does not reflect risk management. For example, choosing not to apply the relief to certain hedging relationships solely to achieve discontinuation of hedge accounting or targeted reclassification of amounts recognised in other comprehensive income for already terminated hedges.[3] The staff note that this would be inconsistent with the objective of hedge accounting to represent, in the financial statements, the effect of an entity's risk management activities.

19. The staff think that such a choice would not result in useful information. In addition, this would be inconsistent with the Board's decision to prohibit voluntary discontinuation of hedge accounting in IFRS 9 when the risk

[3] As discussed in paragraph 34 of the February 2019 Agenda Paper 14 *Issues leading up to IBOR reform*, the relief also applies to hedging relationships that have been previously discontinued for reasons other than IBOR reform with an amount remaining in the cash flow hedge reserve. The staff clarified that applying the relief would allow entities to continue reclassifying the amount accumulated in the cash flow hedge reserve to profit or loss in the same period or periods during which the hedged expected future cash flows affect profit or loss.

management objective for a hedging relationship remains the same.[4] Therefore, the staff do not recommend the above approach.

Approach B: voluntary application to all hedging relationships

20. Under this approach, entities applying hedge accounting would have a choice to apply the proposed relief to all hedging relationships affected by uncertainties around the general conditions (timing and specifics) of the potential replacement of IBOR. This means that, while an entity would not be allowed to select specific hedging relationships to which the relief would be applied, the entity could elect to apply it to all hedges of interest rate risk or not to apply the relief for any hedges of interest rate risk.

21. The staff highlight that, when an entity elects to apply the relief to all hedging relationships, this choice would be consistently applied to both existing and new hedging relationships.

22. The staff is of the view that, although this approach removes an entity's ability to selectively apply the relief to specific hedging relationships, it still allows an entity to discontinue all hedges of interest rate risk ie if an entity chooses not to apply the relief, this could lead to voluntarily discontinuation of all hedging relationships affected by uncertainties around the general conditions (timing and specifics) of the potential replacement of IBOR. This would again allow entities to achieve an accounting outcome that does not reflect risk management. As noted in paragraph 18, this would be inconsistent with the objective of hedge accounting and consequently the staff do not recommend the above approach.

Approach C: mandatory application

23. Under this approach, an entity would be required to apply the relief to all hedging relationships (ie including both existing and new hedging relationships) where relief is applicable in the first place (see discussion in paragraphs 4 and 9 – 12). In other words, an entity would not be able to choose whether to apply the relief and its application would be irrevocable. The relief would mandatorily apply to all hedges of interest rate risk for which the highly probable requirement, the

[4] For further information, refer to paragraph BC6.331 of the Basis for Conclusions of IFRS 9.

prospective assessments, or separate identification of a non-contractual component are affected by uncertainties arising from IBOR reform.

24. The staff do not believe mandatory application of the relief entails significant additional cost for two reasons. Firstly, the hedge accounting requirements of IAS 39 and IFRS 9 already require the definition, documentation and effectiveness measurement of designated relationships on a granular level, therefore, an entity should already have a thorough understanding of its hedge accounting relationships and those that could be affected by IBOR reform. Secondly, a comprehensive review of all hedging instruments and hedged items potentially affected by IBOR reform would be required as part of the process to amend contracts to replace IBOR. Therefore, an entity would be able to identify the hedging relationships for mandatory application of the relief as soon as the applicable hedge accounting requirements start being affected by such uncertainties arising from IBOR reform.

25. In addition, at its February 2019 meeting, the Board tentatively decided that an entity should provide specific disclosures about the extent to which it applies the proposed relief. The staff would again clarify that disclosures should follow from the application of relief. Said differently, mandatory application would imply an entity must comply with the disclosure requirements for any and all hedge relationships where relief is applied. The staff acknowledge that mandatory application of the relief might result in additional costs associated with preparation of such disclosures. However, as noted at the February 2019 Board meeting, the staff think these will not be onerous to preparers, because such disclosures would be provided as a subset of the information already required by IFRS 7 *Financial Instruments: Disclosures* in the context of hedge accounting.

26. The staff are of the view that mandatory application of the relief addresses the concerns around arbitrary discontinuation of hedge accounting (and arbitrary reclassification of the amount recorded in the other comprehensive income related to hedging relationship that have been previously discontinued for reasons other than uncertainties arising from IBOR reform), because an entity would not have a choice not to apply the relief and thus discontinue hedge accounting. In addition, mandatory application of the relief is consistent with the approach taken for the

Novation of Derivatives and Continuation of Hedge Accounting (Amendments to IAS 39 and IFRS 9).[5] Consequently, the staff recommend this approach.

Irrevocable application

27. In case the Board decides that the application of the relief should be voluntary (ie either Approach A or Approach B), the question that follows is whether this choice should be irrevocable. The staff highlight that a choice to revoke the application of the relief would result in the same concerns noted in paragraph 18 regarding opportunities for structuring. More specifically, if an entity decides to stop applying the relief, that hedging relationship may fail either the highly probable requirement or the prospective assessments and consequently must be discontinued. Therefore, the staff is of the view that an entity should not have a choice to revoke the application of the relief.

Staff recommendation

28. For the reasons stated in paragraphs 13 – 26, the staff are of the view that the application of the relief should be mandatory as it addresses the concerns around arbitrary discontinuation of hedge accounting and would be consistent with the Board's decision to prohibit voluntary discontinuation of hedge accounting in IFRS 9. If the Board decides that relief should be voluntary, the staff would recommend that relief should be voluntary but irrevocable for the reasons stated in paragraph 27.

Question for the Board

Question for the Board
2) Does the Board agree with the staff recommendation in paragraph 28 that the application of the relief should be mandatory?

[5] The Board considered the financial reporting effects arising from novations that result from new laws or regulations and decided to amended IAS 39 to provide relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument met certain criteria. The application of the relief was mandatory.

End of relief

29. The staff note that IBOR reform will likely follow different timelines in different jurisdictions and therefore it is difficult to define a period of applicability for the proposed amendments because, thus far, there are no dates specifying when IBOR reform will start and when it will end. While, at this stage, it is not possible to determine the end of IBOR reform, the staff think it is important to define when the relief proposed will no longer be available. This is because the transitional period from IBOR to the alternative RFR will be temporary and, without defining the end of the proposed relief, the Board will need to amend IFRS 9 and IAS 39 again when uncertainties around the general conditions (timing and specifics) of the potential replacement of IBOR are no longer present (ie there would be no need for such relief). However, given that markets may develop at different speeds, proposing an approach whereby the relief is deleted at some point in the future is difficult because it would preclude certain jurisdictions from using the relief when it may be required whilst allowing it for others where it is not required. Therefore, the staff think the end of the proposed relief needs to be linked to the structure of the market.

30. In view of this, at its February 2019 meeting the Board discussed the period over which an entity could apply the proposed relief. During that meeting, the staff proposed that entities should cease applying the proposed relief when the uncertainty regarding the nature and timing of designated future cash flows is no longer present. More specifically, the staff proposed this would occur at the earlier of contractual amendment or the termination of the hedge relationship. The relevant extracts from the February 2019 Agenda Paper 14 *Issues leading up to IBOR reform* have been included in Appendix A of this paper for ease of reference.

31. While agreeing with the above principle, the Board questioned whether the amendment of the relevant contracts would provide sufficient certainty regarding the timing and amount of the resulting cash flows. They noted that it is possible for uncertainty to remain even after contracts are amended. Consequently, the Board requested the staff to consider the issue for further deliberation.

32. For the purpose of this paper, the term amendment is used to refer to a change to a contract resulting in inclusion of new terms and conditions or the alteration of the original terms and conditions of that contract. For example, this would be the case when the parties agree to replace IBOR for the alternative RFR.

33. The staff would re-iterate that the following discussion regarding contractual amendments is limited to identifying when entities should stop applying the proposed relief. As agreed at the December 2018 Board meeting,[6] evaluating the financial reporting implications of the contractual amendments themselves and the usefulness of the resulting information will be discussed during Phase II of the project. Examples of topics to be discussed in Phase II are as follows:

    (a) Do the contractual amendments represent a modification or a derecognition event; and

    (b) What are the hedge accounting implications if an entity alters their hedge documentation or re-defines the hedged risk to accommodate IBOR reform.

34. The staff acknowledge that, while it is possible for entities to amend contracts stipulating how IBOR reform will impact those contracts (colloquially referred to as a fall-back clause), the mere existence of such a clause may not eliminate the uncertainty regarding the nature and timing of designated future cash flows. For example, the amount of cash flows that would result from replacing IBOR with the alternative RFR could remain unclear even after the insertion of the fall-back clause. As noted in the December 2018 Agenda Paper 14 *Research findings*, while IBOR are available in different tenors (eg one, three, six and twelve months are the most commonly used tenors used as contractual references), the alternative RFR are primarily overnight rates and there is no consensus as to whether robust forward-looking term rates based on alternative RFR will be available. As such, fall-back clauses that are inserted before decisions are made regarding whether RFR will be either an overnight or a term rate may be worded vaguely to provide flexibility.

[6] For further information, refer to the December 2018 Agenda Paper 14 *Research findings*.

35. To further illustrate the discussion in paragraph 34, the staff considered the following scenarios to demonstrate the general principle that entities should cease applying the proposed relief when the uncertainty regarding the nature (ie amount) and timing of designated future cash flows is no longer present:

    (a) Scenario A: Fall-back clauses that specify how IBOR reform will impact amount and timing;

    (b) Scenario B: Fall-back clauses that do not specify how IBOR reform will impact amount and timing;

    (c) Scenario C: Fall-back clauses where a third-party controls how IBOR reform will impact a contract;

    (d) Scenario D: Fall-back clauses that specify the timing of IBOR reform but not the amount; and

    (e) Scenario E: Fall-back clauses that specify the amount of IBOR reform but not the timing.

Scenario A: Fall-back clauses that specify how IBOR reform will impact amount and timing

36. If a contract is amended with a fall-back clause that specifies both (a) the exact date IBOR will be replaced by the alternative RFR and (b) the exact alternative RFR on which the cash flows will be based, then the uncertainty regarding the timing and amount of cash flows for this contract is eliminated. Therefore, consistent with the principle that relief should cease when uncertainty is no longer present, in this scenario, relief should no longer be applied after the contract is amended.

Scenario B: Fall-back clauses that do not specify how IBOR reform will impact amount and timing

37. This scenario can arise when a generic fall-back clause is inserted in anticipation of IBOR reform without specifying the actual amount and timing of cash flows. If a contract is amended with a fall-back clause but that fall-back clause does not specify the date IBOR will be replaced by the alternative RFR nor does it specify

the exact alternative RFR on which the amended cash flows will be based, then uncertainty regarding the timing and amount of cash flows has not been eliminated. Therefore, consistent with the principle that relief should cease when uncertainty is no longer present, in this scenario, an entity should continue to apply the relief until the uncertainty is no longer present. In this scenario, certainty would be eliminated when the generic fall-back clause is again amended specifying the timing and amount of cash flows, or when the counterparties agree on the specifics. This is because, under these circumstances Scenario B has transitioned to Scenario A.

Scenario C: Fall-back clauses where a third-party controls how IBOR reform will impact a contract

38. This scenario assumes that contracts are amended with a fall-back clause that states the contract will be amended at a future date, but the general conditions (ie amount and timing) will be determined by a central authority at some point in the future. If this occurs, then uncertainty regarding the timing and amount of cash flows for this contract are present until that central authority, for example, irrevocably mandates how and when IBOR will be replaced by the alternative RFR. Therefore, consistent with the principle that relief should cease when uncertainty is no longer present, in this scenario, an entity should continue to apply the relief until the central authority determines how IBOR reform will affect the contract (ie amount and timing). Said differently, relief should end when Scenario C transitions to Scenario A.

Scenario D: Fall-back clauses that specify the timing of IBOR reform but not the amount

39. If a contract is amended with a fall-back clause that states the contract will be amended at a specified future date, but the amount has not yet been determined, then uncertainty has not been eliminated. The fact that the timing of the reform has been determined is almost irrelevant given the impact on the amount is unknown. Without determining the amount, reform cannot be enacted in the first place. Therefore, consistent with the principle that relief should cease when uncertainty is eliminated, in this scenario, the entity should continue to apply the relief until uncertainty regarding the amount is no longer present.

Scenario E: Fall-back clauses that specify the amount of IBOR reform but not the timing

40. If a contract is amended with a fall-back clause that specifies how the cash flows of the contract will be amended (ie the exact alternative RFR is specified) but the date the change will be enacted is not specified, then uncertainty has not been eliminated. Therefore, consistent with the principle that relief should cease when uncertainty is eliminated, the staff think, as in other cases, an entity should continue to apply the relief in this scenario. However, in the following paragraphs, the staff discuss a potential concern regarding this scenario if, in addition, it is known that the amounts will diverge between the hedged item and hedging instrument.

41. At the February 2019 meeting, some Board members questioned whether relief should continue to apply if it becomes evident that the strength of the economic link between the hedged item and hedging instrument will significantly deteriorate (ie it becomes evident that the hedge will not be effective). As such, the staff have considered if entities should discontinue hedge accounting even though some uncertainty remains. More specifically, if there is certainty over the amount but not the timing leading to certainty that the cash flows arising from the hedged item and hedging instrument will diverge, should the relief enable entities to continue hedge accounting under these circumstances?

42. For example, assume a situation where an entity had a 1-month IBOR based derivative (ie the hedging instrument) that will mature in 30 years designated against a 1-month IBOR based loan (ie the hedged item) that will also mature in 30 years. At some point, a fall back clause is inserted[7] that specifies the hedging instrument will transition away from 1-month IBOR to a rate that resembles something similar to 3x 1-month IBOR whereas the hedged item has a fall back clause is inserted that specifies it will transition to an alternative RFR that resembles1-month IBOR. Furthermore, while the timing is not certain for either instrument it is evident that transition will occur for both within the next 5 years. In this instance, even though uncertainty remains regarding the timing of

[7] As noted in paragraph 33, the staff will consider the implications for modification versus derecognition during Phase II of the project.

transition and consequently uncertainty remains over the total amount of cash flows, it is clear that the prospective assessments will not be met given the material difference that will exist between years 5 to 30.

43. However, if this example was altered such the contractual maturity of both the hedged item and hedging instrument were 5 years rather than 30 years, then it would be no longer clear whether the hedging relationship will fail the prospective assessment because it is not clear that IBOR reform will impact the strength of the economic link between the hedged item and hedging instrument prior to the contractual maturity of the relationship.

44. Regarding this specific scenario where there is certainty over amount but not timing, and certainty that the cash flows arising from the hedged item and hedging instrument will diverge, the staff have considered the following two alternatives:

(a) *Alternative 1 - If it is evident that the strength of the economic link between the hedged item and hedging instrument will significantly deteriorate during the life of the relationship, entities are required to complete further quantitative analysis to continue applying the relief.* While the principle is to permit relief until uncertainty is removed, one could argue that, in the scenario described, the certainty over amount will dominate the effects of timing and thus uncertainty regarding the impact of IBOR reform has been sufficiently eliminated. The staff acknowledge the scenario described might be unlikely, nonetheless, the staff think entities could determine if the strength of a relationship will significantly deteriorate given the contracts involved have been, at least partially, amended. Therefore, entities could evaluate whether applying the relief would be consistent with the objective of hedge accounting to represent, in the financial statements, the effect of an entity’s risk management activities. Given questions regarding interpretations of “evident” and “significantly deteriorate” would be inevitable, this approach would require scenario analysis to understand and quantify the potential impact of the contractual amendments becoming effective at different points in time combined with different gaps between the interest rates on the hedged item and hedging instrument. While this would require entities to evaluate more critically the impact of IBOR reform, the staff are concerned that such a requirement would be difficult and costly to implement in practice. This would be a new test within IFRS Standards concerning termination of relief. The would like to note that the current proposals do not amend the effectiveness requirements of IAS 39 or IFRS 9 and further complications could arise as this new “test” would have to interact with the existing prospective assessment requirements of IFRS 9 and IAS 39, which are themselves different.

(b) *Alternative 2 - Relief should continue even if the scenario described in paragraph 42 arises:* The agreed upon principle is that relief should continue until uncertainty is no longer present and, in this scenario, that principle would apply because uncertainty is present. In the scenario described, it could be argued that hedge accounting may continue for “too long” because once the timing is certain, there is a high likelihood the relationship will fail as under normal circumstances, relationships with material basis risk are often not effective. However, in practice, it will be difficult to define the concept of “evident” as discussed above. Furthermore, the scenario described in paragraph 42 is considered unlikely for two reasons. Firstly, the quantum of the implied basis risk is exaggerated for illustrative purposes and secondly, entities must agree to amend both contracts before basis risk can arise in the first place. The staff think the unlikely instances in which entities will either accept, or be forced to accept, basis risk that would imply hedge accounting is not an appropriate way to represent the effect of an entity’s risk management activities, without knowing the timing of when that basis risk will materialise, do not merit the complications implied by alternative (a). In addition, the staff would also highlight that the impact of allowing such hedges to continue is limited to a delay in reflecting the impact of failing the prospective assessments because, once the timing feature is determined, this scenario transitions to Scenario A.

Staff View

45. On balance, the staff support Alternative 2. While the staff acknowledge there could be situations where applying relief could be inconsistent with the objective and requirements of hedge accounting, the staff think the potential impact and the likelihood of occurrence do not merit the complications as discussed in paragraph 44(a).

Are contractual amendments required?

46. During the same February 2019 meeting, some Board members questioned whether it was necessary to wait for contractual amendments in order for the uncertainty regarding the timing and amount of the cash flows to be no longer present. The staff continue to think that amendments to the contracts will be necessary. This is because, in the absence of an organisation with the authority to unilaterally amend existing contracts for all parties involved, the counterparties to the contract must agree to any and all amendments. For this reason, the staff think contractual amendments are necessary but not sufficient to remove the uncertainty regarding the timing and amount of the resulting cash flows in the context of IBOR reform.

Staff Recommendation

47. The staff think that entities should stop applying the proposed relief at the earlier of:

(a) When the uncertainty regarding the timing and amount of the resulting cash flows is no longer present; and

(b) The termination of the hedging relationship.

Question for the Board

Question for the Board
3) Does the Board agree with the staff recommendation in paragraphs 47?

End of relief – other areas

48. In the following paragraphs, we discuss specific issues related to the end of relief for the following hedge accounting requirements:

(a) Separately identifiable risk components; and

(b) Hedges of highly probable forecast transactions.

Separately identifiable risk components

49. The staff recommendation in paragraph 47 regarding when an entity should stop applying the proposed relief is not applicable to the separately identifiable requirement. This is for two reasons. Firstly, the relief states that an entity should be allowed to continue hedge accounting when an IBOR risk component meets the separately identifiable requirement at the inception of the hedging relationship. In case an entity ceased to apply the relief subsequently, hedge accounting could immediately terminate and thus the relief would not achieve its objective. Secondly, because, by definition, non-contractually specified risk components are not explicitly defined in a contract (eg the IBOR risk component of a fixed-rate financial instrument), these contracts will not necessarily be amended for IBOR reform. This is particularly relevant for fair value hedges when the hedged item is

typically fixed-rate and an entity's risk management objective is to hedge against changes in fair value. Therefore, in this case the relief will end at the termination of the hedging relationship.

50. As noted in paragraph 4, relief should not be provided for risk components that are not separately identifiable at the inception of a hedging relationship. Thus, the staff highlight that, although the relief would continue until termination of the hedging relationship, the proposals retain the discipline for designation of non-contractually specified risk components at the inception of the hedging relationship.

Hedges of highly probable forecast transactions

51. When the highly probable assessment is based on future transactions not recognised on the balance sheet (eg a future issuance of a floating-rate debt instrument), the elimination of uncertainty cannot be linked to a contractual amendment, as no such contract exists. However, the staff think that even for such transactions the principles developed in paragraphs 29 to 47 apply ie an entity should stop applying the proposed relief to such hedging relationships at the earlier of:

    (a) When the uncertainty regarding the timing or amount of the resulting cash flows is no longer present; and

    (b) The termination of the hedging relationship.

52. The staff note that IFRS 9 and IAS 39 require an entity to identify and document a forecast transaction with sufficient specificity so that when the transaction occurs, the entity is able to determine whether the transaction is the hedged transaction. In view of this, there will be instances where the hedge documentation will refer specifically to IBOR as the designated forecast cash flows. For example, this would be the case when an entity designates a future issuance of an IBOR-based debt instrument as the hedged item. Consequently, the staff think that entities will be able to identify when the uncertainty regarding the timing or amount of the resulting cash flows is no longer present.

Staff recommendation

53. To summarize, the staff would clarify that:

    (a) End of relief, prior to the termination of the hedge relationship, is not applicable for separately identifiable risk component; and

    (b) When a highly probable assessment is based on future transactions not recognised on the balance sheet, relief should end when the uncertainties regarding IBOR reform are no longer present.

Question for the Board

Question for the Board
4) Does the Board agree with the staff recommendations in paragraph 53?

Amendments to contracts at different points in time

54. It is possible that the contractual terms of the hedged item and the hedging instrument may be amended at different times. For example, if the hedged item is contractually amended to replace IBOR with the alternative RFR but the hedging instrument is not, the question regarding the continuation of relief is dependent upon whether such an amendment leads to a derecognition of the hedged item or it represents a modification of the same. If the amendment leads to derecognition of the hedged item in the above instance, IFRS Standards would require the discontinuation of the hedging relationship and the question of whether relief continues becomes irrelevant.

55. If, on the other hand, the entity concludes that the amendment results in a modification instead of derecognition of the hedged item, then it might be possible for an entity to continue hedge accounting after modification under specific circumstances. As the principle is that relief should end when the uncertainty is no longer present, in this instance relief can continue if uncertainty is only partially removed ie only in the hedged item and not the hedging instrument. As discussed in paragraph 6, just because an entity applies the relief, it

does not mean a hedging relationship would always be accounted for as a continuing relationship. To apply hedge accounting, an entity would still need to satisfy all other hedge accounting qualifying criteria, which remain unchanged.

56. The staff would also like to highlight that, as noted in paragraph 33, the Board has tentatively agreed at its December 2018 meeting that the financial reporting implications of the contractual amendments themselves, including the impact on hedge accounting, and the usefulness of the resulting information would be considered during Phase II of the project.

57. For completeness, the staff would highlight this same issue arises for hedges of highly probable forecast transactions not recognised on the balance sheet, for example a future issuance of a floating rate debt instrument. For example, consider a situation where an entity hedges a highly probable forecast issuance of debt expected to occur in five years and today the relief is applied. After three years, the RFR market is fully developed and the entity now knows that the debt instrument will be RFR-based rather than IBOR-based. The question of how to reflect the change in the hedged item is no different than if the hedged item was recognised on the balance sheet. While the discussion of modification versus de-recognition is not applicable, the potential change to hedge documentation regarding definition of the hedged risk are identical in the case of a recognised hedged item and will again need to be addressed during Phase II of the project.

Appendix A – Extracts from the February 2019 Agenda Paper 14 *Issues leading up to IBOR reform*

Highly probable requirement and prospective assessments[8]

A1. The proposed amendments provide relief from uncertainties arising from IBOR reform that would otherwise impact the highly probable requirement and prospective assessments in IFRS 9 and IAS 39. As a result, when these uncertainties are no longer present, entities would not require relief from the requirements of IFRS Standards as originally issued. In this context, the staff have identified two questions regarding hedge relationships:

(a) When should hedging relationships that have used the proposed relief stop using the said relief; and

(b) When should designation of new relationships revert to the hedge accounting requirements as originally written (ie they need to be designated without using the proposed relief).

A2. For the first group of transactions (ie hedging relationships using the proposed relief), when an IBOR financial instrument is contractually amended to reflect the alternative RFR, the uncertainties arising from IBOR reform would no longer affect both the highly probable requirement and the prospective assessments. Therefore, the staff think an entity should stop applying the proposed relief when the earlier of the following occurs:

(c) the designated IBOR financial instrument is contractually amended to replace IBOR for the alternative RFR; or

(d) the hedging relationship terminates.

A3. In addition, as noted in paragraph 19, IBOR reform might also impact reclassification of the amount accumulated in the cash flow hedge reserve related to hedging relationships that have been previously discontinued for reasons other than IBOR reform. For the same reasons stated in paragraph 99 above, an entity should apply the proposed relief for this specific scenario until the earlier of contractual amendment or the cash flow hedge reserve has been

[8] Refer to paragraphs 98–101 of the February 2019 Agenda Paper 14 *Issues leading up to IBOR reform*.

fully reclassified to the statement of profit or loss. This would allow these relationships to “run-off” until they are contractual amended. The impact of contractual amendments on existing hedge relationships will be discussed in Phase II of the project.

A4. The staff think that when the alternative RFR becomes separately identifiable, this implies the market has developed and entities should have clarity regarding the transition from IBOR to the alternative RFR and the impact on their contracts and operations. Consequently, with respect to the second group of hedging relationships noted in paragraph 99(b) above, the staff propose that entities be not permitted to apply the proposed relief for all hedging relationships designated after the RFR is separately identifiable. This is because, when the RFR is separately identifiable, there would be no uncertainty arising from IBOR reform and thus no need for such relief. At this point, entities must use the requirements of IFRS Standards as originally issued.