May 2019

IFRS® Standards
Exposure Draft

Snapshot: *Interest Rate Benchmark Reform*

This Snapshot provides an overview of the Exposure Draft *Interest Rate Benchmark Reform* published by the International Accounting Standards Board (Board).

Exposure Draft objective:

To modify IFRS Standards so companies apply specific hedge accounting requirements as if the interest rate benchmark that indexes hedged cash flows and cash flows from the hedging instrument is not altered as a result of interest rate benchmark reform.

Project stage:

The proposals set out in the Exposure Draft address only issues affecting financial reporting before an existing interest rate benchmark is replaced with an alternative interest rate (pre-replacement issues).

Next steps:

The Board will consider comments received on the Exposure Draft and then develop the final amendments to IFRS 9 *Financial Instruments* and its predecessor, IAS 39 *Financial Instruments: Recognition and Measurement*. The Board aims to issue the final amendments in 2019.

The Board will separately assess any financial reporting issues that might arise when existing interest rate benchmarks are replaced with alternative interest rates (replacement issues).

Comment deadline:

17 June 2019

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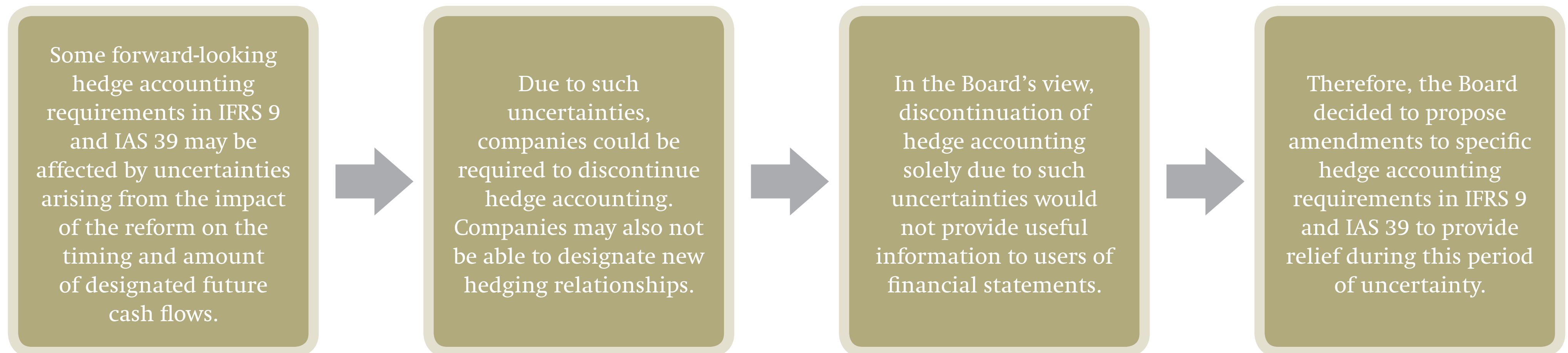
Why is the Board proposing these amendments?

Interest rate benchmarks such as interbank offer rates (IBORs) play an important role in global financial markets. These benchmarks index a wide variety of financial products worth trillions of dollars and other currencies, ranging from mortgages to derivatives.

Market developments have undermined the reliability of some existing benchmarks. In this context, the Financial Stability Board has published a report setting out recommendations to reform such benchmarks[1]. Some jurisdictions have already made clear progress towards replacing existing benchmarks with alternative, nearly risk-free rates (RFRs).

This work has, in turn, led to uncertainty about the future of existing interest rate benchmarks, which may affect companies' financial reporting.



1 The *Reforming Major Interest Rate Benchmarks* report was published in July 2014, and is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf

Why does the ED address *pre-replacement issues* only?

The Board noted the increasing level of uncertainty about the long-term viability of some interest rate benchmarks and decided to add a project to its agenda to consider the financial reporting implications of the reform.

In its outreach with stakeholders, the Board identified two groups of accounting issues that could have financial reporting implications. These are:

(a) *pre-replacement issues*—issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an alternative RFR; and

(b) *replacement issues*—issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative RFR.

At the time of the Board's discussions leading to the ED, the specific conditions and details of the replacement have yet to be finalised. The Board, therefore, decided to monitor developments in this area and, as more information becomes available, the Board will assess the potential implications of the replacement issues and determine whether it should take any action.

The Board decided to prioritise the pre-replacement issues because they are more urgent. Therefore, the ED addresses only the following hedge accounting requirements that are based on forward-looking analysis:

(a) the highly probable requirement;

(b) prospective assessments; and

(c) separately identifiable risk components.

Other than these specific amendments, the hedge accounting requirements would be unchanged.

IFRS 9 allows companies, when they first apply IFRS 9, to choose as an accounting policy to continue to apply the hedge accounting requirements of IAS 39.

A significant number of IFRS preparers – financial institutions in particular – have elected to continue to apply hedge accounting according to IAS 39 rather than IFRS 9. For this reason, the Exposure Draft proposes amending both IFRS 9 and IAS 39.

(a) Highly probable requirement

Hedge accounting requirement

According to IFRS 9 and IAS 39, when a forecast transaction is designated as a hedged item, that transaction must be highly probable.

Potential effects due to reform

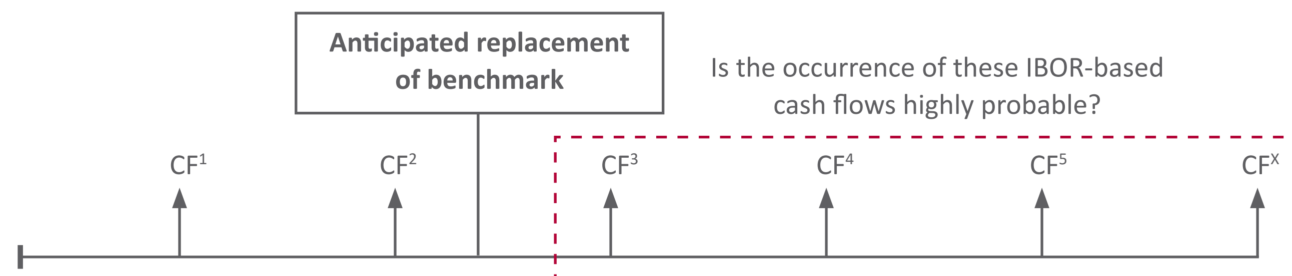
At some point in time, forecast IBOR-based cash flows may no longer meet the highly probable requirement due to uncertainties arising from interest rate benchmark reform.

This is because the underlying contracts might need to be amended with the result that the future cash flows will be based on an alternative RFR, rather than on IBOR.

Proposed amendment

When determining whether a forecast transaction is highly probable, a company shall assume that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of the reform.

For example, assume that a company designates as the hedged item cash flows (shown as 'CF' below) that are contractually linked to an interest rate benchmark, such as IBOR, and that these cash flows are expected to occur after interest rate benchmark reform has taken place.



Applying the amendments, the company will assume that the designated forecast cash flows will not be altered as a result of the reform (ie they will continue to be IBOR-based). If, however, the forecast cash flows are no longer highly probable for other reasons, then the company must discontinue the hedging relationship.

The amendment applies to existing and new hedging relationships, as well as to cash flow hedges that have been discontinued with an amount remaining in the cash flow hedge reserve.

(b) Prospective assessments

Hedge accounting requirement

A hedging relationship qualifies for hedge accounting only if there is an economic relationship between the hedged item and the hedging instrument (described in IFRS 9) or the hedge is expected to be highly effective in achieving offsetting (IAS 39). Companies must demonstrate such prospective assessments on a regular basis.

Potential effects due to reform

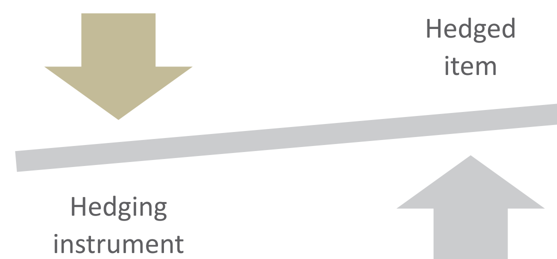
Today, in making these assessments, companies would consider possible changes to future cash flows of hedged items and hedging instruments.

Prospective assessments could be affected due to the uncertainties arising from the reform and potentially this could result in discontinuation of hedge accounting.

Proposed amendment

When performing prospective assessments, a company shall assume that the interest rate benchmark on which the hedging instrument and hedged item are based is not altered as a result of the interest rate benchmark reform.

For example, in making these prospective assessments, companies would have to consider possible changes to future cash flows of hedged items and hedging instruments.



At some point in time, it is possible that companies would not be able to demonstrate the prospective assessments due to uncertainties arising from the reform.

These assessments might be affected by uncertainties around timing and amount of designated cash flows. Examples of uncertainties are:

(a) what are the cash flows from the hedging instrument and hedged item after the reform; and

(b) when will the replacement occur?

Applying the amendments, companies will assume that the interest rate benchmark on which the cash flows of the hedged item and the hedging instrument are based is not altered as a result of interest rate benchmark reform.

(c) Separately identifiable risk components

Hedge accounting requirement

While there are some differences between IFRS 9 and IAS 39 regarding designation of risk components, both Standards require a risk component (or a portion) to be separately identifiable to be eligible for hedge accounting.

A company may designate an item in its entirety or a component of an item as a hedged item in a hedging relationship. IFRS 9 and IAS 39 require the component to be separately identifiable to qualify as a hedged item.

Potential effects due to reform

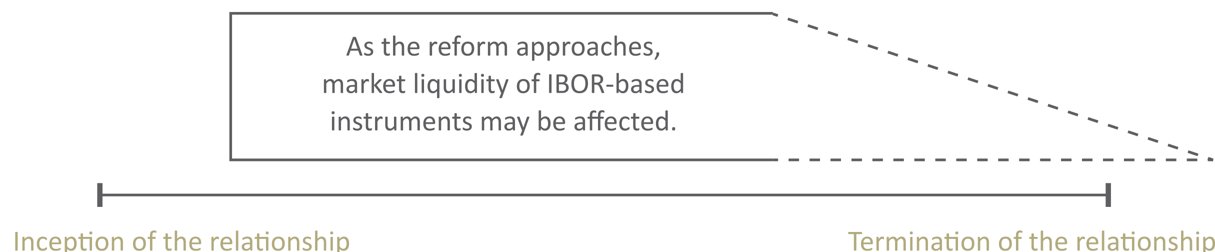
Determining whether a non-contractually specified risk component is separately identifiable requires an assessment of facts and circumstances around the particular market structure to which that risk relates.

Interest rate benchmark reform could affect the market structure and, consequently, the assessment of whether risk components are separately identifiable.

Proposed amendment

For hedges of the benchmark component of interest rate risk affected by the reform, a company shall apply the separately identifiable requirement only at the inception of such hedging relationships.

For example, assume a company designates the IBOR component of a fixed-rate financial liability as the hedged item in a fair value hedge. At inception, the company assesses the relevant facts and circumstances and concludes that IBOR is a separately identifiable risk component.



The amendments will require companies to assess the separately identifiable requirement at the inception of the hedging relationship only. In other words, the company does not continue this assessment over the life of the hedge.

End of application of the relief

Why is the end of application important?

The objective of the proposed amendments is to provide temporary exceptions from applying specific hedge accounting requirements during the period of uncertainty arising from the reform.

In view of this, the relief has been designed to cease being applicable once the uncertainty is resolved. This also means that the period for which the relief is necessary and available may vary by jurisdiction.

End of application

It is proposed that the relief is applicable until the earlier of:

(a) 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

(b) when the hedging relationship is discontinued.

End of application does not apply to separately identifiable risk components.

The way in which the uncertainty is resolved will vary. In some situations, contractual amendments might eliminate uncertainties arising from benchmark interest rate reform.

For example, if a contractual amendment specifies the replacement date and the alternative RFR on which the designated cash flows will be based, the uncertainty regarding the timing and amount of those cash flows is eliminated when the contract is amended. In this scenario, the company would cease to apply the exceptions once the contract is amended.

However, some contractual amendments might not eliminate the uncertainties (eg timing and amount of the amended cash flows are not specified or only one of them is specified). In such cases, the exceptions would still apply.

Disclosures and effective date

Disclosures

The Board is proposing disclosures to provide users of financial statements with information about the extent to which a company has applied the amendments. For those hedges affected by the amendments, companies should provide a separate subset of the disclosures already required by IFRS 7 *Financial Instruments: Disclosures*.

Effective date

It is proposed that the amendments apply to annual periods beginning on or after 1 January 2020. Earlier application is permitted. The proposed effective date reflects the urgency of this issue.

The proposed amendments are mandatory for all hedges of interest rate risk affected by uncertainties arising from interest rate benchmark reform. The Board rejected voluntary application as it could give rise to selective discontinuation of hedge accounting.

Disclosures for hedging relationships applying the amendments	IFRS 7 reference
For hedging instruments in either fair value or cash flow hedges: • the carrying amount • the change in fair value used as the basis for recognising ineffectiveness for the period • the nominal amount	Paragraph 24A(a), 24A(c)–(d)
For hedged items in fair value hedges: • the carrying amount • the accumulated amount of fair value hedge adjustments • the change in value used as the basis for recognising ineffectiveness for the period	Paragraph 24B(a)(i)–(ii), 24B(a)(iv)
For cash flow hedges: • the change in value of the hedged item used as the basis for recognising ineffectiveness for the period • the balance in the cash flow hedge reserve for continuing hedges • the balance remaining in the cash flow hedge reserve from any relationships for which hedge accounting is no longer applied	Paragraph 24B(b)

Further information

Respondents are invited to respond to any or all of the questions in the Exposure Draft and to comment on any other matter that the Board should consider when finalising the Exposure Draft. The Board's discussions will take place in public meetings. To access information about those public meetings, to view the Exposure Draft and to submit your comments, please visit www.ifrs.org.

The deadline for comments on the Exposure Draft is 17 June 2019 (45 days).

To stay up to date with the latest developments and to sign up for email alerts about the project, please visit the project homepage on https://www.ifrs.org/projects/work-plan/ibor-reform-and-the-effects-on-financial-reporting/#current-stage.

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