STAFF PAPER

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Project	**IBOR Reform and the Effects on Financial Reporting**		
Paper topic	Research findings		

CONTACT(S)	Fernando Chiqueto	fchiqueto@ifrs.org	+44 (0) 20 7246 6496
	Ross Turner	rturner@ifrs.org	+44 (0) 20 7246 6920
	Kumar Dasgupta	kdasgupta@ifrs.org	+44 (0) 20 7246 6902

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Introduction

1. At its June 2018 meeting, the Board decided to add to its active research agenda a research project to assess the effects on financial reporting of the potential discontinuation of IBORs. The purpose of this paper is to present the staff research findings and propose that the Board move the *IBOR Reform and the Effects on Financial Reporting* project to its standard-setting programme.

2. This paper is structured as follows:

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

   (b) Background (paragraphs 4 – 7);

   (c) Research findings – Market implications (paragraphs 8 – 19);

   (d) Research findings – Accounting implications (paragraphs 20 – 23);

   (e) Issues affecting financial reporting leading up to IBOR reform (paragraphs 24 – 41);

   (f) Issues affecting financial reporting on transition to new risk-free rates (RFR) (paragraphs 42 – 59); and

   (g) Criteria for adding a project to the standard-setting programme (paragraphs 60 – 67).

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Summary of staff recommendations

3. In this paper, the staff recommend that the *IBOR Reform and the Effects on Financial Reporting* project:

   (a) is moved to the Board standard-setting programme; and

   (b) prioritises the analysis of accounting issues affecting financial reporting leading up to IBOR reform by examining first issues where IFRS Standards have forward-looking requirements and, subsequently, issues which will impact financial reporting when the reform is enacted.

Background

4. As discussed at the June 2018 Board meeting, recent developments have brought into question the long-term viability of some interest rate benchmarks (such as LIBOR, EURIBOR and TIBOR). In this context, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest benchmarks and develop plans for reform to ensure that these benchmarks are robust and appropriately used by market participants.

5. In some jurisdictions, there is already a clear steer towards replacing them by alternative, nearly risk-free rates (RFR), which are based to a higher extent on transaction data. This is the case, for example, for the Secure Overnight Funding Rate (SOFR) in the US, and the reformed Sterling Overnight Index Average (SONIA) in the UK. However, although significant progress towards developing alternative RFRs has been made, some aspects regarding how transition away from IBORs[1] will happen are yet to be determined. According to the *IBOR Global Benchmark Transition Report*,[2] basis risk and valuation issues associated with

[1] As noted in the June 2018 Agenda Paper *Research project proposal*, interbank offered rates (IBORs) are interest rates that represent the cost of obtaining unsecured funding, in a particular combination of currency and maturity, and in a particular interbank term lending market. The most widely used of these reference rates is the London Interbank Offered Rate (LIBOR). Other examples of IBORs are the Euro Interbank Offered Rate (EURIBOR) and the Tokyo Interbank Offered Rate (TIBOR).

[2] The report was issued in June 2018 and includes a survey with over 150 market participants in 24 countries. Participants included banks, hedge funds, asset managers, government-sponsored entities, pension funds, insurance companies and other types of financial entities, corporates and end users. The report was issued by International Swaps and Derivatives Association (ISDA), Association for Financial

amending existing transactions are among the challenges that are in the process of being finalised through a series of consultations. These are further discussed in this paper along with other research findings.

6. While the future of each IBOR and the specific conditions for transition remain uncertain, some market participants, regulators and industry bodies have already started to consider what are the effects to financial reporting of a scenario where these benchmarks are no longer available. With this background, at its June 2018 meeting, the Board decided to add to its active research agenda a research project on the effects on financial reporting of a potential discontinuation of IBORs.

7. At same June 2018 Board meeting, the staff noted that the potential discontinuation of IBORs could have a significant and widespread impact on financial markets. These benchmarks index trillions of dollars in a wide variety of financial products, including derivatives and cash instruments, which are held or issued by a vast number of IFRS reporters globally. In view of this, the staff started gathering evidence to be able to assess the nature and extent of the potential effects to financial reporting. The purpose of this paper is to present the findings of the staff research and propose that the Board move the *IBOR Reform and the Effects on Financial Reporting* project to its standard-setting programme, so that the Board would be in a position react rapidly in case it decides to take actions in form of narrow amendments to IFRS Standards to address the issues discussed in this paper.

Research findings – Market implications

8. At the June 2018 Board meeting, the staff noted that a transition away from IBORs presented challenges which could have implications for financial reporting, including:

    (a) amending legacy contracts to replace an IBOR by its respective RFR;

Markets in Europe (AFME), International Capital Market Association (ICMA), Securities Industry and Financial Markets Association (SIFMA) and SIFMA's Asset Management Group (SIFMA AMG) (hereafter referred to as 'trade associations'). The report is available at https://www.isda.org/a/OqrEE/IBOR-Transition-Report.pdf.

(b) dealing with the pricing gap between IBOR (which includes bank credit risk) and the respective RFR, which are nearly risk-free; and

(c) many of the alternative RFRs reflect the rate of overnight transactions and currently lack the term structure offered by IBORs, which are produced for multiple maturity periods.

9. These uncertainties were also noted in the *IBOR Global Benchmark Transition Report*, issued in June 2018 as a joint effort of several international trade associations to consolidate market participants' views on the impact of a transition from IBORs to alternative RFRs. Based on this information, we grouped our findings into two sections discussed below:

(a) Valuation issues associated with amending existing transactions; and

(b) Basis risk.

Valuation issues associated with amending existing transactions

10. Assuming IBORs are either discontinued or no longer an acceptable benchmark rate to reference, then the terms and conditions of floating-rate financial instruments will likely need to be amended to provide for an alternative floating rate. Amending legacy positions will require parties to negotiate and agree commercial terms to address, among other things, differences between the IBOR and the alternative RFR. These differences will arise mainly because:

(a) IBORs include a bank credit risk premium while alternative benchmark RFRs are nearly risk-free rates; and

(b) the alternative RFRs are primarily overnight rates whereas the relevant IBORs are available in different tenors (eg one, three, six and twelve months are the most commonly tenors used as contractual references).

11. Contractual amendments to legacy positions may vary across products, especially between derivatives and cash instruments. In the case of derivatives, the International Swaps and Derivatives Association (ISDA) expects to use a standardised process to facilitate amendments to legacy positions between adhering parties. According to the *Consultation on Certain Aspects of Fallbacks for Derivatives*, issued by ISDA in July 2018 (the ISDA consultation), by

adhering to a protocol,[3] market participants would agree that their legacy derivative contracts will include the amended alternative RFR in place of the relevant IBOR. However, the specific conditions for the contractual amendments have not been defined yet. In particular, in the *IBOR Global Benchmark Transition Report* market participants noted that a protocol may not be appropriate if commercial terms need to be agreed between the parties bilaterally. In addition, these market participants also noted that, historically, not all counterparties adhere to multilateral protocols and, therefore, bilateral amendments are still likely to be required.[4]

12. Public consultations are considering different approaches to adjust the relevant IBOR to the alternative RFR, so that it is comparable to the relevant IBOR. Adjusting the rate on a contract is a complicated undertaking. Put simply, in most cases IBORs are expected to be higher than the alternative RFR because IBORs include a bank credit premium and is available in different tenors, while the alternative RFR are nearly risk-free and overnight. Consequently, amending legacy contracts is more complicated than removing an IBOR and replacing it with the alternative RFR because this would fundamentally alter the economics and expected cash flows of that contract. To amend existing contracts while minimising the economic impact, IBORs will have to be replaced by the alternative RFR plus an adjustment in the form of a spread. For example, rather than the RFR replacing IBOR, the replacement rate will be RFR + X whereby X is a calculated figure intended to minimise the transfer of value between counterparties on transition. The three approaches being contemplated in the ISDA consultation to calculate X thus far are:

    (a) Forward approach: where the spread adjustment (ie X) would be calculated based on observed market prices for the forward spread between the relevant IBOR and the adjusted RFR;

[3] According to the ISDA consultation, a protocol is 'a multilateral contractual amendment mechanism used to effectuate standard amendments to ISDA documentation among adhering counterparties'. The ISDA consultation is available at http://assets.isda.org/media/f253b540-193/42c13663-pdf.

[4] The staff highlight that the ISDA consultation covers GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW. In the future, ISDA expects to launch supplemental consultations covering USD LIBOR, EUR LIBOR and EURIBOR.

(b) Historical mean/median approach: where the spread adjustment would be based on the mean or median spot spread between the IBOR and the adjusted RFR calculated over a significant, static lookback period (eg 5 years, 10 years); or

(c) Spot-spread approach: where the spread adjustment would be based on the spot spread between the IBOR and the adjusted RFR on the day preceding the relevant announcement or publication triggering transition.

13. While the three approaches outlined above could minimise value transfer at the time IBORs are transitioned to alternative RFRs, the staff note that, while value transfers on enactment of IBOR reform appear likely, at this stage it is not possible to quantify the extent of value transfers that might occur.

14. Regarding cash instruments (ie financial instruments that are not derivatives), while their nature, similar to derivatives, varies across jurisdictions, product types and agreements, there is no central organisation, such as ISDA, that can coordinate efforts to enact standard protocols for cash instruments. Therefore, negotiation between parties on a contract-by-contract basis will likely be required. For example, a change in the reference rate of syndicated loans will most likely require a unanimous consent between several lenders, the agent and the borrower involved in the loan arrangement.

15. In summary, it is likely that amending the terms and conditions of legacy positions will be required to enact IBOR reform. However, consensus has not yet been reached on how contracts will be amended and whether or not there will be value transfers on transition. While the derivative markets could have a standardised protocol enacted, if agreed by all parties, to reduce the burden of re-negotiating outstanding contracts, the process of amending legacy positions in the cash markets is yet to be determined.

Basis risk

16. Due to the inherent complexities associated with the transition, market participants are also concerned with basis risk being introduced in the system.[5] This could emerge if:

   (a) derivatives and the cash products they hedge transition to alternative RFRs under different timelines; and

   (b) cash products reference term versions of the alternative RFRs while derivatives reference the overnight alternative RFRs.

17. Assuming an ideal scenario, market participants would negotiate amendments to derivatives that hedge cash products at the same time as they amend the hedged cash products ensuring renegotiation terms are appropriately aligned. However, at current stage, it is not clear whether derivatives and cash instruments they hedge will transition to alternative RFRs under different timelines. This could lead to a situation where market participants are left with basis risk arising from derivatives and cash products that are referenced to different rates during an undefined transitional period.

18. Furthermore, participants in cash markets often prefer term rates due to economic and operational reasons compared with an overnight rate. In this context a term rate would be similar to 1-month or 3-month IBOR, for example, whereby the interest rate on a particular contract is fixed for a period of time (eg 1 month or 3 months) but the contractual maturity of the contract is longer than the fixing period. Overnight rates, by comparison, fix the interest rate for 1 day and are reset daily. According to the *Consultation on Term SONIA Reference Rates*, issued in July 2018 by the Working Group on Sterling Risk-Free Reference Rates,[6] an important subset of end users in loan and debt capital markets report that term rates are essential for their business needs. In addition, the *IBOR Global*

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[5] According to the ISDA consultation, basis risk was cited by some survey respondents as a cause for concern in transitioning to alternative RFRs. The ISDA consultation is available at http://assets.isda.org/media/85260f13-66/406780f5-pdf/.

[6] The Working Group on Sterling Risk-Free Reference Rates was constituted by the Bank of England and the Financial Conduct Authority (FCA) to catalyse a broad-based transition to SONIA by end-2021 across sterling bond, loan and derivative markets, in order to reduce the financial stability risks arising from widespread reliance on LIBOR. The consultation is available at https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/consultation-on-term-sonia-reference-rates.pdf.

Benchmark Transition Report notes that survey participants believe term rates are most critical for cash products, while derivatives could generally reference overnight rates. However, the staff note that, unlike IBORs, the alternative RFRs are primarily overnight rates and there is no consensus as to whether robust forward-looking term reference rates based on alternative RFRs will be available when IBORs transition to alternative RFRs. In fact, according to the *IBOR Global Benchmark Transition Report*, the development of cash products that reference term versions of the alternative RFRs might be a source of basis risk because derivatives might only reference the overnight alternative RFRs.[7]

19. In summary, it is possible that the process for amending contracts for legacy positions may vary across products, especially between derivatives and cash instruments. This could introduce temporary basis risk between derivative and cash markets if the transition is completed under different timelines or the basis risk could be more permanent if the derivative markets select an overnight rate whereas cash markets select a term rate going forward.

Research findings – Accounting implications

20. While there are many aspects of IBOR reform that are developing, the staff started considering the impact on financial reporting based upon the information contained in paragraphs 8 – 19. In addition, the staff also engaged with securities regulators, central banks, audit firms and a financial institutions (stakeholders) to obtain an understanding of the effects to financial reporting due to the potential discontinuation of IBORs. The feedback received confirmed the challenges of IBOR reform identified in paragraphs 8 – 19 of this paper.

21. These stakeholders also expressed strong support for monitoring further developments of IBOR reform and emphasised that, similar to other situations in

[7] The *IBOR Global Benchmark Transition Report* also note that there is an ongoing discussion over whether any derivatives should reference term alternative RFRs. The report highlights that those against are concerned that the term rates being constructed are not robust enough to support the potential weight of derivatives transactions; while those in favour expressed the view that derivatives should be permitted to reference term alternative RFRs to the extent that they are used to hedge exposure to term alternative RFR cash products.

the past that involved regulatory changes,[8] the Board may need to react rapidly to avoid potential undesirable effects on financial reporting.

22. The staff considered the feedback from the activities above and developed its preliminary views on the potential implications for the existing accounting requirements. Our analysis identified two groups of accounting issues that will affect financial reporting at different moments. These two groups of issues, also echoed by stakeholders, include:

    (a) Issues affecting financial reporting leading up to IBOR reform: there are some areas in hedge accounting that require forward-looking analyses, such as the ‘highly probable’ requirement for forecast transactions designated as hedged items and the existence of an economic relationship, according to *IFRS 9: Financial Instruments* (IFRS 9), or expectation that the hedge will be highly effective in achieving offsetting, as per *IAS 39: Financial Instruments: Recognition and Measurement* (IAS 39), which are prospective assessments in nature. These issues might affect existing hedging relationships leading up to IBOR reform and therefore might require the Board to react rapidly in case it decides to take actions in form of narrow amendments to IFRS Standards; and

    (b) Issues affecting financial reporting on transition to RFR: as noted in paragraphs 10 – 15, there is an ongoing debate about how market participants will approach some key issues related to amendment of legacy positions and whether value transfers will occur as a result. Furthermore, these amendments can vary across jurisdictions, product types and agreements. Therefore, for a comprehensive assessment of the potential effects on financial reporting, the staff will need to monitor further developments in this area so that, as more information becomes available, we will be able to assess the potential implications of IBOR reform on financial reporting.

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[8] For example, in June 2013 after considering the financial reporting effects arising from novations that result from new laws or regulations, the IASB decided to amended IAS 39 to provide relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument meets certain criteria.

23. Based on the above, the staff think the *IBOR Reform and the Effects on Financial Reporting* project should be divided in two phases. The first phase proposes to focus on issues that might affect financial reporting before IBOR reform is enacted and therefore might require the Board to react rapidly in case it decides to take any action. The second phase proposes to focus on situations affecting financial reporting on transition from IBORs to alternative RFRs. Given that details concerning how transition away from IBORs will happen are developing, the staff will need more information to be able to develop a comprehensive analysis of the potential implications of IBOR reform in these areas. The two groups of issues are discussed in detail in paragraphs 24 – 59 of this paper.

Issues affecting financial reporting leading up to IBOR reform

24. As discussed in paragraph 22, there are some areas in hedge accounting that require forward-looking analyses, such as the 'highly probable' requirement for forecast transactions designated as hedged items and the existence of an economic relationship, according to IFRS 9, or expectation that the hedge will be highly effective in achieving offsetting, as per IAS 39, which are prospective assessments in nature. These issues might affect existing hedging relationships before IBOR reform is enacted.[9] In the following paragraphs, we discuss whether the guidance in IFRS 9 and IAS 39 provides an adequate basis to determine the accounting implications of IBOR reform in these areas. More specifically, we first discuss the following situations where the replacement of IBOR could result in discontinuation of hedge accounting:

(a) Highly probable requirement (paragraphs 26 – 28); and

(b) Prospective assessments (paragraphs 29 – 32).

[9] The staff highlight that other issues related to hedge accounting might arise on transition to IBOR reform. These are further discussed in paragraphs 47–55 of this paper.

25. Subsequently, we discuss the accounting implications due to discontinuation of hedge accounting and if further consideration is required as to whether this would provide the most useful[10] information to users of financial statements.

Highly probable requirement

26. According to paragraph 6.3.3 of IFRS 9, when a forecast transaction is designated as a hedged item in a cash flow hedge, that transaction must be highly probable. Furthermore, paragraph 6.5.6 of IFRS 9 requires an entity to discontinue hedge accounting prospectively when the hedging relationship ceases the meet the qualifying criteria, such as the highly probable requirement. In addition, if the hedged future cash flows are no longer expected to occur, paragraph 6.5.12(b) of IFRS 9 states that an entity should discontinue hedge accounting for a cash flow hedge, and the amount accumulated in the cash flow hedge reserve should be immediately reclassified from the cash flow hedge reserve to profit or loss.[11]

27. When the hedged item is designated in terms of forecast IBOR cash flows and these cash flows will occur after IBOR reform, the question that follows is whether those forecast IBOR cash flows would meet the highly probable requirement because the underlying contracts will likely be amended at some point in the future, as discussed in paragraphs 10 – 15. The possibility of IBOR reform and resulting contractual amendments will increase uncertainty around the occurrence of those cash flows and thus decrease the likelihood that IBOR cash flows will occur, all other things being equal. Therefore, as the clarity and certainty of IBOR reform increase and time to transition approaches, it could be argued the forecast IBOR cash flows would be no longer highly probably given IBOR reform will, at some point, result in amendments to the hedged item. This could result in entities not being able to meet the highly probable requirement in IAS 39 and IFRS 9 at some point.

28. The staff also highlight that IFRS 9 and IAS 39 require an entity to identify and document a forecast transaction with sufficient specificity so that when the

[10] Per paragraph 2.4 of the Conceptual Framework ‘if financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely, and understandable.’

[11] Similar hedge accounting requirements exist in IAS 39 – refer to paragraph 101(c) of IAS 39.

transaction occurs, the entity is able to determine whether the transaction is the hedged transaction.[12] According to paragraph B6.3.11 of the Application Guidance of IFRS 9, when designating a risk component as a hedged item, the hedge accounting requirements apply to that risk component in the same way as they apply to other hedged items that are not risk components. Consequently, given the requirement for specificity when documenting the hedged item and the hedged risk, there will be instances where the hedge documentation refers specifically to IBOR as a risk component and the staff think it will be difficult, at some point in the future, to demonstrate those specified cash flows are highly probable given IBOR reform.

Prospective assessments

29. According to paragraph 6.4.1(c)(i) of IFRS 9, a hedging relationship qualifies for hedge accounting only if there is an economic relationship between the hedged item and the hedging instrument. Paragraph B6.4.4 of the Application Guidance of IFRS 9 states that an economic relationship exists when there is an expectation that the value of the hedging instrument and the value of the hedged item will move in the opposite direction because of the same risk, which is the hedged risk.[13] When an entity cannot demonstrate the existence of an economic relationship, paragraph 6.5.6 of IFRS 9 requires the entity to discontinue hedge accounting prospectively.

30. Demonstrating the existence of an economic relationship according to IFRS 9 or expectation that the hedge will be highly effective in achieving offsetting as per IAS 39 would require the estimation of future cash flows because both assessments are prospective in nature. However, for those hedging relationships going beyond the expected replacement of IBOR, it may be more difficult for an entity to demonstrate whether there is an economic relationship between the

[12] Refer to paragraphs F.3.10 and F.3.11 of the Implementation Guidance accompanying IAS 39. The staff note that, while the Board decided not to carry forward any of the hedge accounting related Implementation Guidance that accompanied IAS 39, paragraph BC6.95 of the Basis for Conclusions of IFRS 9 emphasises that not carrying forward the Implementation Guidance did not mean that the Board had rejected that guidance.

[13] According to paragraph 88(b) of IAS 39, hedging relationship qualifies for hedge accounting only if ‘the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk.’ Similar to IFRS 9, IAS 39 also requires an entity to discontinue hedge accounting prospectively when the hedge is no longer expected to be highly effective.

hedged item and the hedging instrument, because the general conditions (timing and specifics) for the replacement of IBOR and therefore the future cash flows from the new benchmark RFRs are not yet determined for both the hedged items and the hedging instruments.

31. As the specific conditions of IBOR reform develop and time to transition approaches, the prospective assessment could be affected as it is performed on a forward-looking basis. This is because, as discussed in paragraphs 26 – 28 regarding the highly probable requirement, entities are required to make positive statements on a forward-looking basis to qualify for hedge accounting. Therefore, at some point it could be difficult for entities to meet the prospective assessment criteria due to IBOR reform.

32. As of now, the staff are proposing to evaluate the impact of uncertainty arising from IBOR reform on the forward-looking prospective assessment required for hedge accounting under both IFRS 9 and IAS 39. The staff are not proposing an evaluation of the fundamental concept of economic offset between the hedged item and the hedging instrument that are the drivers behind the hedge accounting requirements in both IFRS 9 and IAS 39.[14] On transition to the new RFRs, entities would have to evaluate whether or not such an offset exists through prospective assessment and measurement of hedge effectiveness.

Staff analysis

33. Based on our analysis, the staff think the guidance in IFRS 9 and IAS 39 provides an adequate basis to determine how the replacement of IBOR will affect the prospective assessment and the highly probable requirements; both which could lead to the discontinuation of hedge accounting. The implications from discontinuing hedge accounting are discussed in the subsequent paragraphs of this paper.

[14] Refer to paragraph B6.4.7 of IFRS 9.

Accounting implications: Discontinuation of hedge accounting

34. If an entity discontinues a hedge accounting relationship, under IFRS 9 it should apply paragraph 6.5.10 for a fair value hedge and paragraph 6.5.12 for a cash flow hedge. With respect to discontinuation of fair value hedges, paragraph 6.5.10 of IFRS 9 states[15]:

> Any adjustment arising from paragraph 6.5.8(b) shall be amortised to profit or loss if the hedged item is a financial instrument (or component thereof) that is measured at amortised cost. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for hedging gains and losses. The amortisation is based on a recalculated effective interest rate at the date that amortisation begins. In the case of a financial asset (or component thereof) that is a hedged item and that is measured at fair value through Other Comprehensive Income in accordance with paragraph 4.1.2A, amortisation applies in the same manner but to the amount that represents the cumulative gain or loss previously recognised in the accordance with paragraph 6.5.8(b) instead of by adjusting the carrying amount.

35. Regarding discontinuation of cash flow hedges, paragraph 6.5.12 of IFRS 9 states[16]:

> When an entity discontinues hedge accounting for a cash flow hedge, it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 6.5.11(a) as follows:
>
> (a) If the hedged future cash flows are still expected to occur, that amount shall remain in the cash flow hedge reserve until the future cash flows occur or until paragraph 6.5.11(d)(iii) applies. When the future cash flows occur, paragraph 6.5.11(d) applies.

[15] Similar requirements exist within paragraph 92 of IAS 39.

[16] Similar requirements exist within paragraph 101(b) and (c) of IAS 39.

> (b) If the hedge future cash flows are no longer expected to occur, that amount shall be immediately reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment. A hedged future cash flow that is no longer highly probable to occur may still be expected to occur.

36. As explained in paragraphs 34 – 35 above, discontinuation of hedge accounting due to the replacement of IBORs will affect the statement or profit or loss as the fair value hedge adjustment is amortised and the cash flow hedge reserve is reclassified to profit or loss.

37. With respect to highly probable forecast transactions designated as hedged items in a cash flow hedge relationship, as discussed in paragraph 35 above, if the hedged future cash flows are no longer highly probable but still expected to occur, the amount in the cash flow hedge reserve is reclassified to profit or loss when the future cash flows occur. However, if the hedge future cash flows are no longer expected to occur, that amount in the cash flow hedge reserve should be immediately reclassified to profit or loss. The staff note that the quantification of the amounts potentially at risk of immediate reclassification can be material in certain instances.

Accounting implications: Ability to designate new hedging relationships

38. After discontinuation of hedge accounting, entities will likely continue using the same derivatives, presumably for risk management purposes. These derivatives would be measured at fair value through profit and loss absent hedge accounting. Assuming the entity decides to re-designate these derivatives as hedging instruments in a new hedging relationship, the derivatives would have a non-zero fair value at initial designation. Consequently, increased hedge ineffectiveness would have to be measured and recognised in profit or loss[17], especially for cash flow hedges. This is because the derivative that would be newly designated as the hedging instrument would be on terms that would be different than new

[17] The recognition is subject to the outcome of the 'lower of test' in paragraph 6.5.11(a) of IFRS 9 and paragraph 96(a) of IAS 39.

derivatives, ie it is unlikely to be 'at-market' at the time of designation.[18] In addition, there would also be an increased risk that the hedging relationship would fail to demonstrate the existence of an economic relationship as required by IFRS 9 or the 80 per cent-125 per cent hedge effectiveness range required by IAS 39. Finally, it could also be difficult to designate new cash flow hedge relationships given the discussion on the highly probable requirement in paragraphs 26 – 28.

Staff summary

39. Based on our analysis, the staff think the guidance in IFRS 9 and IAS 39 provide an adequate basis to determine how the replacement of IBOR will affect the prospective assessment and the highly probable requirements; both which could lead to the discontinuation of hedge accounting. The consequences from the discontinuation of hedge accounting and the inability to designate new hedging relationships, discussed in paragraphs 34 – 38, could have an impact on the financial statements. However, such a change in market structure was not contemplated when IFRS 9 and IAS 39 were written and the staff think it is reasonable to consider whether the resulting information content arising from the application of these requirements will provide useful information to users of financial statements.

40. The staff are of the view that further consideration is required on whether accounting for a hedging relationship that existed before the replacement of IBORs as a continuing hedging relationship, in this specific situation, would provide more useful information to users of financial statements. The staff note that the replacement of IBORs have arisen as a result of a market wide reform of benchmark RFR. More specifically, the replacement of IBORs arises from a G20 request to the FSB to undertake a fundamental review of major interest rate benchmarks and develop plans for reform to ensure that these benchmarks are robust and appropriately used by market participants.

41. Because the accounting issues discussed above would affect financial reporting leading up to IBOR reform, the staff propose to prioritise the analysis of these issues in the forthcoming meetings, so that the Board would be able to react

[18] Refer to paragraph 6.338 of the Basis for Conclusions of IFRS 9.

rapidly in case it decides to take any action. The staff also highlight that, in the past, the Board considered the potential financial reporting effects arising from novations that result from new laws or regulations and decided to amended IAS 39 in June 2013 to provide relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument met certain criteria.

Issues affecting financial reporting on transition to RFR

42. While the future of each IBOR and specific conditions for transition are developing, the staff note that accounting implications from these issues, if any, will arise only when the amendments to legacy positions come into effect (ie on transition from IBORs to alternative RFRs). Therefore, while some aspects regarding how transition away from IBORs will happen are developing, the staff plan to monitor further developments in this area so that, as more information become available, the staff will be able to assess the potential implications of IBOR reform to financial reporting and recommend whether the Board would need to take any action.

43. Based on the available information, the staff have identified a few areas in financial reporting that might be affected when transition is enacted, including:

    (a) Modification vs. derecognition; and

    (b) Hedge accounting (excluding those areas affected leading up to IBOR reform, which are discussed in paragraphs 26 – 28).

44. While the staff have identified other areas in financial reporting that could be impacted, such as accounting for the modification of IBOR-referenced lease contracts or the fair value hierarchy applied to financial instruments, this paper will focus on the areas identified in paragraph 43 as the conclusions offered would be similar.

Modification vs. derecognition

45. When the terms of a financial instrument (including derivatives) are modified or renegotiated, such as situations when IBOR-referenced financial instruments are

amended to reflect a new benchmark RFR, the question that follows is whether such modification or renegotiation meets the derecognition conditions in IFRS 9 and IAS 39. This is because the accounting implications will differ depending on whether the it is accounted for as a derecognition event (see paragraphs 3.2 and 3.3 of IFRS 9) or as a modification of financial instrument (see paragraphs 3.3 and 5.4.3 of IFRS 9).

46. The staff note that evaluating the accounting requirements and the usefulness of the resulting information will depend on the specific facts and circumstances of how IBOR reform is enacted. More specifically, at the current stage, it is not clear how market participants will approach some key issues related to amendment of legacy positions and whether value transfers will occur as discussed in paragraphs 10 – 15. Therefore, the staff plan to monitor further developments in this area, so that, as more information become available, the staff will be able to assess the potential implications of IBOR reform in totality and recommend whether the Board would need to take any action.

Hedge accounting – issues arising on when transition is enacted

47. Based on the staff preliminary analysis and the feedback received from stakeholders, the following areas of hedge accounting might be affected on transition from IBORs to alternative RFRs. These topics include:

    (a) Changes in the hedged item and hedged risk (paragraphs 48–51); and

    (b) Non-contractual component designated as a hedged item (paragraphs 52–55).

Changes in the hedged item or hedged risk

48. To qualify for hedge accounting, paragraph 6.4.1 of IFRS 9 requires that, at the inception of the hedging relationship, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include the hedged item and the nature of the risk being hedged.[19]

[19] Similar hedge accounting requirements exist in IAS 39 – refer to paragraph 88(a) of IAS 39.

49. In situations where contractual amendments do not result in derecognition, the discontinuation of IBORs may require redefining the hedged risk in the hedge documentation to make reference to the new benchmark RFR when the hedged risk is specified and documented in terms of a benchmark interest rate (ie a component of an eligible hedged item), which would result in discontinuation of the hedge relationship. This is because paragraph B6.5.26(a) of the Application Guidance of IFRS 9 states that a hedge relationship should be discontinued when the hedging relationship no longer meets the risk management objective on the basis of which it qualified for hedge accounting (ie the entity no longer pursues that risk management objective).

50. However, because it is uncertain what the future of each IBOR will be and the conditions for the replacement of IBORs on a contract-specific basis, the staff note that it is not possible to analyse:

(a) how the hedged item will need to be updated in the hedge accounting documentation; nor

(b) how the hedged risk and the risk management objective will need to be updated in the hedge accounting documentation.

51. As a result, the staff recommend similar action as described in paragraph 46.

New RFR designated as a non-contractual component

52. When designating risk components as hedged items, an entity should consider whether the risk components are explicitly specified in a contract (contractually specified risk components) or whether they are implicit in the fair value or the cash flows of an item of which they are a part (non-contractually specified risk components). In that respect, paragraph B6.3.10(d) of the Application Guidance of IFRS 9 provides the following example where a benchmark rate such as LIBOR can be identified as a non-contractually specified risk component of the debt instrument:

> 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, irrespective of the spread of debt instruments to that benchmark rate. The price of fixed-rate debt instruments varies directly in response to changes in the benchmark rate as they happen. Entity D concludes that the benchmark rate is a component that can be separately identified and reliably measured. Consequently, Entity D may designate hedging relationships for the fixed-rate debt instrument on a risk component basis for the benchmark interest rate risk.

53. In this example, the benchmark rate (LIBOR) can be identified as a risk component because a large variety of similar fixed rate debt instruments are compared by their spreads to the benchmark rate and variable-rate instruments in that environment are typically indexed to the same benchmark rate. In addition, interest rate swaps are frequently used to manage interest rate risk on the basis of that benchmark rate. This background is important because this provides the basis to demonstrate whether a benchmark RFR will be separately identifiable and reliably measurable as required by paragraph 6.3.7 of IFRS 9.[20]

54. In practice, hedging relationships are commonly designated whereby IBOR is a non-contractually specified risk component of a financial instrument. However, as IBORs are replaced by new benchmark RFRs and IBOR-referenced financial instruments are amended to reflect the new benchmarks, some stakeholders are concerned that entities might not be able to demonstrate the benchmark RFR is separately identifiable and reliably measurable due to the lack of historical data or other type of evidence, such as market activity for interest rate swaps indexed to that benchmark RFR.

55. Because it is uncertain what the future of each IBOR will be and the specific conditions for the replacement of IBORs, at this stage, the staff note that it is not

[20] More specifically, paragraph B6.3.8 of the Application Guidance of IFRS 9 states that ‘to be eligible for designation as a hedged item, a risk component must be a separately identifiable component of the financial or the non-financial item, and the changes in the cash flows or the fair value of the item attributable to changes in that risk component must be reliably measurable.’ Similar hedge accounting requirements exist in IAS 39 – refer to paragraph 81 of IAS 39.

possible to determine whether the benchmark RFR will be separately identifiable and reliably measurable. As a result, the staff recommend similar action as described in paragraph 46.

Staff summary

56. Our analysis identified two groups of accounting issues that will affect financial reporting in different moments. The second group of issues, discussed in paragraphs 42 –55 above, include situations affecting financial reporting on transition. As noted in paragraph 44, the staff have identified other areas in financial reporting that could be impacted, but we have not listed all additional areas as the conclusions offered would be similar.

57. While the future of each IBOR and specific conditions for transition remain uncertain, the staff note that accounting implications from these issues, if any, will arise only when the amendments to legacy positions come into effect (ie on transition from IBORs to alternative RFRs). In particular, the staff note that there is an ongoing debate about how market participants will approach some key issues related to amendment of legacy positions and whether value transfers will occur as a result. Furthermore, these amendments can vary significantly across jurisdictions, product types and agreements. As a result, for a comprehensive assessment of the potential effects on financial reporting, the staff will need to monitor further developments in this area so that, as more information become available, the staff will be able to assess the potential implications of IBOR reform to financial reporting.

Why the staff analysis contemplates IFRS 9 and IAS 39

58. According to paragraph 7.2.21 of IFRS 9, when an entity first applies IFRS 9, it may choose to continue to apply the hedge accounting requirements of IAS 39 instead of those in IFRS 9. Furthermore, it is understood that a significant number of IFRS preparers, particularly financial institutions and insurance companies, have elected to apply the hedge accounting according to IAS 39 rather than those specified in IFRS 9. In addition, although IFRS 9 replaces the derecognition and modification requirements in IAS 39, companies applying *IFRS 4: Insurance Contracts* (IFRS 4), and that meet certain conditions, may continue to apply IAS

39 for annual periods beginning before 1 January 2021.[21] In November 2018, the Board tentatively decided to propose that entities that meet those conditions may continue to apply IAS 39 for annual periods before 1 January 2022.

59. In this paper, the staff have considered modification of financial instruments and hedge accounting as examples of possible areas affected by IBOR reform. If the Board in future decides that requirements in IFRS 9 related to these areas should be amended, the staff note that similar narrow amendments might also be required to the corresponding requirements in IAS 39. For this reason, our analysis contemplates the effects of the potential discontinuation of IBORs for financial instruments accounted for under both IFRS 9 and IAS 39.

Criteria for adding a project to the standard-setting programme

60. The *Due Process Handbook* states that when adding a standard-setting project to its agenda or making major amendments to existing Standards, the Board evaluates the merits of adding the project primarily on the basis of the needs of users of financial reports, while also taking into account the costs of preparing the information. When deciding whether a proposed agenda item will address users' needs, the Board considers the following:[22]

    (a) whether there is a deficiency in the way particular types of transactions or activities are reported in financial reports and the importance to users of financial statements;

    (b) the types of entities likely to be affected by any proposals and the pervasiveness of the financial reporting issues; and

    (c) whether the benefits of the improvements to financial reporting will outweigh the costs.

[21] For further information, refer to paragraph 20A of IFRS 4.

[22] Due Process Handbook, paragraphs 5.4 and 5.7.

Deficiency in the way particular transactions are reported in financial reports

61. As noted in paragraph 20, the staff engaged with securities regulators, central banks, audit firms, and financial institutions to obtain an understanding of the effects to financial reporting due to the potential discontinuation of IBORs. The staff considered the feedback from these activities and developed their preliminary views on the implications for the existing accounting requirements. In particular, the research findings indicate that the financial reporting implications from a possible replacement of IBOR can be grouped into two phases:

    (a) Issues affecting financial reporting leading up to IBOR reform; and

    (b) Issues affecting financial reporting on transition to RFR.

62. As discussed in paragraphs 39 – 41, based on our analysis and the feedback received from stakeholders, the staff think that even though the accounting requirements of IFRS 9 and IAS 39 already provide an adequate basis to account for some specific situations arising due to the replacement of IBORs, further consideration is required on whether the accounting outcomes provide useful information to users of financial statements. This is because such changes reflect the fundamental review of IBORs undertaken by the FSB to ensure that these benchmarks are robust and appropriately used by market participants. Such a change in the structure of interest rate markets was not contemplated when the applicable accounting requirements were written.

Types of entities affected and pervasiveness of the financial reporting issues

63. It is likely that IBOR reform will have a pervasive effect. IBORs are used extensively in the global financial markets by a variety of market participants and in a number of different financial products. They are used to specify the contractual cash flows for a wide range of credit products – such as loans, structured products and bonds – as well as derivatives such as swaps, options and forwards. According to the FSB, the total estimated notional outstanding amount of contracts indexed to IBORs is over US$300 trillion.[23]

[23] For further discussion, see section III ‘The Role of Reference Interest Rate’ in FSB ‘Reforming Major Interest Rate Benchmarks’ report issued in July 2014. The report is available at http://www.fsb.org/2014/07/r_140722/.

64. Consequently, the staff are of the view that the possible discontinuation of IBORs could have a significant and widespread impact to a vast number of IFRS reporters globally.

Costs and benefits

65. It is difficult to be certain about the likely costs and benefits of any potential amendments to IAS 39 and IFRS 9 at this stage of the project. However, the feedback received from stakeholders indicates that this project will be beneficial to preparers and users of financial statements. In addition, the proposed amendments are expected to be as narrow as possible which will likely mitigate eventual implementation costs. Consequently, the staff's preliminary assessment is that the benefits from this project are likely to outweigh the costs.

Staff view

66. Based on the assessment of the criteria for adding a project to the standard-setting programme discussed in paragraphs 60 – 65, the staff recommend that the *IBOR Reform and the Effects on Financial Reporting* project is added to the Board standard-setting programme.

67. The staff also recommend that the *IBOR Reform and the Effects on Financial Reporting* project should prioritise the analysis of the accounting issues affecting financial reporting leading up to IBOR reform, so that the Board is able to react rapidly if it so decides. While the first phase of the project will address more urgent accounting issues that may arise due to IBOR reform, the second phase of the project will focus on situations affecting financial reporting on transition from IBORs to alternative RFRs. Given some aspects regarding how transition away from IBORs will happen are still developing, the staff plan to monitor further developments in these areas so that, as more information become available, the staff will be able to assess the potential implications of IBOR reform to financial reporting and recommend whether the Board would need to take any action.

Questions for the Board

Questions for the Board
1) Does the Board agree with the staff recommendation to move the *IBOR Reform and the Effects on Financial Reporting* project to its standard-setting programme?   2) Does the Board agree with the staff recommendation that the *IBOR Reform and the Effects on Financial Reporting* project should prioritise the analysis of accounting issues affecting financial reporting leading up to IBOR reform by examining first issues where IFRS Standards have forward-looking requirements and, subsequently, issues which will impact financial reporting when the reform is enacted?