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Project	**IBOR Reform and its Effects on Financial Reporting – Phase 2**		
Paper topic	Hedge accounting		
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Purpose of this paper

1. The purpose of this paper is to discuss the potential hedge accounting issues that could arise as a result of interest rate benchmark reform (IBOR reform). This paper is structured as follows:

    (a) Summary of staff recommendations (paragraph 2);

    (b) Background (paragraphs 3–5);

    (c) Interaction with tentative decisions on classification and measurement (paragraphs 6–55);

    (d) Valuation adjustments due to modifications directly required by the reform (paragraphs 56–76);

    (e) Hedges of group of items (paragraphs 77–100); and

    (f) IAS 39 fair value hedge accounting for a portfolio hedge of interest rate risk (paragraphs 101-103).

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Summary of staff recommendations

2. In this paper the staff recommend that:

   (a) no amendments should be made to the current requirements in IFRS 9 and IAS 39 to determine whether a hedging relationship should be discontinued following:

      (i) a substantial modification that results in derecognition of the hedged item and/or the hedging instrument; or

      (ii) a modification that did not result in derecognition and that is not directly required by the reform;

   (b) IFRS 9 and IAS 39 should be amended to clarify that following changes in hedge documentation necessary to reflect modifications that are directly required by the reform do not result in discontinuation of hedge accounting:

      (i) redefining the hedged risk to make reference to an alternative benchmark rate; and

      (ii) redefining the description of the hedging instruments and/or hedged items to reflect the alternative benchmark rate;

   (c) IAS 39 should be amended to clarify that changes to the method used for assessing hedge effectiveness due to modifications that are directly required by the reform do not result in discontinuation of hedge accounting;

   (d) no exceptions should be provided from existing IFRS 9 and IAS 39 requirements to measure and recognise:

      (i) valuation adjustments arising when the hedge documentation is updated to reflect an alternative benchmark interest rate as the new hedged risk in a fair value hedge;

      (ii) any hedge ineffectiveness attributable to changing the hypothetical derivative to reflect a modification to the hedged item that is directly required by the reform; and

(iii) valuation adjustments arising when derivatives designated as hedging instruments are amended to replace IBOR with an alternative benchmark interest rate.

(e) IFRS 9 and IAS 39 should be amended, so that when items within a designated group of items are amended for modifications that are directly required by the reform, entities are required to:

(i) amend the hedge documentation to define the hedged items by way of two subgroups within the designated group of items, one referencing the original interest rate benchmark and the other the alternative benchmark rate;

(ii) perform the proportionality test separately for each subgroup of items designated in the hedging relationship;

(iii) treat the hedge designation as a single hedging relationship and allow entities to amend the hypothetical derivative to reflect the combination of the subgroups of items; and

(iv) for group of items designated under IAS 39 only, entities could treat IBOR and its alternative benchmark rate as if they would share similar risk characteristics.

(f) regarding IAS 39 fair value hedge accounting for a portfolio hedge of interest rate risk, IAS 39 should be amended so that, when entities change the hedged risk to an alternative benchmark rate in the hedged documentation, it is assumed that all items included in the portfolio of financial assets or financial liabilities share the risk being hedged.

Background

3. According to the September 2019 Agenda Paper 14 *Project plan and preliminary timing*, hedge accounting is the next key area of the project *IBOR Reform and its Effects on Financial Reporting – Phase 2* for discussion with the Board following the discussion at the October 2019 Board meeting on classification and measurement of financial instruments.

4. This paper considers the potential effects of IBOR reform on hedging relationships designated under both standards – IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement*. This is because,

according to paragraph 7.2.21 of IFRS 9, when entities first apply IFRS 9, they are permitted to choose to apply the hedge accounting requirements of IAS 39. Furthermore, it is understood that a significant number of IFRS preparers, particularly financial institutions, have made such an accounting policy choice.

5. In identifying the potential hedge accounting issues that could affect financial reporting due to IBOR reform, the staff considered:

   (a) The interaction with the tentative decisions on classification and measurement from the October 2019 Board meeting; and

   (b) The preliminary list of potential accounting issues to be considered by the Board during Phase 2, discussed in the September 2019 Agenda Paper 14 *Project plan and preliminary timing*. In this paper, these issues are grouped as follows:

      (i) Hedge documentation issues;

      (ii) Valuation adjustments;

      (iii) Hedges of group of items; and

      (iv) IAS 39 fair value hedge accounting for a portfolio hedge of interest rate risk.

Interaction with the tentative decisions on classification and measurement

6. At its October 2019 meeting, the Board tentatively decided to provide a practical expedient allowing entities to apply paragraph B5.4.5 of IFRS 9 to account for modifications to the interest rate benchmark on which a financial instrument's contractual cash flows are based, that are: (a) required as a direct consequence of IBOR reform; and (b) done on an economically equivalent basis. For ease of reference, this paper refers to those modifications as modifications 'directly required by the reform'.[1]

[1] The staff highlight that hedging relationships affected by modifications directly required by the reform is a subgroup of the hedging relationships within the scope of Phase 1. This is because, in Phase 1, the Board decided to amend IFRS 9 and IAS 39 to address specific aspects of hedge accounting affected by uncertainties arising from the reform in relation to the timing and the amount of future cash flows of the hedged item and the hedging instrument. In other words, not all relationships affected by such uncertainties would result in a modification directly required by the reform.

7. In summary, when the contractual cash flows of a financial instrument are renegotiated or otherwise modified, the accounting outcomes resulting from the application of current IFRS 9 requirements and the Board's tentative decisions from its October 2019 meeting may differ depending on whether the modification:

   (a) *results in derecognition*: according to paragraphs 3.2.12 and 3.3.3 of IFRS 9, entities would derecognise the existing financial instrument and subsequently recognise a new one. Any difference between the carrying value of the derecognised financial instrument and the fair value of the new financial instrument is recorded in profit or loss.

   (b) *does not result in derecognition and is not directly required by the reform*: as per paragraph 5.4.3 of IFRS 9, entities would recalculate the gross carrying amount of the financial instrument as the present value of the modified cash flows discounted at the original effective interest rate with any modification gain or loss recognised in profit or loss. For accounting purposes, the same financial instrument would continue to exist (ie derecognition is not required).

   (c) *is directly required by the reform:* at its October 2019 meeting, the Board tentatively decided to provide a practical expedient allowing entities to apply paragraph B5.4.5 of IFRS 9 to account for modifications directly required by the reform. More specifically, entities would re-estimate the cash flows and update the effective interest rate ('EIR') for the change in benchmark rate similar to the way floating rate instruments are updated for movements in the market rates of interest. Therefore, for accounting purposes, the modification will not result in a modification gain or loss and the entity would not need to assess whether the modification is considered to be substantial.

8. As discussed at the September 2019 Board meeting, these tentative decisions with regards to classification and measurement could have consequential implications for hedge accounting purposes if a financial instrument that is modified to replace the current interest rate benchmark with an alternative benchmark rate, is also

been designated as hedging instrument or hedged item in a hedging relationship[2]. Accordingly, in considering the interaction between hedge accounting and the possible accounting outcomes discussed in paragraph 7 above, the staff analysis was structured as follows:

(a) Modifications that result in derecognition (paragraphs 9–16).

(b) Modifications that do not result in derecognition and are not directly required by the reform (paragraphs 17–22); and

(c) Modifications that are directly required by the reform (paragraphs 23–55).

Modifications that result in derecognition

9. At its October 2019 meeting, the Board tentatively decided that, in the context of IBOR reform, current requirements in IFRS 9 provide an adequate basis to account for the derecognition of a financial asset or financial liability, the recognition of the new financial instrument and the recognition of the resulting gain or loss in the statement of profit or loss following a substantial modification. Therefore, the Board concluded that no amendment to IFRS 9 was needed in this regard. In the context of hedge accounting, the derecognition of a financial instrument designated as a hedging instrument or hedged item will result in the discontinuation of the hedging relationship under IFRS 9 and IAS 39.

10. More specifically regarding hedging instruments, a substantial modification of the terms of a derivative designated as hedging instrument will result in discontinuation of hedge accounting, because the original derivative would be derecognised and a new derivative would be subsequently recognised.[3] Assuming the entity decides to designate the modified derivative as the hedging instrument in a new hedging relationship, such derivative would have a non-zero fair value at initial designation because of its ‘off market terms’. Consequently, there would be an increased risk that the new hedging relationship would fail the effectiveness requirements in IFRS 9 and IAS 39, particularly when the hedge is a cash flow

[22] In the Phase 1 amendments, these hedging relationships have been described as those that are directly affected by interest rate benchmark reform.

[3] According to paragraphs 6.5.6 of IFRS 9 and 91(a) and 101(a) of IAS 39, when the hedging instrument expires or is sold, terminated or exercised, an entity should discontinue hedge accounting prospectively.

hedge and the 'off market' derivative is compared to a new 'at-market' hypothetical derivative.

11. Regarding hedged items, paragraph 6.4.1 of IFRS 9 requires formal documentation of the hedged item and the nature of the risk being hedged at the inception of the hedge. In addition, according to paragraph B6.5.26(a) of IFRS 9, a hedging relationship should be discontinued when it 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). IFRS 9 also states that risk management objective for a hedging relationship applies at the level of a particular hedging relationship (ie it relates to how the particular hedging instrument that has been designated is used to hedge the particular exposure that has been designated as the hedged item).[4] In other words, amending the particular exposure designated as the hedged item (such as IBOR for example) would represent a change in risk management objective.

12. While similar application guidance does not exist within IAS 39, the requirements of paragraph 88(a) of IAS 39 are identical requiring the identification of the hedged item, the hedged risk and the risk management objective and strategy for undertaking the hedge. Consequently, a change in the hedged item or hedged risk would represent a change in the risk management objective and therefore would trigger discontinuation of hedge accounting under IFRS 9 and IAS 39.

Staff analysis

13. At the October 2019 meeting, the Board tentatively confirmed the current requirements in IFRS 9 that when the terms of a financial instrument are substantially modified, the original financial instrument would cease to exist and thus recognising a new financial instrument under the modified contractual terms, would appropriately reflect the economics of a substantial modification. In view of this, the Board tentatively decided that IFRS 9 would provide an adequate basis to account for the derecognition of a financial instrument following a substantial modification. In this context, the staff think that, when a financial instrument designated as hedging instrument or hedged item is substantially modified,

[4] Refer to paragraph B6.5.24 of the Application Guidance of IFRS 9.

discontinuation of hedge accounting would be consistent with the view that the financial instruments designated in that hedging relationship would no longer exist.

14. Therefore, the staff is of the view that discontinuation of a hedging relationship in which either the hedging instrument or the hedged item has been substantially modified would provide useful information to users of financial statements. This is because discontinuation would reflect the economics of a financial instrument that was substantially modified and a new financial instrument is recognised. Accordingly, the staff do not recommend any amendment to be made to IFRS 9 and IAS 39 in this regard.

15. Finally, the staff also considered how the accumulated changes in fair value attributable to the hedged risk (in case of fair value hedges) and the changes in fair value of the hedging instrument accumulated in the cash flow hedge reserve (in case of cash flow hedges) should be accounted for upon discontinuation of hedge accounting and whether current IFRS 9 and IAS 39 requirements should be amended in this regard. However, the staff do not consider any exception to existing hedge accounting requirements is needed because:

    (a) This would result in deferring changes in fair value related to hedged items that no longer exist (in case of fair value hedges) or related to forecast transactions that are no longer expected to occur (in case of cash flow hedges); and

    (b) This would be inconsistent with the end of application requirements in the 2019 *Interest Rate Benchmark Reform* (Amendments to IFRS 9, IAS 39 and IFRS 7), which requires an entity to cease applying the exception from the highly probable requirement when the hedging relationship that the hedged item is part of is discontinued.

Staff recommendation

16. For the reasons stated in paragraphs 13–14, the staff is of the view that the current requirements in IFRS 9 and IAS 39 provides sufficient guidance to determine whether a hedging relationship in which either the hedging instrument or the hedged item has been substantially modified should be discontinued. The staff also do not consider that providing any exceptions from these requirements would

provide useful information to users of financial statements. This is because discontinuation would reflect the economics of a financial instrument that was substantially modified and became a new financial instrument. Accordingly, the staff do not recommend any amendment to be made to IFRS 9 and IAS 39 in this regard.

Modifications that do not result in derecognition and are not directly required by the reform

17. As discussed at the October 2019 Board meeting, entities could use IBOR reform as an opportunity to make modifications to other terms in a financial instrument at the same time, which are not directly required by the reform and thus would not qualify for the practical expedient.

18. The objective of Phase 2, as discussed at the September 2019 Board meeting, is to provide useful information about the effects of the transition to alternative benchmark rates on an entity's financial statements and support preparers in applying the requirements of the IFRS Standards during IBOR reform. Such an objective is intended to assist the Board in defining the scope of potential issues to be considered during Phase 2 and assessing whether it should take any action in the form of amendments to IFRS Standards. In light of this, the Board agreed that the scope of any guidance to be provided should be limited to modifications that are made in the context of IBOR reform.

19. At the October 2019 Board meeting, the Board tentatively confirmed that any modifications that are not directly required by the reform should be assessed in accordance with the current requirements in IFRS 9 to determine whether the modification is substantial. At that meeting, the Board also considered that IFRS 9 provides an adequate basis to determine how to account for modifications that are not substantial (ie entities would apply paragraph 5.4.3 of IFRS 9 to recalculate the gross carrying amount of the financial instrument with any modification gain or loss recognised in profit or loss).

20. In view of this, assessing the implications of modifications that are not directly required by the reform on hedging relationships would be beyond the scope of this project. Therefore, the staff is of the view that providing any sort of exception in

the context of hedge accounting for such modifications would be inconsistent with the objectives of Phase 2.

21. Finally, the staff note that, based on input gathered from research activities as well as the feedback received from the Accounting Standards Advisory Forum (ASAF) at its October 2019 meeting, stakeholders recommended that the Board should address only the issues arising due to IBOR reform as a priority given the timing of the reform and current uncertainty around when contracts will start being amended. The feedback received from the ASAF at the October 2019 meeting, was also consistent in this regard, ie to focus only on issues arising from IBOR reform.

Staff recommendation

22. For the reasons stated in paragraphs 18–21, the staff note that modifications other than those that are directly required by the reform, are a common occurrence in the day-to-day activities of entities for which they apply the current requirements in IFRS 9 and IAS 39 to determine whether these modifications result in the discontinuation of hedging relationships. The staff is therefore of the view that providing any exception for the effects of modifications that are not directly required by the reform on hedge accounting would be beyond the scope of this project and inconsistent with the objectives of Phase 2. Accordingly, at this stage, the staff recommend that no amendment should be made to IFRS 9 and IAS 39 in this regard and that entities should continue to apply the current requirements in IFRS 9 and IAS 39 to determine whether a hedging relationship should be discontinued following a modification to the hedged item or hedging instrument that does not result in derecognition and that is not directly required by the reform.

Modifications that are directly required by the reform

23. Many respondents to the 2019 Exposure Draft *Interest Rate Benchmark Reform* (*proposed amendments to IFRS 9 and IAS 39*) (May 2019 ED) requested the Board to consider whether entities could make changes to their hedge documentation to transition from IBOR to an alternative benchmark rate without it

resulting in discontinuation of hedge accounting.[5] These would include situations where, as a result of the reform, entities update the hedge documentation to make changes to the hedged risk, hedged item and/or hedging instrument and potentially identify new sources of ineffectiveness that did not exist at the inception of the hedge.

24. Considering the staff recommendations in paragraphs 16 and 22, this section focuses on hedge documentation issues arising as a result of modifications that are directly required by the reform. To assess these issues, we have structured our analysis as follows:

    (a) Current requirements under IFRS 9 and IAS 39 (paragraphs 25–29);

    (b) Hedge documentation issues arising as a result of modifications directly required by the reform (paragraphs 30–41);

    (c) Staff analysis (paragraphs 42–53); and

    (d) Staff recommendation (paragraphs 54–55).

Current requirements under IFRS 9 and IAS 39

25. To qualify for hedge accounting, both IFRS 9 and IAS 39 include similar requirements for documentation of hedging relationships as follows:

    (a) Paragraph 6.4.1(b) of IFRS 9 requires that, at the inception of the hedging relationship, there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).

[5] For further information, refer to the July 2019 Agenda Paper 14B *Additional issues for consideration before finalising the proposed amendments*.

(b) Paragraph 88(a) of IAS 39 requires that, at the inception of the hedge, there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

26. Paragraph 6.5.6 of IFRS 9 requires an entity to discontinue hedge accounting prospectively when the hedging relationship ceases to meet the qualifying criteria.[6] Circumstances that trigger discontinuation of hedge accounting are similar in both IFRS 9 and IAS 39, except that IAS 39 permits an entity to revoke the hedge designation whereas IFRS 9 prohibits voluntary discontinuation of hedge accounting when the risk management objective for a particular hedging relationship remains the same and all the other qualifying criteria are still met.[7]

27. Paragraph 6.5.6 of IFRS 9 also explains that a replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination that would preclude hedge accounting if such replacement or rollover is part of the entity's documented risk management objective. Similar guidance exists in paragraphs 91(a) and 101(a) of IAS 39.

28. The Application Guidance of IFRS 9 provides specific guidance for updates to hedge documentation that do not result in discontinuation of hedge accounting:

(a) *Assessment of hedge effectiveness*: according to paragraph B6.4.19 of IFRS 9, the hedge documentation should include how an entity will assess hedge effectiveness, including the method or methods used. The hedge documentation should be updated for any changes to the methods. In addition, paragraph B6.4.17 of IFRS 9 states that, if there are changes in circumstances that affect hedge effectiveness, an entity may have to change the method for assessing whether a hedging

[6] Circumstances in which IAS 39 requires an entity to discontinue hedge accounting are included in paragraphs 91 and 101 of IAS 39.

[7] Paragraph B6.5.23 of IFRS 9; paragraphs BC6.314 and BC6.331 of the Basis for Conclusions on IFRS 9.

relationship meets the hedge effectiveness requirements in order to ensure that the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness, are still captured;

(b) *Rebalancing*: paragraph B6.5.21 of IFRS 9 states that, when rebalancing a hedging relationship, an entity should update its analysis of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its (remaining) term. The hedge documentation should be updated accordingly; and

(c) *Sources of ineffectiveness*: according to paragraph B6.4.2 of IFRS 9, when designating a hedging relationship and on an ongoing basis, an entity should analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis is the basis for the entity's assessment of meeting the hedge effectiveness requirements.

29. While IFRS 9 permits updating the hedge documentation without resulting in discontinuation of hedge accounting in limited instances (see paragraph 28 above), IAS 39 does not allow adjustments that were not envisaged and documented at the inception of the hedge to be treated as adjustments to a continuing hedging relationship. IAS 39 treats such changes as a discontinuation of the original hedging relationship and the start of a new one.[8]

Hedge documentation issues arising as a result of modifications that are directly required by the reform

30. As discussed at the September 2019 Board meeting, the staff have engaged with securities regulators, central banks, audit firms, industry groups and financial institutions to obtain an understanding of the effects of IBOR reform on financial reporting. The staff also gathered input from the ASAF and considered the feedback received from comment letters[9] on the May 2019 ED to identify potential issues for the Board to consider as part of Phase 2. In addition, the staff

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[8] Paragraphs BC6.300 and BCE.200 of the Basis for Conclusions on IFRS 9.

[9] For further information, refer to the July 2019 Agenda Paper 14A *Summary of feedback from comment letters* and Agenda Paper 14B *Additional issues for consideration before finalising the proposed amendments*.

considered the hedge documentation issues that could arise as a consequence of modifications directly required by the reform. Based on these activities, the staff have identified the following hedge documentation issues that could affect financial reporting due to IBOR reform:

(a) Changes to the hedge documentation necessary to reflect modifications that are directly required by the reform (paragraphs 31-34);

(b) Changes to the hedged risk in fair value hedges (paragraphs 35-37);

(c) Changes to the method used for assessing hedge effectiveness (paragraphs 38-39); and

(d) Trigger of fallback provisions for modifications that are directly required by the reform (paragraphs 40-41).

Changes to the hedge documentation necessary to reflect modifications directly required by the reform

31. As mentioned in paragraph 6, at its October 2019 meeting, the Board tentatively decided to provide a practical expedient allowing an entity to apply paragraph B5.4.5 of IFRS 9 to account for modifications directly required by the reform. Examples of such modifications include situations where the current interest rate benchmark is replaced with an alternative benchmark rate on an economically equivalent basis, as well as modifications to the timing and frequency with which the benchmark rate is reset.

32. Applying the practical expedient that the Board tentatively agreed on at the October 2019 meeting, the modification will be accounted for as an amendment to the EIR to reflect the alternative benchmark rate. If the modified financial instrument has been designated in a hedging relationship, changes in hedge documentation will likely be necessary to reflect modifications directly required by the reform and could include:

(a) redefining the hedged risk to make reference to an alternative benchmark rate when the hedged risk is specified and documented in terms of a benchmark interest rate (ie a component of an eligible hedged item);

(b) redefining the description of the hedging instruments and/or hedged items to reflect the alternative benchmark rate; and

(c) changes to the method used for assessing hedge effectiveness.

33. As mentioned in paragraph 25 of this paper, to qualify for hedge accounting, paragraphs 6.4.1(b) of IFRS 9 and 88(a) of IAS 39 require that, at the inception of the hedging relationship, there is formal documentation of the relationship and the entity's risk management objective and strategy for undertaking the hedge. This effectively implies that any subsequent changes to the hedge documentation, other than those discussed in paragraph 28, constitute a change in the hedging relationship that was neither anticipated nor intended when that relationship was initially designated and therefore would require discontinuation of hedge accounting.

34. In other words, it is likely that changes in hedge documentation necessary to reflect modifications directly required by the reform, discussed in paragraph 30 above, would result in discontinuation of hedge accounting when applying the current requirements in IFRS 9 and IAS 39. For instance, amending the hedge documentation to redefine the hedged risk from IBOR to an alternative benchmark rate would result in discontinuation of hedge accounting because it would constitute a change in the risk management objective on the basis of which that hedging relationship was designated.

Changes to hedged risk in fair value hedges

35. According to paragraph 6.5.2 of IFRS 9 and paragraph 86 of IAS 39, a fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss. A common example is the hedge of exposure to changes in the fair value of a fixed-rate financial instrument attributable to changes in benchmark interest rate. In this case, a non-contractually specified risk component (for example IBOR) would be designated as the hedged item, provided it is separately identifiable and reliably measurable.

36. When derivatives designated as hedging instruments are amended to replace IBOR with an alternative benchmark rate and such modification is directly

required by the reform, entities might want to update the designated risk component of a fixed-rate financial instrument to make reference to an alternative benchmark rate. The fact that derivatives have been amended might provide indication that the hedged risk is no longer IBOR, but is the alternative benchmark rate instead. In addition, changing the hedge documentation to update the designated risk component would eliminate the basis risk arising from an alternative benchmark rate-based derivative and a designated IBOR risk component of a fixed-rate financial instrument, therefore enhancing the effectiveness of such hedging relationship.

37. In such cases, even though the designated fixed-rate financial instrument is not expected to be amended due to IBOR reform, in accordance with IFRS 9 and IAS 39, redefining the hedged risk to refer to an alternative benchmark rate instead of IBOR would result in discontinuation of hedge accounting.

Changes to the method used for assessing hedge effectiveness

38. There might be situations where, due to changes in hedge designations for modifications that are directly required by the reform , it may be impractical for an entity to continue using the same method for assessing hedge effectiveness under IFRS 9 and IAS 39 as was initially defined in the hedge documentation. For example, when an entity uses regression analysis to assess hedge effectiveness (as initially defined in the hedge documentation), at the time that hedging instruments and hedged items are amended to replace IBOR with an alternative benchmark rate, the available historical information for the alternative benchmark rate might not be sufficient to run the regression analysis. Therefore, the entity may need to change the method for assessing hedge effectiveness. Similarly, an entity might want to change the hedge effectiveness assessment method to a quantitative approach due to changes in hedge designations for modifications that are directly required by the reform, where previously more qualitative approaches were applied as terms were perfectly matched. In addition, under IFRS 9 entities would need to update the hedge documentation to capture new sources of ineffectiveness created by IBOR reform that did not exist at the inception of the hedge (see paragraph 28(c)), so that the effects of such sources of ineffectiveness are reflected when assessing whether the hedging relationship meets the hedge effectiveness requirements.

39. While IFRS 9 explicitly requires updating the hedge documentation for any changes to the methods for assessing hedge effectiveness and for sources of ineffectiveness (see paragraph 28) without requiring discontinuation of hedge accounting, IAS 39 does not provide explicit guidance in this context. However, the staff note that the following instances in IAS 39 would imply that any change in the method for assessing hedge effectiveness subsequent to initial designation and documentation of the hedging relationship would represent a change in the hedging strategy that would require discontinuation of hedge accounting (under IAS 39 only):

a) paragraph AG107 states that the method an entity adopts for assessing hedge effectiveness depends on its risk management strategy and an entity's documentation of its hedging strategy includes its procedures for assessing effectiveness.

b) for a portfolio hedge of interest rate risk, the Board decided that entities could use any method to assess retrospective effectiveness, but noted that the chosen method would form part of the documentation of the hedging relationship made at the inception of the hedge in accordance with paragraph 88(a) and hence could not be decided at the time the retrospective effectiveness test is performed.[10]

Trigger of fallback provisions for modifications that are 'directly required by the reform

40. Based on the feedback received and the research done by the staff about the potential effects of IBOR reform, it is expected that 'fallback clauses' already incorporated into the contracts would be triggered to replace IBOR with an alternative benchmark rate when parties do not amend the underlying contracts before such clauses take effect. Such fallback provisions may specify, for example:

(a) the replacement benchmark rate in case the existing benchmark rate ceases to exist;

[10] Paragraph BC218 of the Basis for Conclusions on IAS 39.

(b) changes to the reset period, reset dates, the number of days between coupon payments and payment dates.

41. The trigger of a fallback provision is not a contractual modification of a financial instrument because such a provision was already part of the original terms of the financial instrument. However, when the trigger of a fallback provision results in modifications directly required by the reform (for example, it replaces IBOR with an alternative benchmark rate on an economically equivalent basis), the implications for hedge documentation are similar to those discussed in paragraphs 31-39 of this paper.

Staff analysis

42. As discussed in paragraphs 25-29 of this paper, under the current requirements in IFRS 9 and IAS 39, changes in hedge documentation necessary to reflect modifications directly required by the reform would require an entity to discontinue hedge accounting prospectively. The consequences of prospective discontinuation of hedge accounting are:

(a) regarding fair value hedges, the fair value hedge adjustment will be amortised to profit or loss. The amortisation is based on a recalculated effective interest rate at the date amortisation begins;[11]

(b) for cash flow hedges, the accumulated amount in the cash flow hedge reserve will be immediately reclassified to profit or loss because the IBOR-based cash flows will no longer be expected to occur after the reform has been enacted;[12]

43. In addition, changes in fair value of derivatives previously designated in cash flow hedges would start being recognised in profit or loss (instead of the cash flow hedge reserve in other comprehensive income). Regarding derivatives previously designated in fair value hedges, offsetting would not be achieved in profit or loss because the hedged item would no longer be measured at fair value.

[11] Refer to paragraph 6.5.10 of IFRS 9 and paragraphs 91-92 of IAS 39.

[12] Refer to paragraph 6.5.12 of IFRS 9 and paragraph 101(bc) of IAS 39.

44. Therefore, discontinuation of hedge accounting due changes in hedge documentation necessary to reflect modifications directly required by the reform would create volatility in profit or loss that may not be representative of the actual changes to the entity's hedging relationships.

45. Although after the discontinuation of hedge accounting an entity could re-designate a new hedge accounting relationship based on the replacement benchmark rate, the hedging instrument will have a non-zero fair value at inception and this could result in more hedge ineffectiveness, especially for cash flow hedges, compared to a continuing hedging relationship. This is because it is unlikely that the terms of the newly designated derivative would be 'at-market' at the time of designation.[13] Therefore, there would be an increased risk that such 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.

46. The staff think that discontinuation of hedge accounting and the consequential accounting implications described in paragraphs 42-45 above would not provide useful information to users of financial statements because:

    (a) Changes in hedge documentation necessary to reflect modifications directly required by the reform would not constitute a change in the general risk management strategy and the risk management objective for hedging underlying risks that would generally continue to be either:

        (i) hedge of the exposure to variability in cash flows, albeit now associated with movements in alternative benchmark rate (ie cash flow hedge), or

        (ii) hedge of the exposure to changes in fair value, albeit now associated with movements in alternative benchmark rate (ie fair value hedge).

    (b) The accounting outcome would not reflect the economics of the underlying instruments subjected to modifications directly required by the reform because such modifications would occur on an economically equivalent basis and the same financial instrument would continue to

[13] Refer to paragraph BC6.338 of IFRS 9.

exist for accounting purposes and would continue to be held for hedging risks and achieving offsetting.

(c) Considering that modifications to financial instruments that are directly required by the reform would be accounted for as an update to the EIR, similar to how floating-rate instruments are accounted for – which do not impact eligibility criteria for a hedging instrument or a hedged item – it would seem counterintuitive to discontinue a hedging relationship when those very same changes are made to the hedging relationship.

47. In addition, the staff think that discontinuation of hedge accounting due changes in hedge documentation necessary to reflect modifications directly required by the reform could be perceived as being inconsistent with the Board's decision in Phase 1 to amend IFRS 9 and IAS 39 to provide exceptions from specific hedge accounting requirements on the basis that discontinuation of hedge accounting solely due to uncertainties arising from IBOR reform would not provide useful information to users of financial statements.

48. Some may argue that modifications of hedging instruments could be considered as replacements or rollovers that are not expirations or terminations and thus would not require discontinuation of hedge accounting.[14] However, even when the replacement of IBOR with an alternative benchmark rate is documented at the inception of the hedging relationship[15] as part of the risk management objective (as per IFRS 9) or hedging strategy (IAS 39), the staff think that modifications directly required by the reform do not represent replacements or rollovers because they would be treated as 'movements in market rates of interest' and the same financial instrument(s) would continue to exist. It is also important to note that the guidance for replacement or rollover in IFRS 9 and IAS 39 is explicitly in the context of expiration or termination of the hedging instrument whereas the implications of IBOR reform on hedging relationships are not restricted to hedging instruments.

[14] Paragraph 6.5.6 of IFRS 9 and paragraphs 91 and 101 of IAS 39.

[15] Paragraph BC6.344 of IFRS 9 and paragraph BC220N of IAS 39.

49. Considering the above, the staff is of the view that amending IFRS 9 and IAS 39 to permit changes in hedge documentation necessary to reflect modifications that are directly required by the reform would provide more useful information to users of financial statements. This would have the effect of treating hedging relationships affected by IBOR reform as continuing hedging relationships, provided they still meet all other qualifying criteria for hedge accounting (including the hedge effectiveness requirements).

50. The staff also note that permitting continuation of hedge accounting in this specific instance would significantly reduce the operational burden on preparers as they would not have to discontinue hedging relationships only due to changes in hedge documentation that are necessary to reflect modifications that are directly required by the reform. The staff also consider that costs of updating hedge documentation would be limited because:

    (a) entities already have documented hedging relationships as required by IFRS 9 and IAS 39; and

    (b) entities could use a master documentation approach, whereby the documentation of individual hedging relationships include references to master documents that set out effectiveness testing methods for example.[16]

51. 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.[17] Accordingly, providing relief from discontinuing hedge accounting in the context of IBOR reform as discussed above, would be consistent with this approach.

52. In their feedback on the May 2019 ED, respondents suggested that to avoid discontinuation of hedge accounting due to changes in hedge documentation that are a direct consequence of the reform, the Board could consider allowing hedge

[16] BCE.228 of the Basis for Conclusion on IFRS 9.

[17] *Novation of Derivatives and Continuation of Hedge Accounting* (Amendments to IAS 39 and IFRS 9)

designations to reference both the IBOR and RFR rate as the hedged risk (ie ‘flexible hedged risk’ designations) to permit continuous hedge accounting throughout the transition period. [18] The staff considered but rejected such an approach because 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.[19] Consequently, the staff note that the current requirements in IFRS 9 and IAS 39 would preclude documenting the hedged risk in terms of both IBOR and RFR as the benchmark rate. Accordingly, the staff do not propose any amendments to those requirements.

53. The staff also considered whether specific requirements should be included for **when** the amendments to the hedge documentation should be made following the modifications directly required by the reform to financial instruments designated in hedging relationships. However, the staff noted that changes to the hedge documentation will be driven by changes to the hedged risk and this will differ from one hedging relationship to another. Therefore, the staff do not consider it necessary to provide any specific requirements or guidance in this regard.

Staff recommendation

54. For the reasons set out in paragraphs 46-52, the staff therefore recommend that IFRS 9 and IAS 39 should be amended to clarify that changes in hedge documentation necessary to reflect modifications that are directly required by the reform do not result in the discontinuation of hedge accounting. The staff acknowledge that it will be important to clearly define those changes in hedge documentation so that this practical expedient is applied only for those changes and that the requirements in IFRS 9 and IAS 39 are not side-stepped for any other changes. Accordingly, the staff recommend that IFRS 9 and IAS 39 should specify only the following changes in hedge documentation necessary to reflect

[18] Agenda Paper 14B discussed at the July 2019 Board meeting.

[19] 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.

modifications directly required by the reform do not result in discontinuation of hedge accounting:

(a) redefining the hedged risk to make reference to an alternative benchmark rate;

(b) redefining the description of the hedging instruments and/or hedged items to reflect the alternative benchmark rate; and

(c) for IAS 39 only, changes to the method used for assessing hedge effectiveness (paragraph 39).

55. After making these amendments to the related hedge designations, if the hedging relationship does not meet the qualifying criteria and hedge effectiveness requirements for other reasons, the entity shall discontinue hedge accounting as required by IFRS 9 and IAS 39. The staff also highlight that, for the avoidance of doubt, upon any changes to the hedge documentation necessary to reflect modifications directly required by the reform, an entity should reflect those changes in the assessment of hedge effectiveness and the measurement of hedge ineffectiveness.[20]

Questions 1 and 2 for the Board

Questions for the Board
1) Does the Board agree with the staff recommendations in paragraphs 16 and 22 that: (a) no amendments should be made to the current requirements in IFRS 9 and IAS 39 to determine whether a hedging relationship should be discontinued following a substantial modification that results in derecognition of the hedged item and/or the hedging instrument;

[20] Similar to the requirements in paragraphs B6.4.3 and AG113A of IFRS 9 and IAS 39, respectively for the novation of derivatives.

Questions for the Board

(b) no amendments should be made the current requirements in IFRS 9 and IAS 39 to determine whether a hedging relationship should be discontinued following a modification that did not result in derecognition and that is not directly required by the reform?

2) Does the Board agree with the staff recommendations in paragraphs 54 and 55 that IFRS 9 and IAS 39 should be amended to provide an exception from the current requirements so that changes to the hedge documentation necessary to reflect modifications that are directly required by the reform without resulting in the discontinuation of the hedging relationship?

Valuation adjustments due to modifications directly required by the reform

56. Assuming the Board agrees with the staff recommendation to allow changes in hedge documentation to reflect modifications directly require by the reform, some valuation adjustments might arise to reflect the replacement of IBOR with an alternative interest rate in a continuing hedging relationship. Such valuation adjustments would arise due to modifications in the:

(a) Hedged risk designated in fair value hedges;

(b) Hedged risk and hedged items designated in cash flow hedges; and

(c) Derivatives designated as hedging instruments.

Hedged risk designated in fair value hedges

57. In a fair value hedge of interest rate risk, the designated hedged risk is usually the IBOR risk component of a fixed-rate hedged item. While the hedged item would be a fixed-rate financial instrument and hence is not expected to be amended due to IBOR reform, the entity might want to update the hedge documentation to reflect an alternative benchmark interest rate as the new hedged risk when the hedging instrument is amended to reference an alternative benchmark rate.

58. To illustrate, assume an entity designate the IBOR risk component of a fixed-rate financial instrument as the hedged item in a fair value hedge. To achieve its risk management objective, the entity designates an IBOR-based derivative as the

hedging instrument and the hedging relationship meets the hedge effectiveness requirements in IFRS 9 and IAS 39. As the reform progresses towards transition, the derivative is amended to replace the interest rate benchmark with an alternative benchmark rate. In this situation, the entity concludes that updating the hedge documentation to reflect the alternative benchmark rate as the new hedged risk component would be consistent with the entity's risk management objective and strategy for undertaking the hedge. In addition, it is likely that updating the hedge documentation will enhance effectiveness of that hedging relationship as the amended derivative would be compared to the alternative benchmark risk component of the fixed-rate financial instrument designated as hedged item, provided the alternative benchmark is separately identifiable and reliably measurable, as required by IFRS 9 and IAS 39.

59. Following the update in the hedge documentation, the entity would remeasure the hedged item for changes in fair value attributable to the updated hedged risk (ie the alternative benchmark rate) which might give rise to a valuation adjustment at the date the hedged risk is amended.

Staff analysis

60. In its deliberations leading to the 2019 *Interest Rate Benchmark Reform* (Amendments to IFRS 9, IAS 39 and IFRS 7), the Board noted in paragraphs BC6.568 of IFRS 9 and BC254 of IAS 39 that no exceptions should be made to the measurement of hedged items or hedging instruments because this would be inconsistent with the decision not to change the requirements to measure and recognise hedge ineffectiveness in the financial statements (see paragraphs BC6.567 of IFRS 9 and BC253 of IAS 39). The Board further explained that that the actual results of the hedging relationships would provide useful information to users of financial statements. Therefore, the Board decided not to provide an exception from the measurement of hedging instruments and hedged items.

61. Consistent with the Board's decision noted in paragraph 60 above, the staff consider that the existing requirements in IFRS 9 and IAS 39 to measure hedging instruments and hedged items would provide useful information to users of financial statements. In addition, the staff think that recognising any valuation adjustment arising on transition in the financial statements as currently required

by IFRS Standards would reflect the economics of the amendments. Therefore, the staff think that no exceptions should be provided for valuation adjustments arising when the hedged documentation is updated to reflect an alternative benchmark rate as the new hedged risk in a fair value hedge.

62. The staff also considered alternative approaches for recognising in the financial statements the change in fair value attributable to changing the designated hedged risk from IBOR to an alternative benchmark rate and whether any amendment to IFRS 9 and IAS 39 would be required in this regard. In particular, the staff considered, but rejected, the following approaches:

   (a) *Recognition in profit or loss over time*: Under this approach, the valuation adjustment would be recognised in profit or loss over time, in the same manner as the hedged item affects profit or loss. This would require recording an offsetting entry as an asset or liability on the statement of financial position and subsequently amortise the adjustment to profit or loss over the life of the hedged item. However, the staff rejected this approach on the basis that such an offsetting entry would not meet the definition of an asset or a liability under the *Conceptual Framework*. Alternatively, if the offsetting entry was to be recognised as an adjustment to the carrying amount of the hedged item, this would result in a valuation adjustment of zero upon changing the designated hedged risk from IBOR to an alternative benchmark rate, which would be inconsistent with the decision noted in paragraph 60 that no exceptions should be made to the measurement of hedged items or hedging instruments. In addition, the staff note that such an approach could result in additional complexity as entities would need to track the adjustments in other to amortise them over time.

   (b) *Adjustment to opening retained earnings*: Under this approach, a valuation adjustment would be recognised as an adjustment to opening retained earnings. The staff, however, rejected this approach on the basis that changes to the hedged risk might be driven by amendments to derivatives designated as hedging instruments, which may occur across different reporting periods, particularly if an entity has derivatives designated in different hedging relationships with various benchmark

interest rates that may be replaced at different times. The staff think that allowing multiple adjustments to retained earnings across different reporting periods could be confusing to users of financial statements. In addition, allowing retained earnings adjustments would be inconsistent with the decision that updating the hedge documentation to reflect an alternative benchmark rate as the new hedged risk should be accounted for as a continuation of the same hedging relationship.

63. Therefore, the staff think that changes in fair value attributable to changing the designated hedged risk from IBOR to an alternative benchmark rate should be recognised in profit or loss, as currently required by IFRS 9 and IAS 39, and no exceptions should be provided in this regard.

Hedged risk and hedged items designated in cash flow hedges

64. Unlike fair value hedges of interest rate risk, where the hedged item is usually a fixed-rate financial instrument and changes in fair value attributable to the hedged risk are recognised on the statement of financial position, in cash flow hedges the designated hedged item is typically a floating-rate financial instrument measured at amortised cost or a highly probable forecast transaction not recognised in the financial statements.

65. Because the hedged item in cash flow hedges is often not recognised on the statement of financial position, entities commonly use a hypothetical derivative (called ‘hypothetical’ as it does not exist) whose terms mirror the hedged item and the hedged risk to measure hedge ineffectiveness. The change in the fair value of the hypothetical derivative is then compared with the change in the fair value of the hedging instrument to determine the effective portion of the fair value movements of the hedging instrument that should be recorded in the cash flow hedge reserve.

66. As discussed in paragraphs 30–41, modifications directly required by the reform would require updating the hedge documentation to reflect the new terms of the hedged item as well as the alternative benchmark rate as the new hedged risk. Provided the Board agrees with the staff recommendation that such updates to the hedge documentation should not result in discontinuation of hedge accounting,

entities would need to update the terms of the hypothetical derivative used to measure hedge ineffectiveness.

67. Following the update in the hedge documentation, the entity would remeasure the hypothetical derivative for changes in fair value attributable to the updated hedged risk (ie the alternative benchmark rate). As the hedging relationship is continuing following the amendments to the hedged risk and hedged item, the hypothetical derivative is also continuing and not reset to a fair value of zero.

68. Because the hypothetical derivative is not recognised on the statement of financial position, this would not affect how the hedged item is measured and recognised in the financial statements. However, as explained in paragraph 65, the hypothetical derivative is a method used to measure hedge ineffectiveness – ie change in the fair value of the hypothetical is compared with the change in the fair value of the hedging instrument to determine the effective portion that should be recorded in the cash flow hedge reserve. Therefore, such valuation adjustments could affect hedge ineffectiveness recognised in profit or loss, subject to the 'lower of' test as required by IFRS 9 and IAS 39.

Staff analysis

69. Consistent with the Board's decision noted in paragraph 60 above, the staff see no reason to change the view that the existing requirements in IFRS 9 and IAS 39 to measure and recognise hedge ineffectiveness in the financial statements would provide useful information to users of financial statements. Therefore, as the hypothetical derivative is a method used to measure hedge ineffectiveness, the staff think that no exceptions should be provided for any adjustment to hedge ineffectiveness when an entity reviews the hypothetical derivative in the hedge documentation to reflect modifications to the hedged item that are directly required by the reform and any consequential change to the designated hedged risk.

70. For example, assuming an entity initially designates IBOR-based cash flows as the hedged item in a cash flow hedge and the entity applies the practical expedient to account for a modification directly required by the reform to that financial instrument designated as the hedged item and the hedge documentation is updated accordingly. In this scenario, when applying a present value technique to measure

changes in fair value of the updated hypothetical derivative, the entity would consider the revised cash flows based on the alternative benchmark rate discounted at a market-based discount rate that reflects market participants' assumptions about the modified hedged item. Therefore, any change in hedge ineffectiveness attributable to changing the hypothetical derivative to reflect a modification to the hedged item that is directly required by the reform should be recognised in profit or loss, subject to the 'lower of' test. The staff do not think any exceptions should be provided in this regard.

Derivatives designated as hedging instruments

71. When derivatives designated as hedging instruments are amended to replace the interest rate benchmark with an alternative benchmark rate and such modification is regarded as being directly required by the reform, valuation adjustments might arise when measuring the derivatives in accordance with current IFRS Standards, which reflect the economics of the amendments. More specifically, in measuring the fair value of an amended derivative upon its modification, some adjustments might arise due to differences in yield curves, market liquidity or other situations resulting in minimal value transfers. Such valuation adjustments, while non-substantial, would be considered as derived from modifications to the terms of derivatives on an economically equivalent basis.

72. Assuming the Board agrees with the staff recommendation in paragraphs 54 and 55 that updating the hedge documentation to reflect modifications directly required by the reform should not result in discontinuation of hedge accounting, the question that follows is how an entity should account for such valuation adjustments that may arise upon modification of such derivatives designated as hedging instruments.

Staff analysis

73. For the same reasons discussed in paragraphs 60–62, the staff think that no exceptions should be made to the IFRS 9 and IAS 39 requirements to measure derivatives at fair value. The staff is therefore of the view that changes in fair value of derivatives arising due to such valuation adjustments should be recorded in profit or loss, as currently required by IFRS Standards. In addition, the staff see no reason to change the Board's view during its deliberations that led to the 2019

Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7) that the existing requirements in IFRS 9 and IAS 39 to measure and recognise hedge ineffectiveness in the financial statements would provide useful information to users of financial statements.[21]

74. The staff also considered alternative approaches for recognising such valuation adjustments in the financial statements. In particular, the staff considered whether these should be recognised in profit or loss over time (ie amortised) or as an adjustment to opening retained earnings. However, for the same reasons noted in paragraph 62, the staff rejected both approaches.

75. Therefore, the staff is of the view that no exceptions should be provided from existing IFRS 9 and IAS 39 requirements to measure and recognise valuation adjustments arising when derivatives designated as hedging instruments are amended to replace IBOR with an alternative benchmark interest rate.

Staff recommendation

76. For the reasons stated in paragraphs 73–74, the staff is of the view that no amendments should be made to IFRS 9 and IAS 39 requirements to measure and recognise hedge ineffectiveness in the financial statements. Accordingly, no exceptions should be provided to the measurement of hedged items or hedging instruments designated under IFRS 9 and IAS 39. In particular, the staff recommend that no exceptions should be provided from existing IFRS 9 and IAS 39 requirements to measure and recognise:

    (a) valuation adjustments arising when the hedge documentation is updated to reflect an alternative benchmark interest rate as the new hedged risk in a fair value hedge (paragraphs 57–63).

    (b) any hedge ineffectiveness attributable to changing the hypothetical derivative to reflect a modification that is directly required by the reform (paragraphs 64–70).

[21] For further information, refer to paragraphs BC6.567 and BC253 of the 2019 *Interest Rate Benchmark Reform* (Amendments to IFRS 9, IAS 39 and IFRS 7).

(c) valuation adjustments arising when derivatives designated as hedging instruments are amended to replace IBOR with an alternative benchmark interest rate (paragraphs 71–75).

Question 3 for the Board

Question for the Board
3) Does the Board agree with the staff recommendation in paragraph 76 that no exceptions should be provided from existing IFRS 9 and IAS 39 requirements to measure and recognise: a) valuation adjustments arising when the hedge documentation is updated to reflect an alternative benchmark interest rate as the new hedged risk in a fair value hedge (paragraphs 57–63). b) any hedge ineffectiveness attributable to changing the hypothetical derivative to reflect a modification that is directly required by the reform (paragraphs 64–70). c) valuation adjustments arising when derivatives designated as hedging instruments are amended to replace IBOR with an alternative benchmark interest rate (paragraphs 71–75).

Hedges of a group of items

77. As mentioned in paragraph 4, when entities first apply IFRS 9, they are permitted to choose to apply the hedge accounting requirements of IAS 39. Therefore, this paper discusses the implications of IBOR reform on hedges of groups of items designated in accordance with either IFRS 9 or IAS 39.

78. In practice, it may be more practical and cost-efficient for an entity to enter into fewer derivatives to hedge a group of items instead of hedging individual exposures. In view of this, both IFRS 9 and IAS 39 allow an entity to designate a group of items as the hedged item in a hedging relationship.

79. The qualifying criteria for hedge accounting in IFRS 9 and IAS 39 that apply to individual items also apply to groups of items. In addition, both Standards include specific requirements for designation of a group of items. More specifically, paragraphs 78 and 83 of IAS 39 state that:

> […] The hedged item can be a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics. (paragraph 78)
>
> Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. (paragraph 83)

80. With regards to designation of group of items under IFRS 9, paragraph 6.6.1 of IFRS 9 states that:

> A group of items (including a group of items that constitute a net position) is an eligible hedged item only if:
>
> (a) it consists of items (including components of items) that are, individually, eligible hedged items;
>
> (b) the items in the group are managed together on a group basis for risk management purposes; and
>
> (c) in the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group so that offsetting risk positions arise:
>
> (i) it is a hedge of foreign currency risk; and
>
> (ii) the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.

81. Accordingly, the staff note that IAS 39 permits application of hedge accounting to a group of items, provided the individual items within the group have similar risk characteristics and share the risk exposure that is designated as being hedged. Also, IAS 39 requires a test commonly referred to as the 'proportionality test' for designation of a group of items in a hedging relationship. On the other hand, IFRS 9 retains only the 'proportionality test' for groups of items that are designated in a cash flow hedge, unless it is a hedge of foreign currency risk.[22]

82. The 'proportionality test' plays an important role in ensuring discipline around designation of group of items, particularly in the case of cash flow hedges. This is because, in measuring hedge ineffectiveness, entities usually define a derivative whose terms match the critical terms of the designated group of items (commonly referred to as a 'hypothetical derivative') to calculate the change in the value of the designated group of items that is attributable to the hedged risk. Ensuring the items within a group share similar risk characteristics allows a single hypothetical derivative to match those terms. If items within the group had different risk characteristics, the entity would need to designate different groups of items based on common risk characteristics and define a hypothetical derivative separately for each designated group of items in order to appropriately capture changes in fair value attributable to such different risks. Without the 'proportionality test', different risks could be 'hidden' within the same group of items, given the hypothetical derivative would mirror the general risk characteristics of the entire group designated as the hedged item (and not a specific risk associated with one single item within that group).

Staff analysis

83. As part of the staff research on the hedge accounting issues expected to arise as the IBOR reform progresses, stakeholders noted that when the items within a designated group are amended at different times to replace IBOR with an alternative benchmark rate, assuming those modifications are directly required by the reform, some could question whether the designated group of items would

[22] Paragraphs BC6.428-BC6.432 of the Basis for Conclusions on IFRS 9.

continue to meet the relevant hedge requirements in IFRS 9 and IAS 39 for designation of a group of items.

84. For example, while IBORs are available in a range of different tenors (eg from overnight to one year), the currently available alternative benchmark rates are predominantly overnight rates and thus could exhibit different volatility patterns. In addition, alternative benchmark rates could be subject to different liquidity constrains as compared to IBOR. This could affect the 'proportionality test' required by IFRS 9 and IAS 39 as well as the assessment of whether IBOR-based financial instruments and alternative benchmark rate-based financial instruments share similar risk characteristics required by IAS 39 for designation of a group of items.[23]

85. The staff highlight that, even though both IBOR and alternative benchmark rate-based financial instruments within a designated group of items may continue to be managed together on a group basis for interest rate risk management purposes, failure to meet the 'proportionality test' (as per IFRS 9 and IAS 39) and to demonstrate that the items within the designated group share similar risks characteristics (as per IAS 39) would require an entity to discontinue hedge accounting prospectively for that group of items.

86. Consistent with the reasons discussed in paragraphs 42-46, the staff consider that discontinuation of hedge accounting would not provide useful information to users of financial statements when modifications are directly required by the reform. Therefore, the staff is of the view that an amendment to IFRS 9 and IAS 39 to accommodate both IBOR and alternative benchmark rate-based items within the same hedging relationship would be consistent with the Board's objective for Phase 2.

87. In considering the potential amendments to IFRS Standards necessary to address the issues discussed in paragraph 85, the staff analysed separately the following requirements for designation of group of items:

    (a) Proportionality test (paragraphs 88-96); and

[23] In some situations, entities might designate a group of items as the hedged item and uses a dynamic process in which both the hedged items and the hedging instruments used to manage that exposure do not remain the same for long.

(b) Similar risk characteristics (paragraph 97-98).

Proportionality test

88. In the 2019 *Interest Rate Benchmark Reform* (Amendments to IFRS 9, IAS 39 and IFRS 7), the Board clarified that, when an entity designates a group of items as the hedged item, the end of application requirement should be applied to each individual item in the group.[24] Implicit in this requirement, an entity would effectively have, as part of the same hedging relationship, items that are amended to reflect an alternative benchmark rate for which the Phase 1 exceptions no longer apply; and IBOR-based items that have not been amended yet and for which the Phase 1 exceptions continue to apply. Therefore, the entity would need to identify which items would be subject to Phase 1 exceptions and those that would not.

89. Accordingly, the staff is of the view that for hedges of groups of items, an entity should be permitted to amend the hedge documentation to define the hedged items as two subgroups within an existing group of items (ie one for IBOR-based items and another for alternative benchmark rate-based items). Under this approach, the proportionality test would continue to apply, albeit separately for each subgroup. As individual items are amended to reference the alternative benchmark rate, provided modifications are directly required by the reform, such amended items would be transferred to its corresponding subgroup. Both subgroups would continue to be part of the same hedging relationship.[25]

90. For the purposes of assessing hedge effectiveness, this approach would require an entity to redefine the hypothetical derivative so that its terms mirror the two hedged subgroups. This could be achieved for example by using weighted averages or splitting the existing hypothetical derivative into two (one reflecting the IBOR subgroup and the other modelling the alternative benchmark subgroup). The chosen approach should be applied with consistency during the transition period. Effectively, this approach would result in continuously updating the

[24] Refer to paragraph 6.8.12 of IFRS 9 and paragraph 102N of IAS 39.

[25] As discussed in paragraph 52 of this paper, ‘flexible hedged risk’ designations are not allowed under IFRS Standards.

hypothetical derivative to reflect modifications directly required by the reform to the individual items within the designated group of items. Any valuation adjustments would be treated as currently required by IFRS 9 and IAS 39, as discussed in paragraphs 56–76 of this paper.

91. The subgroups would continue to be designated as the hedged item in the same hedging relationship. This means that the hedge effectiveness requirements in IFRS 9 and IAS 39 would continue to apply to that hedging relationship in its entirety. For example, the change in the fair value of the hypothetical derivative (or the combination of changes in fair value of the two hypothetical derivatives, in case the entity decides to split it as discussed in paragraph 90) would be compared with the change in the fair value of the hedging instruments designated in the hedging relationship.

92. The advantage of this approach is that it would require entities to continue applying the principles embedded in the proportionality test to each subgroup of items. Accordingly, should any subgroup fail to meet the proportionality test, this would be captured and in the staff's view discontinuation of hedge accounting for the entire hedging relationship in this case would provide useful information to users of financial statements.

93. The disadvantage of this approach is that it may pose operational difficulties for entities as they would be required to:

    (a) perform the proportionality test separately to each subgroup of items designated in the hedging relationship. In other words, entities would perform two tests instead of just one; and

    (b) track items moving from one subgroup to another. For example, as items are amended to reference the alternative benchmark rate and provided the modification is directly required by the reform, the amended item would be transferred to its corresponding subgroup. This may require additional system changes.

94. Nevertheless, the staff note that IFRS 9 and IAS 39 require an entity to identify and document hedged items designated within a hedging relationship with sufficient specificity and therefore entities are likely to have readily available information to track items that are amended for modifications directly required by

the reform.[26] In addition, the staff note that the costs incurred to track items are likely to be lower than the potential costs associated with de-designating and re-designating items.

95. The staff considered but rejected requiring entities to split the items within a group of items into two different hedging relationships. The is because, in doing so, entities would also need to allocate the derivatives designated as hedging instruments into those two hedging relationships, which could be arbitrary considering it is likely that derivatives will be amended first in relation to hedged items. This could also result in additional complexity as changes in fair value of derivatives accumulated in the cash flow hedge reserve would need to be tracked separately after allocation.

96. The staff also considered providing an exception from the proportionality test for groups of items designated in existing hedging relationships. In particular, under this approach, entities would need to meet the proportionality test only at the inception of the hedging relationship. The staff acknowledge that such an exception would reduce the operational burden on preparers, as they would only be required to perform the proportionality test when an individual item is initially designated in the hedging relationship. However, the staff is concerned about potential unintended consequences resulting from the absence of the proportionality test, such as those described in paragraph 82 above. Therefore, on balance, the staff do not support this approach.

Similar risk characteristics

97. The staff also consider the proportionality test to be a quantitative assessment to prove the qualitative assertion that individual items in the group share a risk exposure that is designated as being hedged. Accordingly, retaining the proportionality test for a group of items would substantiate whether items within a designated group of items continue to share the risk exposure, and therefore common risk characteristics on the basis of which those items were designated as

[26] The staff also note that existing requirements in IFRS 9 relating to group of items (in particular hedge designations) contain explicit requirements for tracking – see paragraphs 6.6.3, B6.6.11 and B6.3.19 of IFRS 9.

a group. Supplemented by the continuing requirements for assessing hedge effectiveness and measuring hedge ineffectiveness, the staff think this would provide useful information to users of financial statements.

98. Accordingly, the staff is of the view that IAS 39 should be amended so that, when items within a designated group are amended for modifications that are directly required by the reform , entities could treat IBOR and its alternative benchmark rate as if they would share similar risk characteristics. This would be consistent with the Board's tentative decision to provide a practical expedient to modifications 'directly related to the reform', where the replacement of IBOR with an alternative benchmark rate would be treated as a 'movement in the market rates of interest' and do not result in the recognition of a modification gain or loss.

Staff recommendation

99. For the reasons discussed in paragraphs 88–96, the staff recommend that, for a group of items designated in a hedging relationship, IFRS 9 and IAS 39 should be amended to require an entity to:

    (a) amend the hedge documentation to define the hedged items by way of two subgroups within the designated group of items, one referencing the original interest rate benchmark and the other the alternative benchmark rate;

    (b) perform the proportionality test separately for each subgroup of items designated in the hedging relationship; and

    (c) treat the hedge designation as a single hedging relationship and allow entities to amend the hypothetical derivative to reflect the combination of the subgroups of items.

100. In addition, for the reasons expressed in paragraphs 97–98, the staff recommend that IAS 39 should be amended so that, when items within a designated group of items are amended to replace IBOR with an alternative benchmark rate ie modifications directly required by the reform, entities could treat IBOR and its alternative benchmark rate as if both benchmark rates would share similar risk characteristics.

IAS 39 fair value hedge accounting for a portfolio hedge of interest rate risk

101. For fair value hedges of interest rate risk associated with a portfolio of financial assets or financial liabilities, IAS 39 does not require an entity to meet the 'proportionality test'.[27] In particular, paragraph BC 181 of IAS 39 states that:

> […] if the items in the hedged portfolio are subject to different amounts of prepayment risk, they may fail the test in paragraph 78 of being similar and the related requirement in paragraph 83 that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. The Board decided that, in the context of a portfolio hedge of interest rate risk, these requirements could be inconsistent with the Board's decision, set out in the previous paragraph, on how to incorporate the effects of prepayment risk. Accordingly, <u>the Board decided that they should not apply. Instead, the financial assets or financial liabilities included in a portfolio hedge of interest rate risk need only share the risk being hedged</u>.

102. In other words, the only requirement in IAS 39 is that the financial instruments included in a portfolio hedge of interest rate risk need to share the risk being hedged.

103. Accordingly, regarding IAS 39 fair value hedge accounting for a portfolio hedge of interest rate risk, for the same reasons expressed in paragraphs 97–98, the staff is of the view that IAS 39 should be amended so that, when entities change the hedged risk to an alternative benchmark rate in the hedged documentation as discussed in paragraph 54(a), it is assumed that all items included in the portfolio of financial assets or financial liabilities share the risk being hedged.

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[27] Paragraph 6.1.3 of IFRS 9 states that for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only for such a hedge), an entity may apply the hedge accounting requirements in IAS 39 instead of those in IFRS 9.

Questions 4 and 5 for the Board

Questions for the Board
4) Does the Board agree with the staff recommendation in paragraph 99 that IFRS 9 and IAS 39 should be amended, so that when items within a designated group of items are amended for modifications that are directly required by the reform, entities are required to: a) amend the hedge documentation to define the hedged items by way of two subgroups within the designated group of items, one referencing the original interest rate benchmark and the other the alternative benchmark rate; b) perform the proportionality test separately for each subgroup of items designated in the hedging relationship; c) treat the hedge designation as a single hedging relationship and allow entities to amend the hypothetical derivative to reflect the combination of the subgroups of items; and d) for group of items designated under IAS 39 only, entities could treat IBOR and its alternative benchmark rate as if they would share similar risk characteristics. 5) Does the Board agree with the staff recommendation in paragraph 103 that, regarding IAS 39 fair value hedge accounting for a portfolio hedge of interest rate risk, IAS 39 should be amended so that, when entities change the hedged risk to an alternative benchmark rate in the hedged documentation, it is assumed that all items included in the portfolio of financial assets or financial liabilities share the risk being hedged.