STAFF PAPER

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Project	**IBOR Reform and its Effects on Financial Reporting – Phase 2**		
Paper topic	End of application – Phase 1 exceptions		
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Purpose of this paper

1. The purpose of this paper is to consider the interaction between the Board's tentative decisions in Phase 2 of the project (as summarised in Agenda Paper 14 *Cover paper and summary of tentative decisions to date* of this meeting) and the end of application requirements for the Phase 1 amendments to IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* and whether any amends to the requirements should be made in this regard.

2. This paper is structured as follows:

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

   (b) Background (paragraphs 4–9);

   (c) General end of application requirements (paragraphs 10–17)

   (d) Highly probable requirement (paragraphs 18–23);

   (e) Prospective assessments (paragraphs 24–29); and

   (f) IAS 39 retrospective assessment (paragraphs 30–35).

Summary of staff recommendations

3. In this paper the staff recommend that:

   (a) no additional guidance or amendments should be made to the current end of application requirements in IFRS 9 and IAS 39 with respect to the highly probable requirement for cash flow hedges;

   (b) no additional guidance or amendments should be made to the current end of application requirements in IFRS 9 and IAS 39 with respect to the prospective assessments; and

   (c) IAS 39 be amended to allow that, for the purposes of assessing retrospective effectiveness only, the cumulative fair values reset to zero at the date the exception to the retrospective assessment ceases to apply.

Background

4. Following the tentative decisions taken by the Board at the October and December 2019 meetings, the next key area for discussion – as per the September 2019 project plan – is the requirements pertaining to the end of application of the Phase 1 exceptions.

5. The underlying principle of the Phase 1 amendments to IFRS 9 and IAS 39 issued in September 2019 was to provide exceptions to specific hedge accounting requirements such that entities would apply those requirements assuming the interest rate benchmark on which the hedged risk and/or cash flows of the hedged item or of the hedging instrument are based, is not altered as a result of IBOR reform.

6. Those amendments specified that an entity would apply the exceptions while there are uncertainties about the interest rate benchmark designated as the hedged risk and/or the timing or amount of interest rate benchmark-based cash flows of the hedged item or the hedging instrument. However to ensure that the exceptions are not applied after the uncertainty was resolved, the Board included specific requirements for when the exceptions cease to apply and an entity would revert to applying the hedge accounting requirements in IFRS 9 or IAS 39 without applying the exceptions (referred to as 'end of application' in the amendments).

7. The end of application requirement applies to the following Phase 1 exceptions:

   (a) Highly probable requirement for cash flow hedges;

   (b) Prospective assessments; and

   (c) IAS 39 retrospective assessments.

8. As explained in paragraphs BC6.597 of IFRS 9 and BC283 of IAS 39, the Board decided not to specify end of application requirements with respect to the exception for the separately identifiable requirement.

9. The analysis in this paper considers the interaction between the Board's tentative decisions as set out in Agenda Paper 14 for this meeting and the end of application requirements for the Phase 1 amendments to IFRS 9 and IAS 39, and whether any additional guidance is needed in this regard. However, this paper does not discuss the interaction between the Phase 1 exception (see paragraph 8) and Phase 2 tentative decisions with respect to the separately identifiable criteria. The staff analysis on the application of the separately identifiable criteria in the context of the Phase 2 tentative decisions will be discussed at the next Board meeting.

General end of application requirements

10. The overarching principle for the end of application sections in IFRS 9 and IAS 39 is that the exceptions to the hedge accounting requirements cease to apply at the earlier of:[1]

   a) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk or the timing and the amount of the interest rate benchmark-based cash flows of the hedged item or the hedging instrument; and

   b) when the hedging relationship that the hedged item or hedging instrument is part of, is discontinued.

[1] Paragraphs 6.8.9-6.8.12 of IFRS 9 and 102J-102N of IAS 39

11. Paragraphs BC6.584 of IFRS 9 and BC270 of IAS 39 state that uncertainties arising from IBOR reform relate to uncertainties about:

    (a) when the interest rate benchmark will change to an alternative benchmark rate, when the spread adjustment between the current benchmark and alternative benchmark rate will be determined (collectively referred to as timing); and

    (b) what the cash flows based on the alternative benchmark rate will be, including their frequency of reset and the spread adjustment (collectively referred to as amount).

12. The Board further noted in paragraphs BC6.587 of IFRS 9 and BC273 of IAS 39 that for uncertainty regarding the timing and amount of cash flows arising from a change in an interest rate benchmark to be eliminated, the underlying contracts are generally required to be amended to specify the timing and the amount of the alternative benchmark rate-based cash flows (including any spread adjustment between IBOR and the alternative benchmark rate where necessary). Although contractual amendments are expected to be the most likely manner in which uncertainty will be eliminated, neither is it required nor is it the only way to resolve uncertainty arising from IBOR reform (for example, when fallback provisions already incorporated into the contracts are triggered in a way that eliminates uncertainty). An extract of the examples included in the Basis for Conclusions on IFRS 9 and IAS 39 to illustrate the end of application requirements have been included in Appendix A to this paper.

Interaction with the tentative decisions on modifications[2]

13. In October 2019, the Board tentatively decided that a change in the basis on which the contractual cash flows of a financial instrument are determined, that alters the calculation of the contractual cash flows applicable at the time the contract was entered into (even in the absence of an amendment to the contractual terms of a financial instrument) constitutes a modification of a financial instrument in accordance with IFRS 9.

[2] As discussed in AP14A *Modification of financial instruments* for the October 2019 meeting

14. The Board also tentatively decided to include a practical expedient in IFRS 9 so that a modification to the contractual cash flows that is (a) required as a direct consequence of IBOR reform; and (b) done on an economically equivalent basis, is accounted for by applying paragraph B5.4.5 of IFRS 9 (ie as an update to the effective interest rate for the change in the benchmark rate).[3]

15. As noted in paragraph 12, although modification of the contractual cash flows is expected to be the most prevalent scenario in which uncertainty about the timing and amount of interest rate benchmark-based cash flows are eliminated, uncertainty could be eliminated before then. However, the staff is of the view that a modification of the contractual cash flows is the last point at which uncertainty about the timing and amount of interest rate benchmark-based cash flows is eliminated (ie a backstop). In other words, when the contractual cash flows of a financial instrument are modified as described in paragraph 14, the uncertainty with respect to the timing and the amount of the designated IBOR-based cash flows would be eliminated. As a result, the entity can no longer assume that the interest rate benchmark on which the cash flows were based is not altered as a result of IBOR reform.

16. In December 2019, the Board tentatively decided to include an exception to the hedge designation and documentation requirements in IFRS 9 and IAS 39 to permit changes to the hedging relationship and hedge documentation to be made that are necessary to reflect the modifications directly required by the reform to the hedged item and/or the hedging instrument, subject to all qualifying criteria for hedge accounting being met at that time. Therefore, when the hedged items or hedging instruments have been modified and the relevant changes to the hedging relationship and hedge documentation have been made, uncertainty about the interest rate benchmark designated as the hedged risk and the timing and amount of hedged cash flows are eliminated.

17. However, as noted in paragraphs BC6.595 of IFRS 9 and BC281 of IAS 39, not all the Phase 1 exceptions apply at the hedging relationship level but are applied separately to the different elements of the hedging relationship. The following

[3] For ease of reference, this paper refers to those modifications as modifications directly required by the reform

sections of the analysis therefore consider the interaction of the tentative decisions to date with each of the exceptions listed in paragraph 7.

Highly probable requirement

18. As the highly probable requirement applies to the hedged item only, ie assessing whether the hedged cash flows are still expected to occur, the Phase 1 exception and the related end of application requirement therefore apply to the hedged item only.

19. In applying the tentative decisions as discussed in paragraphs 13-17, the alternative benchmark rate-based cash flows will be the hedged cash flows to which the highly probable requirement (without the exception) will be applied.

20. Furthermore, the hypothetical derivative in a cash flow hedge will also be updated to reflect the change in the hedged risk and hedged cash flows (as discussed in Agenda Paper 14A *Hedge accounting* for the December 2019 meeting), with any valuation adjustments included in the measurement of ineffectiveness. It therefore follows that the amount accumulated in the cash flow hedge reserve continues to represent the extent to which the change in the fair value of the hedging instrument was offset by the changes in the fair value of the hedged item (ie the effective portion). As such the amount accumulated in the cash flow hedge reserve is reclassified to profit or loss in the same period or periods during which the hedged cash flows (based on the alternative benchmark rate) affect profit or loss by applying paragraph 6.5.11(d) of IFRS 9 or paragraph 97 of IAS 39.[4]

21. This is consistent with the Board's view that, when a hedging relationship is affected by modifications that are directly required by the reform, not requiring discontinuation of hedge accounting (and thereby not requiring immediate reclassification of amounts in the cash flow hedge reserve to profit or loss) would provide more useful information to users of financial statements as it will better

[4] Reclassification of the amount accumulated in the cash flow hedge reserve to profit or loss in the same period or periods during which the hedged forecast cash flows affect profit or loss is consistent with existing hedge accounting requirements in IFRS 9 and IAS 39. For further information, refer to paragraph 6.5.11(d)(ii) of IFRS 9 and paragraph 97 of IAS 39.

reflect the economic effects of such modifications compared to a situation in which the tentative decisions are not applied with respect to IBOR reform.

22. The staff is also of the view that the same accounting treatment would apply to amounts accumulated in the cash flow hedge reserve relating to hedging relationships that have been discontinued. In other words, when a modification to a hedged item is directly required by the reform (even though the hedging relationship has been discontinued), any amount remaining in the cash flow hedge reserve related to a discontinued hedging relationship is assumed to relate to the alternative benchmark rate and reclassified to profit or loss in the same period or periods during which the hedged alternative benchmark rate-based cash flows (ie the modified former hedged item) affect profit or loss.

23. The staff therefore do not consider any additional guidance or amendments to the end of application of Phase 1 exceptions for the highly probable requirement to be needed to improve the interaction with the Board's tentative decisions in Phase 2.

Prospective assessments

24. Consistent with Phase 1, the collective term 'prospective assessments' is used to refer to the requirements in paragraph 6.4.1(c)(i) of IFRS 9 (the existence of an economic relationship) and paragraph AG105(a) of IAS 39 (whether the hedge is expected to be highly effective in achieving offsetting).

25. The end of application requirement for the prospective assessments is similar to the general requirements described in paragraph 10, with the assumption that the interest rate benchmark rate on which the hedged cash flows and/or hedged risk are based, is not altered as a result of IBOR reform (and therefore the end of application requirement), is applied to the hedged item and hedging instrument respectively.

26. For example, if the hedging instruments in a hedging relationship are modified such that the uncertainty about the timing and amount of interest rate benchmark-based cash flows is eliminated, the entity should cease applying the exception for the prospective assessment (ie cease assuming that the interest rate benchmark is not altered) to the hedging instruments, while it continues to apply the exception to the hedged items until the uncertainty for these items is eliminated.

27. Such a timing mismatch between the dates on which the exception from the prospective assessments ceases to apply to the hedging instruments and the hedged items, could affect the prospective assessment of effectiveness due to the resulting basis risk – ie when the hedged items and hedging instruments are based on different benchmark interest rates. Although the hedging relationship will continue to benefit from the exception from the retrospective assessment and will not be discontinued if the actual results are not within the 80%-125% range (see section below), the entity will be required to perform the prospective assessments as described in paragraph 26 and in some situations this could result in the hedging relationship no longer being expected to meet the effectiveness requirements.

28. The staff therefore considered whether additional exceptions or guidance to the end of application requirement for the prospective assessments is needed. However, the staff noted that proposed exception that permits changes to the hedging relationships and hedge documentation to be made (as summarised in Agenda Paper 14 for this meeting), provides entities the ability to minimise the ineffectiveness (for example, by changing the hedged risk to be the alternative benchmark rate instead of the interest rate benchmark) that might arise due to timing mismatch between the modifications to the hedging instruments and hedged items[5].

29. The staff therefore is not recommending any additional guidance or amendments to be made to the end of application requirement for the prospective assessments.

IAS 39 retrospective assessments

30. Unlike the exceptions to the highly probable requirement and prospective assessments that apply to the hedged item and hedging instrument respectively, the exception from the retrospective effectiveness assessment in IAS 39 applies at the level of the hedging relationship. This is because a hedging relationship is considered effective if the actual results of the hedge (ie the extent to which offsetting changes in fair value or cash flows attributable to the hedged risk is

[5] Subject to the hedging relationship continuing to satisfy the qualifying criteria for hedge accounting

achieved) are within a range of 80%-125%. Therefore, by applying paragraph 102M in IAS 39, the exception from the retrospective assessment ceases to apply when uncertainty arising from the reform is no longer present with respect to the hedged risk, and the timing and amount of IBOR-based cash flows of the hedged item and the hedging instrument. In other words, the exception from the retrospective assessment is applied until there is no uncertainty arising from IBOR reform in the hedging relationship.

31. Similar to the other Phase 1 exceptions, the consequence of ceasing to apply the exception from the retrospective assessment is that an entity would start assessing whether the actual results of the hedge are within a range of 80%-125% from the date that uncertainty has been eliminated.

32. The staff considered the end of application requirement in a situation where, during the period of uncertainty that the exception to the retrospective assessment was applied, the actual results of the hedge were not within the prescribed range. The Phase 1 exception resulted in the hedging relationship not being discontinued (assuming all other qualifying criteria continued to be met) during this period, while all ineffectiveness was recognised in profit or loss. However, when starting to assess retrospective effectiveness based on cumulative fair value changes, the hedging relationship could fail the retrospective assessment upon ceasing to apply the exception. The staff considered that such an outcome would be inconsistent with the Board's objective with the Phase 1 amendments to not discontinue hedge accounting solely due to the uncertainties arising from IBOR reform.

33. The staff noted that this would only be a concern when an entity assesses hedge effectiveness on a cumulative basis. Furthermore, the tentative decisions made in December 2019 (as summarised in Agenda Paper 14 for this meeting) permits an entity to change the method used to assess effectiveness (for example from a quantitative to a qualitative method or from using a cumulative to a periodic basis) as part of the changes to the hedging relationship and hedge documentation following the modification of financial instruments designated in a hedging relationship.

34. However, the staff considered that further exception could be provided to support entities in applying the hedge accounting requirements in IAS 39 by allowing the

cumulative fair value changes, for the purposes of the retrospective assessment only, to be reset to zero at the date that the entity ceases to apply the exception in paragraph 102G of IAS 39. This means that for the purpose of the retrospective assessment, the fair values will accumulate from that date on, similar to the way they accumulate for a new hedging relationship. The benefit of such an approach is that the uncertainties arising from IBOR reform, that resulted in increased ineffectiveness being recognised in profit or loss (and that could potentially have resulted in the hedging relationship failing the qualifying criteria in periods subsequent to the reform) are excluded from the ongoing assessment of hedge effectiveness when those uncertainties have been eliminated.

35. The staff therefore recommend that IAS 39 be amended to allow that, for the purposes of assessing retrospective effectiveness only, the cumulative fair values reset to zero at the date the exception to the retrospective assessment ceases to apply.

Question for the Board

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1) Does the Board agree with the staff recommendations that: a) IAS 39 be amended to allow that, for the purposes of assessing retrospective effectiveness only, the cumulative fair values reset to zero at the date the exception to the retrospective assessment ceases to apply (paragraph 35); and b) no amendments be made to the end of application requirements for the Phase 1 exceptions (paragraphs 23 and 29).

Appendix A:

Phase 1 scenarios illustrating whether uncertainty has been eliminated[6]

1. Scenario A—a contract is amended to include a clause that specifies (a) the date the interest rate benchmark will be replaced by an alternative benchmark rate and (b) the alternative benchmark rate on which the cash flows will be based and the relevant spread adjustment between the interest rate benchmark and the alternative benchmark rate. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract is eliminated when the contract is amended to include this clause.
2. Scenario B—a contract is amended to include a clause that states modifications of contractual cash flows will occur due to the reform but that specifies neither the date that the interest rate benchmark will be replaced nor the alternative benchmark rate on which the amended cash flows will be based. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract has not been eliminated by amending the contract to include this clause.
3. Scenario C—a contract is amended to include a clause which states that conditions specifying the amount and timing of interest rate benchmark-based cash flows will be determined by a central authority at some point in the future. But the clause does not specify those conditions. In this case, the uncertainty regarding the timing and the amount of the interest rate benchmark-based cash flows for this contract has not been eliminated by including this clause in the contract. Uncertainty regarding both the timing and the amount of cash flows for this contract will be present until the central authority specifies when the replacement of the benchmark will become effective and what the alternative benchmark rate and any related spread adjustment will be.

[6] Included as paragraphs BC6.588 – BC6.593 of IFRS 9 and paragraphs BC274 – BC279 of IAS 39

4. Scenario D—a contract is amended to include a clause in anticipation of the reform that specifies the date the interest rate benchmark will be replaced and any spread adjustment between the interest rate benchmark and the alternative benchmark rate will be determined. However, the amendment does not specify the alternative benchmark rate or the spread adjustment between the interest rate benchmark and the alternative benchmark rate on which the cash flows will be based. In this scenario, by amending the contract to include this clause, uncertainty regarding the timing has been eliminated but uncertainty about the amount remains.

5. Scenario E—a contract is amended to include a clause in anticipation of the reform that specifies the alternative benchmark rate on which the cash flows will be based and the spread adjustment between the interest rate benchmark and the alternative benchmark rate but does not specify the date from which the amendment to the contract will become effective. In this scenario, by amending the contract to include this clause, uncertainty about the amount has been eliminated but uncertainty with respect to timing remains.

6. Scenario F—in preparation for the reform, a central authority in its capacity as the administrator of an interest rate benchmark undertakes a multi-step process to replace an interest rate benchmark with an alternative benchmark rate. The objective of the reform is to cease the publication of the current interest rate benchmark and replace it with an alternative benchmark rate. As part of the reform, the administrator introduces an interim benchmark rate and determines a fixed spread adjustment based on the difference between the interim benchmark rate and the current interest rate benchmark. Uncertainty about the timing or the amount of the alternative benchmark rate-based cash flows will not be eliminated during the interim period because the interim benchmark rate (including the fixed spread adjustment determined by the administrator) represent an interim measure in progressing towards the reform but it does not represent the alternative benchmark rate (or any related spread adjustment agreed between parties to the contract).