

## STAFF PAPER

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Project	IBOR Reform and its Effects on Financial Reporting – Phase 2		
Paper topic	Other IFRS Standards		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in the IASB® *Update*.

**Purpose of this paper**

1. The purpose of this paper is to discuss the potential effects of interest rate benchmark reform (IBOR reform) on IFRS Standards other than those related to financial instruments accounting.

**Background**

2. The scope of Phase 2 is broader than the previous phase as it will encompass different areas of accounting for financial instruments as well as other areas of accounting. However, this does not mean that all those accounting issues will result in amendments to IFRS Standards to provide relief through exceptions to existing requirements. In particular, when IFRS Standards provide an adequate basis to account for a particular issue and the accounting outcome results in useful information to users of financial statements by faithfully representing the economic effects of IBOR reform, the staff do not believe that any amendments to current IFRS Standards are needed.

3. 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 Accounting Standards Advisory Forum (ASAF) and considered the feedback received from comment letters<sup>1</sup> on the 2019 Exposure Draft *Interest Rate Benchmark Reform* (2019 ED) to identify potential issues for the Board to consider as part of Phase 2. Based on these activities, the staff identified some areas of accounting that could be affected by IBOR reform.
4. This paper is structured as follows:
- (a) Summary of staff recommendations (paragraph 5);
  - (b) IFRS 16 *Leases* (paragraphs 6–26);
  - (c) IFRS 17 *Insurance Contracts* (paragraphs 27–40);
  - (d) IFRS 13 *Fair Value Measurement* (paragraphs 41–49);
  - (e) Discount rates (paragraphs 50–56); and
  - (f) Insurance companies applying the temporary exemption from IFRS 9 (paragraphs 57–62).

### **Summary of staff recommendations**

5. In this paper the staff recommend that:
- (a) IFRS 16 *Leases* should be amended to provide a practical expedient, so that a lessee applies paragraphs 42(b) and 43 of IFRS 16 to account for lease modifications directly required by IBOR reform. More specifically, a lessee would re-estimate the variable lease payments linked to IBOR and revise the discount rate to reflect changes in the benchmark interest rate. No amendments are needed for lessor accounting.

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<sup>1</sup> 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*.

- (b) IFRS 17 provides an adequate basis for an entity to account for modifications an entity makes to insurance contracts in the context of the IBOR reform, and that such accounting results in useful information to users of financial statements.
- (c) IFRS 13 already provides sufficient guidance to determine if and when a financial asset or financial liability should be transferred to a different level within the fair value hierarchy and that these transfers reflect the economic reality of IBOR reform, therefore providing useful information to users of financial statements.
- (d) the current IFRS Standards already provide adequate guidance to determine the appropriate accounting treatment for the potential impacts of the replacement of IBORs on discount rates.
- (e) amend IFRS 4 to allow insurers applying the temporary exemption to apply the amendments and practical expedient in accounting for modifications directly required by IBOR reform.

## **IFRS 16 Leases**

6. Some leases include lease payments linked to a benchmark interest rate, such as IBOR. Applying paragraph 26 of IFRS 16, a lessee measures the lease liability at the present value of the lease payments that are not paid at that date. Included in the lease liability are, for example, variable lease payments linked to a benchmark interest rate or payments linked to a consumer price index.<sup>2</sup> Similarly, from the perspective of a lessor, lease payments included in the measurement of the net investment in a finance lease include variable lease payments that depend on an index or benchmark interest rate.<sup>3</sup>
7. A lease modification is defined in Appendix A to IFRS 16 as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease. In the context of IBOR reform, amending an IBOR-referenced lease to reflect an alternative benchmark rate would meet the

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<sup>2</sup> For further information, refer to paragraph 28 of IFRS 16.

<sup>3</sup> For further information, refer to paragraph 70(b) of IFRS 16.

definition of a lease modification because a change in the benchmark rate would change the original terms and conditions determining the consideration for the lease. Similarly, a lease modification would occur when a change in the calculation methodology of an existing interest rate benchmark modifies the basis for determining the consideration for a lease. For example, this would be the case when the calculation methodology of a term rate changes to be based on an overnight rate.

8. With regards to modifications of financial instruments related to IBOR reform, the Board tentatively decided at its October 2019 meeting to provide a practical expedient 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 to be accounted for as 'a movement in market rates of interest' by applying paragraph B5.4.5. For ease of reference, those modifications are referred to as modifications 'directly required by IBOR reform'.<sup>4</sup> Stakeholders questioned whether providing a similar practical expedient specific for lease modifications directly required by IBOR reform could:
  - (a) provide useful information to users of financial statements; and
  - (b) support preparers in applying the requirements of IFRS 16 during IBOR reform.
9. Considering the different outcomes for lessee and lessor accounting, the staff analysis is structured as follows:
  - (a) Lease modifications: lessee (paragraphs 10–20); and
  - (b) Lease modifications: lessor (paragraphs 21–25).

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<sup>4</sup> More specifically, entities would apply paragraph B5.4.5 of IFRS 9 to account for such modifications directly required by IBOR reform (ie entities would re-estimate the cash flows and update the effective interest rate for the change in benchmark rate similar to the way floating rate instruments are updated for movements in the market rates of interest).

**Lease modifications: lessee***How would a lessee account for modifications directly required by IBOR reform?*

10. As noted above, IFRS 16 requires a lessee to include variable lease payments linked to IBOR in the measurement of the lease liability. A lessee remeasures the lease liability related to an IBOR-referenced lease when benchmark rate changes such that the lease payments change—it does so by discounting the revised lease payments (as required by paragraph 42(b) of IFRS 16) using a revised discount rate that reflects changes in the interest rate, as required by paragraph 43 of IFRS 16:

In applying paragraph 42, a lessee shall use an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate.

11. However, if an IBOR-referenced lease is amended to reflect an alternative benchmark rate in the context of IBOR reform, a lessee would not apply paragraphs 42(b) and 43 of IFRS 16. Instead, the lessee is required to apply the lease modification requirements in IFRS 16. This is because the change to the contract to replace the benchmark interest rate would meet the definition of a lease modification in IFRS 16 as it represents a change to the consideration for the lease that was not part of the original terms and conditions of the lease (as explained in paragraph 7 of this paper).
12. Paragraphs 44 – 46 of IFRS 16 apply to lease modifications for a lessee. Applying the requirements in paragraph 44 of IFRS 16, a lessee accounts for a lease modification as a separate lease if, among other conditions, the modification increases the scope of the lease by adding the right to use one or more underlying assets. Amending an IBOR-referenced lease to reflect an alternative benchmark rate would not increase the scope of the lease. Therefore, the staff is of the view that paragraph 44 of IFRS 16 would not apply in the context of IBOR reform (ie a lease agreement amended to reflect an alternative benchmark rate would not be accounted for as a separate lease) if the changes to the lease contract are required

as a directly consequence of IBOR reform and are done on an economically equivalent basis.

13. With respect to lease modifications that are not accounted for as a separate lease—which the staff expect to be the case in the context of IBOR reform—paragraph 45 of IFRS 16 requires that, at the effective date of the lease modification, a lessee remeasures the lease liability by discounting the revised lease payments using a revised discount rate. Applying that same paragraph in IFRS 16, the revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee’s incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.
14. Thus, by way of example, assuming a lessee uses its revised incremental borrowing rate to discount the alternative benchmark rate cash flows, the lease modification would be expected to result in an adjustment to the carrying amount of the lease liability. This is because even if IBOR is replaced with an alternative benchmark rate on an economically equivalent basis (ie upon modification, any difference between the variable lease payments linked to IBOR and the alternative benchmark interest rate are expected to be minimal), the lessee’s incremental borrowing rate at the effective date of the lease modification would likely change compared to the lessee’s incremental borrowing rate at the commencement date. For example, the incremental borrowing rate could change due to a change in the lessee’s own credit risk for that period. Consequently, this would result in either an increase or decrease in the carrying amount of the lease liability at the effective date of the lease modification.
15. As required by paragraph 46 of IFRS 16, a lessee would account for the remeasurement of the lease liability by making a corresponding adjustment to the right-of-use asset. The accounting implications are illustrated in Example 19 – Modification that is a change in consideration only in paragraph IE7 of the Illustrative Examples accompanying IFRS 16:

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from CU100,000

per year to CU95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. Lessee's incremental borrowing rate at the beginning of Year 6 is 7 per cent per annum. The annual lease payments are payable at the end of each year.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of CU95,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. Lessee recognises the difference between the carrying amount of the modified liability (CU389,519) and the lease liability immediately before the modification (CU421,236) of CU31,717 as an adjustment to the right-of-use asset.

*Should IFRS 16 be amended in the context of IBOR reform?*

16. As discussed above, without any amendment to IFRS 16, the replacement of IBOR with an alternative benchmark rate would require a lessee to remeasure the lease liability related to an IBOR-referenced lease by discounting the revised lease payments using a revised discount rate. That revised discount rate would be determined as the interest rate implicit in the lease for the remainder of the lease term (if that rate can be readily determined) or the lessee's incremental borrowing rate at the effective date of the modification (if the interest rate implicit in the lease cannot be readily determined).
17. However, it is questionable whether such an outcome would provide useful information to users of financial statements. For example, when a lease has been amended only to reflect an alternative benchmark and is done on an economically equivalent basis rate (ie a modification directly required by IBOR reform), reassessing the lessee's entire incremental borrowing rate would not necessarily reflect the economics of the amended lease. Such a requirement might also impose additional cost on preparers, particularly when IBOR-referenced leases are expected to be amended at different times. This is because preparers would have

to determine a new incremental borrowing rate at the effective date of each lease modification.

18. The staff is of the view that remeasuring the lease liability by applying paragraphs 42(b) and 43 of IFRS 16 would provide useful information to users of financial statements in the context of modifications directly required by IBOR reform. This is because a lessee would remeasure the lease liability using a discount rate that reflects the changes in the interest rate. The staff also does not expect incremental costs for preparers because the effects of IBOR reform would be accounted for in the same way as any other change in lease payments that results from a change in floating interest rates.
19. The staff therefore recommend that a practical expedient be included in IFRS 16 so that entities would apply paragraphs 42(b) and 43 of IFRS 16 to account for lease modifications directly required by IBOR reform. This approach would be consistent with the Board's tentative decision to provide a practical expedient for modifications of financial instruments directly required by IBOR reform.
20. The staff highlight that the practical expedient would be applied only to those modifications directly required by IBOR reform consistent with the Board's tentative decisions to date on IFRS 9. If a lease modification includes changes to the scope of a lease, or the consideration for a lease, beyond the change directly required by the reform, then those modifications would not qualify for the practical expedient. Such modifications are similar to any lease modification made outside the context of IBOR reform and, in the staff's view, should be accounted for applying the lease modification requirements in IFRS 16.

### ***Lease modifications: lessor***

21. Applying IFRS 16, a lessor classifies each of its leases as either an operating lease or a finance lease. IFRS 16 specifies requirements for modifications to each type of lease, and in the following paragraphs we discuss lease modifications directly required by IBOR reform from the perspective of the lessor.

### ***Finance Leases***

22. Applying paragraph 79 of IFRS 16, one condition required to account for a finance lease modification as a separate lease is that the modification increases the

scope of the lease by adding the right to use one or more underlying assets. For the same reasons as explained earlier in paragraph 12, amending leases to replace IBOR with an alternative benchmark rate would not increase the scope of the lease. Therefore, the staff conclude that paragraph 79 of IFRS 16 would not apply in the context of IBOR reform (ie a lease agreement amended to reflect an alternative benchmark rate would not be accounted for as a separate lease).

23. With respect to lease modifications that are not accounted for as a separate lease—which the staff expect to be the case in the context of IBOR reform—paragraph 80 of IFRS 16 states that:

For a modification to a finance lease that is not accounted for as a separate lease, a lessor shall account for the modification as follows:

- (a) if the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor shall:

- (i) account for the lease modification as a new lease from the effective date of the modification; and
- (ii) measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.

- (b) otherwise, the lessor shall apply the requirements of IFRS 9.

24. Given that paragraph 80(a) of IFRS 16 would not apply in the context of IBOR reform, a lessor would apply the requirements of IFRS 9 to a lease modification directly required by IBOR reform. Therefore, the analysis and the practical expedient discussed at the October 2019 Board meeting<sup>5</sup> would also apply to finance lease modifications from the perspective of a lessor.

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<sup>5</sup> For further information, refer to the October 2019 Agenda Paper 14A *Classification and measurement – modification of financial instruments*

### *Operating Leases*

25. For modification to operating leases, paragraph 87 of IFRS 16 requires a lessor to account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. Accounting for an operating lease modification as a new lease would appropriately reflect the change in terms and conditions directly required by IBOR reform given the mechanics of the operating lease accounting model. The staff see no reason to apply a different approach for modifications to operating leases directly required by IBOR reform.

### *Staff recommendation*

26. For the reasons stated in paragraphs 16–25, the staff recommend that IFRS 16 be amended to provide a practical expedient, so that a lessee would apply paragraphs 42(b) and 43 of IFRS 16 to account for lease modifications directly required by IBOR reform. The staff is not recommending any amendments to IFRS 16 for lessor accounting. Furthermore, IFRS 16 already provides adequate guidance to determine the appropriate accounting treatment for modifications to lease contracts from a lessor perspective and no amendments to IFRS 16 are needed in this regard.

### **Question 1 for the Board**

#### **Question 1 for the Board**

Does the Board agree with the staff recommendation set out in paragraph 26 that IFRS 16 should be amended to provide a practical expedient, so that a lessee would apply paragraphs 42(b) and 43 of IFRS 16 to account for lease modifications directly required by IBOR reform and that no amendments are needed for lessor accounting?

## **IFRS 17 Insurance Contracts**

### *What is the problem?*

27. Some insurance contracts may include IBOR-based cash flows. For example, premiums received from policyholders or payments made to policyholders under interest-rate guarantees might be based on an IBOR rate. Similar to other contracts discussed in this paper, insurers may amend such contracts to replace the IBOR rate with an alternative benchmark rate in the context of the IBOR reform.
28. A question arises as to how an entity would account for such modifications applying IFRS 17 *Insurance Contracts* and whether such accounting would result in useful information to users of financial statements by faithfully representing the economic effects of the reform.<sup>6</sup> For example, if the modifications could result in derecognition of the insurance contract without reflecting the economics of the reform or the amendments being made, the resulting accounting would not provide useful information for users of financial statements.

### *Current IFRS 17 requirements*

29. Paragraph 74 of IFRS 17 states that an insurance contract will only be derecognised when it is extinguished (ie the obligation expires, is discharged or cancelled) or any of the conditions in paragraph 72 of IFRS 17 are met.
30. Paragraphs 72 of IFRS 17 states the following:

If the terms of an insurance contract are modified, for example by agreement between the parties to the contract or by a change in regulation, an entity shall derecognise the original contract and recognise the modified contract as a new contract, applying IFRS 17 or other applicable Standards if, and only if, any of the conditions in (a)–(c) are satisfied...

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<sup>6</sup> IFRS 4 *Insurance Contracts* does not contain any requirements on how an entity accounts for modifications to insurance contracts. Therefore, we have not analysed the accounting under IFRS 4 further in this paper.

31. Appendix A to this paper reproduces the conditions (a)–(c) in paragraph 72 of IFRS 17. These conditions capture situations in which the modification to the terms of an existing contract would have significantly changed the accounting of the contract if the new terms had always existed (eg the original contract met the definition of an insurance contract with direct participation features, but the modified contract no longer meets that definition, or vice versa).
32. Paragraph 76–77 of IFRS 17 sets out the requirements an entity follows when the modification results in derecognition of the original contract applying paragraph 72. Appendix A reproduces these paragraphs. In summary, an entity:
- (a) derecognises the insurance contract from within the group of contracts it was included by adjusting the present value of future cash flows and risk adjustment for non-financial risk, the contractual service margin and the number of coverage units for expected remaining coverage of that group of contracts; and
  - (b) measures the new contract based on the premium the entity would have charged had it entered into a contract with equivalent terms at the date of modification.
33. If the contact modification does not result in derecognition of the original contract, paragraph 73 of IFRS 17 requires an entity to treat changes in cash flows caused by the modification as changes in estimates of fulfilment cashflows.

### *Staff analysis*

34. Unlike the derecognition requirements in IFRS 9, IFRS 17 only requires an insurance contract to be derecognised when the obligation specified in the insurance contract is extinguished or when specific conditions in paragraph 72 are met.
35. We first observed that if the only modifications being made to an insurance contract are those that are (a) required as a direct consequence of IBOR reform, and (b) done on an economically equivalent basis (modifications directly required by IBOR reform), they would not result in the extinguishment of the insurance obligation and therefore would not lead to derecognition applying paragraph 74(a) of IFRS 17. Consistent with previous staff analysis on modification of financial

instruments, such modifications include, for example, changes to the existing benchmark rate and changes to the fixed spread to reflect basis difference between benchmark rates.<sup>7</sup>

36. The staff then considered whether such modifications would be likely to result in a different accounting outcome (ie classification or recognition) for the insurance contract under IFRS 17 if they were present at contract inception, ie would meet the conditions for derecognition in paragraph 72 of IFRS 17. Because the modifications we are considering are done on an economically equivalent basis, we are of the view that it should be clear that any such modifications would not result in derecognition applying paragraph 72 of IFRS 17.
37. The entity would therefore apply paragraph 73 of IFRS 17 in accounting for modifications that do not result in derecognition by changing the estimates of fulfilment cashflows of the relevant group of insurance contracts—as explained above, at the time of the modification, we do not expect the estimated fulfilment cashflows to change significantly. After the modification, the entity would re-estimate the fulfilment cashflows based on the alternative benchmark rate at the end of each reporting period as normally required by IFRS 17.
38. However, if an entity renegotiates other terms of the insurance contract with the policyholder in addition to making modifications directly required by IBOR reform, those further modifications could be made in a way that results in derecognition of the contract applying paragraph 72 of IFRS 17. Such modifications would be similar to any modification made to a contract outside the context of the IBOR reform. In such circumstances, we think an entity should continue to apply the existing requirements IFRS 17 (ie account for it as any other modification).
39. We also considered that insurance contracts that do not include IBOR-based cash flows may nonetheless include cashflows that are indirectly based on an IBOR rate. In such situations, rather than account for a modification of an insurance contract, the entity would account for changes in the expected cash flows resulting from the IBOR reform as a change in the estimate of future cash flows applying

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<sup>7</sup> See [Agenda Paper 14A](#) for the October Board meeting.

the normal requirements in IFRS 17. We think such accounting would also be consistent with the general requirements in IFRS 17 and would provide useful information to users of financial statements.

### *Staff recommendation*

40. Based on our analysis in paragraph 34–39 of this paper, we are of the view that IFRS 17 provides an adequate basis for an entity to account for modifications to insurance contracts in the context of the IBOR reform and that such accounting results in useful information to users of financial statements. The staff is therefore not recommending any amendments to IFRS 17 in this regard.

### **Question 2 for the Board**

#### **Question 2 for the Board**

Does the Board agree with our conclusion in paragraph 40 that no amendments to IFRS 17 are needed as the Standard provides an adequate basis for an entity to account for modifications to insurance contracts in the context of the IBOR reform and that such accounting results in useful information to users of financial statements?

### ***IFRS 13 Fair Value Measurement***

#### *What is the problem?*

41. IBOR reform and the uncertainties arising from the process of replacing the IBOR rates with alternative benchmark rates, could affect the observability of the inputs used to measure the fair value of financial assets or financial liabilities as IBORs become less liquid. For example, as more alternative benchmark rate-based instruments are issued, the decrease in the volume or level of activity for IBOR-based financial instruments could result in the IBOR-inputs becoming less observable, resulting in IBOR-based instruments being transferred to a lower level within the fair value hierarchy in accordance with IFRS 13. Similarly, as the volumes of the alternative benchmark rate-based instruments increase, those inputs could become more observable, resulting in alternative benchmark rate-

based instruments being transferred to a higher level within the hierarchy over time.

42. Some stakeholders have raised concerns about the potential impact of more instruments being classified as Level 3 in the hierarchy on the amount of regulatory capital they are required to hold as the risk weighting of Level 3 instruments is higher, resulting in a higher capital charge.

### *Current IFRS 13 requirements*

43. For the purpose of increasing the consistency and comparability in fair value measurements and related disclosures, IFRS 13 establishes a fair value hierarchy that categorises into three levels (Level 1, Level 2 or Level 3) the inputs to valuation techniques used to measure fair value. As explained in paragraph 72 of IFRS 13, the fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).
44. For Level 1 inputs, Appendix A of IFRS 13 states that these are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date. IFRS 13 defines an active market as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. Regarding Level 2 inputs, these are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. To further illustrate the concept of Level 2 inputs, paragraph 82 of IFRS 13 provides some examples of Level 2 inputs, including interest rates and yield curves observable at commonly quoted intervals that could be included in Level 2 input category. Lastly, Level 3 inputs refer to unobservable inputs for the asset or liability.
45. In order to provide users with useful information about the valuation techniques and inputs used to develop fair value measurements and how those measurements use significant unobservable inputs, paragraph 93(b) of IFRS 13 requires an entity to disclose the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (ie Level 1, 2 or 3).

*Staff analysis*

46. As explained in paragraph 41, IBOR reform could potentially trigger reclassification within the fair value hierarchy. Consequently, entities would need to assess whether this reclassification would be necessary due to limited liquidity when quoted prices of IBOR or alternative benchmark rate-based assets or liabilities are used as inputs to measure fair value. Nevertheless, the staff note that IBOR reform progresses in different ways and at a different pace across several jurisdictions, therefore some specific conditions and details of the IBOR reform are not yet known (for example, when liquidity for IBORs and alternative benchmark rates is anticipated to decline and increase, respectively).
47. Paragraph B37 of IFRS 13 sets out a list of factors that may indicate that there has been a significant decrease in the volume or level of activity for that asset or liability in relation to normal market activity for the asset or liability. An entity evaluates the significance and relevance of the factors listed when determining whether there has been a decrease in volume or level of activity for a financial instrument. In addition, paragraph B38 of IFRS 13 requires further analysis of the transactions or quoted prices if an entity concludes that there has been a significant decrease in the volume or level of activity for the asset or liability in relation to the normal activity of the asset or liability. The staff is therefore of the view that IFRS 13 provides sufficient guidance to determine if and when the volume or level of activity for an asset or a liability has significantly decreased for the purpose of determining the hierarchy level in which to classify a financial instrument.
48. As noted in paragraph 41, reclassification might also be necessary due to lack of observable inputs when these are used in valuation techniques. That would be the case, for example, if an IBOR forward curve can no longer be generated for the life of an instrument. While changes in the categorisation within the fair value hierarchy might be a potential issue arising as a result of the IBOR Reform, the staff is of the view that transfers within the fair value hierarchy reflects the economic reality of IBOR reform and therefore provide useful information to the users of financial statements by indicating the observability of a fair value measurement over time.

*Staff recommendation*

49. Based on the above, the staff is of the view that IFRS 13 already provides sufficient guidance to determine if and when a financial asset or financial liability should be transferred to a different level within the fair value hierarchy and that these transfers reflect the economic reality of IBOR reform, therefore providing useful information to users of financial statements. Therefore, the staff is not recommending any amendments to the fair value hierarchy requirements in IFRS 13.

**Question 3 for the Board****Question 3 for the Board**

Does the Board agree with our conclusion in paragraph 49 that IFRS 13 provides sufficient guidance to determine if and when a financial instrument should be transferred to a different level within the fair value hierarchy and that no amendments are required for IBOR reform?

***Discount rates****What is the problem?*

50. When applying some fair value techniques, entities generally use a discount rate derived from yield curves observed at commonly quoted intervals. In practice, many yield curves are built based on the yields on instruments linked to IBORs, such as future contracts traded on active markets. As future contracts have standardised maturity dates (for example, the first working day of each month), interpolation methodologies are applied to determine the market rate for different maturities.
51. With the replacement of IBORs it is expected that IBOR-referenced financial instruments will be amended to reflect the alternative benchmark rates, which could therefore also impact the yield curves over time. As a result, the replacement of IBORs might have an indirect effect on discount rates in general and consequently impact fair value measurements.

52. The indirect impact of IBOR reform on fair value measurements are more pronounced where IBOR was previously a component of the discount rate, as the way in which the discount rate is determined, may need to change.
53. Similarly, IBORs are often a key component of the discount rate required to be used by other IFRS Standards and the effect of a change in the discount rates might impact valuations other than fair value. For example, potential areas that might be affected include provisions under IAS 37, defined benefit obligations under IAS 19, and value-in-use models for the impairment assessment of non-financial assets under IAS 36. Even though many of the IFRS Standards mentioned above might not explicitly refer to IBORs, their corresponding line items might be impacted indirectly by IBOR Reform.

### *Staff analysis*

54. When the replacement of IBOR with an alternative benchmark rate impacts the discount rate or valuation of items in the financial statements (other than those financial instruments specifically in the scope of the IBOR reform project), the staff consider that a change in the discount rate should continue to be accounted for as a change in an accounting estimate under IAS 8, similar to the current accounting treatment. Paragraph 34 of IAS 8 states that:
- An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.
55. The staff think that changes in an estimate arising as an indirect result of IBOR reform meet the criteria in paragraph 34 of IAS 8 and could be considered as changes in the circumstances on which the estimate was based. Furthermore, as explained in paragraph 36 of IAS 8 the effect of a change in an accounting estimate (such as fair value measurements) should be recognised prospectively.

*Staff recommendation*

56. For the reasons stated in paragraphs 54–55, the staff is of the view that the current IFRS Standards already provide adequate guidance to account for changes in discount rates and valuations resulting from the indirect effect of IBOR reform and that no amendments in this regard are needed.

**Question 4 for the Board****Question 4 for the Board**

Does the Board agree with our conclusion in paragraph 56 that the current IFRS Standards already provide adequate guidance to account for changes in discount rates and valuations resulting from the indirect effect of IBOR reform and that no amendments in this regard are needed?

***Insurance companies applying the temporary exemption from IFRS 9****What is the problem?*

57. Paragraph 20A of IFRS 4 permits an insurer that meets specific criteria to apply IAS 39 rather than IFRS 9 for annual periods beginning before 1 January 2021 (temporary exemption).
58. In October 2019, the Board tentatively decided to amend IFRS 9 to modify some aspects of, and provide a practical expedient to, the accounting for modifications to financial instruments that are directly required by IBOR reform (amendments and practical expedient).<sup>8</sup>
59. An insurer applying the temporary exemption would therefore apply the requirements in IAS 39 in accounting for any modifications directly required by IBOR reform without the benefit of the proposed amendments and practical expedient to be added to IFRS 9. However, the applicable requirements in IAS 39 on accounting for modifications to financial instruments are similar to those in IFRS 9. Therefore, such insurers should be able to benefit from the same

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<sup>8</sup> Refer to the AP14 *Cover Paper and summary of tentative decisions to date* for this meeting

amendments and practical expedient the Board intends to provide for entities applying IFRS 9.

*Staff analysis and recommendation*

60. We think the Board could provide the same amendments and practical expedient to insurers applying the temporary exemption by proposing an amendment to IFRS 4. Such amendment would allow these insurers to apply the amendments and practical expedient when they apply the requirements in IAS 39 in accounting for modifications directly required by IBOR reform. We note that IFRS 4 already permits an insurer applying the temporary exemption to apply only specific requirements in IFRS 9.<sup>9</sup> The proposed amendment could follow a similar approach.
61. At its November 2019 meeting, the Board tentatively decided to finalise the proposed amendment to IFRS 9 included in the Exposure Draft *Annual Improvements to IFRS Standards 2018–2020*.<sup>10</sup> At that meeting, the Board confirmed its decision not to amend the equivalent requirements in IAS 39, considering (among other factors) that it had not contemplated maintaining IAS 39 (other than for hedge accounting), given the temporary nature of the exemption from applying IFRS 9.
62. Notwithstanding the above, we recommend that the Board propose the amendment to IFRS 4 described in paragraph 60. This proposed amendment would be different from other maintenance amendments in the sense that it addresses issues arising from an extraordinary event with widespread effects (IBOR reform).

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<sup>9</sup> Paragraph 20C of IFRS 4 permits an insurer applying the temporary exemption to elect to apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in IFRS 9.

<sup>10</sup> The amendments clarify the fees that an entity includes when assessing whether the terms of a new or modified financial liability are different from the terms of the original financial liability applying the requirements in paragraph B3.3.6 of IFRS 9. These requirements are the same as those in paragraph AG62 of IAS 39. See [Agenda Paper 12G](#) for the November 2019 Board meeting for further details.

## Question 6 for the Board

### Question 6 for the Board

Does the Board agree with our recommendation in paragraph 60 of proposing an amendment to IFRS 4 to allow insurers applying the temporary exemption to apply the amendments and practical expedient in accounting for modifications directly required by IBOR reform?

**Appendix A – Extracts from IFRS 17**

A1. We have reproduced below paragraphs 72–73 and 76–77 of IFRS 17:

72 If the terms of an insurance contract are modified, for example by agreement between the parties to the contract or by a change in regulation, an entity shall derecognise the original contract and recognise the modified contract as a new contract, applying IFRS 17 or other applicable Standards if, and only if, any of the conditions in (a)–(c) are satisfied. The exercise of a right included in the terms of a contract is not a modification. The conditions are that:

- (a) if the modified terms had been included at contract inception:
  - (i) the modified contract would have been excluded from the scope of IFRS 17, applying paragraphs 3–8;
  - (ii) an entity would have separated different components from the host insurance contract applying paragraphs 10–13, resulting in a different insurance contract to which IFRS 17 would have applied;
  - (iii) the modified contract would have had a substantially different contract boundary applying paragraph 34; or
  - (iv) the modified contract would have been included in a different group of contracts applying paragraphs 14–24.
- (b) the original contract met the definition of an insurance contract with direct participation features, but the modified contract no longer meets that definition, or vice versa; or
- (c) the entity applied the premium allocation approach in paragraphs 53–59 or paragraphs 69–70 to the original contract, but the modifications mean that the contract no

longer meets the eligibility criteria for that approach in paragraph 53 or paragraph 69.

...

76 An entity derecognises an insurance contract from within a group of contracts by applying the following requirements in IFRS 17:

- (a) the fulfilment cash flows allocated to the group are adjusted to eliminate the present value of the future cash flows and risk adjustment for non-financial risk relating to the rights and obligations that have been derecognised from the group, applying paragraphs 40(a)(i) and 40(b);
- (b) the contractual service margin of the group is adjusted for the change in fulfilment cash flows described in (a), to the extent required by paragraphs 44(c) and 45(c), unless paragraph 77 applies; and
- (c) the number of coverage units for expected remaining coverage is adjusted to reflect the coverage units derecognised from the group, and the amount of the contractual service margin recognised in profit or loss in the period is based on that adjusted number, applying paragraph B119.

77 When an entity derecognises an insurance contract because it transfers the contract to a third party or derecognises an insurance contract and recognises a new contract applying paragraph 72, the entity shall instead of applying paragraph 76(b):

- (a) adjust the contractual service margin of the group from which the contract has been derecognised, to the extent required by paragraphs 44(c) and 45(c), for the difference between (i) and either (ii) for contracts transferred to a third party or (iii) for contracts derecognised applying paragraph 72:
  - (i) the change in the carrying amount of the group of insurance contracts resulting from the derecognition of the contract, applying paragraph 76(a).

- (ii) the premium charged by the third party.
  - (iii) the premium the entity would have charged had it entered into a contract with equivalent terms as the new contract at the date of the contract modification, less any additional premium charged for the modification.
- (b) measure the new contract recognised applying paragraph 72 assuming that the entity received the premium described in (a)(iii) at the date of the modification.