

STAFF PAPER

June 2020

IASB® meeting

Project	IBOR Reform and its Effects on Financial Reporting—Phase 2		
Paper topic	Feedback analysis—Modifications of financial assets and financial liabilities		
CONTACT(S)	Iliriana Feka	ifeka@ifrs.org	+44 (0) 20 7246 6482
	Elizabeth Figgie	efiggie@ifrs.org	+44 (0) 20 7246 6410
	Riana Wiesner	rwiesner@ifrs.org	+44 (0) 20 7246 6412
	Christos Sortsis	csortsis@ifrs.org	+44 (0) 20 7246 6964

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*.

1. Introduction

1. The International Accounting Standards Board (Board) published the Exposure Draft *Interest Rate Benchmark Reform—Phase 2 (Proposed Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)* (Exposure Draft) on 9 April 2020. The 45-day comment period closed on 25 May 2020.
2. As noted in Agenda Paper 14, this paper provides a detailed summary of feedback from comment letters on question 1 of the Exposure Draft, which relates to the proposed amendments for modifications of financial assets and financial liabilities.

2. Structure of this paper

3. This paper is structured as follows:
 - (a) Summary of staff recommendations (Section 3);
 - (b) Feedback received and staff analysis (Section 4); and
 - (c) Questions for the Board (Section 5)
4. This paper has one appendix: Appendix A—Analysis of other comments.

3. Summary of staff recommendations

5. We recommend that the Board make no substantial changes to the proposals in the Exposure Draft related to modifications of financial assets and financial liabilities. However, as explained more fully in the staff analysis we have identified some drafting suggestions that we will consider when preparing the final amendments (if the Board decides to proceed).

4. Feedback received and staff analysis

6. We have separately analysed feedback related to the following topics:
- (a) What constitutes a ‘modification’ of financial assets and financial liabilities (paragraphs 8-18);
 - (b) Practical expedient in IFRS 9 (paragraphs 19-26);
 - (c) Conditions for applying the practical expedient (paragraphs 27-52);
 - (d) Amendments to IFRS 4 and IFRS 16 (paragraphs 53-56); and
 - (e) Other comments (paragraph 57)
7. For each topic we provide:
- (a) a summary of the proposals in the Exposure Draft;
 - (b) a summary of the feedback received on those proposals; and
 - (c) staff analysis and recommendations.

4.1 What constitutes ‘modifications’ of financial assets and financial liabilities

Proposals in the Exposure Draft

8. Paragraph 6.9.2 of the Exposure Draft proposed that, for the purpose of applying the proposals in the Exposure Draft, a financial asset or financial liability is modified if the basis for determining the contractual cash flows is changed after the initial recognition of the financial instrument. Paragraph 6.9.2 also proposed that, in this context, a modification can arise even if the contractual terms of the financial instrument are not amended.

9. Paragraphs BC13–BC20 of the Basis for Conclusions on the Exposure Draft describe the Board’s reasons for these proposals. In particular, paragraph BC20 explains that the scope of the proposed amendment in paragraph 6.9.2 is limited to changes in the basis for determining the contractual cash flows made as a result of interest rate benchmark reform. The Board also noted that it will consider proposing a separate, narrow-scope amendment to the requirements in IFRS 9 for all modifications (Board’s possible future project).

Feedback

10. Many respondents broadly agreed with the description of modifications as proposed in paragraph 6.9.2 of the Exposure Draft. These respondents agreed with the accounting outcome of applying the practical expedient proposed in paragraph 6.9.3 of the Exposure Draft to the population of modifications as described in paragraph 6.9.2 in the context of interest rate benchmark reform or raised no specific concerns directly related to the effects of this proposal in that specific context.
11. Some of these respondents (such as bodies representing a group of national standard setters and organisations representing groups of regulators) explicitly supported the Board’s efforts in the Exposure Draft to help entities achieve consistent accounting outcomes for similar transactions, regardless of the transition’s legal form. They said the different wording used in IFRS 9 to refer to a ‘modification’ of a financial asset versus a ‘modification’ of a financial liability (as described in paragraph BC14 of the Basis for Conclusions on the Exposure Draft) could lead to different interpretations of what constitutes a modification.
12. However, some respondents disagreed with the proposed amendment in paragraph 6.9.2 of the Exposure Draft. They said describing what constitutes a modification of financial assets or financial liabilities is not necessary to meet the objective of the practical expedient proposed in paragraph 6.9.3 of the Exposure Draft. The most prevalent reasons for disagreeing were as follows:
- (a) *Lack of diversity in practice.* These respondents said that what constitutes a modification is well understood and consistently applied in practice. Some of these respondents said, in practice, they consider that a modification of a financial instrument arises only when there is a change

in the instrument's contractual terms. These respondents said this interpretation provides an objective, verifiable and auditable framework for determining whether a modification has occurred.

(b) *Potential consequences if the proposed amendment is applied by analogy.* These respondents were primarily concerned that, given IFRS 9 does not describe what constitutes a 'modification', preparers may inappropriately apply this amendment by analogy to circumstances beyond the context of interest rate benchmark reform. One respondent suggested that the Board explicitly specify that this amendment cannot be applied by analogy to other circumstances.

13. Many respondents made drafting suggestions that they thought would improve the clarity of the proposed amendments in this section of the Exposure Draft. Those comments relate to the distinction the Board makes between a 'modification', as described in paragraph 6.9.2 of the Exposure Draft, and 'other changes' in the basis for determining contractual cash flows, as described in paragraph 6.9.5 of the Exposure Draft. Some respondents suggested that the Board use a single term (or label) to capture both of these populations of changes in order to simplify the articulation and drafting of the proposed amendments.

Feedback on the Board's possible future project

14. Several respondents expressed their views on the Board's possible future project described in paragraph 9 of this paper. Since these comments are beyond the scope of the amendments proposed in the Exposure Draft, we have not analysed them further in this paper. We will consider them when the Board discusses that future project.

Staff analysis and recommendations

15. We continue to agree with the Board's reasons underpinning the proposed amendment in paragraph 6.9.2 of the Exposure Draft—that is, changes in the basis for determining contractual cash flows with equivalent economic effects should be accounted for consistently. As noted in paragraph BC17 of the Basis for Conclusions on the Exposure Draft, applying the proposals for modifications of financial instruments only to cases in which the contractual terms of the financial instrument are amended would mean that the form rather than the substance of the

change determines the appropriate accounting treatment. We think this would be an inappropriate outcome and would not provide useful information to users of financial statements.

16. We also think that describing what constitutes a modification in the context of interest rate benchmark reform is helpful to clearly articulate the scope of the practical expedient in paragraph 6.9.3 of the Exposure Draft. Consistent with the feedback summarised in paragraph 11 of this paper, we think describing a modification as proposed in paragraph 6.9.2 of the Exposure Draft reduces the risk of inconsistencies arising as a result of the differences in wording for financial assets and financial liabilities in IFRS 9, therefore, resulting in consistent accounting outcomes—such that the economic effects of a change arising as a result of interest rate benchmark reform are not hidden or obscured by the form of the change.
17. That said, we agree with the comments described in paragraph 13 of this paper that the description of the population that is in the scope of the practical expedient in paragraph 6.9.3 of the Exposure Draft could be articulated more clearly. For example, the Board could consider referring to this cumulative population (ie the ‘modifications’ described in paragraph 6.9.2 and the ‘other changes’ described in paragraph 6.9.5) using a common term or wording—eg ‘changes in the basis for determining contractual cash flows required by interest rate benchmark reform’, or a shortened version thereof.
18. For the avoidance of doubt, the possible drafting improvement described in paragraph 17 would not change the population that is in the scope of the practical expedient in paragraph 6.9.3 of the Exposure Draft. Rather, the aim of that drafting improvement would be to simplify and streamline the wording in paragraphs 6.9.2 and 6.9.5.

4.2 Practical expedient in IFRS 9

Proposals in the Exposure Draft

19. Paragraph 6.9.3 of the Exposure Draft proposed an entity would be required to apply paragraph B5.4.5 of IFRS 9, as a practical expedient, to account for a modification of a financial asset or financial liability that is required by interest rate

benchmark reform. The proposed conditions for applying the practical expedient are described in paragraph 27 of this paper.

20. Paragraph 6.9.5 of the Exposure Draft proposed an entity also would be required to apply the practical expedient proposed in paragraph 6.9.3 if an existing contractual term is activated and that contractual term changes the basis for determining the contractual cash flows. The proposed conditions for applying the practical expedient in these circumstances are also described in paragraph 27.
21. Paragraph 6.9.6 of the Exposure Draft proposed that if there are changes to the basis for determining the contractual cash flows of a financial asset or financial liability in addition to changes required by interest rate benchmark reform, an entity would be required to first apply the practical expedient in paragraph 6.9.3 to the changes required by interest rate benchmark reform. The entity would then apply the applicable requirements in IFRS 9 to the additional changes. If the additional changes result in the derecognition of the financial asset or financial liability, the derecognition requirements would apply.

Feedback

22. Almost all respondents expressed support for the proposed practical expedient. They agreed that accounting for changes to the basis for determining the contractual cash flows of a financial asset or financial liability required by interest rate benchmark reform by applying paragraph B5.4.5 of IFRS 9 provides an appropriate accounting outcome for the reasons explained in paragraph BC26 of the Basis for Conclusions on the Exposure Draft.
23. Respondents said the practical expedient would provide significant relief to preparers while enabling them to continue providing useful information to users of financial statements about financial assets and financial liabilities which reference interest rate benchmarks subject to the reform.
24. There was also general support for the proposed amendment in paragraph 6.9.5 of the Exposure Draft that would extend the application of the practical expedient to changes required by interest rate benchmark reform that arise from the activation of existing contractual terms (for example, an existing fallback clause is triggered). Respondents said that applying the practical expedient to such changes will result in

consistent accounting and comparability across all changes required by interest rate benchmark reform.

25. Respondents also agreed with the proposal in paragraph 6.9.6 of the Exposure Draft. However, some respondents noted that the wording in paragraph BC35 of the Basis for Conclusions on the Exposure Draft, which explained the Board's reasons for that proposal, seemed slightly different from the wording in paragraph 6.9.6 itself and suggested that the wording in those two paragraphs is aligned to avoid any confusion.

Staff analysis and recommendations

26. We recommend the Board finalise the proposed amendments described in paragraphs 19-21 of this paper related to the practical expedient. We will consider respondents' suggestion about the wording in paragraphs 6.9.6 and BC35 in drafting the final amendments.

4.3 Conditions for applying the practical expedient

Proposals in the Exposure Draft

27. Paragraphs 6.9.3 and 6.9.5 of the Exposure Draft proposed that a modification, or a change in the basis for determining the contractual cash flows arising from the activation of an existing contractual term, is required by interest rate benchmark reform (and therefore is within the scope of the practical expedient) if and only if:
- (a) it is required as a direct consequence of interest rate benchmark reform; and
 - (b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the modification).
28. Paragraph 6.9.4 of the Exposure Draft provided examples of modifications required by interest rate benchmark reform.
29. Paragraph BC28 of the Basis for Conclusions on the Exposure Draft explained that consistent with the objective of Phase 2—which is to assist entities in providing useful information to users of financial statements and to support preparers in applying IFRS Standards when changes are made to contractual cash flows or

hedging relationships, as a result of the transition to alternative benchmark rates—the Board considered only those changes that are required as a direct consequence of the reform. Furthermore, as the objective of the interest rate benchmark reform is limited to the transition to alternative benchmark rates, ie the objective of the reform does not encompass other changes that would lead to value transfer between parties to the financial instrument, the Board also decided that the proposals should apply only when the new basis for determining the contractual cash flows is economically equivalent to the previous basis (economic equivalence condition).

30. Paragraph BC29 in the Basis for Conclusions on the Exposure Draft explains that, in discussing whether the concept of economic equivalence was appropriate, the Board considered circumstances in which an entity makes changes required as a direct consequence of the interest rate benchmark reform in a way so that the overall contractual cash flows (including the interest rate) of the financial instrument are *substantially similar* before and after the modification.

Feedback

31. Almost all respondents agreed with the Board’s reasons underpinning the two conditions that must be met in order to apply the proposed practical expedient (reproduced in paragraph 19 of this paper). However, many respondents asked the Board to develop more examples, application guidance or clarify aspects of those conditions. In the following paragraphs in this section we provide details of those comments.

Direct consequence of interest rate benchmark reform

32. Respondents broadly agreed that the proposed amendments should apply only to changes in the basis for determining contractual cash flows that are a direct consequence of interest rate benchmark reform. However, some respondents asked the Board to clarify some of the wording used in the Exposure Draft such as ‘a direct consequence of’ or ‘required by’ interest rate benchmark reform.
33. Some respondents asked whether the practical expedient would apply even if the transition to alternative benchmark rates is not necessarily *required* by law, regulation or because the existing interest rate benchmark is being discontinued. For example, some respondents said some existing interest rate benchmarks

prevalent in their jurisdictions are not being discontinued (or at least not in the near future), but nonetheless, entities are expected to voluntarily effect interest rate benchmark reform, ie they are expected to transition to alternative benchmark rates in anticipation of the reduced liquidity of the existing benchmark or to align with global market developments. They suggested the Board clarify that the proposed amendments could also apply in these situations.

34. Some other respondents asked what type of changes would be in the scope of the practical expedient. Said differently, these respondents asked what changes are considered to be ‘required as a direct consequence’ of interest rate benchmark reform; and therefore, could be within the scope of the practical expedient.
35. More specifically, a few of these respondents said that an entity may decide to make particular changes to a financial instrument—as part of its overall process to effect interest rate benchmark reform—that are not *required* for the purpose of effecting interest rate benchmark reform in that respective jurisdiction. Instead the entity may decide to make such changes as a result of entity-specific circumstances, motivated by economic reasons in the context of interest rate benchmark reform. For example, replace an existing interest rate benchmark with a fixed interest rate or an entity’s cost of funding; or addition of payments that are indexed to the price of entity’s equity. These respondents suggested the Board extend the practical expedient to apply to such changes on the basis that they are related to (but not required by) interest rate benchmark reform.

Economic equivalence

36. Many respondents said that the Exposure Draft introduced the notion of ‘economic equivalence’, which is critical for determining when the practical expedient applies. Therefore, they suggested the final amendments:
 - (a) *explain the concept of ‘economic equivalence’ further and provide application guidance or illustrative examples.* Many respondents said, at a minimum, the Board should explicitly specify whether entities are expected to exercise judgement when assessing if the economic equivalence condition is met; and whether entities are required to perform a quantitative assessment in all cases or if a qualitative

assessment would suffice (and if so, in what circumstances). Further suggestions included:

- (i) if the condition requires a quantitative assessment, specify how an entity should perform it; eg whether an entity would need to determine whether the discounted present value of the cash flows is substantially similar before and after the transition and whether the spread adjustment used in the derivative markets could be a reference point for cash market products;
 - (ii) include the description in paragraph BC29 of the Basis for Conclusions on the Exposure Draft of economic equivalence in the amendments themselves; and
 - (iii) describe economic equivalence by reference to another concept—eg that the change in the basis for determining the contractual cash flows is expected/intended to result in no net transfer of economic value.
- (b) *include a rebuttable presumption.* Respondents suggested including a rebuttable presumption in the final amendment that the economic equivalence condition is met in particular scenarios, such as one in which a fixed spread is added to compensate for a basis difference between an existing interest rate benchmark and an alternative benchmark rate based on a framework established by an industry group or regulatory guideline.

37. Some of these respondents also highlighted a potential issue with the application of the economic equivalence condition in the context of what they referred as ‘historical fallback clauses’ that exist in some contracts. For example, such fallback clauses might refer to a central bank rate (+ a fixed spread) or fix the interest rate to the last available interest rate benchmark.

38. Respondents said these historical fallback clauses could be activated as a direct consequence of interest rate benchmark reform and change the basis for determining the contractual cash flows. However, they said that the new basis would not be economically equivalent to the basis immediately preceding the activation. Consequently, the entity would not be eligible to apply the practical

expedient in paragraph 6.9.3 of the Exposure Draft and thus the entity would be required to apply existing requirements in IFRS 9.

39. These respondents said the activation of these ‘historical fallback clauses’ would be an interim step until the underlying terms of a contract are modified to refer to an alternative benchmark rate. They suggested extending the proposed practical expedient to apply to these situations by suspending or changing how the economic equivalence condition set out in paragraph 6.9.5(c) of the Exposure Draft would be applied in such cases. They expressed the view that recognising a modification gain or loss would not faithfully represent the economic effects related to this interim step in effecting interest rate benchmark reform.

Staff analysis and recommendations

Direct consequence of interest rate benchmark reform

40. With respect to the comments described in paragraph 33 of this paper, we note that while the interest rate benchmark reform¹ has a regulatory context, in our view, the Board did not intend to capture only those situations in which effecting interest rate benchmark reform is required by law, regulation or when the existing interest rate benchmark is being discontinued.
41. We note that, in Phase 2, the Board addresses issues that might affect financial reporting during *the reform of an interest rate benchmark*. Accordingly, we think the Board did not intend to limit the practical expedient to only particular ways of effecting interest rate benchmark reform, provided the interest rate benchmark reform is consistent with the description in paragraphs 6.8.2 of IFRS 9 and 102B of IAS 39.
42. Also, for the avoidance of doubt, we note that when the Exposure Draft uses the phrases ‘changes required by’, or ‘changes that are a direct consequence of’ interest rate benchmark reform, it means that the **changes are required** (to effect interest rate benchmark reform) or the **changes are a direct consequence of** (interest rate

¹ As described in paragraphs 6.8.2 of IFRS 9 and 102B of IAS 39, the term ‘interest rate benchmark reform’ refers to the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations set out in the Financial Stability Board’s July 2014 report ‘Reforming Major Interest Rate Benchmarks’, available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

benchmark reform); these phrases are not meant to imply that the interest rate benchmark reform itself is necessarily required.

43. The proposed condition that requires changes to be a direct consequence of interest rate benchmark reform is intended to capture changes in the basis for determining contractual cash flows that are necessary for—or said differently, are a direct result of—effecting interest rate benchmark reform. As described in paragraph BC28 of the Basis for Conclusions on the Exposure Draft, this approach is consistent with the objective of Phase 2 (reproduced in paragraph 29 of this paper).
44. Therefore we do not agree with the view described in paragraph 35 that the scope of the practical expedient in paragraph 6.9.3 of the Exposure Draft should extend to changes that an entity chooses to make but are not required as a direct consequence of interest rate benchmark reform. We think such changes are akin to what is contemplated by paragraphs 6.9.6 and BC35 of the Exposure Draft. Paragraph BC35 of the Basis for Conclusions on the Exposure Draft specifically notes that if, during negotiations with counterparties to agree changes to the contractual cash flows required by the reform, entities at the same time make changes to the contractual terms that are not a direct consequence of the interest rate benchmark reform, entities would account for such other changes applying paragraph 5.4.3 or paragraph B5.4.6 of IFRS 9.
45. Accordingly, we recommend that the Board does not change this condition. However, we will consider whether any drafting improvements could enhance the understandability of the terms used. For example, consider including clarifications consistent to what is described in paragraphs 40-42 of this paper.

Economic equivalence

46. With respect to the comments in paragraph 36 of this paper, the staff note that the Board intended the notion of ‘economic equivalence’, as described in the Exposure Draft, to be principle-based and therefore intentionally did not include detailed application guidance. Paragraphs BC28 and BC29 of the Basis for Conclusions on the Exposure Draft explain what the Board considered when it developed that condition. The concept of economic equivalence focuses on outcomes in which the overall contractual cash flows (including the interest rate) of the financial instrument would be substantially similar before and after the modification.

47. The Board acknowledged that interest rate benchmark reform would be effected differently in different jurisdictions. For this reason, the Board did not require a particular approach to assess that condition. Paragraph 6.9.4 of the Exposure Draft provides a non-exhaustive list of examples for this purpose.
48. We continue to agree with the Board’s view that it would not be possible to address every situation. We think prescribing a particular approach or attempting to develop an exhaustive list of examples or more detailed application guidance would be unhelpful for the reason noted in paragraph 47 above, and indeed could be interpreted as the only appropriate approach in every case or have other unintended consequences. Accordingly, we recommend not doing so.
49. Nonetheless, consistent with some respondents’ suggestions, we will consider whether the amendments could better explain the concept of economic equivalence. Such drafting improvements could include:
- (a) an acknowledgement that, depending on the particular changes required by interest rate benchmark reform, a qualitative assessment may be sufficient. Furthermore, making the changes specified in paragraph 6.9.4 of the Exposure Draft does not require a further assessment, either quantitative or qualitative, since such changes meet the conditions in paragraphs 6.9.3 and 6.9.5(b)–6.9.5(c) of the Exposure Draft; and
 - (b) highlighting that there are no ‘bright lines’ for what is considered to be economically equivalent, therefore, it is necessary for an entity to make an assessment about the economic equivalence condition (ie other than for changes specified in paragraph 6.9.4). This was acknowledged when the Board proposed paragraph 24J(c) of the draft amendments to IFRS 7 in the Exposure Draft—this paragraph proposed that entities would be required to disclose information including any significant judgements made in assessing whether the conditions in paragraphs 6.9.3 and 6.9.5(b)–6.9.5(c) were met.
50. With respect to feedback described in paragraphs 37-39 of this paper, we acknowledge the challenges related to the activation of the ‘historical fallback clauses’. We understand the matter applies only to legacy contracts for which an entity does not amend the contractual terms to replace the existing interest rate

benchmark with an alternative benchmark rate before the former is discontinued and the basis resulting from the activation of the historical fallback clause is not economically equivalent to the previous basis.

51. While the change triggered by the activation of a historical fallback clause may be an interim step, we agree with respondents that such a change would need to meet the economic equivalent condition in paragraph 6.9.5(c) of the Exposure Draft in order for it to be eligible for the proposed practical expedient. This is consistent with the explanation in paragraph BC101 of the Basis for Conclusions in the Exposure Draft, which acknowledges that there could be situations in which there are more than one change to the basis for determining the contractual cash flows required by the reform and, as each change is made, an entity would be required to apply the proposed amendments in paragraphs 6.9.3–6.9.6 of the Exposure Draft to account for that change.

52. We recommend that the Board does not change or suspend the economic equivalence condition proposed in paragraph 6.9.5(c) of the Exposure Draft in these circumstances for the following reasons:
 - (a) changing or suspending the requirement in paragraph 6.9.5(c) would create an exception to economic equivalence condition. We note that there could be challenges in scoping such an exception; and defining a temporary period which would, by nature, be arbitrary.
 - (b) as described in paragraph 39 of this paper, these fallback clauses were not designed to contemplate interest rate benchmark reform. Instead, they represent an interim step until the entity makes the changes required by interest rate benchmark reform; consequently, accounting for the changes in the basis for determining contractual cash flows that arise from the activation of these fallback clauses could be inconsistent with the objective of the practical expedient proposed in paragraph 6.9.3 of the Exposure Draft.
 - (c) in absence of information indicating that this is a widespread issue we think it is insufficiently prevalent to justify making an exception to the economic equivalence condition.

4.4 Amendments to IFRS 4 and IFRS 16

Proposals in the Exposure Draft

53. The Exposure Draft proposed to make corresponding amendments to IFRS 4, which would require insurers applying the temporary exemption from IFRS 9 to apply the same practical expedient as described in paragraph 6.9.3 of the Exposure Draft.
54. The Exposure Draft also proposed amendments to IFRS 16 that would require entities to apply paragraph 42 of IFRS 16 to account for a lease modification that is required by interest rate benchmark reform.

Feedback

55. Almost all respondents agreed with these proposals for the reasons set out in the Basis for Conclusions on the Exposure Draft. Respondents said these proposals support consistent accounting and comparability of the effects of modifications required by interest rate benchmark reform across all affected entities regardless of the industry in which entities operate.

Staff analysis and recommendations

56. The staff, therefore, recommend the Board finalise these amendments as proposed in the Exposure Draft.

Other comments

57. Appendix A to this paper summarises other comments received, together with our analysis of those comments. By comparison, the comments in Appendix A represent a mixture of different suggestions, clarifying or editorial in nature. Based on our analysis of those comments, we recommend no substantial changes to the proposed amendments. However, the staff will consider some suggested drafting improvements.

5. Questions for the Board

Questions for the Board

1. Do Board members have any questions on the feedback received or staff analysis on this agenda paper?
2. Does the Board agree with the staff recommendations to finalise without substantial changes the proposals set out in the draft amendments to IFRS 9, IFRS 4 and IFRS 16 in the Exposure Draft with respect to modifications of financial assets and financial liabilities? As explained in this agenda paper, we will consider some drafting suggestions when preparing the final amendments.

Appendix A—Analysis of other comments

A1. This table summarises other comments on modifications required by interest rate benchmark reform, together with our analysis and conclusions.

Feedback	Staff analysis	Recommendations
Location of the proposed amendments on modifications of financial assets and financial liabilities (paragraphs 6.9.3-6.9.6 of the Exposure Draft)		
<p>Some respondents suggested the Board move these proposed amendments from Chapter 6 to another location in IFRS 9. Specifically, these respondents were concerned that putting these amendments in Chapter 6 would have the effect that they would be unavailable to entities that apply the hedge accounting requirements in IAS 39 instead of IFRS 9. Most respondents suggested the Board move these amendments to Section 5.4 Amortised cost measurement in Chapter 5 Measurement.</p>	<p>We acknowledge that the proposed location of these draft amendments may not be a ‘natural’ location given these amendments relate to the measurement of financial assets and financial liabilities, rather than hedge accounting.</p> <p>These proposals were inserted into Chapter 6 in the Exposure Draft so that all of the amendments related to interest rate benchmark reform would be together.</p> <p>For the avoidance of doubt, these proposed amendments were intended to be available to entities that apply the hedge accounting requirements in IAS 39. Consequently, the staff will consider changing the location during drafting of the amendments.</p>	<p>The staff will consider this matter as part of drafting the final amendments.</p>
Application of the practical expedient (paragraph 6.9.3 of the Exposure Draft)		
<p><i>(a) The term ‘practical expedient’</i></p> <p>Without disagreeing with the accounting outcome resulting from applying the practical expedient set out in paragraph 6.9.3, a few respondents questioned whether ‘practical expedient’ is the appropriate term to describe the requirement to apply B5.4.5 of IFRS 9 in accounting for changes required by interest rate benchmark reform.</p> <p>As a related point, these respondents also said that the wording in paragraph BC25 in the Basis for Conclusions on the Exposure Draft implies a narrower view on the application of paragraph B5.4.5 of IFRS 9 compared to what may exist in practice.</p> <p>In their view, given that paragraph B5.4.5 of IFRS 9 applies to floating-rate financial instruments when the cash flows are re-estimated to reflect changes in market rates of interest, in some cases, that paragraph might ordinarily apply. Some said that the term ‘practical expedient’ is more appropriate to describe an option, rather than a requirement.</p>	<p>We continue to think that describing the accounting treatment set out in paragraph 6.9.3 as a ‘practical expedient’ remains appropriate. Consistent with the discussion in the Basis for Conclusions on the Exposure Draft related to this practical expedient, we note that paragraph 6.9.3 proposes that B5.4.5 of IFRS 9 is applied to changes in contractual cash flows that it <i>ordinarily</i> would not have applied to. This is the primary reason stakeholders asked the Board to consider this amendment.</p> <p>Furthermore, paragraph BC29 of the Basis for Conclusions on the Exposure Draft explained that in developing the practical expedient, the Board considered circumstances in which an entity makes modifications required as a direct consequence of the interest rate benchmark reform in a way such that applying either paragraph B5.4.5 of IFRS 9 or paragraphs 5.4.3 or B5.4.6 of IFRS 9 would have resulted in similar accounting outcomes, as it is unlikely that the resulting modification gain or loss would have been significant.</p> <p>Nonetheless, the practical relief that the Board provided is such that for changes in the basis for determining contractual cash flows that meet the conditions in paragraphs 6.9.3 or 6.9.5(b)-6.9.5(c) of the Exposure Draft, the entity would not be required to further assess the effect of such changes (for example, the entity would not be required to assess whether such changes result with derecognition of the affected financial instrument).</p> <p>In our view, this simplified approach fits the description of practical expedient.</p>	<p>We recommend no change to the term ‘practical expedient’ in paragraph 6.9.3 of the Exposure Draft.</p> <p>The staff will, however, consider drafting improvements to the wording in paragraph BC25 of the Basis for Conclusions on the Exposure Draft.</p>

Feedback	Staff analysis	Recommendations
<p><i>(b) The practical expedient and derivatives</i></p> <p>A few respondents asked the Board to clarify that the practical expedient in paragraph 6.9.3 <i>does not</i> apply to derivatives. These respondents were primarily concerned that—if this is not clarified—there is a risk that changes in the fair value of modified derivatives would not be recognised immediately in profit or loss.</p>	<p>The application of the practical expedient in paragraph 6.9.3 of the Exposure Draft was not intended to apply to derivatives.</p> <p>The practical expedient in paragraph 6.9.3 requires entities to apply paragraph B5.4.5 of IFRS 9 to account for a modification of a financial asset or financial liability. Paragraph B5.4.5 of IFRS 9 applies to financial instruments that are measured using the effective interest method—the method used to calculate amortised cost and in the allocation and recognition of interest revenue or interest expense in profit or loss over the relevant period.</p>	<p>The staff think that changing the location of the proposed amendments as described above would clarify and emphasise their link to amortised cost measurement.</p>
<p><i>(c) The practical expedient and hybrid contracts</i></p> <p>A few respondents asked the Board to acknowledge that the practical expedient also applies to hybrid financial liabilities that have been separated into a host contract (measured at amortised cost) and an embedded derivative (measured at fair value through profit or loss). Specifically, in these situations the interest rate benchmark may not be a contractual term of the financial instrument but is imputed at initial recognition for the purpose of separating the embedded derivative.</p> <p>For example, an entity may have separated an issued equity-linked note into a 3-month GBP LIBOR floating rate host contract with a receive 3-month GBP LIBOR, pay GBP equity index.</p>	<p>We note that interest rate benchmarks are used when determining the floating interest rate on a host contract with the same interest rate benchmark used for the floating leg of the separated embedded derivative.</p> <p>Applying paragraph 6.9.2 of the Exposure Draft, in the context of interest rate benchmark reform, a financial asset or financial liability is modified if the basis for determining the contractual cash flows is changed after the initial recognition of the financial instrument regardless of whether the contractual terms of the financial instrument are amended.</p> <p>Therefore, it would follow that if the transition of an imputed interest rate benchmark to an alternative benchmark rate changed the basis for determining the contractual cash flows—and if the conditions set out in paragraph 6.9.3 of the Exposure Draft are met— then the proposed practical expedient would apply.</p>	<p>The staff will consider this suggestion during drafting the final amendments.</p>