STAFF PAPER

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IASB® meeting

Project	**IBOR Reform and its Effects on Financial Reporting—Phase 2**
Paper topic	Feedback analysis—Designation of risk components

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1. Introduction

1. The 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 for this meeting the purpose of this paper is to summarise the feedback on Question 4 of the Exposure Draft related to designation of risk components. Specifically, that an alternative benchmark rate is deemed to be separately identifiable if an entity has a reasonable expectation that it will satisfy the requirement within 24 months from the date it is designated.

3. This paper is structured as follows:

   (a) Summary of staff recommendations (paragraph 4);

   (b) Summary of the proposals in the Exposure Draft (paragraphs 5–7);

   (c) Feedback received (paragraphs 8–17);

   (d) Staff analysis and recommendations to clarify the proposed amendments (paragraphs 18–30); and

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(e) Question for the Board (Section 6).

2. Summary of staff recommendations

4. The staff recommends finalising the proposals in the Exposure Draft, subject to clarifying that the 24-month period applies to the individual alternative benchmark rate and hence, begins from the date that an entity designates a particular alternative benchmark rate as the hedged risk for the first time.

3. Proposals in the Exposure Draft

5. The Exposure Draft proposed in paragraphs 6.9.16 and 102Y that an alternative benchmark rate designated as a non-contractually specified risk component that is not separately identifiable at the date it is designated, would be deemed to have met that requirement at that date, if and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within a period of 24 months from the date the alternative benchmark rate is designated as a risk component.

6. Paragraphs 6.9.17 and 102Z further stated that if subsequent to designation of the risk component, an entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months, the entity would discontinue hedge accounting prospectively from the date of that reassessment.

7. The Exposure Draft also proposed that these requirements apply to new hedging relationships in which an alternative benchmark rate is designated as a risk component.

4. Feedback received from comment letters

8. Most respondents agreed with the proposals in paragraphs 6.9.16–6.9.17 and 102Y–102Z as they consider the relief to allow sufficient time for alternative benchmark rates to become established. They also noted that the relief would ensure that entities that seek to move to alternative benchmark rates early are not unduly disadvantaged relative to those that wait until the alternative benchmark rates are

more established. Respondents also agree with the Board's statement in paragraph BC97 of the Exposure Draft that any relief from the separately identifiable requirement in Phase 2 should be temporary in nature.

9. However, some respondents commented that although they agree with the proposed amendments, the proposed wording in paragraph BC87 of the Exposure Draft could be interpreted to create a higher threshold for satisfying the separately identifiable requirement than they believe is required by IAS 39 and is in their view not aligned to the current market practice.

10. Some respondents specifically commented on the 24-month relief period, including the time limit of 24 months; clarification of the date from which the relief applies; and when reassessment must be performed. Although the Exposure Draft did not include any proposed amendments with respect to the requirement for a risk component to be reliably measurable, a few respondents also specifically commented on this. The following sections provide more details on these comments.

4.1 Time limit of 24 months

11. Many respondents commented that limiting the temporary relief to a 24-month period is not expected to be an impediment for timely transition to alternative benchmark rates and that in absence of such a relief period, or if the relief period would be significantly shorter than the proposed 24-month period, it would be more challenging for entities to designate such a risk component when transitioning to alternative benchmark rates in the early stages of the reform.

12. However, although some respondents agreed that the proposed relief would support entities applying the hedge accounting requirements in IFRS 9 and IAS 39, they disagreed with the proposed time limit of 24 months for reasons that included:

    (a) it would not support aligning hedge accounting with an entity's risk management objective.

    (b) 24 months may be too short a period for a new market to be developed for an alternative benchmark rate.

    (c) the development of a new market in an alternative benchmark rate could be delayed by unforeseeable events such as Covid-19;

(d) the 24-month period is an arbitrary period and in absence of information suggesting this period aligns with the development of markets for alternative benchmark rates, it is not possible to determine that it would be sufficient.

13. Respondents suggested alternative approaches for the Board to consider, which included:

(a) instead of proposing a set time limit, require an entity to have a reasonable expectation that the alternative benchmark rate will eventually become separately identifiable.

(b) include a rebuttable presumption that alternative benchmark rates that have been published by the relevant national regulators or supervisory bodies that are tasked with the reform in respective jurisdictions, are considered separately identifiable. Such a presumption would be rebutted only when there is evidence that the relevant benchmark rate is unrepresentative of interest rate risk in the respective market structure.

(c) any rate that is deemed a risk-free rate should be available to be designated as a separately identifiable component as such a rate would necessarily be considered a building block of a contractually specified rate in that currency.

(d) in light of the Covid-19 pandemic extend the relief period to 36-months to allow sufficient time for the market to develop.

14. A few respondents did not raise any concerns about the 24-month period or made alternative suggestions, however, they recommended that the Board actively monitors ongoing developments and take appropriate action such as extending the period if deemed necessary at a later date.

4.2 Date from which relief applies and subsequent reassessment

15. Although most respondents agreed with the proposed amendment in paragraphs 6.9.17 and 102Z, some respondents asked the Board to consider confirming the following matters in drafting the final amendments:

(a) hedge accounting is only discontinued when an entity no longer has a reasonable expectation that the alternative benchmark rate will be separately identifiable at the end of the 24-month period.

(b) the reassessment of an entity's expectation with regards to designation of the alternative benchmark rate as a risk component could be done at each reporting date as opposed to during the reporting period; and

(c) an entity should apply the existing requirements for the discontinuation of hedge accounting.

16. A few respondents also raised concerns about the date from which the 24-month relief period starts to apply. These respondents were particularly concerned about the relief starting and ending at different times for entities within the same jurisdiction or the operational challenges if it is applied on a hedge-by-hedge basis. Respondents asked the Board to clarify how the 24-month period would be applied, for example:

(a) on hedge-by-hedge basis (ie to each hedge designation individually);

(b) on a rate-by-rate basis (ie the date when an entity first designates a particular alternative benchmark rate as a hedged risk);

(c) from the beginning of the reporting period in which an entity first applies the amendments instead of a specific date a hedging relationship is designated; or

(d) from the same date for all entities within the same jurisdiction.

4.3 Reliable measurement

17. A few respondents commented on the fact that the Exposure Draft did not propose an equivalent relief from the requirement of a risk component being reliably measurable. These respondents noted that generally the separately identifiable and reliably measurable requirements for designating a risk component are linked so that typically either both or none are met. Therefore, granting relief only from the separately identifiable requirement might in some situations result in an alternative benchmark rate not being eligible to be designated as risk component. However, some of these respondents also noted that reliable measurement is one of the key principles of hedge accounting and, consequently, any exception from a component

being reliably measurable could undermine the objective and discipline of hedge accounting and result in information with little, or no, information value to users of financial statements. The respondents therefore agreed that, from a conceptual perspective, it is difficult to grant robust relief from the basic principle of reliable measurement. However, a few respondents commented that in their view, guidance or examples illustrating cases where a risk component can be reliably measured but not separately identifiable, should be provided.

5. Staff analysis and recommendations

18. The staff note that the intention of the proposed amendment in the Exposure Draft was to provide entities with temporary relief from having to satisfy the separately identifiable requirement for hedging relationships in which an alternative benchmark rate is designated as a hedged risk. The intention was not for the proposed amendments to be interpreted as changing the current requirements in IFRS 9 or IAS 39 in this regard. In addition, the proposed amendments would only apply if an alternative benchmark rate does not satisfy the separately identifiable requirement at the date it is designated. In other words, if an alternative benchmark rate meets the requirements to be separately identifiable when it is designated as the hedged risk, the proposed relief in paragraphs 6.9.16–6.9.17 and 102Y–102Z of the Exposure Draft do not apply to such a rate.

5.1 Time limit of 24 months

19. The Board acknowledged in paragraph BC94 of the Exposure Draft that a period of 24 months may seem like an arbitrary period, however the Board is of the view that a clearly defined end point is necessary given the temporary nature of the proposed amendment. The Board also stated in paragraph BC97 that the proposed amendment is different from the Phase 1 exception because an alternative benchmark rate to which the proposed Phase 2 relief applies has not yet satisfied the separately identifiable requirement as a non-contractually specified risk component. For these reasons, the Board considered that any relief from the separately identifiable requirement should be intentionally short-lived to maintain the robustness of the hedge accounting requirements in IFRS 9 and IAS 39.

20. The staff have considered the alternatives suggested by respondents, but are not recommending making substantial changes to the proposed amendments for the following reasons:

(a) requiring a non-contractually specified risk component to be considered separately identifiable on the basis that the alternative benchmark will eventually meet the requirements, lacks a clearly defined end point. If relief was to be provided on this basis, such relief would not be temporary in nature as it is unclear at which point the rate will no longer eventually meet the requirements.

(b) including a rebuttable presumption that any alternative benchmark rate that has been published by the relevant national regulator or supervisory body that is tasked with the reform in a jurisdiction, is considered separately identifiable, would be inconsistent with the current requirements in IFRS 9 and IAS 39, which do not include a similar rebuttable presumption. Given the temporary nature of the intended relief, it is unclear how such rebuttable presumption could be short-lived, what the end date for the rebuttable presumption would be and how an entity would transition from the rebuttable presumption to the current requirements in IFRS 9 and IAS 39 when the presumption no longer applies.

(c) it is questionable whether requiring any risk-free rate to be a separately identifiable component would provide any additional relief from the requirement as paragraph 81 of IAS 39 includes a risk-free interest rate as an example of an identifiable portion of the interest rate exposure of an interest-bearing asset or liability.

21. We have considered the suggestions to extend the relief period to 36 months, especially in the context of the Covid-19 pandemic and the potential delays this may cause to the transition to alternative benchmark rates. However, prior to publishing the Exposure Draft, we have consulted with some regulators, national standard-setters and banking industry groups to determine whether the timelines and target dates for the reform have been delayed as a result of the pandemic. The unanimous message we received was that there were no planned delays to the

formal target dates set for the reform and that the urgency of finalising the Phase 2 relief has not decreased. We also note that the intention of the 24-month relief period is that it is up to an entity to decide when that period starts, therefore if there are delays in the market for a particular alternative benchmark rate, an entity could delay the designation of a rate that does not meet the requirements. Lastly, we considered that the threshold for having a reasonable expectation is relatively high, therefore we do not think it would be appropriate to require entities to have such an expectation over a period longer than 24 months. We therefore do not consider this to be a viable alternative.

22. The staff continue to agree with the reasons set out in BC94 of the Exposure Draft for setting the time limit at 24 months and we do not recommend any substantial changes to the proposed time limit of 24 months.

5.2 Date from which relief applies and subsequent reassessment

23. The staff agree with respondents that the proposed wording in paragraphs 6.9.16 and 102Y could lead to different interpretations about the date from which the proposed relief from the separately identifiable requirement should be applied. In our view, there are two possible interpretations; (a) that the relief should be applied to individual hedging relationships; or (b) on a rate-by-rate basis, ie from the date an entity designates a particular alternative benchmark rate as a hedge risk for the first time.

24. It could be argued that the 24-month period should be applied to individual hedging relationships, ie on a hedge-by-hedge basis as this is the basis on which hedging relationships are designated. For each new hedge designation, an entity must assess whether the qualifying criteria to apply hedge accounting, including the separately identifiable requirement, have been met. However, we considered that if the period starts to apply to different hedging relationships (that have designated the same alternative benchmark rate as a risk component) at different times, it will add unnecessary operational burden as the period would end at different times. For example, if an entity designates the alternative benchmark rate as the hedged risk in two hedging relationships– the first designated on 31 March 2021 and the second on 30 June 2021– the 24-month period for each hedge will begin and end at

different dates, although the designated risk is the same in both hedging relationships.

25. Furthermore, if an entity concludes that it no longer has a reasonable expectation that the alternative benchmark rate would meet the requirements at the end of the 24-month period on one hedging relationship, it is more likely than not, that the entity would reach the same conclusion for all other hedging relationships in which that particular rate has been designated. We consider it more appropriate for the 24-month period to apply to each alternative benchmark rate (ie on a rate-by-rate basis). Applying this to the example in paragraph 24, the 24-month period will begin on 31 March 2021 for that particular alternative benchmark rate. Therefore, the staff recommends clarifying that the 24-month period applies to the individual alternative benchmark rate and hence, begins from the date that an entity designates an alternative benchmark rate as a hedged risk for the first time.

26. The staff considered the concerns raised about the relief applying from different dates to entities within the same jurisdiction. However, entities will make changes to their hedging relationships at different times, depending on their risk management practices and progress with transitioning to alternative benchmark rates. As the timing of designating an alternative benchmark rate will differ, the start of the relief period will therefore also have to differ. This is also consistent with the notion that there is no defined date by when entities must make modifications to the hedged items and hedging instruments or make changes to the hedging relationships.

27. The staff also considered the suggestion to require the 24-month period to start at the beginning of the reporting period in which an entity first applies the amendments. We assumed respondents were referring to the reporting period in which an entity first applies the relief from the separately identifiable requirement, otherwise, if the relief period was to start on the effective date, it could in some situations result in the relief period ending before an entity made any changes to the relevant hedging relationships.

28. Even so, we are of the view that starting the relief period from the beginning of the reporting period in which an entity first applies the specific relief from the separately identifiable requirement, would be defeating the purpose of requiring

entities to have a reasonable expectation at the date the rate is designated as the hedged risk, because the beginning of the reporting period always precede the actual change to the hedging relationship is made, thereby effectively shortening the period of relief.

29. With respect to the suggestion to clarify that the reassessment of the separately identifiable requirement could be performed at the reporting date rather than during the reporting period, the staff note that neither IFRS 9 nor IAS 39 includes specific requirements about the date on which the assessment of whether the qualifying criteria to apply hedge accounting continue to be met, is performed. Therefore, we are of the view that specifying a particular date on which the assessment must be performed, would be inconsistent with the current requirements in IFRS 9 and IAS 39. For this reason, we do not recommend any changes to the proposed amendments for this matter.

5.3 Reliable measurement

30. The staff acknowledge the comments made by a few respondents about the reliably measurable requirement and the potential dependency between this requirement and the separately identifiable requirement. However, the staff continue to agree with the reasons for the Board's decision set out in paragraphs BC93–BC97 of the Exposure Draft, and therefore, we are not recommending any changes to the proposed requirements.

6. Questions for the Board

Questions for the Board
1. Do Board members have any questions on the feedback analysis on this agenda paper? 2. Does the Board agree with the staff recommendation to finalise the proposals in the Exposure Draft, subject to clarifying that the 24-month period applies to the individual alternative benchmark rate and hence, begins from the date that an entity designates a particular alternative benchmark rate as the hedged risk for the first time?