STAFF PAPER

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Project	**IBOR Reform and its Effects on Financial Reporting—Phase 2**
Paper topic	Feedback on the Exposure Draft—Effective date and transition

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1. Introduction

1. This paper discusses the effective date and transition requirements proposed in the Exposure Draft *Interest Rate Benchmark Reform—Phase 2* (Exposure Draft).

2. This paper is structured as follows:

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

   (b) Summary of the proposals in the Exposure Draft (paragraphs 4-5);

   (c) Feedback received (paragraphs 6-12);

   (d) Staff analysis and recommendation (paragraphs 13-24); and

   (e) Question for the Board.

2. Summary of staff recommendation

3. We recommend that the Board finalise the effective date and transition requirements proposed in the Exposure Draft with one change as follows (underlined text indicates the change):

An entity would reinstate a discontinued hedging relationship if and only if:

(a) the entity discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and, therefore, the entity would not have been required to discontinue that hedging relationship if the amendments had been applied at that time; <u>and</u>

(b) <u>at the date of initial application of the amendments, that discontinued hedging relationship:</u>

(i) <u>still meets the risk management objective on the basis of which it qualified for hedge accounting (ie the entity still pursues the risk management objective for that hedging relationship); and</u>

(ii) <u>continues to meet all other qualifying criteria (after taking into account the amendments)</u>.

3. Summary of the proposals in the Exposure Draft

3.1 Effective date

4. The Exposure Draft proposed that entities would be required to apply the amendments for annual periods beginning on or after 1 January 2021. Earlier application would be permitted. If an entity applied the amendments for an earlier period, it would be required to disclose that fact.

3.2 Transition

5. The Exposure Draft proposed that entities:

(a) would apply the amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in (b) below. As a result, an entity would be required to reinstate a discontinued hedging relationship if, and only if, the entity discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and, therefore, the entity would not have been required to discontinue that hedging relationship if the amendments had been applied at that time.

(b) would not be required to restate prior periods to reflect the application of the amendments. However, the entity would be permitted to restate prior periods if, and only if, it is possible without the use of highlight.

4. Feedback received

4.1 Effective date

6. Almost all respondents that addressed this matter agreed with the effective date requirements proposed in the Exposure Draft (including permitting earlier application). Respondents that provided a reason for their view said that the proposals appropriately reflect the urgency of the amendments.

7. A few respondents disagreed with effective date proposals. These respondents said either the amendments should be effective sooner (eg for annual periods beginning on or after 1 January 2020 or as soon as the amendments are issued) or, while they agreed with the proposed effective date, earlier application should be prohibited.

4.2 Transition

8. Almost all respondents that addressed this matter generally agreed with the transition requirements proposed in the Exposure Draft, including the proposal that at least some discontinued hedging relationships would be reinstated.

9. However, some respondents asked the Board to reconsider the proposal that would require entities to reinstate some discontinued hedging relationships. Some of these respondents said entities should not be required to reinstate discontinued hedging relationships. These respondents generally expressed the view that such a requirement would be operationally burdensome to apply. Accordingly, some of these respondents

said that reinstatement should be optional or required only if it could be done without undue cost and effort. A few of the respondents that said reinstatement should be optional noted that 'cherry picking' could be minimised by requiring the chosen approach to be applied consistently, ie it could be an all-or-nothing option rather than a hedge-by-hedge option.

10. In contrast, many of the respondents that asked the Board to reconsider the proposal that would require entities to reinstate particular discontinued hedging relationships focused on specific circumstances in which they said reinstating discontinued hedging relationships would be challenging and/or have limited benefit—for example, when:

(a) the hedging instruments and/or the hedged items in the discontinued hedging relationships have been subsequently designated into new hedging relationships;

(b) the hedging instruments in the discontinued hedging relationships no longer exist at the date of initial application of the amendments—eg they have been terminated or sold; or

(c) the hedging instruments in the discontinued hedging relationships are being managed within a trading mandate with other trading positions and reported as trading instruments.

11. Some of these respondents said that reinstating a discontinued hedging relationship in such circumstances would be impracticable, for example, due to systems constraints. Other respondents said that while reinstatement would be practicable (at least in some cases), it would be very challenging and/or would have little or no benefit. For example, these respondents said there seems to be little point in reinstating the hedging relationship if, for example, that relationship would be subsequently discontinued (ie before the initial application of the amendments) because the hedging instrument is terminated. Similarly, if the hedging instrument or hedged item has been designated in a new hedging relationship, these respondents said that it seems inappropriate to require entities to reinstate the 'old' (original) hedging relationship and discontinue or unwind the 'new' (valid) hedging relationship. A few of these respondents said the

proposals are unclear about which hedging relationship would 'survive'. Finally, a few respondents said that, if the derivative has been moved to a trading portfolio, reinstating the hedging relationship would lead to restatement of the overall trading position, which would require changes to regulatory reports already filed and would not seem to provide users of financial statements with useful information.

12. Some respondents provided suggestions for how the Board could change the proposal to address the circumstances described in paragraph 10 of this paper, for example:[1]

(a) Entities would be required to reinstate the hedging relationships, except if it is impracticable to do so.

(b) Entities would be required to reinstate the hedging relationships only in particular circumstances, such as '…only where possible, and necessary to faithfully present the economic position of the entity' or '…as long as [such reinstatement is] consistent with the entity's documented risk management objective and strategy'.

(c) Entities would be required to reinstate the hedging relationships except in specifically listed circumstances, ie the Board would create a list similar to that in paragraph 10 of this paper.

(d) Entities would be permitted (but not required) to reinstate the hedging relationships. To address concerns about 'cherry-picking', the Board could require this option to be applied consistently, ie it would be an all-or-nothing option rather than a hedge-by-hedge option.

5. Staff analysis and recommendation

5.1 Effective date

13. As explained in paragraph BC110 of the Basis for Conclusions on the Exposure Draft, the Board decided to propose an effective date of annual periods beginning on or after

[1] For the avoidance of doubt, in all cases, these suggestions assume that the entity discontinued the hedging relationship solely due to changes required by interest rate benchmark reform. That aspect of the proposal would remain unchanged.

1 January 2021 (with earlier application permitted) because it acknowledged the urgency of the proposed amendments. During its deliberations, the Board noted that this proposal would not allow for a long implementation period—entities are usually allowed at least eighteen months to apply amendments to IFRS Standards. However, these amendments are intended to ease the operational burden on preparers and other affected parties, while continuing to provide useful information to users of financial statements. Therefore, the Board decided that a shorter implementation period would be justified.

14. In addition, we note this urgency is similar to that of the Phase 1 amendments. In that case, the Board issued the amendments in September 2019 with an effective date of annual periods beginning on or after 1 January 2020 (with earlier application permitted).

15. Accordingly, consistent with almost all feedback received on this matter, we think the Board should confirm the effective date requirements proposed in the Exposure Draft —that is, the amendments would have an effective date of annual periods beginning on or after 1 January 2021 and earlier application should be permitted. We think there is not a compelling reason to make the amendments mandatorily effective sooner (such that there would be no implementation period provided) or to prohibit early application (which would be inconsistent with the effective date requirements for Phase 1, and IFRS 9 *Financial Instruments* generally).

5.2 Transition

16. As described previously in this paper, almost all respondents that provided feedback on this matter generally agreed with—and welcomed— the proposed transition requirements. But some respondents asked the Board to reconsider a particular aspect of the proposal that would require entities to reinstate some discontinued hedging relationships. We have analysed that matter below.

Circumstances in which reinstating a discontinued hedging relationship is impracticable

17. The Exposure Draft proposed that the amendments would be applied retrospectively in accordance with IAS 8 and, as a result, an entity would be required to reinstate a

discontinued hedging relationship if (and only if) the entity discontinued that hedging relationship solely due to changes required by interest rate benchmark reform. As discussed in paragraph 11 of this paper, some respondents indicated that, in some cases, it would be impracticable to reinstate some hedging relationships and asked the Board to make an exception in those cases.

18. Paragraph 23 of IAS 8 states that when retrospective application is required, a change in accounting policy must be applied retrospectively <u>except to the extent that it is impracticable</u>. Paragraph 5 of IAS 8 provides the definition of ‘impracticable’.

19. Therefore, we think the transition requirements proposed in the Exposure Draft to apply the amendments retrospectively—including the requirement to reinstate particular discontinued hedging relationships—would be subject to impracticability applying IAS 8. So we think it is unnecessary for the Board to consider further relief for circumstances in which it is impracticable for an entity to reinstate a discontinued hedging relationship. However, we will consider whether the drafting and/or structure of those transition requirements (and/or the related paragraphs in the Basis for Conclusions) could be improved to ensure this is clear.

Other circumstances

20. Some respondents indicated that, in other cases, it would not be impracticable to reinstate the hedging relationship, but such reinstatement would be challenging and/or would have limited (or no) benefit. We agree with those concerns and think the Board should consider making a change to the transition requirements proposed in the Exposure Draft to address such circumstances.

21. Broadly speaking, we think many of the respondents that expressed these concerns suggested that entities should not be required to reinstate a discontinued hedging relationship if that relationship would no longer meet the qualifying criteria for hedge accounting at the date of initial application of the amendments. That may be the case if the hedging instrument no longer exists at the date of initial application (eg it has been terminated or sold) or the entity is no longer pursuing the same risk management objective for that ‘old’ hedging relationship (eg the hedging instrument is now

managed as a trading instrument, or the hedging instrument and/or hedged item have been subsequently designated in a new hedging relationship). We agree that, in such cases, entities should not be required to reinstate a discontinued hedging relationship for a short period of time (ie until the hedging instrument is subsequently terminated or sold) or unwind a 'new' (valid) hedging relationship in order to reinstate an 'old' hedging relationship.

22. Therefore, we think the Board should make a change to the transition requirement for reinstating particular discontinued hedging relationships. Specifically, an entity would be required to reinstate a discontinued hedging relationship if (and only if) the entity discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and, at the date of initial application of the amendments, that discontinued hedging relationship still meets the risk management objective on the basis of which it qualified for hedge accounting (ie the entity still pursues the risk management objective for that hedging relationship) and continues to meet all other qualifying criteria.

23. We think this approach is similar to the suggestion described in paragraph 12(b) of this paper but we have aimed to anchor the wording in our recommendation to the wording in existing hedge accounting requirements; in particular the existing wording related to when an entity is permitted to apply (and discontinue) hedge accounting. We think this is preferable to developing a list of exceptions (as suggested in paragraph 12(c) of this paper) because there would be a risk that such a list would be incomplete and thus not capture all of the intended circumstances. We have not considered an approach that would give entities the option to reinstate discontinued hedging relationships (as suggested in paragraphs 9 and 12(d) of this paper). The Board previously considered, and rejected, such optionality because it could result in 'cherry-picking' to achieve a particular accounting outcome. We acknowledge the suggestion that the Board could address cherry-picking by requiring such an option to be applied consistently (rather than on a hedge-by-hedge option) but we think such an 'all or nothing' option could be restrictive and reduce the benefit that the Board intended to provide when it proposed that entities would reinstate particular discontinued hedging relationships. For

example, an entity may have a small number of the circumstances described in paragraph 10 of this paper and if the entity decides not to reinstate those discontinued hedging relationships (for the reasons described in paragraph 11), then it would be prohibited from reinstating all discontinued hedging relationships (even if some of those relationships otherwise would have qualified for reinstatement and such reinstatement would have provided useful information to users of financial statements).

24. Finally, as explained in paragraphs BC111-BC113 of the Basis for Conclusion on the Exposure Draft, the Board acknowledged that the proposal to reinstate particular discontinued hedging relationships is inconsistent with the Board's previous decisions in respect to hedge accounting in IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement*, eg hedge accounting is applied prospectively. However the Board noted this proposal would apply only to a very targeted population and only for a short period of time—ie it would apply only to situations in which an entity discontinued a hedging relationship solely due to changes required by interest rate benchmark reform in the period before the entity first applies the amendments. We think our recommended change to this transition requirement maintains the discipline, as well as the benefit, that the Board intended.

Questions for the Board

1. Does the Board agree with the staff recommendation to finalise the effective date requirements proposed in the Exposure Draft — that is, entities would be required to apply the amendments for annual periods beginning on or after 1 January 2021, with earlier application permitted?

2. Does the Board agree with the staff recommendation to finalise the transition requirements proposed in the Exposure Draft (reproduced in paragraph 5), with the change set out in paragraph 3?