# STAFF PAPER

June 2020

## IASB® meeting

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| **Project** | **IBOR Reform and its Effects on Financial Reporting—Phase 2** |
| Paper topic | Feedback analysis—Other comments |


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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, this paper summarises comments on areas that were not directly addressed by the Exposure Draft. Therefore, the paper contains a mixture of different topics raised by a few respondents.

3. This paper is structured as follows:

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

   (b) Feedback analysis (paragraphs 5 –27).

## 2. Summary of staff recommendations

4. We recommend no substantial changes to the proposed amendments in response to the issues discussed on this paper. However, as noted in the staff analysis we have

identified some drafting suggestions which we will consider when drafting the final amendments.

## 3. Feedback analysis

5. In this section, we have separately analysed feedback related to:

   (a) Classification of financial assets—SPPI (paragraphs 7 – 11);

   (b) Embedded derivatives (paragraphs 12 – 23); and

   (c) End of application of the Phase 1 exceptions—drafting suggestions (paragraphs 24 – 27)

6. The analysis provides for each of the topics listed in paragraph 5:

   (a) background information;

   (b) feedback; and

   (c) staff analysis and recommendations about whether the Board should make any amendments.

### *3.1 Classification of financial assets—SPPI*

*Background information*

7. As described in paragraph BC37 of the Exposure Draft, some stakeholders had previously asked the Board to consider whether relief should be provided with respect to the solely payments of principal and interest (SPPI) assessment in IFRS 9 for financial assets—that is, assessing whether the contractual cash flows of the financial assets referenced to an alternative benchmark rate represent solely payments of principal and interest on the principal amount outstanding.

8. Specifically, whether the interest component of the contractual cash flows of the financial assets referenced to overnight alternative benchmark rates, is consistent with the requirements in paragraph 4.1.3(b) of IFRS 9. At the time, stakeholders had highlighted circumstances that in their view could potentially affect an entity's ability to meet these criteria. Such circumstances included the consideration for the modified time value of money requirement in IFRS 9 in the context of lagging

interest rates[1] and tenor mismatches. These issues together with the staff analysis highlighting the relevant requirements in IFRS 9 to consider in doing this assessment, were discussed by the Board at its October 2019 meeting.[2]

9. As explained in paragraph BC38 of the Exposure Draft, the Board concluded that IFRS 9 provides an adequate basis to determine whether the interest component of the contractual cash flows of the new financial asset referenced to alternative benchmark rates meets the SPPI criteria in IFRS 9 in the context of interest rate benchmark reform and therefore, proposed no amendments to IFRS 9 considering the objective of Phase 2.[3]

### *Feedback*

10. A few respondents from the same jurisdiction described the characteristics of a particular alternative benchmark rate and highlighted the practical challenges encountered when doing the SPPI assessment under these circumstances. They said that in their jurisdiction the central authorities decided that no forward-looking term rates[4] will be officially provided and consequently the alternative benchmark rate has an imperfect time value of money element. These respondents asked the Board to reconsider providing an exemption from the SPPI requirements in these circumstances to enable the affected financial assets to be measured at amortised cost or fair value through other comprehensive income. In their view, this potential exemption could be developed similarly to what the Board provided for regulated interest rates set out in B4.1.9E of IFRS 9.

### *Staff analysis*

11. The staff do not recommend adding an amendment to IFRS 9 with respect to this issue for the following reasons:

[1] An example of lagging interest rate could be a 3-month interest benchmark rate set for a 3-month period, but where the rate is fixed one month before the start of the interest period.
[2] For further information, refer to the October 2019 Board agenda paper is available here.
[3] The Board's conclusion is based on new financial assets only as the SPPI assessment is only done at initial recognition.
[4] Forward-looking term rates—term rates might be fixed at the outset of a given period, hence capturing expected rates over the period ('forward-looking'). In principle, forward-looking term rates could be based on derivatives referenced to overnight alternative benchmark rates such as futures or overnight index swaps in which case a fixed rate payment is exchanged (swapped) for the floating alternative benchmark rate, because these provide information on market expectations of the alternative benchmark rates over a forward-looking period.

(a) the principles underpinning the SPPI criteria in IFRS 9, including the application guidance, includes examples on a range of circumstances that meet the SPPI criteria provided that the contractual cash flows of a financial asset are consistent with a basic lending arrangement and with regards to the modified time value of money element does not result in cash flows that are significantly different from the undiscounted benchmark cash flows. Examples include financial assets referenced to fixed interest rates, variable interest rates, or a combination thereof, regulated rates, lagging interest rates and tenor mismatches. Accordingly, there are no specific conditions or exceptions that in itself automatically disqualify contractual cash flows from being SPPI;

(b) the judgements entities will have to make in assessing whether the contractual cash flows based on alternative benchmark rates (including any related terms such as frequency of reset, and tenor of reset) satisfy the SPPI criteria, are similar to the judgements that had to be made at initial application of IFRS 9. The staff think that the principle-based application guidance and examples in IFRS 9, especially those addressing the modified time value of money element, are helpful in assisting entities in making those judgements; and

(c) any potential relief from the SPPI requirement would likely involve permanently amending IFRS 9—that is, it would not be part of the temporary amendments added to IFRS Standards for the purpose of interest rate benchmark reform. This is because, the issue raised by respondents relates to characteristics of an alternative benchmark rate that is expected to continue to exist in the future; therefore the issue will continue to be relevant for new financial assets that reference this alternative benchmark rate. Consequently, we think addressing this issue is beyond the objective and scope of Phase 2.

### *3.2. Embedded derivatives*

*Background information*

12. At its October 2019 meeting, the Board also considered concerns expressed by some stakeholders that a potential issue may arise with accounting for embedded derivatives in accordance with IFRS 9 in circumstances when the contract for a

financial instrument contemplates the interest rate benchmark reform by way of a fallback clause. More specifically, such analysis also highlighted the relevant requirements in IFRS 9 for reassessment of separated embedded derivatives.

13. As explained in paragraph BC38 of the Basis for Conclusions on the Exposure Draft, the Board discussed this matter and concluded that IFRS 9 provides an adequate basis to account for embedded derivatives and therefore proposed no amendments considering the objective of Phase 2.

*Feedback*

14. A few respondents to the Exposure Draft said that while they agree with the analysis and the Board's conclusion as discussed in the October 2019 Board meeting, they are concerned that the transition to alternative benchmark rates could consequentially cause unintended separation of embedded derivatives. They suggested the Board clarify that—for the modified financial instruments affected by interest rate benchmark reform—making modifications required by interest rate benchmark reform does not give rise to the reassessment of embedded derivatives in accordance with IFRS 9.

*Staff analysis*

15. As noted in agenda paper 14B for the October 2019 Board meeting, paragraph 4.3.3 of IFRS 9 states that 'if a hybrid contract contains a host that is not an asset within the scope of IFRS 9, an embedded derivative shall be separated from the host and accounted for as a derivative under IFRS 9 if, and only if: (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host; […]'.

16. Also, that paper highlighted that paragraph B4.3.11 of IFRS 9 provides further information by stating that 'in accordance with paragraph 4.3.3 of IFRS 9, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. **Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract**, **in which case reassessment is required**. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with

the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.'[Emphasis added]

17. We note that the Exposure Draft describes modifications required by interest rate benchmark reform by reference to the conditions set out in paragraph 6.9.3 of the Exposure Draft. Specifically, paragraph 6.9.3 proposed that a modification is required by interest rate benchmark reform (and therefore eligible to apply this practical expedient) if and only if: (i) it is required as a direct consequence of interest rate benchmark reform; and (ii) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the modification).

18. Furthermore, paragraph BC29 of the Exposure Draft follows 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**. [Emphasis added]

19. On the basis of the information described above, the staff conclude that subsequent reassessment of embedded derivatives would be prohibited when making modifications required by interest rate benchmark reform—that is, modifications that meet the qualifying conditions set out in paragraph 6.9.3 of the Exposure Draft.

20. This is because, consistent with paragraph BC29 of the Exposure Draft, making the modifications required by interest rate benchmark reform does not contemplate changes in the terms of the contract that would significantly modify the cash flows that otherwise would be required under the contract.

21. In contrast, as noted in paragraph BC29 of the Exposure Draft the outcome of making modifications required by interest rate benchmark reform is contemplated such that the contractual cash flows (including the interest rate) of the financial instrument would be substantially similar before and after the modification; this outcome is inconsistent to what is contemplated in paragraph B4.3.11 of IFRS.

22. Nonetheless, if the entity makes modifications other than those required by the interest rate benchmark reform, consistent with paragraphs 6.9.6 and BC35 of the

Exposure Draft, an entity shall apply the relevant requirements in IFRS 9 to account for such changes; this includes considering the requirements for reassessment of embedded derivatives.

23. We continue to agree with the Board's conclusion that IFRS 9 provides adequate basis to account for embedded derivatives and do not recommend making any changes to the proposed amendments with respect to this issue.

### *3.3 End of application of the Phase 1 exceptions—drafting suggestions*

*Background information*

24. The Exposure Draft included an editorial correction to paragraph 102M of IAS 39. This paragraph is part of the amendments to IAS 39 added as part of Phase 1, specifically related to the end of application of the exception from the retrospective assessment.

25. Separately, paragraphs BC86-BC87 of the Exposure Draft explain that having considered the interaction between the Phase 1 exception from the separately identifiable requirement (see paragraphs 6.8.7– 6.8.8 of IFRS 9 and paragraphs 102H–102I of IAS 39) and the proposals in the Exposure Draft, the Board observed that it might be unclear when an entity shall cease to apply the Phase 1 exception from the separately identifiable requirement. The Board, therefore, proposed that the Phase 1 exception from the separately identifiable requirement ceases to apply at the earlier of: (a) when changes required by the reform are made to the hedging relationship as proposed in paragraph 6.9.7 or paragraph 102O of this Exposure Draft; or (b) when the hedging relationship is discontinued.

*Feedback*

26. A few respondents commented on these paragraphs to suggest the following:

    (a) consider replicating the same editorial correction described in paragraph 24 also to paragraph 102L of IAS 39, because in their view, the current wording could cause the underlying amendment (ie amendment in paragraph 102F of IAS 39) to end prematurely and consequently, hedging relationships to discontinue;

(b) include paragraph BC86 of the Exposure Draft in the amendments to IAS 39 instead of the Basis for Conclusions to the amendments.

*Staff analysis*

27. The staff will consider making these corrections as part of drafting the final amendments.

## Questions for the Board

| Questions for the Board |
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| 1. Do Board members have any questions on the feedback analysis on this agenda paper?<br><br>2. Does the Board agree with the staff recommendation to make no substantial changes to the proposals in the Exposure Draft in response to the issues discussed on this agenda paper? |