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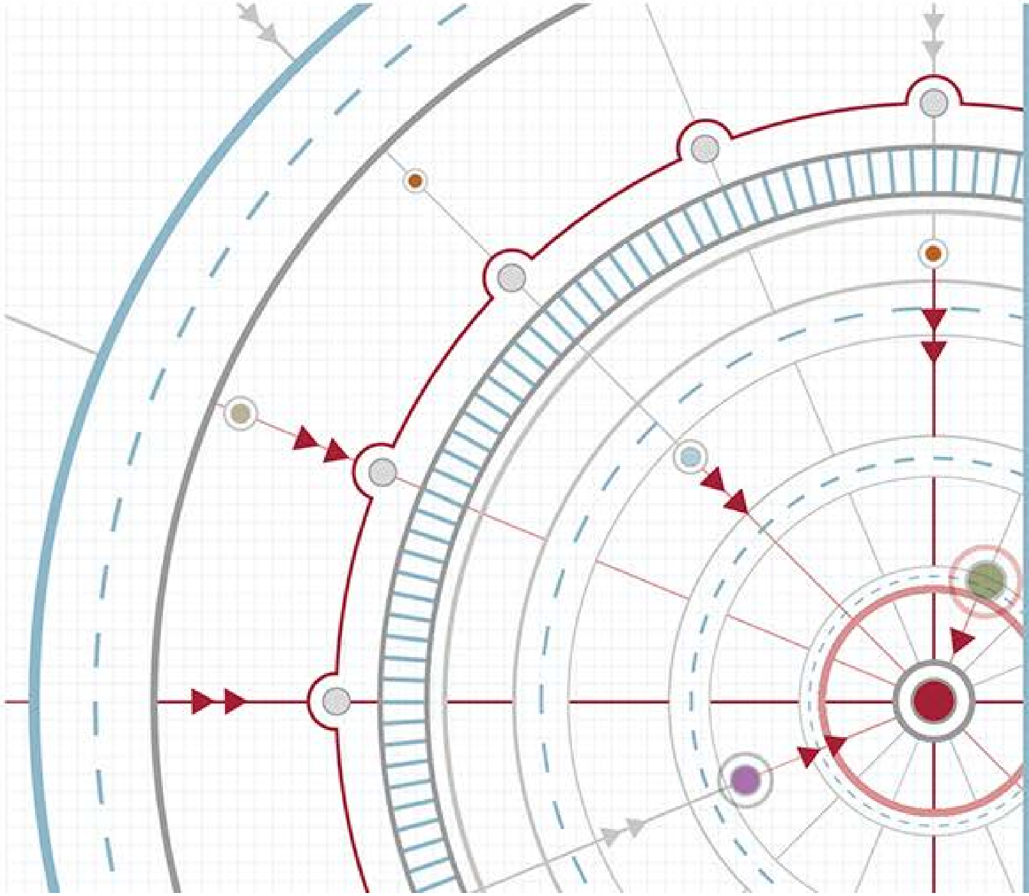

Agenda paper 3

IBOR Reform and its Effects in Financial Reporting—Phase 2

Disclosures

Capital Markets Advisory Committee – March 2020

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board or the IFRS Foundation.

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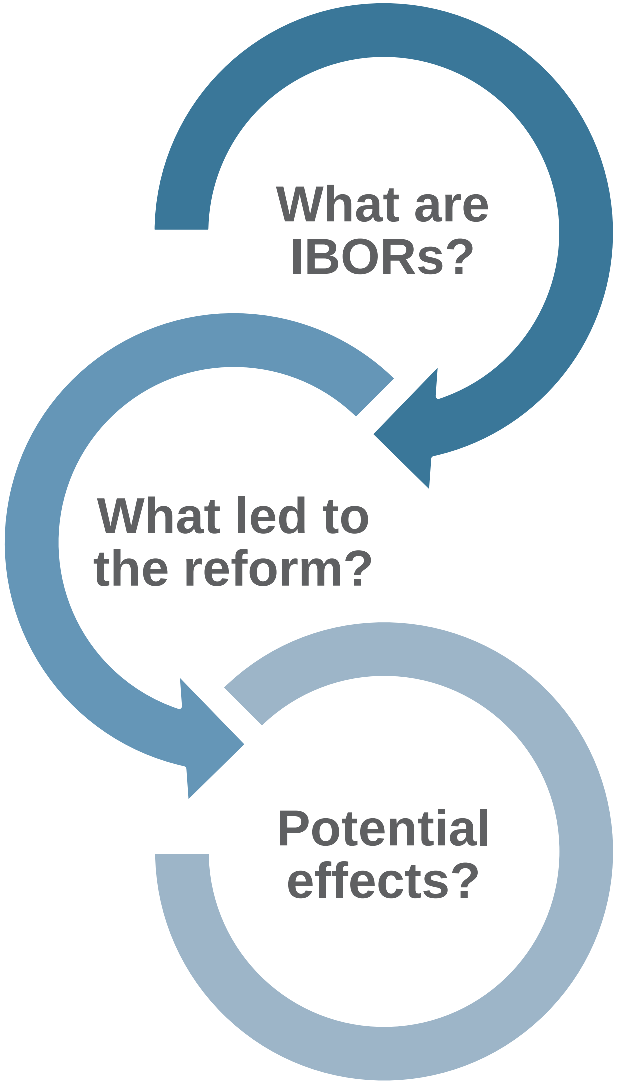
Background



Interest rate benchmarks such as interbank offered rates (IBORs) play an important role in global financial markets. They index a wide variety of financial products worth trillions of dollars, ranging from mortgages to derivatives.

Market developments have undermined the reliability of existing benchmarks. In 2014 the Financial Stability Board recommended reforms of some major interest rate benchmarks. Since then, many jurisdictions have made progress towards replacing existing benchmarks with nearly risk-free rates (RFRs or alternative benchmark rates).

This has, in turn, led to uncertainty about the future of existing interest rate benchmarks. The potential discontinuation of interest rate benchmarks could affect the usefulness of information provided in IFRS financial statements.

Two-phase project and timeline

The Board identified two groups of accounting issues:

Phase I *Pre-replacement issues*

- The Board decided to address *pre-replacement issues* as a priority as they were considered more urgent because they may affect financial reporting **before** the reform is effected.
- See Appendix for Phase 1 amendments.

Phase II *Replacement issues*

- Issues that might affect financial reporting **after** the reform of an interest rate benchmark, including its replacement with alternative benchmark rates.

Q3 2019 Phase I completed

Q3 2019 Board discussed the scope of Phase II issues

Q4 2019 Board started deliberations on Phase II issues

April 2020 Expected publication of Exposure Draft

Purpose and structure of the session

- To hear your preliminary views on the disclosure proposals that will be included in the upcoming Exposure Draft for Phase 2.

- The slides are structured as follows:
  - Overview of proposed amendments in Phase 2 (slides 6-11);
  - Proposed disclosures (slides 13-17);
  - Questions to CMAC members (slide 19); and
  - Appendix (slides 21-22)

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Phase 2

Overview of the proposed amendments

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Who would be affected by the proposals?

- The Board expects the proposals in the upcoming Exposure Draft (ED) to affect many entities given the extensive use of IBORs in global financial markets.
- In particular, the ED will affect entities that have financial assets, financial liabilities or lease liabilities that are referenced to an IBOR and have already been or will be required to replace that IBOR with an RFR as a result of the IBOR reform.
- The affected entities would also include those that apply the hedge accounting requirements in IFRS 9 or IAS 39 to hedging relationships that are affected by the IBOR reform.

Scope of proposed amendments in Phase 2

- The Board decided to propose amendments in the following areas:

1. Modification of financial assets, financial liabilities and lease liabilities;
2. Specific hedge accounting requirements;
3. Disclosure requirements applying IFRS 7 to accompany the Board's proposals for classification and measurement and hedge accounting.

Subject of this session

1 Modification of financial assets, financial liabilities and lease liabilities

What is the problem?

- Applying IFRS 9, when a financial asset or financial liability is modified, an entity is required to determine:
  - whether the modification results in the derecognition of the financial instrument; and
  - if not derecognised, recognise a modification gain or loss in P&L at the modification date.
- **Could replacing IBORs with RFRs alone lead to derecognition?**
  - The RFRs are intended to be nearly risk-free whereas many IBORs are not, hence a fixed spread will be added to compensate for a basis difference between an IBOR and an RFR to mitigate significant transfer of economic value between the parties to the contract.
  - If this is the only change made, it is unlikely that the transition to an RFR alone would result in the derecognition of the financial instrument.
- **Calculation of modification gain or loss would include:**
  - Recalculation of the present value of contractual cash flows for each financial instrument (eg each variable rate loan in a bank's portfolio), with the difference recognised in P&L;
  - Continue to use IBORs instead of RFRs to calculate interest revenue or interest expense;
  - However, maintaining IBORs may be difficult, and perhaps impossible, if the IBORs are no longer available.

1 Modification of financial assets, financial liabilities and lease liabilities

What is the Board proposing?

- Practical expedient for **modifications required by the reform**—those are, modifications required as a direct consequence of IBOR reform and made on an economically equivalent basis.
- These are accounted for by updating the effective interest rate (EIR)
- All other modifications are accounted for using the current IFRS requirements (ie recalculate carrying amount and recognise a gain or loss).
- A similar practical expedient is proposed for lessee accounting applying IFRS 16.

What would the reporting outcomes be?

For qualifying modifications, there would be no specific gain or loss associated with the replacement of the IBOR rate

- The EIR is updated to reflect replacement in benchmark from IBOR to RFR.
- No change to carrying amount of financial instrument.
- Interest recognised in P&L using alternative benchmark rate (ie RFR rate).
- Lessees will update incremental borrowing rate to reflect alternative benchmark rate

2 Specific hedge accounting requirements

What is the problem?

- When there is a modification to a financial asset or a financial liability designated in a hedging relationship, an entity will likely need to amend its hedge documentation to reflect those modifications. Examples may include:
  - changing the designated hedged risk from an IBOR to an RFR;
  - amending the description of the hedging instruments or the hedged items to refer to an RFR.
- Under the current requirements, amending the formal designation of a hedging relationship would generally result in hedge accounting being discontinued.
- However, in the Board’s view, requiring entities to discontinue hedge accounting solely due to changes required by the reform would not provide useful information to users of financial statements. This is because, such changes would not reflect the economic effects of the changes to the underlying financial asset or a financial liability that are required by the reform.

2 Specific hedge accounting requirements

What is the Board proposing?

- Hedging relationships (and related documentation) must be amended to reflect modifications to the hedged item, hedging instrument and hedged risk
- Any valuation adjustments resulting from the amendments are recognised as part of ineffectiveness
- Amended hedging relationship should meet all qualifying criteria to apply hedge accounting, including effectiveness requirements

What would the reporting outcomes be?

As a result, there would be no gains or losses associated with discontinuation of hedge accounting due to IBOR reform

- Hedge accounting is not discontinued solely because of IBOR reform.
- Hedging relationships to be amended as the changes occur at different times
- Hedge items and hedging instruments continue to be measured in accordance with IFRSs
- Hedge ineffectiveness, any measurement differences continue to be recognised in the financial statements as usual.

3 Proposed disclosure requirements

Are disclosures for Phase 2 needed?

- In assessing whether any disclosures for Phase 2 needed, the Board considered the following:

Current requirements

- the extent to which current presentation and disclosure requirements would provide information about the effect of IBOR reform on an entity’s financial statements.

User needs

- the information needed by users of financial statements to enable them to understand the effects of the transition to alternative benchmark rates on an entity’s financial statements.

Preparers

- the incremental costs for preparers to disclose additional information and how that balances with the benefits of the relief that the Board is proposing to provide.

Phase 1

- the potential interaction with disclosures that are required as part of the Phase 1 amendments.

Are disclosures for Phase 2 needed?

In absence of additional disclosure requirements proposed as part of Phase 2, users of financial statements may not be provided with useful information about the effects of IBOR reform on an entity's financial statements. This is because:

IFRS 7 requires entities to provide information about:

- gains or losses on financial assets or financial liabilities recognised in the statement of comprehensive income;
- risk exposures that an entity hedges and for which it elects to apply hedge accounting;
- nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period; and
- the nature and the effect of modifications that have not resulted in derecognition and the effect of such modifications on the measurement of expected credit losses.

However, the proposed accounting outcomes are such that for qualifying modifications and changes the reform **would not result in a gain or loss** being recognised in the entity's financial statements.
Consequently, information about the effects of IBOR reform on the entity's financial position and performance resulting from transitioning to alternative benchmark rates will not be captured by these requirements.

What we heard from users?

Key messages we received

users

Overall

- Supportive of the Phase 2 tentative decisions

Want more information about

- How entities distinguished the qualifying modifications (ie modifications that qualified for the practical expedient in slide 8), from other concurrent modifications, and how the entity determined the economically equivalent rate?
- Magnitude of financial assets and liabilities that are still referenced to IBORs and the entity’s expectations about when transition will be completed.
- Any significant change to an entity’s risk management strategy as a result of IBOR reform.
- Where applicable, new risks due to IBOR reform and the alternative benchmark rates to which the entity is transitioning.

Proposed amendments—Objective and disclosures

Summary of proposed amendments

Objectives	To meet the objectives an entity would disclose information about:
(a) The nature and extent of risks arising from IBOR reform to which the entity is exposed to, and how the entity manages those risks; and (b) The entity's progress in transitioning from IBORs to alternative benchmark rates, and how the entity is managing this transition	(a) how the transition from interest rate benchmarks to alternative benchmark rates is managed and progress made at the reporting date; (b) carrying amount of financial assets and financial liabilities, (including the nominal amount of the derivatives), that continue to reference benchmarks subject to the reform, disaggregated by significant interest rate benchmark; (c) for each significant alternative benchmark rate to which the entity is exposed, an explanation of how the entity determined which modifications qualified for the practical expedient, including a description of significant judgements the entity made to determine qualifying modifications; and (d) to the extent that IBOR reform has resulted in changes to an entity's risk management strategy, a description of these changes and how is the entity managing those risks.

What information would be provided based on these proposals?

- The disclosure proposals in slide 16 require information that is primarily qualitative in nature.
- If finalised as proposed, these disclosures would form part of IFRS 7.
- Applying the proposal in slide 16 point (c), entities would need to explain how the entity determined which modifications are required by the reform (ie which modifications met conditions in slide 8) and any significant judgement made in this process.
- The proposed disclosures aim to explain the process that an entity followed for the purpose of determining the population to which the practical expedient (described in slide 9) applied.
- However, there is a concern that the disclosed information might not be entity-specific or sufficiently granular for it to be useful to users of financial statements.

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Questions for CMAC members

Questions for CMAC members

Q1

Do you think the proposed disclosures on slide 16 would provide useful information to users of financial statements?

Q2

Do you have concerns with information that would be disclosed to address the requirement in point (c) on slide 16?

In particular, do you think this information would be useful even if entities prepare it with some limitations ie entities disclose ranges of the base rate and relevant adjustments to that rate?

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Appendix

Phase 1—Pre-replacement issues

Phase I amendments

- Amendments to IFRS 9, IAS 39 and IFRS 7 issued in September provide exceptions to some specific hedge accounting requirements.

- The outcome of these exceptions is such that entities would assume the interest rate benchmark is not altered as a result of the interest rate benchmark reform (IBOR reform).

- As a result, entities can continue their hedging relationships while all ineffectiveness is measured and recognised applying the existing IFRS requirements.

- Therefore, the particular impact of the IBOR reform is not required to be presented separately in P&L

Phase I disclosures

Given the outcome of Phase I amendments to IFRS 9 and IAS 39 would not lead to specific information about IBOR reform, specific disclosure requirements were added to IFRS 7 to provide users of financial statements with the following information about **hedging relationships** affected by the amendments:

a) significant interest rate benchmarks to which the entity’s hedging relationships are exposed;

b) how the entity is managing the process to transition to RFRs;

c) the extent of the entity’s risk exposure that is directly affected by the reform;

d) significant assumptions or judgements the entity made in applying the exceptions; and

e) the nominal amount of the hedging instruments in those hedging relationships.

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