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Project	**IBOR Reform and its Effects on Financial Reporting—Phase 2**		
Paper topic	Feedback analysis—Modification/replacement of derivatives		
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1. Introduction

1. This paper addresses a matter raised by respondents in their feedback on the Exposure Draft *Interest Rate Benchmark Reform—Phase 2* (Exposure Draft). Specifically, respondents asked the Board to consider how the requirements proposed in the Exposure Draft would apply to particular approaches that are expected to be used in practice to replace (rather than modify) derivatives designated as hedging instruments.

2. This paper is structured as follows:

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

   (b) Feedback received (paragraphs 4–7);

   (c) Staff analysis and recommendations to clarify the proposed amendments (paragraphs 8–29); and

   (d) Question for the Board (Section 5).

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2. Summary of staff recommendations

3. The staff recommend the Board clarify that, for the purpose of the changes required to a hedging instrument (as contemplated by proposed paragraphs 6.9.7(c) and 102O(c)), modifications required by the reform could be effected in ways other than modifying the contractual terms of the hedging instrument as long as the outcome is economically equivalent to modifying the hedging instrument to refer to an alternative benchmark rate.

3. Feedback from comment letters

4. Some respondents said the Exposure Draft is unclear whether the proposed amendments in paragraphs 6.9.7–6.9.10 and paragraphs 102O–102R of the Exposure Draft would permit a hedging relationship to continue if the contractual terms of a derivative designated as a hedging instrument are not modified to change the interest rate benchmark, but instead the derivative is replaced with a new derivative that is referenced to an alternative benchmark rate.

5. These respondents noted that, instead of modifying the contractual terms of derivatives, central clearing parties may facilitate the transition to alternative benchmark rates using approaches that result in the termination and replacement of derivatives on an economically equivalent basis. This is because such approaches would result in a similar economic outcome compared to modifying the original contracts but would be easier to execute. Many of these respondents were not specific about the approaches implied in their comment letters, however a few respondents gave examples of potential approaches that, in their view, provide an outcome that is economically similar to a modification, for example:

   (a) terminating the original derivative and replacing it with a new <u>off</u>-market derivative ('terminate and replace');

   (b) terminating the original derivative with a cash settlement and replacing it with a new <u>on</u>-market derivative ('close-out and replace');

   (c) entering into a new basis swap to economically effect the transition of the original derivative to an alternative benchmark rate without modifying the derivative; or

(d) novating the existing interest rate benchmark-based derivative to a new counterparty and then subsequently modifying the derivative to replace the interest rate benchmark.

6. Respondents said that the analysis of these approaches could be similar to that in the proposed amendments in paragraph 6.9.2 of the Exposure Draft. Specifically, these respondents said that a modification of the hedging instrument could be achieved without amending the contractual terms of the derivative and that the substance of the change, rather than its legal form, should determine the accounting treatment. These respondents also analogised to the requirement in paragraph 3.3.2 of IFRS 9, which states that an exchange between an existing borrower and lender of debt instruments with substantially different terms must be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Therefore, in these respondents' view, an exchange between the parties to a derivative contract <u>without</u> substantially different terms should <u>not</u> be accounted for as an extinguishment of the hedging instrument.

7. Respondents said they consider the objective of the approaches described in paragraph 5 of this paper to be the replacement of an interest rate benchmark with an alternative benchmark rate; therefore in their view, they consider it to be required by the reform. Respondents have asked the Board to clarify whether such approaches would be treated for hedge accounting purposes as if the contractual terms of the derivative were modified.

4. Staff analysis and recommendations

8. It is important to note that our analysis focuses on the approaches to transition to alternative benchmark rates described in paragraph 5, only in the context of hedge accounting; specifically, whether these approaches should result in the discontinuation of hedge accounting applying the proposals in paragraph 6.9.7 and 102O of the Exposure Draft. In other words, we are not analysing whether the approaches would result in the derecognition of the derivatives. This is because, a derivative that is not designated as a hedging instrument is measured at fair value through profit or loss, and changes in derivative's fair value would include any gains or losses arising from the replacement or modification of the derivative.

However, designating a derivative as a hedging instrument changes the recognition and presentation of the derivative's fair value gains or losses, therefore replacing or modifying a derivative, could have a consequential impact on the continuation of the hedging relationship.

9. We continue to agree with the Board's view described in paragraph BC12 of the Basis for Conclusions on the Exposure Draft, which supports the requirements in paragraph 6.9.2—specifically, that it is the substance of an arrangement, rather than its form, that should determine the appropriate accounting treatment.

10. The requirements in paragraphs 6.9.2–6.9.6 of the Exposure Draft apply specifically to financial assets and financial liabilities measured at amortised cost (including financial assets measured at fair value through other comprehensive income). However, we think the guiding principles in paragraph 6.9.3 of the Exposure Draft are useful to consider in order to analyse the potential impact on the relevant hedging relationships of the various approaches described in paragraph 5 of this paper (and analysed further in paragraphs 14–29 below). These guiding principles in paragraph 6.9.3 look at whether the changes are:

    (a) required as a direct consequence of the reform; and

    (b) done on an economically equivalent basis.

11. Although some may argue that most of the approaches analysed in paragraphs 14– 29 of this paper are required as a direct consequence of the reform—ie derivatives that are designated in a hedging relationship need to transition to alternative benchmark rates—we think it is questionable whether all the approaches will result in changes being done on an economically equivalent basis.

12. Although we are not analysing whether the original derivatives would be derecognised, in analysing the potential impact on the hedging relationships, we think the requirements in paragraph 3.3.2 of IFRS 9 are useful in our analysis. As mentioned in paragraph 6 of this paper, paragraph 3.2.2 states (emphasis added):

> An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing

> financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounting for as an extinguishment of the original financial liability and the recognition of a new financial liability.

13. We are of the view that if the terms of the alternative benchmark-based derivative are substantially different from the original derivative, it indicates that the change would not have been made on an economically equivalent basis.

'Terminate and replace'

14. Most of the respondents who provided comments on this topic said this approach is expected to be the most common approach applied and, in their view, would result in an outcome that is economically equivalent to modifying the contractual terms of (repapering) the original derivative.

15. Applying this approach, an entity would enter into two new derivatives with the same counterparty—first, a new derivative that is equal and offsetting to the original derivative (so both contracts are based on the interest rate benchmark to be replaced) and second, a new alternative benchmark-based derivative that has the same terms as the original derivative so that its fair value at initial recognition is equivalent to the fair value (on that date) of the original derivative (ie the new derivative is off-market).

16. For example, assume that the original IBOR derivative has a fair value of CU300 at the replacement date and the entity enters into an off-setting IBOR derivative with the same, but opposite, terms with a fair value of negative CU300. The entity also enters into an off-market alternative benchmark rate derivative with terms that are the same as the original derivative, resulting in a fair value of the new derivative of CU300.

17. The outcome is that the two IBOR-based derivatives offset each other (and could subsequently either be maintained until maturity or cancelled), leaving the alternative benchmark rate derivative outstanding. From the hedging relationship perspective, the outcome is arguably the same as it would have been if the contractual terms of the original derivative were modified to replace the interest rate benchmark with the alternative benchmark rate.

18. As the counterparties to the derivatives are the same and the derivatives have been entered into on terms that are not substantially different such that the fair values of the original derivative and the alternative benchmark rate derivative at the replacement date are similar, we think this ‘terminate and replace’ approach would seem to indicate that changes were done on economically equivalent terms. Even though on a gross basis the entity is exposed to the interest benchmark rate and therefore retains the uncertainty arising from it, coupling/linking the original derivative and the off-setting derivative is neutralising that exposure.

19. We are therefore of the view that such an approach would be consistent with the Board’s intention of requiring hedge accounting to continue when specified changes to the hedging relationships are made.

‘Close-out and replace’

20. Applying this approach, an entity terminates (closes-out) the existing interest rate benchmark-based derivative with a cash settlement. The entity then enters into a new on-market alternative benchmark rate derivate that has a fair value of zero at initial recognition. Respondents supporting this approach were of the view that since this approach does not result in any gain or loss recognised in profit or loss, the exchange was done on an economically equivalent basis.

21. We disagree with this view. This is because the original derivative is extinguished and replaced with an alternative benchmark rate derivative with substantially different contractual terms. Using the example in paragraph 16 of this paper, a derivative with a fair value of CU300 would be settled for CU300 cash and, at the same time, the parties to that original derivative would enter into a new derivative with a fair value of 0. Therefore, considering it from a hedging relationship perspective, the change was not done on an economically equivalent basis. This is evidenced by the further requests from respondents who supported this view, asking the Board to also be allowed to reset to zero the fair value changes on the hypothetical derivative in a cash flow hedge, or the fair value hedge adjustment in a

fair value hedge, in order to mitigate the ineffectiveness that would otherwise arise.[1]

22. We therefore do not consider this approach to be consistent with the Board's intention of requiring hedge accounting to continue when specified changes to the hedging relationships are made.

Entering into a basis swap

23. Under this approach, an entity retains the original interest rate benchmark-based derivative but enters into a basis swap that swaps the existing interest rate benchmark for the alternative benchmark rate. Respondents expressed the view that the combination of these two derivatives is equivalent to modifying the contractual terms of the original derivative to replace the interest rate benchmark with an alternative benchmark rate.

24. Our understanding is that some central clearing parties may prefer this approach compared to modifying the contractual terms of the original derivative or the 'terminate and replace' approach described in paragraphs 14–19 of this paper. We think that in principle, the combination of an IBOR derivative and an IBOR-RFR swap could achieve an outcome that is economically similar to the modification of the original IBOR derivative. However, we note that in practice, basis swaps are generally applied on an aggregated basis, rather than on an individual derivative basis. Therefore, for this approach to achieve an outcome that is economically equivalent, the basis swap must be coupled/linked with the original derivative, ie done on an individual derivative basis. This is because modifications are made to individual instruments and, to achieve the same outcome, the basis swap would need to be coupled with that individual derivative.

Novation and subsequent modification

25. It is our understanding that this approach might be considered for bilateral derivatives that are not cleared through a central clearing party. Applying this approach, using an example, Bank X has a bilateral derivative with Bank Y.

[1] These requests were made as part of respondents' comments on Question 3 of the Exposure Draft that will be analysed in a separate paper.

However, Bank Y is not willing to modify the derivative with Party X in advance of the market-wide transition (ie as part of the ISDA protocols). Therefore, Bank Y novates the derivative to a third counterparty, Bank Z. Bank Z subsequently modifies the contractual terms of the novated derivative with Bank X to replace the interest rate benchmark with an alternative benchmark rate.

26. Respondents that described this approach noted that the requirements in IFRS 9 and IAS 39 for 'novation of derivatives and continuation of hedge accounting (see paragraph 6.5.6 of IFRS 9 and paragraph 91 of IAS 39, issued in 2013) would not apply in this scenario because the novation is not to a central clearing party. Therefore, the derivatives would be derecognised upon novation even though the novation was done as a result of the reform.

27. When developing the novation requirements, the Board noted (as described in paragraph BC6.334 of the Basis for Conclusions on IFRS 9 and paragraph BC220C of the Basis for Conclusions on IAS 39) that through novation to a central clearing party (CCP), a party (Party A) to the original derivative has new contractual rights to cash flows from a (new) derivative with the CCP and this new contract replaces the original contract with a counterparty (Party B). Thus, the original derivative with Party B has expired and as a consequence the original derivative through which Party A has engaged with Party B meets the derecognition criteria for a financial asset.

28. Therefore, we agree with the respondents that the novation of a bilateral derivative to new counterparty as described in the comment letter, exposes the original counterparty (Bank X) to new contractual rights and risks with the new counterparty (Bank Z) and therefore, it results in the derecognition of the original derivative. Furthermore, we do not think the replacement of the derivative through novation could be considered to be economically equivalent, as the Board intended in the proposed amendments in the Exposure Draft.

29. We are of the view that for the application of hedge accounting to continue when the derivative designated as a hedging instrument has been novated, it would require the Board to either provide an exception from the proposed requirements in in the Exposure Draft, or to expand the scope of the novation requirements in IFRS 9 and IAS 39. However, we note that there could be challenges in scoping such an

exception or amendment, which could have unintended consequences beyond the scope of this project. Furthermore, in the absence of information indicating that this is a widespread issue we think it is insufficiently prevalent to justify making an exception to the proposed requirements in the Exposure Draft.

5. Question for the Board

Question for the Board

1. Does the Board agree with the staff recommendation to clarify that, for the purpose of the changes required to a hedging instrument (as contemplated by proposed paragraphs 6.9.7(c) and 102O(c)), modifications required by the reform could be effected in ways other than modifying the contractual terms of the hedging instrument as long as the outcome is economically equivalent to modifying the hedging instrument to refer to an alternative benchmark rate?