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IBOR Reform

IFRS accounting considerations

9 March 2020

Overview of IBOR replacement and its impacts

IBOR reform
Background

What is IBOR?

- Interbank Offered Rates (IBORs) are commonly used in **benchmark/reference rates** used in the financial markets globally.
- These rates are **quoted on a daily basis** by different banks, the adjusted average becoming the quoted rate which represents the unsecured borrowing/lending rates amongst banks.
- Two of the most frequently referenced rates used are the London Interbank Offered Rate (**LIBOR**) are the Euro Inter-Bank Offered Rate (**EURIBOR**).

What is the future of IBORs?

- In July 2017, the UK Financial Conduct Authority (FCA) reported that **LIBOR will be phased out** as the interest rate index used in calculating floating or adjustable rates for loans, bonds, derivatives and other financial contracts **by the end of 2021** and that GBP LIBOR should be **replaced by the Sterling Overnight Index Average (SONIA)**.
- In the US, the Alternative Reference Rates Committee (ARRC) announced in June 2017 that the **US-LIBOR will also be phased out and replaced by the Secured Overnight Funding Rate (SOFR)**.

Why are IBORs being replaced?

- Several reasons. In the UK confidence in LIBOR has been eroded by alleged 'rigging'. More generally, the widening gap between the risk free rate and LIBOR resulted in the need for an **alternate rate which is more reliable and proxies the risk free rate**.
- Further, because of the declining transaction volumes in the market the **LIBOR quote was increasingly based on the expert judgement of the banks rather than actual trades**.

What are the implications?

- There are wide-ranging impacts on the business – where transition away from IBORs are set to have a significant impact on accounting, particularly on applying **hedge accounting**.
- A change in benchmark will in many cases result in the **need for contractual modification of bilateral arrangements including an adjustment of the fixed spread reflecting the pricing differential of old and new rates**.
- Replacement of IBORs will also drive a need to visit **existing and future state operations/processes**.

IBOR reform
Background

Status of key IBOR alternatives

	Alternative risk free rate	Rate administrator	Key features
UK	Reformed Sterling Overnight Index Average (SONIA)	Bank Of England	• Fully transaction-based rate, based on a functioning underlying market. • Overnight, risk-free reference rate. • Includes an **expanded scope** of transactions to incorporate overnight unsecured transactions negotiated bilaterally and those arranged with brokers. • Includes a volume-weighted trimmed mean.
US	Secured Overnight Financing Rate (SOFR)	Federal Reserve Bank of New York	• Fully transaction-based rate, based on a functioning underlying market. • Overnight, risk-free reference rate that correlates closely with other money market rates. • Covers multiple **repo market segments**, allowing for future market evolution.
Europe	Euro Short Term Rate ("€STR")	European Central Bank	• €STR reflects wholesale euro unsecured **overnight borrowing costs of euro area banks** • The ECB published the €STR for the first time on 2 October 2019, reflecting trading activity on 1 October 2019.
Switzerland	Swiss Average Rate Overnight (SARON)	SIX Swiss Exchange	• Became the reference interbank overnight repo on 25 August 2009. • **Secured rate** that reflects interest paid on interbank overnight repo.
Japan	Tokyo Overnight Average Rate (TONA)	Bank of Japan	• Fully transaction-based benchmark for the functioning **uncollateralised overnight call rate** market. • The Bank of Japan calculates and publishes the rate on a daily basis, using information provided by money market brokers (Tanshi). • An average, weighted by the volume of transactions corresponding to the rate.

Accounting considerations associated with IBOR reform

IBOR reform

Overview of accounting implications

Hedge accounting: Pre-replacement issues

- Qualifying IFRS hedge relationships include requirements that:
  - Hedged cash flows are '**highly probable**'
  - The hedge is expected to be highly effective/an economic relationship exists – '**prospective assessments'**
  - Where a **risk component** is the hedged item (e.g. the LIBOR component in fixed-rate debt) then that component is '**separately identifiable and reliably measurable (SIRM)**'
- IBOR reform and associated uncertainties raises questions for all of the above requirements and **could cause hedge relationships to fail unless an entity applies reliefs finalised by the IASB.**
- There are also implications for **hedge effectiveness** measurement

Hedge accounting: Replacement issues

- Hedge documentation will need to be **updated to reflect the new interest rate benchmark** which raises the following issues:
  - Whether this causes **discontinuation** of hedge relationships.
  - Whether amounts recognised in other comprehensive income will need to be **recycled to profit and loss account**.

Modification/derecognition

- Legacy contracts will need to be amended to transition from IBOR. Contract modifications results in the need to assess whether the terms of modified contract is **substantially different from the terms of original contract resulting in derecognition of the original contract and recognition of a new contract** which raises the following issues:
  - Application of the quantitative **10% test** given it may not be clear how and when cash flows will change when amendments are made to contracts.
  - Application of **effective interest rate and impact on expected credit losses.**
  - Implications on **hedge accounting**.

Valuation and discounting

- IBOR reform and associated uncertainties could have implications for fair value calculations e.g., **changes to discounting methodology and decreased liquidity.**
- Other examples of IFRSs using discount rates which reference IBORs include:
  - IAS 19
  - IAS 37
  - IFRS 2
  - IFRS 3
  - IFRS 5
  - IFRS 15
  - IFRS 16
  - IFRS 17

IBOR reform
IASB response

The International Accounting Standards Board (IASB) identified two groups of accounting issues that could impact financial reporting:

- Pre-replacement issues i.e., issues affecting financial reporting in the period before terms of financial instruments are modified ('Phase 1'); and
- Replacement issues i.e., issues that might affect financial reporting when an existing interest rate benchmark is either reformed or replaced ('Phase 2')

IASB considered the **pre-replacement issues to be more urgent**, and on 26 September 2019 published "Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7)" as a first response to the potential effects the IBOR reform could have on financial reporting.

All other hedge accounting requirements remain unchanged.

The **amendments are mandatory and effective for annual periods beginning on or after 1 January 2020**. The amendments were endorsed for use in the European Union (EU) on 15 January 2020, with early adoption being permitted provided EU endorsement is prior to the financial statements being issued.

IBOR reform

Key dates

2019

26 September
Phase I Amendments to the Standards Issued, available for early adoption subject to EU endorsement

10 October
Comments were requested by EFRAG for EU endorsement and subsequently submitted.

23 October
IASB Phase II deliberations
(Classification & measurement, modifications, derecognition)

14 December
IASB Phase II deliberations
(Hedge accounting)

2020

1 January
Mandatory adoption of Phase 1 amendments (subject to EU endorsement)

15 January
EU endorsement of Phase I amendments. Early adoption available, provided financial statements not issued before 15 January

30 January
IASB Phase II deliberations
(End of application of the Phase 1 exceptions, other standards and disclosures)

26 February
IASB Phase II deliberations
(Modifications, separately identifiable criteria, end of Phase II amendments effective date, transition and due process steps)

Q2 (April 2020)
Phase II Amendments to the Standards Exposure Draft (ED) expected to be published for feedback.

Q3
Phase II Amendments to the Standards expected to be issued.

IBOR reform

Summary of Phase I amendments to IFRS

Amendments to IFRS 9, IAS 39 and IFRS 7

"Highly probable" criterion – cash flow hedges

IFRS 9 and IAS 39 will provide a relief from the effects of IBOR reform uncertainties on the "highly probable" requirement.

Assessment of economic relationship

IFRS 9 and IAS 39 will provide a relief from the effects of IBOR reform uncertainties on the prospective assessment.

Reclassification of cash-flow hedge reserves

IFRS 9 and IAS 39 will provide relief from the effects of the IBOR reform uncertainties on the hedged cash flows.

Designation of risk components

IFRS 9 and IAS 39 will provide a relief from reassessing after initial designation whether the risk component is separately identifiable.

Retrospective assessment

IAS 39 will provide a relief from the effects of IBOR reform uncertainties on the retrospective assessment of the hedging relationships directly affected by the reform.

Disclosures

Entities should provide specific disclosures about the hedging relationships that are affected by the amendments (please see next slide).

End of Relief

Entities should **stop applying the relief** when the earlier of the following occurs:

i. The uncertainty around the timing and the amount of the cash flows arising from IBOR reform is no longer present, or

ii. The hedging relationship is discontinued.

Entities should apply the amendments retrospectively.

IBOR reform

Summary of Phase I amendments to IFRS: Disclosure requirements (IFRS 7)

Entities should provide following disclosures for hedging relationships affected by the amendments:

- A description of the significant interest rate benchmarks to which the company's hedging relationships are exposed to.
- An explanation of the extent of the risk exposure the company manages that is directly affected by the interest rate benchmark reform
- An explanation of how the company is managing the process to transition to alternative benchmark rate
- Description of significant assumptions or judgements the company made in applying the exceptions (for example, assumptions or judgements about when the uncertainty arising from interest rate benchmark reform is no longer present); and
- The nominal amount of the hedging instrument in the those hedging relationships.

IBOR reform

Recap on Phase I

The key changes in the Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7) are summarised as follows:

- Modify specific hedge accounting requirements so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark on which the hedged cash flows and cash flows from the hedging instrument are based will not be altered as a result of interest rate benchmark reform
- Are mandatory for all hedging relationships that are directly affected* by the interest rate benchmark reform
- Are not intended to provide relief from any other consequences arising from interest rate benchmark reform (if a hedging relationship no longer meets the requirements for hedge accounting for reasons other than those specified by the amendments, discontinuation of hedge accounting is required)
- Require specific disclosures about the hedging relationships that are affected by the amendments (please see previous slide)

* A hedging relationship is "directly affected" if the reform gives rise to uncertainties about:

- The interest rate benchmark designated as a hedged risk (contractually or non-contractually specified); and/or
- The timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument.

IBOR reform
Phase II deliberations

Replacement issues

Modification/derecognition

Modification of existing financial instruments:

- What is considered to be a modification?
- When does a modification result in derecognition?
- How should amendments to interest rate benchmark be accounted for?
- Consider impact of modifications on profit and loss account

Recognition of new financial instruments if the existing instrument is derecognized:

- Impact of amendments on solely payment of principal and interest assessment for financial assets
- Embedded derivatives for financial liabilities
- Reset expected credit loss staging if asset is measured at amortised cost or FVTOCI.

Hedge accounting

Hedge designations:

- Would change in hedge documentation due to hedged risk result in discontinuation?
- Would flexible hedged risk designations be permissible?
- Implications of amending some designated loans to reflect the alternative rate but not all within the same portfolio

End of relief:

- Interaction between end of relief in Phase I and hedge designations under Phase II
- If no discontinuation due to change in hedged risk, how should valuation adjustment on the hypothetical derivative and fair value hedge adjustment be accounted for ?

Other IFRS standards

- What are the potential impacts on other Standards (e.g. IAS 19, IFRS 16 and IFRS 17)

Disclosures

- Considering whether additional disclosure requirements should be developed.

IBOR reform

Phase II deliberations – Modification/derecognition

Replacement issues – Modification/derecognition

Modification

Definition: A modification does not necessarily require an amendment to the contractual terms of a financial instrument. A change in the **basis on which the contractual cash flows are determined** that alters what was originally anticipated constitutes a modification in the context of IBOR reform.

Practical expedient: IFRS 9:B5.4.5 applies for modifications related to the IBOR reform (i.e., result in changes to the interest rate benchmark), in other words the change to the benchmark rate is applied prospectively. IFRS 9:5.4.3 applies to modifications of other terms that are not considered substantial.

Practical expedient (to account for the modifications related to the reform) to be applied **first by updating the effective interest rate based on the alternative benchmark rate, and then IFRS 9 current requirements** should apply to determine if any other modifications to that financial instrument are substantial.

Derecognition

Existing requirements in IFRS 9 provide adequate basis to account for accounting implications arising from derecognition of a modified financial instrument and recognition of a new modified financial instrument in the context of IBOR reform.

IBOR reform

Phase II deliberations – Hedge accounting

Replacement issues – Hedge accounting

Hedge accounting

- Requirements of IFRS 9 and IAS 39 in regard to whether a hedging relationship should be discontinued after a modification to be retained.
- Following **updates to hedging documentation to reflect modifications** that are required as a direct consequence of IBOR reform **do not result in the discontinuation** of the hedge accounting:
  - Redefining the hedged risk to refer to an alternative benchmark rate, and
  - Redefining the description of the hedging instruments or the hedged items to refer to the alternative benchmark rate
- IAS 39 to be amended so that **a change to the method used for assessing hedge effectiveness does not result in the discontinuation of hedge accounting** when, due to IBOR reform, it is impractical to continue using the same method defined in the hedge documentation at the inception of the hedging relationship.
- For changes in hedge documentation, an entity is required to continue to apply requirements in IFRS Standards to measure the hedging instrument and the hedged item and to recognise hedge ineffectiveness that may arise due to any consequential valuation adjustments required by IFRS 9 and IAS 39.
- IFRS 9 and IAS 39 to be amended so that **when items within a designated group are amended for modifications** required as a direct consequence of IBOR reform, **following are permitted**:
  - Hedge items can be documented in two sub-groups within designated group of items: items—one referencing the original interest rate benchmark and the other, the alternative benchmark rate
  - Proportionality test can be performed separately for each subgroup
  - Hedge designation can be treated as a single hedging relationship. Hypothetical derivative to reflect the combination of the subgroups of items, and
  - treat IBOR and its alternative benchmark rate as if they share similar risk characteristics (but only in relation to a group of items designated under IAS 39).
- Please also refer to slide 16 for additional **relief on "separately identifiable requirement"**.

IBOR reform

Phase II deliberations – Other IFRS standards and disclosures

Replacement issues – Other IFRS standards and disclosures

Other standards

- IFRS 16 to be amended to provide a practical expedient, so that **a lessee would re-estimate the variable lease payments linked to IBOR and revise the discount rate** to reflect changes in the benchmark interest rate. **No amendments are needed for lessor accounting**.
- IFRS 4 to be amended to allow insurers applying the **temporary exemption to apply the amendments and practical expedient in accounting for modifications** directly required by IBOR reform.
- IFRS 17 provides an **adequate basis** for an entity to account for modifications an entity makes to insurance contracts in the context of the IBOR reform, and that such accounting results in useful information to users of financial statements.
- IFRS 13 already provides **sufficient guidance** to determine if and when a financial asset or financial liability should be transferred to a different level within the fair value hierarchy and that these transfers reflect the economic reality of IBOR reform, therefore providing useful information to users of financial statements.
- The current IFRS Standards **already provide adequate guidance** to determine the appropriate accounting treatment for the potential impacts of the replacement of IBORs on discount rates.

Disclosures

- IFRS 7 to be amended to require entities to provide disclosures that enable users of financial statements to understand:
  - The **nature and extent of risks** arising from IBOR reform to which the entity is exposed, and how the entity manages those risks; and
  - The entity's **progress in transitioning** from IBORs to alternative benchmark rates and how the entity is **managing this transition**.

Following information would be disclosed in reference to above:

- How the entity is managing the transition from IBORs to alternative benchmark rates, and the status/progress made at the reporting date;
- The carrying amount of financial assets and financial liabilities, including the nominal amount of the derivatives, **that continue to reference interest rate benchmarks subject to the reform**, disaggregated by significant interest rate benchmark;
- For each significant alternative benchmark rate that the entity is exposed to, **an explanation of how the entity determined the base rate and relevant adjustments to the rate**, to assess whether the **modifications to contractual cash flows were required as a direct consequence of IBOR** reform and have been done on an economically equivalent basis; and
- The extent to which IBOR reform has resulted in changes to an entity's **risk management strategy** and how the entity is managing those risks.

IBOR reform

Phase II deliberations – End of Phase I exceptions

End of application amendments introduced by Phase I

- No additional guidance or amendments should be made to the current end of application requirements in IFRS 9 and IAS 39 with respect to the **highly probable requirement** for cash flow hedges;
- No additional guidance or amendments should be made to the current end of application requirements in IFRS 9 and IAS 39 with respect to the **prospective assessments**; and
- IAS 39 be amended to allow that, **for the purposes of assessing retrospective effectiveness only**, the cumulative fair values changes reset to zero at the date the exception to the retrospective assessment ceases to apply.
- Relief for applying the **'separately identifiable' requirement** for hedges of the benchmark component of an interest rate risk only at the inception of the hedge is to cease at the earlier of:

  a. when changes to the hedging relationship are made for the hedged risk to reflect modification directly required by the reform, and

  b. when the hedging relationship is discontinued.
- **An additional Phase II relief** is available so that a component is considered to satisfy the separately identifiable requirement if, and only if:

  a. the entity reasonably expects that the alternative benchmark rate will satisfy the requirement in IFRS 9 or IAS 39 to be a separately identifiable component within the particular market structure within 24 months from the date it is designated as a risk component for hedge accounting purposes, and

  b. the component can be measured reliably from the date it is designated as the risk component.

IBOR reform

Phase II deliberations – End of Phase II exceptions, effective date and transition

End of application amendments introduced by Phase II

- No specific end of application requirements are considered necessary, as the nature of the proposed amendments is such that they **can only be applied to financial instruments and hedging relationship that satisfy relevant criteria**.
- Disclosures: **Information should continue to be provided** in a reporting period in which the entity is exposed to risks arising from the reform and the transition to alternative benchmark rates for financial instruments and hedging relationship is not complete.
- Separately identifiable requirement for risk components: This will cease applying **24 months** after the date that the alternative benchmark rate was designated as a risk component for hedge accounting purposes.
- Proposed amendments should apply **mandatorily**.

Effective date and transition requirements

- An effective date for annual periods **beginning on or after 1 January 2021** with earlier application permitted.
- That the proposed amendments should apply retrospectively for items that existed at the beginning of the reporting period in which the entity first applies the proposed amendments. An entity is **required to reinstate hedges that previously failed** due to IBOR reform.
- In the reporting period in which an entity first applies the proposed amendments an entity is **not required to present the disclosures required by IAS 8:28(f)**.

IBOR reform
Useful guidance

Deloitte guidance

IFRS in Focus — IASB issues Interest Rate Benchmark Reform amendments to IFRS 9, IAS 39, and IFRS 7
https://www.iasplus.com/en/publications/global/ifrs-in-focus/2019/ibor-amendments

A closer look at disclosures when applying the amendments to IFRS 9 and IAS 39 on Interest Rate Benchmark Reform
https://www.iasplus.com/en/publications/global/a-closer-look/ibor

IBOR reform
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