EFRAG
European Financial Reporting Advisory Group

This paper provides the technical advice from EFRAG TEG to the EFRAG Board, following EFRAG TEG's public discussion. The paper does not represent the official views of EFRAG or any individual member of the EFRAG Board. This paper is made available to enable the public to follow the EFRAG's due process. Tentative decisions are reported in EFRAG Update. EFRAG positions as approved by the EFRAG Board are published as comment letters, discussion or position papers or in any other form considered appropriate in the circumstances.

Interest Rate Benchmark Reform

You can submit your comments on EFRAG's draft comment letter by using the 'Express your views' page on EFRAG's website, then open the relevant news item and click on the 'Comment publication' link at the end of the news item.

Comments should be submitted by 31 May 2019.

International Accounting Standards Board
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

[XX Month 2019]

Dear Mr Hoogervorst,

Re: IASB ED/2019/1 *Interest Rate Benchmark Reform* (Proposed amendments to IFRS 9 and IAS 39)

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure draft ED/2019/1 *Interest Rate Benchmark Reform* (Proposed amendments to IFRS 9 and IAS 39), issued by the IASB on 3 May 2019 (the 'Amendments').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

EFRAG considers the IASB proposals to be an appropriate solution in addressing the inability to meet specific forward-looking hedge accounting requirements due to uncertainty that exists around the transition of interbank offered rates (IBORs) in the periods before the transition. EFRAG supports the proposals for providing relief on hedge accounting requirements in these periods until the uncertainty ceases to exist regarding how the reform of IBOR rates will affect the cash flows of the hedged item and of hedging instrument because the details of the replacement of interest rate benchmarks are unknown.

EFRAG considers that this first phase is appropriately handling the uncertainty with regards to specific accounting aspects prior to the IBOR transition (pre-replacement issues) and therefore focuses on those hedge accounting requirements only. EFRAG supports this approach and considers appropriate that accounting issues that arise subsequently to the IBOR transition are to be handled in the second phase (replacement issues).

EFRAG is aware that the interest rate benchmark reform creates more accounting issues than the ones addressed in the Amendments. Considering the current speed of the regulatory developments and the corresponding moves in the market to amend contracts in preparation for these changes, EFRAG is of the view that this second phase should be addressed as soon as possible and in parallel to the finalisation of the first phase, without hindering bringing relief for the issues already addressed in the first phase.

EFRAG notes that the transition paths of different IBORs are far from identical: while some rates are being replaced by alternative benchmarks, others are not replaced but undergo a change in underlying methodology. EFRAG is of the view that the IASB should consider the different patterns that the reform will have when assessing the replacement issues.

In this respect, EFRAG has summarised the transition patterns for the main benchmarks affecting jurisdictions in the European Economic Area, i.e. EURIBOR, EONIA and Sterling LIBOR in Appendix II of this letter as a working hypothesis.

In addition, to proactively assist the IASB in the preparation of next phase, EFRAG has identified in Appendix II a number of topics that could potentially be addressed in the second phase.

EFRAG's detailed comments and responses to the questions in the ED are set out in Appendix I.

If you would like to discuss our comments further, please do not hesitate to contact Didier Andries, Galina Borisova or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix I - EFRAG's responses to the questions raised in the ED

Question 1 [paragraphs 6.8.4–6.8.6 of IFRS 9 and paragraphs 102D–102F of IAS 39]

Highly probable requirement and prospective assessments

1 For hedges of interest rate risk that are affected by interest rate benchmark reform, the IASB proposes amendments to IFRS 9 and IAS 39 as described below.

(a) For the reasons set out in paragraphs BC8–BC15, the IASB proposes exceptions for determining whether a forecast transaction is highly probable or whether it is no longer expected to occur. Specifically, the Exposure Draft proposes that an entity would apply those requirements assuming that the interest rate benchmark on which the hedged cash flows are based will not be altered as a result of interest rate benchmark reform.

(b) For the reasons set out in paragraphs BC16–BC23, the IASB proposes exceptions to the hedge accounting requirements in IFRS 9 and IAS 39 so that an entity would assume that the interest rate benchmark on which the hedged cash flows are based, and/or the interest rate benchmark on which the cash flows of the hedging instruments are based, will not be altered as a result of interest rate benchmark reform when the entity determines whether:

(i) there is an economic relationship between the hedged item and the hedging instrument applying IFRS 9; or

(ii) the hedge is expected to be highly effective in achieving offsetting applying IAS 39.

2 Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

Notes to constituents – Summary of proposals in the IASB Exposure Draft

3 *As part of the pre-replacement phase before existing interest rate benchmarks are replaced with alternative, nearly risk-free interest rates (RFRs), the IASB 'considered the implications for specific hedge accounting requirements in IFRS 9 Financial Instruments and IAS 39 Financial Instruments: Recognition and Measurement, which require forward-looking analysis. As a result of the reform, contractual cash flows of hedged items and hedging instruments that are based on an existing interest rate benchmark will likely change when that existing interest rate benchmark is replaced with an alternative interest rate'. 'Until decisions are made with respect to what alternative interest rate is used and when that replacement will occur, uncertainties will exist regarding the timing and the amount of future cash flows of the hedged item and the hedging instrument'.*

Highly probable requirement

4 *The highly probable requirement ensures that changes in fair value of designated hedging instruments are recorded in the cash flow hedge reserve in other comprehensive income only for those hedged forecast transactions for which there is a high probability of occurrence. The IASB noted that if the effects of the interest rate benchmark reform are such that the hedged cash flows are no longer highly probable, then hedge accounting would be discontinued. Nevertheless, the IASB noted that uncertainty exists regarding how the reform will affect the hedged cash*

flows because the details of the replacement of interest rate benchmarks are unknown. In the IASB's view, discontinuing all affected hedging relationships solely due to such uncertainty would not provide useful information to users of financial statements.

5 Therefore, the IASB decided to propose amendments to IFRS 9 and IAS 39 to provide an exception to the highly probable requirement that would provide relief during this period of uncertainty. More specifically, if the hedged future cash flows are based on an existing interest rate benchmark that would be altered by the reform, an entity would assume that the interest rate benchmark on which hedged cash flows are based will not be altered when assessing whether the future cash flows are highly probable.

6 The IASB is also 'proposing an exception for discontinued hedging relationships': any amount remaining in the cash flow hedge reserve would be reclassified to profit or loss in the same period or periods during which the hedged cash flows affect profit or loss, assuming that the interest rate benchmark on which the hedged cash flows are based will not be altered as a result of interest rate benchmark reform.

Prospective assessments

7 The requirements in paragraph 6.4.1(c)(i) of IFRS 9 (the existence of an economic relationship) and paragraph AG105(a) of IAS 39 (whether the hedge is expected to be highly effective) are collectively referred to as 'prospective assessments'.

8 IFRS 9 and IAS 39 require entities to discontinue hedge accounting if the prospective assessment is not met. Once hedge accounting is discontinued, the entity is required to recognise in profit or loss the changes in the fair value of the derivatives (i.e. the hedging instruments before discontinuation), in the same way as trading derivatives.

9 The IASB considered the usefulness of the resulting information and decided to provide relief from the 'prospective assessments' requirements in IFRS 9 and IAS 39.

10 Applying the proposed relief, entities would assess whether the economic relationship required by IFRS 9 exists, or whether the hedge is expected to be highly effective in achieving offsetting as required by IAS 39, assuming the interest rate benchmark on which the hedged item and the hedging instrument are based will not be altered as a result of interest rate benchmark reform. Similarly, if an entity designates a highly probable forecast transaction as the hedged item, the entity would perform the prospective assessments assuming no amendments will be made to future contracts as a result of interest rate benchmark reform with respect to the interest rate benchmark of those forecast transactions.

Retrospective assessments

11 According to paragraph AG105 of IAS 39, a hedge is regarded as highly effective only if both the requirement relating to retrospective and prospective assessments are met. If an entity fails either of these assessments, then paragraphs 91(b) and 101(b) of IAS 39 require the entity to discontinue hedge accounting. IFRS 9 does not require a retrospective assessment.

12 In the IASB view, 'disregarding the effects of IBOR reform on the actual results of a hedge could impact measurement of the hedging instrument and hedged item. This would undermine the fundamental principle in hedge accounting of offset between gains and losses on the hedging instrument and the hedged item. As noted at the IASB December 2018 meeting, the IASB is not considering evaluating that principle'.

EFRAG's response

EFRAG agrees that the relief from the uncertainties arising from the interest rate benchmark reform should be provided for highly probable requirement and prospective assessments required by IFRS 9 and IAS 39.

13 EFRAG supports the overall approach as, without the proposed relief, significant failures in hedge accounting could occur. The resulting one-off impacts on the financial statements are likely to be ignored by analysts as not providing useful information.

Highly probable requirement

14 EFRAG considers that discontinuation of hedging relationships solely due to the uncertainties regarding the timing and the amount of cash flows arising from the reform of interest rate benchmarks will not provide useful information to the users of financial statements.

15 The relief from highly probable requirement will allow entities to continue hedge accounting, as it permits an entity to temporarily ignore the interest rate benchmark reform effects when assessing the probability of future cash flows.

16 In EFRAG's view this approach is needed in order to avoid discontinuation of hedging relationships that would otherwise meet the hedge accounting requirements. The IASB's proposal solely due to the uncertainty about timing and amount of cash flows due to the IBOR reform. EFRAG supports the IASB's proposal for temporary relief from the highly probable requirement.

Prospective assessments

17 As stated in paragraph 14, EFRAG considers that the discontinuation of existing hedging relationships solely due to the uncertainty about the impact of IBOR reform on cash flows of the hedged item and hedging instruments would not result in useful information EFRAG acknowledges the importance of providing the relief from prospective assessments of the hedge effectiveness required by IFRS 9 and IAS 39 as it ensures the continuation of hedging relationships.

18 Therefore, EFRAG supports the relief from prospective assessments, as long as uncertainties from the interest rate benchmark reform exist, as proposed by the IASB.

19 EFRAG agrees with the reasoning of the IASB set forth in paragraph BC22 of the Amendments. The relief refers solely to the uncertainties arising from interest rate reform and the requirements of IFRS 9 and IAS 39 on prospective assessment should continue to apply, including the measurement of hedge effectiveness.

Retrospective assessments

Question to Constituents

20 EFRAG has been informed that, during the period while the relief is ongoing, it will be necessary to have clarity on the outcome of not only the prospective assessment of a cash flow hedge relationship under IAS 39, but also of the retrospective assessment. This in order to determine, at the end of each reporting period, how much of the value difference between the hedged item and the hedging instrument is assigned to other comprehensive income and which amount is assigned to profit or loss. As such, the retrospective assessment at the beginning of the cash flow hedge relationship should be able to be carried forward during the period of the relief solely for the purpose of determining the cash flow hedge reserve.

21 In your view, are there particular circumstances in which a relief of the retrospective test is needed for cash flow hedges applying IAS 39? If so, please describe the reasons why as well as the specific fact patterns it would apply to.

22 The IASB should clarify the treatment for the effective share of the accumulated OCI reserve for cash flow hedging relationships that is under the scope of application of this Amendment, once the relief ends (as a replacement issue). EFRAG understands that, provided that the effects of any ineffectiveness are recognised in profit or loss according to the prevailing market conditions at the end of the relief, the effective share of the OCI reserve can follow the hedge accounting treatment under an assumption of continuity of the hedge (i.e. amounts will be reversed when the hedged transaction occurs in future periods).

Question 2 [paragraph 6.8.7 of IFRS 9 and paragraph 102G of IAS 39]

Designating a component of an item as the hedged item

23 For the reasons set out in paragraphs BC24-BC27, the IASB proposes amendments to the hedge accounting requirements in IFRS 9 and IAS 39 for hedges of the benchmark component of interest rate risk that is not contractually specified and that are affected by interest rate benchmark reform. Specifically, for such hedges, the Exposure Draft proposes that an entity applies the requirement – that the designated risk component or designated portion be separately identifiable – only at the inception of the hedging relationship.

24 Do you agree with this proposal? Why or why not? If you disagree with the proposals, please explain what you propose instead and why.

Notes to constituents – Summary of the proposals in the IASB Exposure Draft

25 *An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. Both IFRS 9 and IAS 39 require that the risk component be separately identifiable and reliably measurable in order to be eligible for hedge accounting.*

26 *The IASB observed that the interest rate benchmark reform could affect an entity's assessment of whether a non-contractually specified IBOR component is separately identifiable and therefore can be an eligible hedged item in a hedging relationship. The IASB noted that the same issue does not arise for risk components that are contractually specified.*

27 *Because a discontinuation of hedging relationships resulting from the uncertainty relating to the interest benchmark reform would not provide useful information, the IASB decided to propose amendments to IFRS 9 and IAS 39 so that entities do not discontinue hedge accounting solely because the hedged item is no longer separately identifiable as interest rate benchmark reform progresses. The separate identification requirement for hedges of the benchmark component of interest rate risk is only applied at the inception of those hedging relationships.*

28 *The IASB did not allow entities to designate the benchmark component of interest rate risk as the hedged item in a new hedging relationship if the risk component is not separately identifiable at inception of the hedging relationship as this would go beyond the objective of the proposed exception.*

29 *Finally, the IASB is not proposing any exception from the requirement relating to reliable measurement.*

EFRAG's response

EFRAG agrees that the hedged risk component or risk portion should only be separately identifiable at inception of the hedging relationship.

30 EFRAG supports the overall aim of the Amendments, i.e. to avoid accounting consequences caused by the transition from existing IBORs to risk-free rates that would not result in useful information.

31 Until uncertainty regarding the timing and amount of future cash flows of the hedged items and the hedging instruments ceases to exist, such uncertainty should not create volatility in financial reporting due to the discontinuation of hedging relationships that would otherwise meet the hedge accounting requirements.

32 Therefore, it is important that entities are able to conclude that the interest rate benchmarks, if they are not contractually specified, are still separately identifiable and reliably measurable for the hedging purposes as it allows the entities to continue hedge accounting. Making this assessment only once, at the inception of the hedging relationship, will achieve this objective.

33 Hence, EFRAG agrees that paragraphs 81 and AG99F of IAS 39 shall apply at inception of the hedging relationship, for a hedge of a benchmark portion of interest rate risk that is affected by interest rate benchmark reform.

34 EFRAG recommends that the final Amendments clarify that, where relevant, the reliefs are applicable to new hedging relationships, without removing the exception in paragraph BC27 of the Amendments.

Question 3 [paragraphs 6.8.8 – 6.8.10 of IFRS 9 and paragraphs 102H – 102J of IAS 39]

Mandatory application and end of application

35 For the reasons set out in paragraphs BC28 – BC31, the IASB proposes that the exceptions are mandatory. As a result, entities would be required to apply the proposed exceptions to all hedging relationships that are affected by interest rate benchmark reform.

36 For the reasons set out in paragraphs BC32 – BC42, the IASB proposes that the exceptions would apply for a limited period. Specifically, an entity would prospectively cease to apply the proposed amendments at the earlier of:

(a) When the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows; and

(b) When the hedging relationship is discontinued, or if paragraph 6.8.9 of IFRS 9 or paragraph 102I of IAS 39 applies, when the entire amount accumulated in the cash flow hedge reserve with respect to that hedging relationship is reclassified to profit or loss.

37 For the reasons set out in paragraph BC43, the IASB is not proposing an end of application in relation to the separate identification requirement.

38 Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

Notes to constituents – Summary of the proposals in the IASB Exposure Draft

39 *The IASB proposed that entities must apply the exceptions in the ED to all hedging relationships to which the exceptions are applicable. Voluntary application is not allowed as it could give rise to selective discontinuation of hedge accounting and selective reclassification of the amounts recorded in other comprehensive income related to previously discontinued hedging relationships.*

40 The IASB also proposed that an entity ceases applying the proposed exceptions at the earlier of (a) when the uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows is no longer present and (b) the discontinuation of the hedging relationship.

41 *The IASB observed that there could be circumstances in which the exceptions in this ED are not applicable for example if a particular interest rate benchmark is not subject to a replacement with an alternative interest rate. Also, there could be circumstances where the exceptions are only partly applicable.*

EFRAG's response

EFRAG agrees with mandatory application of the Amendments to all hedge accounting relationships as this avoids the potential for selective application of hedge accounting requirements. EFRAG also agrees with the temporary nature of the relief as the relief is not needed once the uncertainties about the reform have been lifted. Finally, EFRAG agrees with not proposing an end of application in relation to the separately identifiable requirement as this would be inconsistent with the aim of the relief provided.

42 EFRAG agrees with mandatory application of the Amendments to all existing hedge accounting relationships. This is because voluntary application may lead to earnings management by way of selective discontinuation of existing hedge accounted relationships and selective reclassification of existing OCI balances.

43 EFRAG also agrees with the temporary nature of the relief and the conditions set in determining the end of the relief. The temporary nature of the relief is in line with the overall aim of the Amendments, i.e. there will no longer be a need for relief once the uncertainty on how the reform will impact the amount and timing of the cash flows of the hedged item and hedging instrument has been removed or when the hedging relationship ends.

44 Finally, EFRAG agrees with not proposing an end of application requirement with respect to the proposed exception for the separately identifiable requirement as this would negate the effects of the relief that is proposed.

Question 4 [paragraph 6.8.11 of IFRS 9 and paragraph 102K of IAS 39]

Disclosures

45 For the reasons set out in paragraph BC44, the IASB proposes that entities provide specific disclosures about the extent to which their hedging relationships are affected by the proposed amendments.

46 Do you agree with these proposed disclosures? Why or why not? If not, what disclosures would you propose instead and why?

Notes to constituents – Summary of proposals in the IASB Exposure Draft

47 The IASB proposes that entities applying the reliefs in this Exposure Draft provide disclosure about the magnitude of the hedging relationships to which the reliefs apply. The IASB noted that IFRS 7 Financial Instruments: Disclosures already *requires specific disclosures about hedge accounting and, for some specifically identified disclosures, information provided separately for hedging relationships to which the proposed exceptions apply, would provide useful information to users of financial statements. The IASB expects that the cost of this disclosure proposal would not be onerous because it only requires disaggregating information that is already required to be disclosed by IFRS 7.*

EFRAG's response

EFRAG agrees with the IASB's proposal to require specific disclosures about the extent to which the hedging relationships are affected by the proposed amendments.

48 In EFRAG's view, IFRS 7 represents a good basis for such disclosures. While agreeing to rely on IFRS 7 disclosures, EFRAG is of the view that the objective of providing these should be explained in the final Amendments. EFRAG does not expect that the proposed disclosures will require undue cost or effort to segregate hedging relationships to which the amendments are applied.

49 EFRAG considers that the proposed disclosures will provide users with useful information about how the entity is impacted by the interest rate benchmark reform.

50 Therefore, EFRAG supports the IASB's proposal for additional disclosure requirements as set out in this Exposure Draft.

Question 5 [paragraphs 7.1.9 and 7.2.26(d) of IFRS 9 and paragraph 108G of IAS 39]

Effective date and transition

51 For the reasons set out in paragraphs BC45–BC47, the IASB proposes that the amendments would have an effective date of annual periods beginning on or after 1 January 2020. Earlier application would be permitted. The IASB proposes that the amendments would be applied retrospectively. No specific transition provisions are proposed.

52 Do you agree with these proposals? Why or why not? If you disagree with the proposals, please explain what you propose instead and why.

Notes to constituents – Summary of proposals in the IASB Exposure Draft

53 Acknowledging the urgency of the matter, the IASB proposes that the effective date of these amendments is annual periods beginning on or after 1 January 2020, with earlier application permitted.

54 In addition, the IASB proposes the amendments apply retrospectively.

EFRAG's response

EFRAG supports the IASB proposals on the date of application with earlier application permitted and the retrospective application of the amendments.

55 EFRAG acknowledges the need for the earliest effective date possible for the application of the amendments which in some jurisdictions might be appropriate even before 1 January 2020.

56 EFRAG also agrees that the retrospective application of the Amendments proposed by the IASB will enable continuation of previously designated hedge accounting relationships but will not allow either hindsight designations or reinstatements of

previously discontinued hedging relationships. However, EFRAG notes the possibility that an entity may not apply the Amendments until the effective date, resulting in possible discontinuation of hedge accounting for 2019 and reinstatement of hedge accounting when the Amendments are applied retrospectively. EFRAG sees no practical way to avoid this possible outcome.

57 Therefore, EFRAG supports the IASB proposals on effective date and transition.

Appendix II: Preparation for phase II (replacement issues)

Introduction

1 This Appendix is intended to proactively contribute to the discussion of the replacement issues. It includes:

(a) description of the main IBOR transition patterns that will affect the European Economic Area; and

(b) a number of topics that may be worthy of consideration by the IASB when addressing the replacement issues.

2 EFRAG considers the IASB proposals relating to the pre-replacement issues as a solution in resolving the uncertainty that currently exists around the transition of interbank offered rates (IBORs) and supports the proposals relating to the pre-replacement issues for providing relief on hedge accounting requirements.

3 EFRAG is aware that the Interest Rate Benchmark reform creates more accounting issues than the ones addressed in the Amendments. EFRAG considers that this first phase is handling the uncertainty with regards to accounting aspects before the IBOR transition and therefore is limited to hedge accounting. EFRAG supports this approach and considers that accounting issues that arise subsequently to the IBOR transition (replacement issues) are to be handled in the second phase.

4 EFRAG is further of the view that this second phase should be addressed as soon as possible in parallel with the finalisation of the first phase, without hindering bringing relief for the issues already addressed in the first phase.

Description of possible fact patterns

5 EFRAG expects that the transition path of each IBOR will be different and hence may require different accounting solutions. Specific accounting solutions may therefore be needed when dealing with one IBOR transition but not with another. As European constituents are likely to deal with a range of IBOR transitions, EFRAG is taking a holistic look at these, whilst recognising that some accounting effects may not arise when dealing with a particular IBOR.

6 EFRAG summarises the transition patterns of the main benchmarks affecting the European Economic Area, i.e. EURIBOR, EONIA and LIBOR as general fact patterns. EFRAG relies on these fact patterns in analysing the potential accounting effects that may arise.

EURIBOR

Transition type and date

7 Starting from 01/01/2022, only benchmarks that are compliant with the Benchmark Regulation (BMR) may be used in the EU for new contracts (and, subject to the assessment of the regulator, for legacy contracts).

8 EURIBOR does not transition to a new benchmark index. The administrator of EURIBOR, the European Money Market Institute (EMMI), has defined some changes to its calculation methodology, from ‘quote-based’ to ‘hybrid’, to ensure the compliance of the index with the BMR.

9 The Belgian Financial Services and Markets Authority (FSMA), in its role of National Competent Authority of the administrator, has to assess the compliance of the hybrid EURIBOR methodology with BMR and authorise its administrator EMMI in order to continue the use of EURIBOR in EU.

10 The current working assumption is that EURIBOR's revised framework will be authorised however, this will be certain only after the administrator files for authorisation and once the FSMA has announced its assessment.

11 EMMI will file for authorisation to the Belgian FSMA by Q2 2019. Subsequently, EMMI will start transitioning Panel Banks from the current EURIBOR methodology to the hybrid methodology, with a view of finishing the process before the end of 2019.

12 Many consider that a change in the calculation methodology for EURIBOR is not a change in the benchmark and hence there would not be a transition to a different benchmark. However, others may hold a different view.

Difference between new and old contracts

13 The current version of EURIBOR can be used in existing contracts and new contracts as its underlying interest is considered to remain unchanged by the shift to the new hybrid methodology. EMMI undertook the EURIBOR reform in order to be compliant with the EU BMR. EMMI needs to adapt the current quote-based methodology to a methodology that is anchored in transactions to the extent possible, as is the case in the new hybrid methodology. EMMI is reforming the EURIBOR benchmark for two main reasons:

(a) because the Benchmark Regulation and the guidelines of international organisations on the administration of benchmarks require that benchmarks are be based on arm's length transactions to the extent possible; and

(b) to adapt the methodology to the evolving circumstances in the market that EURIBOR seeks to measure.

EONIA

Transition type and date

14 After conducting an EONIA Review, EMMI concluded that under current market conditions and dynamics (the activity underpinning EONIA is very low and concentrated), EONIA's compliance with the EU Benchmarks Regulation by 1 January 2020 cannot be warranted, as long as its definition and calculation methodology remain in its current format. Therefore, there was a need to find a replacement rate. The working group on euro risk-free rates recommended in September 2018, following a public consultation, the €STR as the new euro risk-free rate and replacement of EONIA.

15 In order to ensure an orderly and smooth transition from EONIA to the new €STR, the working group on euro risk-free rates recommended to follow the so called ''EONIA recalibration approach'' from the first €STR publication date until the end of 2021. Under this approach there will be a transition period, starting from 2 October 2019, during which EONIA changes its calculation methodology, to become "€STR + fixed spread". This recalibrated EONIA will exist until the end of 2021, after which it will be discontinued.

16 €STR starts to be published on the 2 October 2019 and will exist in parallel with the recalibrated EONIA until the end of 2021.

17 In theory, there should be no value transfer as there is no transition and the continuity of EONIA is preserved. The change in calculation methodology, and specifically, the fixed spread embedded in the new EONIA methodology has been quantified so that the recalibrated EONIA would avoid a value transfer.

18 The spread value will be constant during the transition period.

19 The full move to the €STR at the end of 2021 is not expected to create a value transfer, under the assumption that the relevant parties have agreed on and follow a fair compensation mechanism and they have reviewed their contracts accordingly.

Difference between new and old contracts

20 The change in EONIA under the recalibration approach does not intend to affect the underlying interest of the rate, therefore existing contracts indexed to EONIA as of 2 October 2019, will not be discontinued. Between this date and the end of 2021 these contracts will have to transition to €STR, as the recalibrated EONIA will cease to exist. The transition to €STR is not foreseen to be granted by law to all the contracts. As such, the parties to the contracts will have to agree on the transition provisions that will be applicable to the contract.

21 During the transition period, the working group has recommended that parties to new contracts use €STR as interest rate benchmark; however, if they use EONIA, fallback provisions will have to be incorporated in the contracts. After the end of 2021 all the contracts should transition to €STR.

LIBOR

22 LIBOR (London Interbank Offered Rate) is to transition to SONIA (Sterling Overnight Indexed Average).

Transition type and date

23 The transition period starts in 2019 and ends in 2021, after 2021 the LIBOR production is no longer guaranteed. This implies that both LIBOR and SONIA will coexist during a particular timeframe (parallel run).

Difference between new and old contracts

24 SONIA will be used for new contracts, while old contracts will still reference to LIBOR until explicitly changed by the contract parties.

Question to Constituents

25 In addition to the fact patterns above, are there different patterns of IBOR transition that the IASB should consider when dealing with the replacement issues? Please describe.

Topics that have been raised with EFRAG which may need to be considered when dealing with replacement issues

26 EFRAG has been informed about a number of topics that may potentially need to be addressed when dealing with the replacement issues. These topics are listed below with the sole aim of informing the IASB and EFRAG has not developed a view as to whether standard setting is needed.

Topic 1: Derecognition

27 The contractual terms of assets and liabilities will be amended to reflect the new risk-free rate. This modification will trigger accounting consequences, as entities will have to assess whether the change result in derecognition of the old financial instrument and recognition of a new one.

Topic 2: Modification

28 In case modification does not trigger derecognition, a modification gain or loss may arise from recognition in profit or loss of the difference between the carrying amount and the revised contractual cash flows, discounted using the original EIR.

29 It is expected that new-RFRs will be lower than the old IBORs. When IBOR-based financial instruments are modified to be based on the new RFR they may include a

higher fixed spread. To the extent the present value of the increase in the spread is offset by lower forecast floating rate cash flows, at the date of the modification the relationship between the lender and borrower would be unchanged. Accordingly, to the extent the modification does not result in a gain or loss for either borrower or lender, both parties should be able to apply IAS 39, paragraph AG7 or IFRS 9, paragraph B5.4.5.

Topic 3: Retrospective assessment: hedge accounting ineffectiveness

30 As illustrated in paragraph BC23 of the ED, the IASB decided not to propose any exception for the effects of the IBOR reform on 'retrospective assessments' required by IAS 39. Ineffectiveness may arise, for example, from differences in the changes of cash flows of the hedged item and of the hedging instrument, including differences arising from different timing in the benchmark rate replacement between hedged item and hedging instrument. Insofar this topic cannot be addressed as a pre-replacement issue, it could be considered dealt with as replacement issue.

Topic 4: Hedge accounting discontinuation

31 If an instrument (whether a hedging instrument or hedged item) is derecognised as a result of, and only of, modifications due to the replacement of the benchmark following the IBOR reform, this derecognition may lead to a discontinuation of the hedge accounting relationship in accordance with IAS 39, paragraph 91 or IFRS 9, paragraph 6.5.6.

Topic 5: Recalibration of hedging relationship

32 In order to calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item (i.e. a hypothetical derivative) (IAS 39, IG paragraph F5.5 and IFRS 9, paragraph B6.5.5).

33 It has been observed that, when a previously designated old-IBOR hedge relationship is recalibrated to the new RFR, this circumstance may not be considered a new hedge designation for the purposes of determining the hypothetical derivative for cash flow hedges. In other words, the hypothetical derivative for a non-optional derivative, at the date of re-designation, would not be reset to zero at that date, rather would be recalibrated to have a fair value of zero when the hedge accounting relationship was last previously designated.

34 In case a relief is provided this would avoid all cash flow hedges being deemed immediately ineffective when the cause of such ineffectiveness is the replacement of old IBOR to new RFR.

Topic 6: Hedge documentation

35 Hedge documentation should be updated to consider the IBOR transition (IAS 39, paragraph 88(a) or IFRS 9, paragraph 6.4.1 (b)). This process may be burdensome and time consuming and may not be completed in time considering when the relief ends. It has been questioned whether relief would be needed to the extent that discontinuation of a hedge accounting relationship is solely due to the need to update the documentation.

Topic 7: IAS 8 - Change in estimates

36 There may be a lack of clarity as to whether changes in fair value measurement arising from the introduction of new RFRs are a change in estimate or a change in accounting policy (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*).

Topic 8: IFRS 9 – SPPI criterion

37 The transition from an existing IBOR to a risk-free rate raises a question as to whether a financial instrument still meets the SPPI criterion.

38 EFRAG notes that every transition is unique, but the following elements may prove useful in assessing whether the SPPI criterion is still met or not:

(a) continuity in the contractual rates (i.e. where the new risk-free rate is seen as a successor of the current IBOR);

(b) if the change in interest rates has only a de minimis effect on the contractual cash flows, it will not affect the classification of the financial instrument; and

(c) IBORs are generally short-term rates. In determining long-term rates floating interest rates swap rates are used which are based on a spread on top of the IBORs. These spreads represent credit and liquidity risk but as most swap rates are collateralised the credit risk is very limited.

Topic 9: IFRS 9 – Business model

39 In case of modifications that lead to derecognition of an existing financial asset and recognition of a new financial asset, it is not clear whether the recognition of such financial asset can be considered to meet the business model test and be held for collection of cash flows.

40 IFRS 9 notes that in particular circumstances sales that are made for particular reasons can be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows. However, it is unclear whether this can be extrapolated to the situation of derecognising financial assets as a result of the IBOR reform.

Topic 10: IFRS 17 – Interest guarantees in insurance contracts.

41 Interest guarantees in insurance contracts generally rely on references other than IBOR rates (for example, livret A in France). But these references themselves are calculated relying on IBOR rates, so the change to a risk-free rate may affect the calculation of the interest guarantees.

Topic 11: Accounting treatment of OCI balances at the end of relief

42 When the interest rate benchmark reform is enacted and relief ends, the treatment of the amounts accumulated in OCI while the relief was in place should be addressed. Assessment is to be made whether these OCI balances should be immediately recycled to profit or loss or should they be amortised on a systematic and rational basis.

Topic 12: Collateralised derivatives discounting using €STR.

43 Based upon the information on transition path of €*STR,* market participants currently anticipate:

(a) collateralised derivatives will be discounted using €*STR* flat yield curve;

(b) CSA (Credit Support Annex) will no longer be remunerated based on EONIA but on €*STR* flat even if EONIA is supposed to be priced at €*STR* + 9 bp according to the assumptions.

44 If an entity has classified its CSA at fair value through profit or loss according to IFRS 9, paragraph 2.3, then the fair value of the loan is considered not to be affected by the change to the remuneration of the CSA. This arises because the new remuneration - €*STR* flat - is now considered by the market participants as being the new market-based remuneration.

45 If an entity instead has classified and measured its CSA at amortised cost using the IFRS 9 loan commitment exception IFRS 9.2.1(g), then the question arises whether the entity should apply IFRS 9, paragraph 5.4.3 to the modification of the CSA agreement.

Question to Constituents

46 In your view which of the above topics should be addressed by the IASB when dealing with the replacement issues? Please explain the reasons why and your suggested accounting treatment.

47 In addition to the topics listed above, do you have any other matters that the IASB should consider when dealing with the replacement issues? Please describe.