# IBOR reform and effects on financial reporting - update

## Objective

1 The objective of this session is to provide EFRAG TEG members on update on the IASB project relating to the IBOR (Interbank Offered Rate) reform and its effects on financial reporting.

## Project plan and timeline

2 The IASB staff has foreseen the following project plan:

| **Timeline** | **Project plan** |
|---|---|
| March 2019 | Board finishes deliberations, including the comment period, due process steps and permission to ballot.<br>Proceed with drafting those amendments. |
| April/May 2019 | Publish an Exposure Draft |
| June/July 2019 | Comment period ends |
| September/October 2019 | Board re-deliberations |
| November/December 2019 | Issue final amendments |

3 The IASB staff is proposing a 45-day comment period. In case the IASB Board decides on a period shorter than 45 days, the Due Process Oversight Committee has approved a comment period of no less than 30 days. This will be discussed at the March IASB meeting and an oral update will be provided at the EFRAG TEG meeting.

## Background information

4 Recent market developments have brought into question the long-term viability of some interbank offered rates (IBORs). IBORs are reference interest rates which are used as benchmarks for a broad range of financial products and contracts. References rates such as EURIBOR (Euro Interbank Offered Rate) and LIBOR (London Interbank Offered Rate) are based on unsecured interbank term lending and borrowing.

5 In this context, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest benchmarks and develop plans for reform to ensure that these benchmarks are robust and appropriately used by market participants. The FSB published its report *Reforming Major Interest Rate Benchmarks* in July 2014. Since then, the FSB publishes regular updates, the latest being published on 14 November 2018.

6 In some jurisdictions, there is already a clear move towards replacing the IBORs by alternative, nearly risk-free rates (RFR), which are based, to a higher extent, on transaction data. This is the case, for example, for:

(a) the Secure Overnight Funding Rate (SOFR) in the US,

(b) the reformed Sterling Overnight Index Average (SONIA) in the UK,

(c) SARON (the Swiss Average Rate Overnight) in Switzerland.

7 The European Central Bank (ECB), the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission have established the industry-led working group on euro risk-free rates to identify and recommend risk-free rates that could serve as a basis for an alternative to current benchmarks used in the euro area.

8 On 13 September 2018 the group recommended the use of ESTER as the risk-free rate for the euro area.

9 ESTER is a euro short-term rate based on data already available to the Eurosystem. It will reflect the wholesale euro unsecured overnight borrowing costs of euro area banks and will complement existing benchmark rates produced by the private sector, serving as a backstop reference rate.

10 ESTER will replace EONIA (euro overnight index average) and the use of EONIA will be restricted starting from 1 January 2020.

11 Regarding EURIBOR, a hybrid approach is now being considered where the methodology is supported by transactions whenever available and relies on other related market pricing sources when necessary. During 2019 the responsible authorities will continue to assess the feasibility of this method.

**IASB staff analysis of market implications of transition from IBOR to RFR**

12 The IASB staff analysis of market implications of transition from IBOR to RFR presents challenges such as:

(a) Amending legacy contracts to replace an IBOR by its respective RFR;

(b) Dealing with the pricing gap between IBOR (which includes bank credit risk) and the respective RFR, which are nearly risk-free; and

(c) Many of the alternative RFRs reflect the overnight transactions rate and currently lack the term structure offered by IBORs, which are produced for multiple maturity periods.

13 Uncertainties associated with transition can be classified as valuation issues and basis risk.

*Valuation issues*

14 The differences between IBOR and RFR will arise mainly because:

(a) IBORs include a bank credit risk premium while alternative benchmark RFRs are nearly risk-free; and

(b) the alternative RFRs are primarily overnight rates whereas the relevant IBORs are available in different tenors.

15 Contractual amendments to legacy positions may vary across products, especially between derivatives and cash instruments. In the case of derivatives, the International Swaps and Derivatives Association (ISDA) expects to use a standardised process to facilitate amendments to legacy positions between adhering parties. However, the specific conditions for the contractual amendments have not been defined yet.

16 Regarding cash instruments (i.e. financial instruments that are not derivatives), while their nature varies across jurisdictions, product types and agreements, there is no central organisation, such as ISDA, that can coordinate efforts to create standard protocols for cash instruments. Therefore, negotiation between parties on a contract-by-contract basis is likely to be required.

17 It is likely that amending the terms and conditions of legacy positions will be required to enact IBOR reform. However, consensus has not yet been reached on how contracts will be amended and whether or not there will be value transfers on transition.

*Basis risk*

18 Due to the inherent complexities associated with the transition, market participants are also concerned with basis risk being introduced in the system. This could emerge if:

(a) derivatives and the cash products they hedge transition to alternative RFRs under different timelines; and

(b) cash products reference term versions of the alternative RFRs while derivatives reference the overnight alternative RFRs.

19 If derivatives and cash instruments they hedge transition to alternative RFRs under different timelines, it could lead to a situation where market participants are left with basis risk arising from derivatives and cash products that are referenced to different rates during an undefined transitional period.

**IASB staff analysis of accounting implications of transition from IBOR to RFR**

*Scope of the project*

20 The IASB engaged with securities regulators, central banks, audit firms, and financial institutions to obtain an understanding of the effects to financial reporting due to the potential discontinuation of IBORs. The IASB staff considered the feedback from these activities and developed their preliminary views on the implications for the existing accounting requirements.

21 At its December 2018 meeting, the IASB decided to divide the project into two phases:

(a) The first phase will focus on issues affecting financial reporting leading up to IBOR reform. These issues are more urgent because they might affect financial reporting before IBOR reform is enacted and they will be addressed as a priority.

(b) The second phase will focus on issues that affect financial reporting when IBOR reform is enacted. As there is a lot of uncertainty about how market participants will approach some key issues related to amendments of legacy positions and whether value transfers will occur as a result, the IASB has decided to monitor developments in this area.

22 The first phase of the IASB project will cover IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* requirements for hedge accounting.

23 The ESTER working group created by the ECB, FSMA and ESMA raised similar issues to the ones identified by the IASB. However, this working group noted that there are potential effects beyond IAS 39 and IFRS 9. In their view other areas of accounting where the accounting principles provide for the use of a risk-free rate may be impacted. Examples are IAS 19 *Employee Benefits*, IAS 36 *Impairment of Assets*, IAS 37 *Provisions*, *Contingent Liabilities and Contingent Assets* IAS 40 *Investment Property*, IFRS 16 *Leases* and IFRS 17 *Insurance Contracts*.

24 It is unclear whether the impact on other accounting standards might be addressed by the IASB in the second phase of the project after the IBOR reform is enacted.

*Hedge accounting*

25 The IASB identified the following areas in hedge accounting that might be impacted by uncertainties arising from IBOR reform:

(a) Highly probable requirement;

(b) Prospective assessments; and

(c) Risk components.

*Highly probable requirement*

26 According to paragraph 6.3.3 of IFRS 9 and paragraph 88(c) of IAS 39, when a forecast transaction is designated as a hedged item in a cash flow hedge, that transaction must be highly probable.

27 When the hedged item is designated in terms of forecast IBOR cash flows and these cash flows will occur after IBOR reform, the question is whether those forecast IBOR cash flows would meet the highly probable requirement because the underlying contracts will likely be amended in the future to reflect a new benchmark RFR.

28 In practice, hedging relationships are commonly designated whereby the IBOR component of a financial instrument is documented as the hedged risk. In this context, paragraph B6.3.11 of IFRS 9 states that, when designating a risk component as a hedged item, the hedge accounting requirements apply to that risk component in the same way as they apply to other hedged items that are not risk components. Consequently, it might be difficult to demonstrate that, at some point in the future, the designated IBOR cash flows are highly probable given the effects of IBOR reform. The IASB staff notes that, although the words in IFRS 9 and IAS 39 may be slightly different, both standards have the same requirements in this area.

29 Therefore, as uncertainty from IBOR reform increases and time to transition approaches, it is possible that, at some point, these designated forecast cash flows will no longer be highly probable.

30 When the hedging relationship ceases to meet the qualifying criteria, an entity will be required to discontinue hedge accounting prospectively (paragraph 6.5.6 of IFRS 9 and paragraph 101 of IAS 39). For cash flow hedges, this will require the amount accumulated in the cash flow hedge reserve to be reclassified from the cash flow hedge reserve to profit or loss. This would also result in changes in fair value of derivatives being recognised in profit or loss (instead of the cash flow hedge reserve in other comprehensive income).

31 The IASB staff identified the following types of hedges of interest rate risk in which the highly probable requirement might be affected by uncertainties arising from IBOR reform:

(a) *Existing IBOR hedges:* these include hedges of recognised IBOR-based instruments and forecast IBOR cash flows where the hedging relationships were designated before or as at the effective date of any potential amendments to IFRS 9 and IAS 39;

(b) *New IBOR hedges:* these include hedges of recognised IBOR-based instruments and forecast IBOR cash flows, where relationships are designated after the effective date of any potential amendments to IFRS 9 and IAS 39; and

(c) *New RFR hedges*: these refer to hedges of forecast RFR cash flows, where relationships were designated after the effective date of any potential amendments to IFRS 9 and IAS 39.

32 Failure to meet the highly probable requirement will have a significant impact on financial reporting and key accounting ratios for many IFRS preparers. This is because discontinuation of hedge accounting would result in reclassification of the cash flow hedge reserve to profit or loss, and derivatives that would otherwise qualify for hedge accounting purposes would be treated as trading derivatives and measured at fair value through profit or loss.

*Prospective assessments*

33 Prospective assessments apply to both fair value and cash flow hedges. According to paragraph 6.4.1(c)(i) of IFRS 9, a hedging relationship qualifies for hedge accounting only if there is an economic relationship between the hedged item and the hedging instrument. In this context, paragraph B6.4.4 of IFRS 9 notes that an economic relationship exists when there is an expectation that the value of the hedging instrument and the value of the hedged item will move in the opposite direction because of the same risk, which is the hedged risk.

34 A forward-looking prospective assessment is also required for hedging relationships designated under IAS 39.

35 The prospective assessments provide evidence that allows an entity to make the forward-looking assertions related to the existence of an economic relationship according to IFRS 9 or expectation that the hedge will be highly effective in achieving offsetting as per IAS 39. These assertions are part of the set of qualifying criteria an entity must comply with in order to apply hedge accounting.

36 Demonstrating the existence of an economic relationship according to IFRS 9 or expectation that the hedge will be highly effective in achieving offsetting as per IAS 39 would require the estimation of future cash flows because both assessments are prospective in nature. For those hedging relationships going beyond the expected replacement of IBOR, as time to transition approaches, the prospective assessments could be affected as they are performed on a forward-looking basis, and potentially result in discontinuation of hedge accounting (paragraph 6.5.6 of IFRS 9 and paragraphs 91(b) and 101(b) of IAS 39).

37 The consequences of prospective discontinuation of hedge accounting are:

(a) For fair value hedges, the fair value hedge adjustment will be amortised to profit or loss. The amortisation is based on a recalculated effective interest rate at the date amortisation begins; and

(b) For cash flow hedges, the accumulated amount in the cash flow hedge reserve will be reclassified to profit or loss when the hedged cash flows occur.

38 In addition, while entities might re-designate the same derivatives in new hedging relationships, it is likely that these derivatives could fail the prospective assessments again as they are performed on a forward-looking basis.

39 The same type of hedges as described in paragraph 31 of this paper are expected to be affected by the failure to meet the prospective assessments as a result of IBOR reform.

*Risk components*

40 An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. While the words in IFRS 9 and IAS 39 are slightly different, both standards require a risk component to be separately identifiable and reliably measurable (SIRM). The SIRM requirement applies to both cash flow and fair value hedges.

41 When designating risk components as hedged items, an entity considers whether the risk component is explicitly specified in a contract (contractually specified risk components) or whether they are implicit in the fair value or the cash flows of an

item of which they are a part (non-contractually specified risk components). The assessment of whether a risk component is separately identifiable may be straight forward when the component is explicitly stated in a contract.

42 Identifying a non-contractually specified risk component is more difficult. It requires an assessment of facts and circumstances around the particular market structure to which the risks relate.

43 In view of this, assume a scenario where IBOR reform impacts market liquidity to such an extent that there is no available term structure of zero-coupon interest rate for either IBOR or RFR benchmarks. Such a scenario could affect the assessment of whether non-contractually specified IBOR and RFR components are eligible as a hedged item in a hedging relationship.

44 It should be noted that risk components that are separately identifiable are generally discussed both in IFRS 9 and IAS 39 in the context of initial designation at inception of the hedging relationship. There is no explicit requirement for a continuous assessment. Therefore, non-contractually specified IBOR components designated in existing hedging relationships would not be impacted by IBOR reform nor would new designations as long as IBOR continue to be separately identifiable. This significantly reduces the scope of the potential concerns involving new relationships where the entity wants to designate a non-contractually specified risk component.

45 The concerns will arise in two scenarios:

(a) When an entity wishes to designate the alternative RFR as a risk component when a term structure of zero rates is available for IBOR but the RFR market has not yet sufficiently developed; or

(b) When an entity wishes to designate IBOR as a risk component but the market has transitioned away from IBOR to the alternative RFR and a term structure of zero rates is no longer available for IBOR.

46 According to the IASB staff analysis, a scenario where neither IBOR or RFR is separately identifiable is unlikely as it is not probable that there would be no available term structure of zero-coupon interest rate for both IBOR and RFR benchmarks in the same period.

47 In addition, if IBOR is no longer separately identifiable but the RFR is, this would indicate reform has been enacted and thus any issues arising on transition would be addressed in the second phase of the project.

48 Therefore, the scope of the concern surrounding designation of new relationships appears limited to RFR based hedging activities when the RFR market has not yet developed to a stage where a term structure of zero-rates can be constructed.

## IASBs tentative decisions

49 In its February 2019 meeting the IASB Board took the following tentative decisions:

(a) regarding the ‘highly probable’ requirement, that IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* should be amended to provide relief from the effects of uncertainties around the general conditions (timing and specifics) of the potential replacement of IBOR. In particular, when assessing the likelihood that a forecast transaction will occur, an entity can assume the IBOR-based contractual terms will remain unchanged.

(b) regarding the existence of an economic relationship (as required by IFRS 9) and the expectation that a hedge will be highly effective in achieving offsetting (as required by IAS 39), that IFRS 9 and IAS 39 should be amended to provide relief from uncertainties around the general conditions (timing and specifics) of the potential replacement of IBOR. In particular, when performing these assessments an entity should base such assessments on existing contractual cash flows from the hedging instrument and the hedged item.

(c) an entity should be allowed to continue hedge accounting when an IBOR risk component meets the separately identifiable requirement at the inception of the hedging relationship, although identification may be affected by IBOR reform in the future. In addition, the Board tentatively decided that relief should not be provided for risk components that are not separately identifiable at the inception of a hedging relationship.

(d) an entity should cease to apply the proposed relief when the nature and timing of designated future cash flows are certain.

(e) an entity should provide specific disclosures about the extent to which it applies the proposed relief.

(f) an entity should apply the proposed amendments retrospectively. The proposed effective date of the amendments is 1 January 2020 with earlier application permitted.

50 In the March 2019 meeting, the following staff proposals are being discussed:

(a) Clarifying that the relief may not be applicable in all instances (e.g. if a certain jurisdiction has decided there is no need for IBOR reform) and certain aspects of the relief may be applicable whereas others are not (e.g. when an entity designates an RFR-based (risk free rate) hedged item against an IBOR-based derivative, the relief may be necessary for the latter but not for the former).

(b) Mandatory application of the relief in order to address the concerns around arbitrary discontinuation of hedge accounting and being consistent with the prohibition of voluntary discontinuation of hedge accounting in IFRS 9;

(c) Entities should stop applying the proposed relief at the earlier of:

(i) When the uncertainty regarding the timing and amount of the resulting cash flows is no longer present; and

(ii) The termination of the hedging relationship.

(d) The clarification that:

(i) End of relief, prior to the termination of the hedge relationships, is not applicable for separately identifiable risk component; and

(ii) When a highly probable assessment is based on future transactions not recognised on the balance sheet, relief should end when the uncertainties regarding IBOR reform are no longer present.

**EFRAG FIWG comments**

51 EFRAG FIWG discussed the IBOR reform project in its meeting of 1 March 2019 and provided the following comments.

*Scope*

52 Phase 1 of the project considers the impact of uncertainty on highly probable forecast transaction while phase 2 will address other issues (such as when contract modifications occur). The delineation between phase 1 and phase 2 of the IASB's IBOR project was considered unclear. Not only did the IASB not yet specify which issues they are going to address in the second phase, but there was also a concern that phase 2 could address the issues to late. Hence it was suggested to treat phase 2 simultaneously with phase 1. Also, suggestions were made for expanding phase 1 with the following topics:

(a) Modification and extinguishment of financial liabilities;

(b) The treatment of valuation differences between hedging derivatives used before and after transition; and

(c) Change in hedged items and/or hedging instruments and subsequent effects.

53 In order to provide clarity to the market the uncertainty over the accounting outcomes needed to be addressed as soon as possible. It was not sufficient to state whether the relief would be applicable or not, also there was a need for clarifying the accounting that would replace the current accounting.

*Issues raised in relation to the tentative IASB decisions on hedge accounting*

54 EFRAG FIWG members noted the IASB should provide relief from the retrospective test under IAS 39 as measurement changes in the hedged items or hedging instruments could result in ineffectiveness of the hedge relationship.

55 Upon physical change between IBOR and RFR (for both hedged items and hedging instruments) the accounting should provide a relief so that this change would not result in discontinuation of existing hedge relationships. This because the transition from IBOR to RFR was an overall market reform and the old and new rates were both market interest rates.

56 When, upon transition, a cash flow hedge relationship was found to remain highly probable, the amounts in OCI should be retained in order to avoid any impact on profit or loss. Such consequences would also depend on whether a backstop existed on recycling of the cash flow hedge reserve in OCI. This needed to be clarified.

57 Further clarification was needed whether the reliably measuring criterion was required only at inception or continuously.

58 It was unclear whether the transition was seen by the IASB as a single moment in time or as a continuous event as individual hedges transitioned to new RFRs, which affected the possibility to benefit from the proposed relief. In addition, it was unclear whether the relief from the highly probably criterion stopped when contracts were modified and/or when hedging instruments expired or, generally, when the actual transition would be clear in the market, which most likely would take place at a different moment.

59 Although hedge accounting in itself is optional, EFRAG FIWG members were of the view that, once an entity applies hedge accounting, the requirements that related to the transition should be mandatory to avoid earnings management.

60 In case of modifications that lead to derecognition of an existing financial asset and recognition of a new financial asset it was unclear whether this would affect the business model. As the IBOR transition was a one-off event, EFRAG FIWG members thought this should not be the case. However, it was noted that entities might take the opportunity of the transition to change particular other contractual characteristics than the interest rate.

*Endorsement process*

61 The urgency of a timely endorsement was emphasised. Clarity was needed by the end of 2019 or early January 2020 allowing entities to use the amendments. Also, European entities that are SEC-filers might have to publish two sets of financial statements if the final amendments cannot be endorsed in time.

**Questions for EFRAG TEG**

62 Does EFRAG TEG have comments on the information provided in this update?

63 Does EFRAG TEG have preliminary views on the content of the draft comment letter?