

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 – Phase 2 **Project Update**

Background and objective of the session

- 1 The EFRAG Board was updated in December 2019.
- 2 The IASB is advancing in its deliberations on Phase 2, started last October. This phase covers classification and measurement, hedge accounting, interaction with other IFRS standards, disclosures and any other issues if they will arise. Similar to Phase 1, Phase 2 of the project addresses the issues with a similar level of urgency.
- 3 The objective of this paper is to provide the EFRAG Board with an update on the IASB's Project - Phase 2 *Interest Rate Benchmark Reform*.
- 4 The EFRAG Board will also be informed about the discussion at EFRAG TEG in respect of the IASB's tentative decisions taken so far and on the next steps of the project and its implications for EFRAG's endorsement activity.

The IASB tentative decisions in December 2019

- 5 The IASB met on 11 December 2019 to discuss the hedge accounting issues that result from IBOR reform.
- 6 The IASB tentatively decided to retain the requirements in IFRS 9 and IAS 39 that determine whether a hedging relationship should be discontinued after:
 - (a) a substantial modification that results in derecognition of the hedged item or the hedging instrument; or
 - (b) a modification that does not result in derecognition and is not required as a direct consequence of IBOR reform or is not done on an economically equivalent basis.
- 7 The IASB also tentatively decided to amend IFRS 9 and IAS 39 to provide an exception from the current requirements so that the following changes in hedge documentation necessary to reflect modifications that are required as a direct consequence of IBOR reform and are done on an economically equivalent basis do not result in the discontinuation of hedge accounting:
 - (a) redefining the hedged risk to refer to an alternative benchmark rate;
 - (b) redefining the description of the hedging instruments or the hedged items to refer to the alternative benchmark rate; and
 - (c) amend IAS 39 to provide an exception from the current requirements 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.
- 8 The IASB tentatively decided that for changes in hedge documentation noted above, 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.

- 9 The IASB staff tentatively decided that changes in valuation adjustments should be recognised in profit or loss, as currently required in IFRS 9 and IAS 39, and no exceptions should be provided in this regard.
- 10 The IASB tentatively decided to amend IFRS 9 and IAS 39 so that, when items within a designated group are amended for modifications that are required as a direct consequence of IBOR reform and are done on an economically equivalent basis, an entity is permitted to:
 - (a) amend the hedge documentation to define the hedged items by way of two subgroups within the designated group of items—one referencing the original interest rate benchmark and the other, the alternative benchmark rate;
 - (b) perform the proportionality test separately for each subgroup of items designated in the hedging relationship;
 - (c) treat the hedge designation as a single hedging relationship and amend the hypothetical derivative to reflect the combination of the subgroups of items; and
 - (d) 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).
- 11 The IASB tentatively decided that IAS 39 should be amended so that, when entities change the hedged risk to an alternative benchmark rate in the hedged documentation, it is assumed that all items included in the portfolio of financial assets or financial liabilities share the risk being hedged.

EFRAG TEG discussions

Follow up on the IASB's tentative decisions on modification

- 12 The EFRAG Board was informed in December about the tentative decisions taken by the IASB in October. EFRAG TEG members supported the IASB tentative decisions on classification and measurement, except for the approach to the modification, i.e. to clarify that even in the absence of an amendment to the contractual terms, a change in the basis on which the contractual cash flows are determined constitutes a modification. EFRAG TEG members in particular expressed concerns about the possible unintended consequences of the IASB's proposed approach to define what a "modification" is and to shift the emphasis from the contractual to the methodology changes.
- 13 In January EFRAG TEG discussed again these IASB's tentative decisions and listed the following possible unintended consequences (broader than the scope of IBOR reform):
 - (a) there are jurisdictions with a regulation where the rates can change without a contract change;
 - (b) changes in the methodology of the fair value calculation due to the change in market circumstances could also be regarded as a modification; and
 - (c) the instruments with covenants or related to indexes, inflation, baskets or some internal benchmarks created by financial institutions could be seen as undergoing constant modifications.
- 14 Members stressed the importance to 'ringfence' the scope of the Phase 2 amendments to the issues related to the IBOR reform only. This will also limit possible risks of delay of the issuance of the amendments and their endorsement in

Europe for 2020 year-end, in particular as EFRAG would not run a separate impact assessment other than the consultation on the Draft Comment Letter to the forthcoming ED.

- 15 Members suggested that if the IASB intention was to change the definition of the modification, it should be done separately from this project as this would require more detailed impact assessment and analysis.

Hedge Accounting

- 16 EFRAG TEG members noted the discussion of EFRAG FIWG on hedge accounting. Members welcomed the proposed amendments on updating the underlying hedge documentation when transitioning from IBOR to an alternative benchmark rate. However, many members doubted that such transitioning would constitute a change in risk management objective for purposes of IFRS 9 and were concerned that the proposed amendments could create undue complexity; they suggested to focus on clarifying the principles rather than prescribing a particular method.
- 17 EFRAG TEG members observed that it would be difficult to anticipate all the consequences of the IASB tentative decisions on changes to the hedge documentation as they are very prescriptive. There was a risk to go beyond the changes related to the IBOR reform. They suggested that the difference should be made between mandatory change of a benchmark and voluntary changes to the hedging relationships.

Questions for EFRAG Board

- 18 Does EFRAG Board has any comments on the remarks done by EFRAG TEG?

Next steps and planning

- 19 The IASB has discussed the following topics during its 28-30 January meeting:
 - (a) Hedge accounting - end of application for Phase 1 exceptions;
 - (b) The impact of IBOR reform on other IFRS Standards; and
 - (c) Disclosures.
- 20 The IASB tentative decisions on these topics will be discussed with EFRAG FIWG on 24 February and with EFRAG TEG on 5 March.
- 21 The IASB is planning to discuss the following additional topics in its 24-28 February meeting:
 - (a) End of Phase 2 proposed amendments;
 - (b) Voluntary vs mandatory application;
 - (c) Effective date and transition; and
 - (d) Due process steps.
- 22 The IASB tentative decisions on these topics will be discussed with EFRAG FIWG on 9 March and with EFRAG TEG on 26 March. EFRAG IAWG will be updated on the status of the project during its meeting on 19 March.
- 23 The Exposure Draft is expected in April.
- 24 The planning for the endorsement advice will reflect the urgency of this project, due to the need of European issuers to apply the amendments in 2020 year-end reporting at the latest. EFRAG Secretariat expects that a fast-track procedure will be needed for this endorsement. As an example, the amendments for Phase 1 were issued for consultation in May 2019, issued as a final standard at the end of

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September and formally endorsed (published in the Official Journal) in the middle of January.

- 25 EFRAG Board agreed for Phase 1 to shorten significantly the consultation period and to approve by written procedure the draft and final endorsement advices. EFRAG Secretariat considers appropriate to follow the same procedure for Phase 2 as well.

Questions for EFRAG Board

- 26 Does EFRAG Board has any comments on the proposed planning?
- 27 Does EFRAG Board agrees to stand ready to shorten significantly the consultation period and to proceed with written approval, if this is needed in order to facilitate a fast-track endorsement, similarly to what has been done for Phase1?