# IBOR Phase 2 - Project update

## Objective

1 The objective of this session is to update the EFRAG Board on the progresses made by the IASB in the IBOR Phase 2 project and to report the status of EFRAG activities on the same project.

## Background and status of the IASB project

2 Between October 2019 and February 2020, the IASB completed its deliberations for the Amendments needed to IFRS 9 and IAS 39 in order to minimise unintended accounting disruptions due to issues arising from the reform of risk free rates (IBOR reform), in the replacement phase, i.e. when entities amend their contractual agreements to reflect the new benchmark rates.

3 The IASB Staff received permission to ballot and we expect that the ED will be issued in April, with 45 days comment period.

## EFRAG status update

4 EFRAG FIWG discussed on 22 January the IASB tentative decisions taken in October/December 2019. EFRAG TEG discussed the same topics on 29-30 January.

(a) In line with the input expressed by FIWG, EFRAG TEG members stressed that the scope of the Phase 2 amendments should be 'ringfenced' to the issues related to the IBOR reform only. EFRAG TEG 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. We observe that the decision taken by the IASB in February goes in this direction.

(b) EFRAG FIWG 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 hedge documentation purposes and were concerned that the proposed amendments could create undue complexity. EFRAG TEG was sympathetic to the concerns expressed by the EFRAG FIWG members and acknowledged that unintended discontinuations of hedge accounting relationships may occur, due to the need to amend the hedging documentation between the date the contracts are amended and the date the proposed amendments become applicable. We observe that the IASB has decided to provide retrospective reinstatement of the previously discontinued hedges in the 2020 annual financial statements. This allows to mitigate the initial concerns.

5 EFRAG FIWG discussed on 24 February the IASB decisions taken in January and the IASB staff proposals for the IASB February meeting. EFRAG FIWG members observed that the proposed relief on separately identifiable criterion would be limited to a 12 months period once uncertainty is resolved. They were concerned that there would be a disincentive to transition to an alternative benchmark rate sooner, rather than later, given the sooner an entity modifies its contracts the less certain it will know whether the separately identifiable test will be passed in 12 months' time as the entity cannot control how the market evolves. EFRAG TEG on 5 March

considered that the proposal of the IASB Staff, after having been discussed by the IASB on 26 February, was increased to 24 months, as such helping to solve the initial concerns.

6 EFRAG Board agreed in February to adopt an extraordinary procedure and issue a Pre-Consultation Document, prepared on the basis of the IASB tentative decisions (see Appendix to this paper) and approved by EFRAG TEG, in order to provide the constituents with a longer comment period.

7 Considering the above, EFRAG TEG was supportive of the IASB tentative decisions after having considered also the tentative FASB decisions (see Appendix 2) and concluded the discussion on 5 March. Members provided instructions to the EFRAG Secretariat for the preparation of the Pre-Consultation Document.

8 EFRAG FIWG members will provide input on the Pre-Consultation Document on 12 March 2020; their comments will be incorporated in the version that EFRAG TEG will discuss and approve on 26 March 2020. The document will be issued as soon as possible following EFRAG TEG approval, in order to grant to the constituents time until the 15 May 2020. The same end of comment period will also apply for the EFRAG Draft Comment Letter, which will be issued as soon as possible, by the end of April, following the issuance of the Exposure Draft. The Draft Comment Letter will reflect the views exposed in the Pre-Consultation Document, with eventual drafting changes to reflect the final wording of the ED.

9 Next step for EFRAG Board will be to approve the Draft Comment Letter, either through written procedure or in the April meeting, depending on when the IASB ED will finally be issued.

**Question to EFRAG Board members**

10 Do EFRAG Board members have comments on this status update?

# Appendix 1: IASB tentative decisions

***Classification and measurement—modification of financial instruments (October 2019)***

The IASB tentatively decided to amend IFRS 9 to:

(a) clarify that, even in the absence of 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 of a financial instrument in accordance with IFRS 9.

(b) provide a practical expedient allowing an entity to apply paragraph B5.4.5 of IFRS 9 to account for modifications related to IBOR reform and to provide examples in IFRS 9 of modifications that are related to IBOR reform, and examples of those that are not.

(c) clarify that an entity should first apply paragraph B5.4.5 of IFRS 9 to account for modifications related to IBOR reform to which the practical expedient applies. Thereafter, an entity should apply the current IFRS 9 requirements to determine if any other modifications are substantial; if those modifications are not substantial, the entity should apply paragraph 5.4.3 of IFRS 9.

***Sweep issue—Modification of financial instruments (February 2020)***

The IASB tentatively decided the proposed amendment to clarify what constitutes a modification of a financial instrument should apply only to changes made in the context of IBOR reform.

***Accounting implications from derecognition of a modified financial instrument (October 2019)***

The IASB tentatively decided that, in the context of IBOR reform, current requirements in IFRS 9 provide sufficient guidance to determine the appropriate accounting treatment in the following situations:

(a) derecognising a financial asset or a financial liability from the statement of financial position and the recognition of the resulting gain or loss in profit or loss following a substantial modification.

(b) determining an entity's business model for managing financial assets.

(c) determining whether the interest component of the contractual cash flows of a new financial asset referenced to alternative benchmark rates meets the criteria for solely payments of principal and interest on the principal amount outstanding (SPPI), as required by IFRS 9. The IASB also tentatively decided to add an example to IFRS 9 to illustrate the application of the SPPI assessment in the context of IBOR reform.

(d) recognising the expected credit losses for a new financial asset.

(e) accounting for embedded derivatives for financial liabilities.

***Hedge accounting (December 2019)***

The IASB tentatively decided to:

(a) retain the requirements in IFRS 9 Financial Instruments and IAS 39 Financial Instruments: Recognition and Measurement that determine whether a hedging relationship should be discontinued after:

> (i) a substantial modification that results in derecognition of the hedged item or the hedging instrument; or
>
> (ii) 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.

(b) 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:

(i) redefining the hedged risk to refer to an alternative benchmark rate; and

(ii) redefining the description of the hedging instruments or the hedged items to refer to the alternative benchmark rate.

(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.

The IASB also tentatively decided to amend IAS 39 to require an entity changing the hedged risk in the hedge documentation for a portfolio hedge of interest rate risk, as noted in paragraph (b)(i) above, to assume that all items included in the portfolio of financial assets or financial liabilities share the risk being hedged.

For changes in hedge documentation noted in paragraph (b) and (c), 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.

With regard to hedges of a group of items, 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).

***Hedges of risk components—Separately identifiable criteria (February 2020)***

The IASB tentatively decided to provide temporary relief for hedging relationships amended to reflect modifications that are required as a direct consequence of IBOR reform. Applying this relief, a non-contractually specified risk component is considered to satisfy the ‘separately identifiable’ criteria 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 risk component within the particular market structure within 24 months from the date the rate is designated as a risk component for hedge accounting purposes; and

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

***End of application—Phase 1 exceptions (January 2020)***

The IASB tentatively decided to:

(a) amend IAS 39, only for the purpose of assessing retrospective effectiveness, to require entities to reset to zero the cumulative fair value changes of the hedging instrument and the hedged item at the date the exception to the retrospective assessment in paragraph 102G of IAS 39 ceases to apply; and

(b) make no amendments to the end of application requirements for the Phase 1 exceptions to the highly probable requirement for cash flow hedges and prospective assessments in IFRS 9 and IAS 39.

***End of Phase 2 amendments and voluntary versus mandatory application (February 2020)***

The IASB tentatively decided application of all proposed amendments in Phase 2 should be mandatory. The IASB also tentatively decided that the nature of the proposed amendments is such that they can only be applied to modifications of financial instruments and changes to hedging relationships that satisfy the relevant criteria and, as such, no specific end of application requirements need to be specified.

***Other IFRS Standards (January 2020)***

The IASB tentatively decided to amend:

(a) IFRS 16 Leases to require a lessee to apply paragraphs 42(b) and 43 of IFRS 16 to account for lease modifications to the interest rate benchmark on which lease payments are based that are required as a direct consequence of IBOR reform and done on an economically equivalent basis (modifications directly required by IBOR reform).

(b) IFRS 4 Insurance Contracts to require insurers that apply the temporary exemption from IFRS 9 to apply the amendments resulting from the IASB tentative decisions in Phase 2 of the project in accounting for modifications directly required by IBOR reform.

The IASB also tentatively decided that no amendments are made in the context of IBOR reform to:

(a) IFRS 13 Fair Value Measurement because it 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. These transfers reflect the economic effects of IBOR reform, therefore providing useful information to users of financial statements.

(b) IFRS 17 Insurance Contracts because it provides an adequate basis for an entity to account for insurance contract modifications in the context of the IBOR reform. Such accounting results in useful information to users of financial statements.

(c) the current requirements in IFRS Standards with respect to discount rates as they already provide adequate guidance to determine the appropriate accounting treatment for the potential effects of changes to the discount rates resulting from the replacement of interest rate benchmarks.

***Disclosures (January 2020)***

The IASB tentatively decided to amend IFRS 7 Financial Instruments: Disclosures to require an entity to provide disclosures that enable users of financial statements to understand:

(a) the nature and extent of risks arising from IBOR reform to which the entity is exposed, and how it manages those risks; and

(b) the entity’s progress in completing the transition from interest rate benchmarks to alternative benchmark rates, and how the entity is managing the transition.

To achieve this objective, an entity would disclose information about:

(a) how it is managing the transition from interest rate benchmarks to alternative benchmark rates and the progress made at the reporting date, and the risks arising from this transition;

(b) 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;

(c) for each significant alternative benchmark rate to which the entity is exposed, 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

(d) to the extent that IBOR reform has resulted in changes to an entity's risk management strategy, a description of these changes and how is the entity managing those risks.

***Effective date and transition requirements (February 2020)***

The IASB tentatively decided that:

(a) entities should apply the proposed amendments for annual periods beginning on or after 1 January 2021, with earlier application permitted.

(b) the proposed amendments in Phase 2 should apply retrospectively. Retrospective application:

> (i) relates to items that existed at the beginning of the reporting period in which an entity first applies the proposed amendments, including to amounts accumulated in the cash flow hedge reserve related to hedging relationships that have already been discontinued.
>
> (ii) includes reinstating hedging relationships that were discontinued before the entity first applies the proposed amendments solely due to changes in hedging relationships (and the related documentation) necessary to reflect the modifications required as a direct consequence of the reform. These hedging relationships must be reinstated if the entity can demonstrate that the hedging relationship would not have been discontinued if the proposed amendments were available at the time and that it can be done without the use of hindsight.

(c) in the reporting period in which an entity first applies the proposed amendments, an entity is not required to present the disclosures required by paragraph 28(f) of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

# Appendix 2: IASB and FASB tentative decisions - Overview

The following table provides an overview to the tentative decisions the IASB and FASB have taken during their project so far.

| **Issue** | **Description** | **EFRAG preliminary view** (TEG with input of FIWG) | **FASB** (see Appendix II) |
|---|---|---|---|
| Modification: Scope | Change in calculation constitutes a modification even if no change to contractual terms<br>To be limited to IBOR-related changes only | Agree with the scope limitation | Modification relates to changes to the terms only |
| Modification: practical expedient | Apply B5.4.5 instead of modification accounting<br>Applies also to lessees | Supported | Similar proposals<br>No reassessment of embedded derivatives |

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|---|---|---|---|
| Modification: Assessment | No changes to modification or derecognition assessment if modification goes beyond changes directly required by the reform | Supported | Similar proposals |
| Hedge Accounting: Documentation | Changes in hedging relationships and hedge documentation necessary to reflect modifications to the hedged item or hedging instruments 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 | Supported | Similar proposals |
| Hedge Accounting: Portfolio Hedges | Assume that all items included in the portfolio of financial assets or financial liabilities share the risk being hedged | Supported | Topic not addressed |
| Hedge Accounting: Effectiveness measurement | In general, no exceptions.<br>Reset fair value changes to zero when uncertainty is resolved (retrospective assessment under IAS 39) | Supported | Topic not addressed (relief granted is similar to Phase 1) |

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|---|---|---|---|
| Hedge Accounting: Groups of items | Define two subgroups<br>Apply proportionality test separately to each subgroup<br>Amend hypothetical derivative to reflect two subgroups<br>Assume two benchmarks share similar risk characteristics | Supported | May ignore requirement that transactions in a group shall share the same risk (CFH) |
| Hedge Accounting: SIRM | Relief to separately identify a risk component, to be granted for 24 months only. | Supported | Topic not addressed |
| IFRS 4: Deferral approach | Apply the amendments in accounting for modifications directly required by IBOR reform. | Supported | No issue |
| IFRS 13, IFRS 17, other IFRS Standards | No changes<br>Changes in accounting estimates to be applied prospectively | Supported | Topics not addressed |
| IFRS 7 - Disclosures | Focus on nature and extent of risks arising from IBOR reform for each significant benchmark rate, including approach to transition and risk management | Supported, but concern that some disclosures may be of limited use to users of financial statements | Yet to be discussed |

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|---|---|---|---|
| Effective Date | January 1, 2021<br>Early application permitted<br>Mandatory application<br>No defined end of application | Supported | Once ASB is published (during 2020)<br>Voluntary application, case by case<br>Defined end 31.12.2022<br>FASB will continue monitoring future developments |
| Transition | Retrospective application with reinstatement of discontinued hedging relationships due to IBOR reform | Supported | Prospective application |