Interest Rate Benchmark Reform – Hedge Accounting Issues Paper

Objective

1 The objective of this paper is to seek views of the EFRAG TEG on the IASB tentative decisions in respect of the IASB's deliberations on the hedge accounting implications arising from IBOR reform.

The IASB tentative decisions taken in December

2 The IASB met on 11 December 2019 to discuss the following hedge accounting issues that could result from IBOR reform**:**

(a) interaction with tentative decisions on classification and measurement, taken at October meeting;

(b) hedge documentation;

(c) valuation adjustments due to modifications directly required by the reform;

(d) hedges of group of items; and

(e) IAS 39 fair value hedge accounting for a portfolio hedge of interest rate risk.

Interaction with tentative decisions on classification and measurement, taken at October meeting

3 The following tentative decisions on classification and measurement made by the Board in October 2019 interact with the hedge accounting issues discussed in December 2019:

(a) amend IFRS 9 to 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.

4 The interactions between the tentative decisions on classification and measurement and hedge accounting are such that when a financial instrument is modified as directly required by the reform, then:

(a) the proposed clarified definition of a modification in paragraph 3(a) above applies;

(b) the practical expedient on application of paragraph B5.4.5 of IFRS 9 applies; and

(c) the proposed amendments on hedge documentation apply.

5 EFRAG TEG members supported the IASB tentative decisions on classification and measurement, except for the approach to the modification in (a) above. 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. See Agenda Paper *Interest Rate Benchmark Reform – Modification* - Issues Paper for a deeper discussion.

Hedge documentation issues

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 These tentative decisions were based on an analysis of the IASB staff of the current requirements of IAS 39 and IFRS 9 on whether changes to the hedge documentation constitute a change in the hedging relationship that was neither anticipated nor intended when that relationship was initially designated and there would require discontinuation of hedge accounting.

9 The analysis for IFRS 9 identified the following specific updates to the hedge documentation that are addressed in the standard and hence do not result in discontinuation of hedge accounting (cf. AP14A, 28):

(a) assessment of hedge effectiveness (update relates to change in methods);

(b) rebalancing (update relates to analysis of sources of ineffectiveness after rebalancing); and

(c) sources of ineffectiveness (update relates to sources of ineffectiveness).

10 The IASB staff concluded this effectively implied that any other changes would require discontinuation of hedge accounting (cf. AP14A, 33).

11 The analysis for IAS 39 showed that the standard does not allow adjustments that were not envisaged and documented at inception of the hedge (cf. AP14A, 29).

12 Hence, amending the hedge documentation to refine the hedged risk from IBOR to an alternative benchmark rate would result in discontinuation of hedge accounting because it would constitute, according to the IASB staff's analysis, a change in risk

management objective on the basis of which that hedging relationship was designated (cf. AP14A, 34).

The EFRAG Secretariat analysis on IFRS 9

13 The Basis for Conclusions to IFRS 9 says: “There are instances when, although the *risk management objective remains the same*, adjustments to an existing hedging relationship are made because of *changes in circumstances related to the hedging relationship’s underlyings or risk variables*. The IASB concluded that, in situations in which the original risk management objective remained unaltered, the adjustment to the hedging relationship *should be treated as the continuation of the hedging relationship*. This will have the effect of enabling changes in risk management to be properly portrayed in hedge accounting.” (IFRS 9 paragraph BCE.200, emphasis added).

14 Taken to the IBOR reform, the transition from IBOR to an alternative benchmark rate might be seen as “change in circumstances related to the hedging relationship’s underlyings or risk variables”.

15 Where a modification of financial instruments is directly required by the reform and occurs on an economic equivalent basis, it appears unclear whether the risk management objective for undertaking the hedge has actually changed in the sense that requires discontinuation of hedge accounting in accordance with IFRS 9, “i.e. the entity no longer pursues that risk management objective.” (IFRS 9 paragraphs B6.5.23(a), B6.26(b)).

16 In many instances, an entity will continue hedging the same quantities of hedged items with the same hedging instruments, and the only change to the hedge is the modification as directly required by the reform.

17 The IASB staff states (cf. AP14A, 46): “Changes in hedge documentation necessary to reflect modifications directly required by the reform would not constitute a change in the general risk management strategy and the risk management objective for hedging underlying risks that would generally continue to be either:

(a) hedge of the exposure to variability in cash flows, albeit now associated with movements in alternative benchmark rate (i.e. cash flow hedge); or

(b) hedge of the exposure to changes in fair value, albeit now associated with movements in alternative benchmark rate (i.e. fair value hedge).

18 Furthermore, the IASB staff states (cf. AP14, 58): “As the reform progresses towards transition, the derivative is amended to replace the interest rate benchmark with an alternative benchmark rate. In this situation, the entity concludes that updating the hedge documentation to reflect the alternative benchmark rate as the new hedged risk component would be consistent with the entity’s risk management objective and strategy for undertaking the hedge.”

19 Against this background, it appears unclear whether the risk management objective would in this case be no longer pursued and whether discontinuation of hedge accounting is required. In contrast, when an entity still pursues an unaltered risk management objective, instead of discontinuing the hedge, it could actually be required to continue hedge accounting.

The EFRAG Secretariat analysis on IAS 39

20 It is acknowledged that IAS 39 does not allow for adjustments to the hedge documentation that were not envisaged and documented at the inception of the hedge. However, this could in turn imply that a change would be acceptable if it was envisaged and documented at the inception. If so, an entity could have anticipated a change from IBOR to an alternative rate when designating a hedge – provided it had been aware of the IBOR reform when the hedge was designated.

21 This would mean that the same entity could be allowed to continue with "recent" hedges that were designated anticipating the modification but would be required to discontinue hedge accounting for "older" hedges where the entity was not yet aware of the IBOR reform and its implications when designating these hedges.

22 Furthermore, the IASB staff has also analysed potential consequences when fallback provisions are triggered and concluded "the implications for hedge documentation are similar" to those outlined above (AP14A, 41).

23 This could be read as if even the change in reference rate is anticipated in the hedge documentation and already reflected in fallback provisions, continuation under current requirements would not be permitted.

24 It is noted that the IASB has discussed and rejected "flexible hedged risk designations" in Phase 1 of the IBOR project. This was because of the requirement to identify and document a forecast transaction with sufficient specifity. When analysing Phase 2 requirements, the IASB staff referred to this analysis and concluded that "the current requirements in IFRS 9 and IAS 39 would preclude documenting the hedged risk in terms of both IBOR and RFR as benchmark rate." (AP14A, 52).

25 The EFRAG Secretariat notes that the analysis referred to related primarily to the pre-replacement phase when dealing with additional issues for consideration before finalising the proposed phase 1 amendments. However, it is less clear whether there is also a lack of sufficient specifity in documentation when an entity refers to the replacement as identified by the modification of underlying contracts.

The EFRAG Secretariat analysis on labelling the amendments

26 The IASB tentatively decided to amend IFRS 9 and IAS 39 to provide an exception from the current requirements to allow continuation of hedge accounting (see below), it may be important for entities to be clear about the consequences when they amend financial instruments as required directly by the reform.

27 For instance, the transition from EONIA to €STR is currently ongoing.

28 The working group on euro risk-free rates – which was set up by the ECB, together with the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission – recommends that market participants should consider, for existing contracts referencing EONIA and maturing after December 2021, replacing EONIA as a primary rate as soon as possible or embedding robust fallback clauses.

29 It was also recommended that CCPs align their discounting switch dates as much as possible to transition from an EONIA discounting regime to a €STR discounting regime. In this context, the European Association of Central Counterparty Clearing Houses (EACH) suggests that the €STR discounting regime switching date for CCPs be set to Monday 22nd June 2020, subject to the relevant internal agreements on the part of each interested member.

30 Against this background, it is likely that many entities will aim transitioning to €STR rather sooner than later. In absence of the planned amendments to IFRS 9 and IAS 39 being effective (assuming retrospective application provisions for the amendments similar to Phase 1, i.e. without possibility to reinstate hedge relationships that were discontinued in previous reporting periods), the accounting consequences of having to discontinue hedge accounting could represent a hurdle for timely transition.

31 It is unclear whether the amendments would constitute:

(a) an *exception* to the current requirements (which would imply that the current requirements as analysed by the IASB staff would not permit continuation of hedge accounting following a modification); or

(b) a *clarification* to the current requirements (which could imply that the requirement requirements provide already a basis for continuation of hedge accounting following a modification).

32 The IASB notes are using the word "exception" while the staff's proposed recommendations are described as "amendments to clarify" (AP14A, 2 and 54).

Questions to EFRAG TEG:

33 Does EFRAG TEG agree with the tentative decisions made by the IASB in respect of hedge documentation?

34 Does EFRAG TEG share the analysis of the EFRAG Secretariat in respect of:

(a) IFRS 9;

(b) IAS 39;

(c) Labelling the amendments?

35 Does EFRAG TEG have any further comments on this topic?

Valuation adjustments

36 The IASB tentatively decided 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.

37 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.

Question to EFRAG TEG:

38 Does EFRAG TEG agree with the tentative decisions made by the IASB in respect of valuation adjustments? Are there further comments?

Hedges of groups of items

39 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).

Question to EFRAG TEG:

40 Does EFRAG TEG agree with the tentative decisions made by the IASB in respect of hedges of groups of items? Are there further comments?

IAS 39 fair value hedge accounting for a portfolio hedge of interest rate risk items

41 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.

Question to EFRAG TEG:

42 Does EFRAG TEG agree with the tentative decisions made by the IASB in respect of portfolio hedges of interest rate risk? Are there further comments?

Next steps

43 According to the current work plan, it is expected that the IASB will continue its deliberations at its January 2020 meeting on when the application of the exceptions provided in Phase 1 of the project will expire; the impact of IBOR reform on other IFRS Standards; disclosures; and transition and effective date of the proposed amendments.