This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the 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.

IBOR: Modification for EURIBOR and EONIA

Objective

1 The objective of this paper is to seek views of the EFRAG TEG on the IASB tentative decisions on whether a change in calculation methodology would constitute a modification.

The IASB tentative decisions taken in October

2 The Board 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.

3 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.

Clarification on what constitutes a modification (paragraph 2(a))

4 Regarding the scope of the practical expedient in the paragraph 2(a) above, when the IASB staff has analysed what constitutes a modification, it concluded that "there could be no change to the terms written in the contract, but there could instead be a change in the calculation methodology of an interest rate benchmark that modifies the basis for determining a financial instrument's contractual cash flows. For example, […] the calculation methodology is otherwise altered from what it was before. Although the contractual terms of the financial instrument have not been amended to replace the contractual interest rate benchmark, the change in calculation methodology has modified the contractual cash flows of that financial instrument." (IASB 10/2019, AP14A, 13).

EURIBOR and EONIA Background

5 The calculation methodology for **EURIBOR** has changed since the administrator EMMI has started transitioning the panel of contributing banks from the quote-based

EURIBOR methodology to the hybrid methodology, i.e. anchored in transactions to the extent possible. The gradual implementation of the hybrid methodology for EURIBOR was due to be concluded during Q4 of 2019. On 28 November 2019, EMMI confirmed the successful completion of the phase-in of all EURIBOR Panel Banks to the hybrid methodology.

6 As outlined in EFRAG's comment letter on Phase 1, 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. Contracts referring to EURIBOR would not need to be amended to reflect the new methodology.

7 When asked whether EURIBOR calculated under the hybrid methodology was still EURIBOR, EMMI clarified that "with the EURIBOR reform, EMMI does not change EURIBOR's Underlying Interest, which has always been seeking to measure banks' costs of borrowing in unsecured money markets. Subsequently, this reform is a clarification of the existing Underlying Interest of EURIBOR, combined with adapting a robust and BMR compliant methodology."

8 The **EONIA** methodology has been redefined as the €STR plus a fixed spread. The ECB has calculated this spread as 0.085% (8.5 basis points). This spread reflects the historical difference between the Underlying Interests of EONIA and €STR. Published for the first time by the ECB on 2 October 2019, the €STR reflects the wholesale euro unsecured overnight borrowing costs of euro area banks.

9 Prior to 1st October 2019, EONIA was computed as a weighted average of overnight unsecured lending transactions in the EU and EFTA interbank market. The last publication of EONIA based on the previous methodology was on September 30, 2019. EONIA was also published for the first time on 2 October 2019 based on the €STR.

10 EMMI will continue to publish EONIA every TARGET day until 3rd January 2022, the date on which the benchmark will be discontinued.

11 For both EURIBOR and EONIA, the respective change in methodology was in place by year-end 2019. This was confirmed by EMMI (see press release dated 28 November 2019 on EURIBOR and press release dated 2 October 2019 for EONIA).

The EFRAG Secretariat Analysis

12 The IASB has decided to narrow the scope of potential amendments to IBOR-related issues. However, the EFRAG Secretariat considers that the proposed amendment has the potential to be not limited to IBOR-related issues, but could apply on a broader basis to potentially any given change in methodology. During the EFRAG FIWG discussion on 22 January 2019, possible examples identified were SVR in the UK or inflation-based instruments.

13 Hence, if the proposed amendment will include the statement that "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", the implications of this statement may go beyond those related to the IBOR reform unless the amendments are ring-fenced to those modifications arising as a direct consequence of the IBOR reform.

Question to EFRAG TEG:

14 What are the possible unintended consequences that EFRAG TEG members can anticipate from the proposed amendment in paragraph 2(b), outside the scope of the IBOR reform and in the future?

The EFRAG Secretariat analysis on EURIBOR

15 When a modification to the contractual cash flows of a financial instrument is made, usually a clear date of modification and a change in cash flows before and after the modification can be identified, i.e. both legal and economic consequences arise from a modification. In contrast, for EURIBOR this is not the case because:

(a) the benchmark rate as identified in the contract is not replaced by an alternative benchmark rate, i.e. it remains EURIBOR without any amendment to the underlying contract; and

(b) the new calculation methodology was phased-in over time so that the old methodology has no clear cut-off date and hence no “old” or “new” EURIBOR cash flows can be clearly identified from which changes to the cash flows could be quantified.

16 Thus, there is no clear anchor point where a modification of a EURIBOR-based financial instrument can be observed. It follows that there is neither a modification date nor an observable change in cash flows where accounting requirements could apply to. This is particularly true for application of the 10% test under a quantitative derecognition assessment in accordance with paragraph B.3.3.6 of IFRS 9 as well as for determining a modification gain or loss in accordance with paragraph 5.4.3 of IFRS 9. Hence, it is unclear how the assessment of the change to the new hybrid methodology of EURIBOR, if deemed a modification under the proposed amendments, could be practicable.

17 If EURIBOR-based financial instruments would be subject to Phase 2, this could imply that the same is true for Phase 1 (see also paragraph 40 below). However, since EMMI has confirmed to having completed implementation of the hybrid methodology by Q4, 2019, it appears there would be no uncertainty at year-end 2019 in relation of timing or amount of EURIBOR-related cash flows. In addition, no changes to the underlying contracts are needed to reflect the reform of EURIBOR in the 2020 or after.

18 This implies that neither the Phase 1 amendments to IFRS 9 and IAS 39 nor forthcoming Phase 2 amendments would be applicable for EURIBOR on or after 2019 year-end because transition to the new methodology has taken place by then.

19 To illustrate, a EURIBOR-based financial instrument would continue to be carried at amortised cost in accordance with IFRS 9 paragraph 4.1.2 and the effective interest rate method would be applied to it in accordance with IFRS 9 paragraph B5.4.5. If this instrument was designated as a hedged item, the risk management objective would continue to reflect EURIBOR as a hedged risk. Hence, from the current issues discussed in relation to Phase 2 at the IASB, it is unclear how the proposed amendments, if applicable, would impact the accounting for such instrument and in which areas further relief would we required.

Question to EFRAG TEG:

20 Do EFRAG TEG members share the analysis? Are there further areas of relief required in relation to EURIBOR?

The EFRAG Secretariat analysis on EONIA

21 The EFRAG Secretariat has identified two subsets of financial instruments based on EONIA:

(a) Instruments maturing before EONIA ceases to be published, i.e. before 2022;

(b) Instruments maturing after EONIA ceases to be published, i.e. after 2022.

22 For EONIA-based financial instruments maturing before 2022, counterparties to the underlying contract may, but are not obliged to change the contract to transition to

€STR. If no change to the contract is made and it continues to be based on EONIA until maturity, the same conclusions as reached for EURIBOR above apply. This is because, even though there is a clear date on which the change in methodology can be observed, the EFRAG Secretariat understands that there was no observable change in cash flows clearly attributable to the new methodology when the methodology changed between 30 September and 2 October 2019.

23 For EONIA-based financial instruments maturing after 2022, the ECB working group on euro risk-free rates recommends that market participants should consider replacing EONIA as a primary rate as soon as possible or embedding robust fallback clauses.

24 The EFRAG Secretariat concludes that, as long as the replacement has not taken place, there is uncertainty in relation to the timing of contractual cash flows as described in paragraph BC6.584 of IFRS 9. Hence, Phase 1 provisions would apply until the contract is amended to replace EONIA by €STR.

25 Once the contract is amended, there is no uncertainty in relation to the transition from EONIA to €STR any longer, hence Phase 2 provisions would apply. More specifically:

(a) the change to the contract would constitute a modification;

(b) the practical expedient to apply paragraph B5.4.5 of IFRS 9 would apply; and

(c) the proposed amendments on hedge accounting (see AP *Interest Rate Benchmark Reform – Hedge Accounting*) would apply, in particular the hedged risk would then be €STR instead of EONIA.

Question to EFRAG TEG:

26 Do EFRAG TEG members share the analysis? Are there further areas of relief required in relation to EONIA?

Practical expedient to apply IFRS 9 paragraph B5.4.5 (paragraph 2(b))

27 Regarding the scope of the practical expedient in the paragraph 2(b) above, the EFRAG Secretariat works under the presumption that this practical expedient would only apply to financial instruments that:

(a) are subject to modifications required as a direct consequence of IBOR reform and done on an economically equivalent basis ("directly required by the reform");

(b) are measured at amortised cost or fair value through other comprehensive income in accordance paragraphs 4.1.2, 4.1.2A or 4.2.1 of IFRS 9, i.e. to which the effective interest rate method is applied; and

(c) are floating-rate financial assets or financial liabilities.

28 In contrast, the practical expedient would not apply to financial instruments measured at fair value through profit or loss, e.g. derivatives, or financial instruments to which the effective interest rate method is applied to but that are not floating-rate instruments, e.g. fixed-rate loans because those are subject to the specific requirements in paragraph B5.4.6 rather than B5.4.5 of IFRS 9 and are not indexed to a benchmark rate and hence are not subject to a benchmark rate reform.

The EFRAG Secretariat analysis

29 In Phase 1, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate **such as that resulting from** the recommendations set out in the Financial Stability Board's July 2014 report

'Reforming Major Interest Rate Benchmarks' (IFRS 9 paragraph 6.8.2 and IAS 39 paragraph 102B, emphasis added).

30 The IASB decided not to provide an explicit end date for the exceptions made in Phase 1 (IFRS 9 paragraph BC6.585).

31 The EFRAG Secretariat also observed a change in wording compared to the ED/2019/1 where the respective draft paragraphs said "interest rate benchmark reform refers to the market-wide replacement of an existing interest rate benchmark with an alternative interest rate **that results from** the recommendations set out in the Financial Stability Board's July 2014 report, *'Reforming Major Interest Rate Benchmarks'*.

32 Hence, the EFRAG Secretariat concludes from this change in wording that a market-wide reform of an interest rate benchmark could result from the FSB's July 2014 report, but there could also be similar market-wide reforms that do not result from the FSB's July 2014 report. For instance, a change in calculation methodology for an existing benchmark rate may be required in the future under the EU Benchmark Regulation and could be seen as a "market-wide reform of an interest rate benchmark" even if it was not resulting from the FSB's July 2014 report. For such cases, the EFRAG Secretariat works under the presumption that the amendments made in relation to interest rate benchmark reforms continue to be applicable.

33 When the IASB started its deliberations on Phase 2 in September, the IASB staff analysed that "the scope of the issues to be considered by the Board in Phase 2 is broader than the previous phase" (IASB 09/2019, AP 14, 10). This conclusion relates rather to the number of potential issues that could arise on replacement.

34 What is less clear is whether the scope for Phase 1 and Phase 2 is the same, i.e. whether Phase 2 relates to the same definition of "interest rate benchmark reform". However, the IASB intends to discuss at its January 2020 meeting how the end of relief in Phase 1 interacts with hedge designations under Phase 2. Hence, the EFRAG Secretariat works under the presumption that the scopes in relation to a particular benchmark reform for Phase 1 and Phase 2 issues are identical.

Question to EFRAG TEG:

35 Do EFRAG TEG members have further observations?