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.

Interest Rate Benchmark Reform – Phase 2
Additional Issues

Objective

1 The issues in this agenda paper have been identified after the drafting of the pre-consultation document. The objective is to receive feedback from EFRAG TEG on whether these issues should be included in the pre-consultation document.

Issue 1: Close-Outs of Derivatives

2 When transitioning legacy derivatives referenced to IBOR to an alternative benchmark rate, entities may decide to close-out existing IBOR-derivatives and to replace these with new derivatives that have the same terms except that they are now referenced to an alternative benchmark rate.

3 When the derivatives are subject to central clearing with a CCP, such close-out will be subject to individual transactions with other CCP members rather than transacting unilaterally with the CCP.

4 When the close-out is made, either through on-market or off-market trades, the IBOR-based derivatives are subsequently compressed[1] and new derivatives based on alternative benchmark rate are transacted.

EFRAG Secretariat analysis of Issue 1

5 The transaction described above is deemed a termination of an existing IBOR derivative, while the new derivative based on alternative benchmark rate constitutes a separate financial instrument.

6 However, paragraph 3.3.2 of IFRS 9 on derecognition of financial liabilities states:

An exchange between an existing borrower and lender of debt instruments <u>with substantially different terms</u> shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a <u>substantial modification</u> of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

7 We observe that paragraph 6 could equally apply to derivatives with positive fair value by analogy, i.e. the conclusions are the same regardless of the fair value of the derivative when the close-out is made.

[1] Compression is a process of replacing multiple offsetting derivatives contracts with fewer deals of the same net risk to reduce the notional value of the portfolio.

8 Against this background, a close-out would not result in derecognition of the IBOR-based derivatives when the terms of the new derivatives based on alternative benchmark rates are not substantially different to the terms of the old IBOR based derivatives. In particular, for the purposes of applying the hedge accounting relief, the terms of the old and new derivatives would be the same, except for the changes due to the IBOR reform.

9 The IASB has clarified in the Basis for Conclusions in IFRS 9 (BC4.253):

"The IASB decided that standard-setting is not required because the requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition. In doing so, the Board highlighted that the requirements in IFRS 9 for adjusting the amortised cost of a financial liability when a modification (or exchange) does not result in the derecognition of the financial liability are consistent with the requirements for adjusting the gross carrying amount of a financial asset when a modification does not result in the derecognition of the financial asset."

10 When no derecognition applies, the close-out constitutes a modification of the pre-existing financial instrument. As the transaction is made to replace the IBOR based derivative with a derivative based on alternative benchmark rate, same as for bilateral contractual amendments, the close-out is a direct consequence of IBOR reform and is done on an economically equivalent basis. For this reason, the proposed amendments for IBOR would be equally applicable, in particular on hedge accounting.

11 Hence, the accounting outcome would be the same regardless of whether an existing IBOR-based derivative is modified or is closed-out and replaced by a new derivative to reflect an alternative benchmark rate.

Questions for EFRAG TEG

12 Do EFRAG TEG members share the analysis of EFRAG Secretariat?

13 Do EFRAG TEG members agree that issue 1 is solved without the need of further changes to the IASB decisions, accordingly it is not to be incorporated in the pre-consultation document?

Issue 2: Mandatory Reinstatement

14 For transition, the IASB has tentatively decided that

"Retrospective application 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." (February 2020 IASB Update)

EFRAG Secretariat analysis of Issue 2

15 EFRAG Secretariat observed that there may be situations where mandatory reinstatement could be impracticable. For instance:

(a) When a hedging relationship is discontinued due to transition to an alternative benchmark rate, the derivate that has been designated as hedging instrument will then be treated as freestanding derivative. As such, it might be compressed together with other freestanding derivatives due to a particular

policy. If so, the original derivative will no longer exist and it will be impracticable to reinstate the previous hedging relationship.

(b) When a hedging relationship is discontinued due to transition to an alternative benchmark rate, the derivate that has been designated as hedging instrument may be designated as hedging instrument to a new hedging relationship. If so, being required to reinstate the previous hedging relationship will require the new hedging relationship to be discontinued. This may be impracticable for instance under IFRS 9 where a discontinuation is not permitted when the hedging relationship still meets the risk management objective on the basis of which it qualified for hedge accounting in accordance with IFRS 9.B6.5.23(a). As this is true for the new hedging relationship, it will be impracticable to discontinue this new hedging relationship to make the derivative available as hedging instrument for the purpose of reinstateting the previous hedging relationship.

16 EFRAG secretariat notes that application of the proposed amendments, when finalised, would constitute a change in accounting policies in accordance with the specific transitional provisions of these amendments in accordance with IAS 8.19(a).

17 IAS 8 includes guidance on limitations of retrospective application when it is impracticable

(a) to determine the periodic-specific effects of changing an accounting policy on comparative information for one or more prior periods presented (IAS 8.24), and

(b) to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods (IAS 8.25).

18 The term impracticable is defined in IAS 8.5 as "Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so."

19 However, in the context of the situations described in paragraph 15, it appears less clear whether, when anticipating the forthcoming requirement to retrospectively reinstate particular hedging relationships that had to be discontinued as a direct consequence of IBOR reform, it would be impracticable for an entity to avoid these situations.

20 EFRAG Secretariat observes that the IASB has discussed in its February 2020 meeting whether the application of the proposed amendment should be permitted or required, in particular in the context of hindsight considerations. All IASB members present have agreed that it should be required instead of permitted.

Questions for EFRAG TEG

21 Do EFRAG TEG members share the analysis of EFRAG Secretariat?

22 Do EFRAG TEG propose to include this issue 2 in the pre-consultation document?

Issue 3: Requirement to reset cumulative fair value changes to zero

23 The IASB tentatively decided to:

"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." (January 2020 IASB Update)

EFRAG Secretariat Analysis of Issue 3

24 EFRAG Secretariat understands that the proposed amendment is intended to avoid failure of the retrospective effectiveness test because the cumulated fair value changes before transitioning to an alternative benchmark rate were driven by IBOR and would hence give rise to ineffectiveness after the fair value changes are driven by the alternative benchmark rate.

25 However, when the amendment is applied on transition, the fair value changes taken into account for assessing hedge effectiveness will be driven by fair value changes occurring in periods after transition to the alternative benchmark rate. When the market environment in these periods is very volatile, this may have a negative effect on effectiveness that is greater than the negative impact described in paragraph 23 when assessing effectiveness on a cumulative basis. In such situations, the intention to avoid failure of the retrospective effectiveness test may not be met.

26 EFRAG Secretariat observes that the IASB has discussed in its January 2020 meeting whether the application of the proposed amendment should be allowed or required. All 14 IASB members have agreed that it should be required.

Questions for EFRAG TEG

27 Do EFRAG TEG members share the analysis of EFRAG Secretariat?

28 Do EFRAG TEG propose to include this issue 3 in the pre-consultation document?