IFRS

STAFF PAPER

February 2020

IASB® meeting

Project	**IBOR Reform and its Effects on Financial Reporting – Phase 2**		
Paper topic	Hedges of risk components—separately identifiable criteria		
CONTACT(S)	Umair Shahid	ushahid@ifrs.org	+44 (0) 20 7246 6414
	Riana Wiesner	rwiesner@ifrs.org	+44 (0) 20 7246 6412

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in the IASB® *Update*.

Purpose of this paper

1. IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* permit entities to designate only changes in the cash flows or fair value of an item attributable to a specific risk or risks, provided that the 'risk component' (IFRS 9) or 'designated portion' (IAS 39) is separately identifiable and reliably measurable.[1] In September 2019 the Board published *Interest Rate Benchmark Reform* (Amendments to IFRS 9, IAS 39 and IFRS 7), which provided relief from those requirements in some circumstances. In those amendments, the Board decided not to require end of application with respect to that relief. The purpose of this paper is to consider, as part of Phase 2, the end of application of that Phase 1 relief and whether the Board should provide a further relief from the separately identifiable requirement in IFRS 9 and IAS 39.

2. The staff analysis in this paper is structured as follows:

    (a) Phase 1 exception and end of application (paragraphs 3–6);

[1] For simplicity, we have used the term 'risk component' in this paper to capture both risk components (as the term is used in IFRS 9) and designated portions (as that term is used in IAS 39).

The International Accounting Standards Board is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of International Financial Reporting Standards. For more information visit www.ifrs.org.

(b) Interaction with the tentative decisions in Phase 2 (paragraphs 7–9);

(c) Application of the requirements in IFRS 9 and IAS 39 for risk components (paragraphs 10–14);

(d) Whether further relief is needed from the separately identifiable requirement in IFRS 9 and IAS 39 (paragraphs 15–17);

(e) Staff recommendation (paragraphs 18–24) and

(f) Question for the Board (page 10).

Phase 1 exception and end of application

3. When developing the amendments to IFRS 9 and IAS 39 that were published in September 2019, the Board observed that an entity's ability to conclude that an interest rate benchmark is a separately identifiable component in accordance with paragraph 6.3.7(a) of IFRS 9 or paragraph 81 of IAS 39, requires a continuous assessment over the duration of the hedging relationship and could be affected by the reform. For example, if the outcome of the reform affects the market structure of an interest rate benchmark, it could affect an entity's assessment of whether a non-contractually specified IBOR component is separately identifiable and, therefore, an eligible hedged item in a hedging relationship. The Board considered only risk components that are implicit in the fair value or the cash flows of an item of which they are a part (referred to as non-contractually specified) because the same issue does not arise for risk components that are explicitly specified in the contract.

4. The Board decided to amend IFRS 9 and IAS 39 so that entities would not discontinue hedge accounting solely because the risk component is no longer separately identifiable as a result of the reform. The exception requires that, for hedging relationships within the scope of the amendments (ie those affected by IBOR reform), the separately identifiable requirement for hedges of the benchmark component of interest rate risk be applied only at the inception of those hedging relationships.

5. A similar issue arises in the context of hedges of group of items. Consequently, the Board added a similar exception for hedging relationships that, consistent with

an entity's hedge documentation, frequently reset (ie discontinue and restart) because both the hedging instrument and the hedged item frequently change. Applying paragraphs 6.8.8 of IFRS 9 or 102I of IAS 39, an entity determines whether the risk component is separately identifiable only when it initially designates an item as a hedged item in the hedging relationship. The hedged item is not reassessed at any subsequent redesignation in the same hedging relationship.

6. Unlike the specific end of application requirements for the other reliefs set out in the amendments issued in September 2019, the Board decided not to require end of application with respect to the relief for the separately identifiable requirement. That is because including an end date for that exception could require an entity to immediately discontinue hedge accounting at a point in time because, as the reform progresses, the component based on the interest rate benchmark may no longer be separately identifiable (for example, as the market for the alternative benchmark rate is established). Such immediate discontinuation of hedge accounting would be inconsistent with the objective of the exception. Therefore, the Board decided that an entity should cease applying the exception to a hedging relationship only when that hedging relationship is discontinued applying the requirements in IFRS 9 or IAS 39.

Interaction with the tentative decisions in Phase 2

7. When the Board finalised the Phase 1 amendments, it was not known what, if any, further amendments might be considered in Phase 2. Having considered the interaction between the end of application with respect to the relief from the separately identifiable requirement (ie only when the hedging relationship is discontinued) and the Board's tentative decisions in Phase 2 (amending hedging relationships to reflect modifications directly required by the reform may not trigger discontinuation of hedge accounting), the staff observe it may be unclear when the relief from the separately identifiable requirement finalised in Phase 1 would cease to apply—and specifically, there may be an impression that entities would apply that relief until the updated hedging relationship is discontinued.

8. However, as noted in paragraphs BC6.595 of IFRS 9 and BC281 of IAS 39 continuing to apply the Phase 1 exceptions after the uncertainty arising from IBOR reform has been resolved would not faithfully represent the actual characteristics of the elements of the hedging relationship in which the uncertainty has been eliminated. Furthermore, the Board emphasised during its prior discussions that the amendments proposed in Phase 2 would be provided on the basis that all other qualifying hedge accounting criteria are met. For example, changes to a hedging relationship (and related hedge documentation) to reflect modifications, that are directly required by the reform, to the hedged risk, hedged item and/or hedging instrument do not result in the discontinuation of hedge accounting, subject to the hedging relationship continuing to satisfy the qualifying criteria for hedge accounting in IFRS 9 or IAS 39.

9. The staff think this means that, at the time the changes to the hedging relationship are made, in order to continue hedge accounting, the hedge must satisfy all the qualifying criteria, including the requirement that the hedging relationship consists only of eligible hedging instruments and hedged items.[2] Therefore the staff believe that, in the context of the Board's tentative decisions in Phase 2, the relief provided in Phase 1 from the separately identifiable requirement would cease to apply at the earlier of:

   (a) when changes to the hedging relationship are made for the hedged risk to reflect modifications directly required by the reform; and

   (b) when the hedging relationship is discontinued.

Application of the requirements in IFRS 9 and IAS 39 for risk components

10. Similar to the considerations that led to the relief provided in Phase 1 from the separately identifiable requirement (as discussed in paragraphs 3–6 of this paper), the staff note that questions might arise about whether an alternative benchmark rate meets the requirements in IFRS 9 and IAS 39 to be considered separately identifiable and reliably measurable within the context of the particular market structure of the risk component. This may be particularly relevant during the

[2] Paragraph 6.4.1 of IFRS 9 (similar requirements are included in paragraph 88 of IAS 39)

early stages of the transition to alternative benchmark rates.[3] In other words, at the time that hedging relationships are amended to reflect modifications to the hedged risk, hedged item and/or hedging instrument or new hedging relationships are designated, there may be questions about whether the alternative benchmark rate (RFR) meets the requirement that a risk component must be separately identifiable and reliably measurable.

11. As discussed in Agenda Paper 14 (AP14) for the February 2019 meeting, the assessment of whether a risk component is separately identifiable may be straight-forward when the component is explicitly stated in a contract. The staff expect limited concerns to arise about the assessment for contractually specified risk components because those components are a matter of fact and thus would require limited judgement.[4] However, identifying a non-contractually specified risk component is more difficult and, as noted in paragraph B6.3.9 of IFRS 9, it requires an entity to assess the relevant facts and circumstances within the context of the particular market structure to which the risk relates and in which the hedging activity takes place. The Board therefore noted in paragraph BC6.176 of the Basis for Conclusions on IFRS 9 that there is no 'bright line' to determine eligible risk components.

12. IFRS 9 provides a number of examples to illustrate the identification of a risk component that is separately identifiable. The following are particularly relevant to IBOR reform:

    (a) paragraph B6.3.10(d) provides an example whereby an interest rate benchmark is identified as a risk component because variable-rate instruments in that environment are typically indexed to that benchmark, and interest rate swaps are frequently used to manage interest rate risk arising from the benchmark rate (in that example, LIBOR is named as the benchmark rate); and

    (b) paragraph B6.3.14 provides an example of an environment in which inflation-linked bonds have a volume and term-structure that results in a

[3] Paragraphs 6.3.7(a) and B6.3.8 of IFRS 9 and paragraphs 81 and AG99F of IAS 39

[4] https://cdn.ifrs.org/-/media/feature/meetings/2019/february/iasb/ibor/ap14-ibor.pdf

sufficiently liquid market that allows constructing a term structure of zero-coupon real interest rates. This means that for the respective currency, the inflation risk component could be determined by discounting the cash flows of the hedged debt instrument using the term structure of zero-coupon real interest rates (ie in a manner similar to how a risk-free interest rate component can be determined). Conversely, in an environment where the market for inflation-linked debt instruments is not sufficiently liquid to allow a term structure of zero-coupon real interest rates to be constructed, inflation is not a separately identifiable risk component.

13. The most specific guidance in IAS 39 is in paragraph 81 which states '[f]or example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument)'. As noted in AP14 for the February 2019 meeting, while the words in IFRS 9 and IAS 39 are not the same, this does not impact the analysis because the concepts and principles in the two Standards are very similar.

14. Given the objective of IBOR reform, the staff expect an entity might have a reasonable expectation that, at a point in time, the volume and liquidity of debt instruments referenced to an alternative benchmark rate in a particular market structure will be such that 'a large variety of similar fixed rate debt instruments are compared by their spreads to the benchmark rate and variable-rate instruments in that environment are typically indexed to the same benchmark rate' (see example in paragraph 12(a) of this paper) . However, in the early stages of IBOR reform, the staff think concerns likely will arise if an entity wants to designate the alternative benchmark rate as a risk component when that particular market has not yet sufficiently developed for a term structure of zero rates to be available.

Whether further relief is needed from the separately identifiable requirement in IFRS 9 and IAS 39

15. As described in AP14 for the February 2019 meeting, the staff remain concerned that any proposed exception from the requirements for risk components would impact the definition of the hedged item. Without a term structure of zero-coupon interest rates, an entity's ability to independently define the hedged item would be reduced. For example, due to the lack of observable data, entities would likely estimate changes in the fair value of the hedged item based on the same valuation inputs used to estimate changes in the fair value of the hedging instrument. The staff is concerned this would violate the view that the hedge accounting model requires that the value of the hedged item is measured independently from the value of the hedging instrument and, consequently, would also violate the general notion of offset between gains and losses on the hedging instrument and the hedged item on which the hedge accounting models in IFRS 9 and IAS 39 are based.[5] Additionally, this would contradict the statement in paragraph B6.3.14 of IFRS 9 that 'the entity cannot simply impute the terms and conditions of the actual inflation hedging instrument by projecting its terms and conditions onto the nominal interest rate debt'.[6]

16. The staff also consider that permitting entities to designate non-contractually specified risk components when such components are not separately identifiable could be challenging. This is because the future volumes and liquidity of the alternative benchmarks are unknown and the pace of transition to such alternative benchmarks is different from one jurisdiction to another. Thus, we think there could be unintended consequences as a result of such relief.

17. Furthermore, if an entity was permitted to designate risk components that are not separately identifiable, this would imply that the designated component is separately considered by the market when determining the fair value of the hedged item. Therefore, there is link between a risk component being separately identifiable and it being reliably measurable–if a risk component cannot be reliably measured, it is not possible to separately identify such a component.

---

[5] Refer to paragraph B6.4.7 of IFRS 9 and paragraph BC6.290 of the Basis for Conclusions of IFRS 9.

[6] As discussed in AP14 for the February 2019 meeting.

Similarly, it is difficult to reliably measure a component that cannot be separately identified. In situations where a component is not separately identifiable or reliably measurable, the application of hedge accounting may distort the underlying economics of the hedging relationship because it implies the measurement of hedge effectiveness is based on the structure of the relevant market, while in fact it is only producing a result that achieves a particular accounting outcome. Therefore, the resulting information may not provide useful information to the users of financial statements.

Staff recommendation

18. The staff considered whether the Board should propose an exception from both the separately identifiable and reliably measurable requirements for the designation of the alternative benchmark rate because of the linkage between the requirements. The staff observe that, instead of designating a risk component, the entire fair value or all the cash flows of the interest-bearing financial instrument could be designated. However, this will require the measurement of effectiveness of that hedging relationship to be based on all the cash flows (or fair value), rather than on only the risk component. This would most likely increase the measured ineffectiveness that does not reflect the way the entity is managing the risk and potentially result in the hedging relationship not satisfying the hedge effectiveness requirements.

19. The staff think that reliable measurement is one of the key principles of hedge accounting and, consequently, any exception from a component being reliably measurable would undermine the objective and discipline of hedge accounting and result in information with little, or no, information value to users of financial statements. Therefore, for the reasons specified in the Phase 1 amendments, the staff do not recommend any relief or exception from the requirement that a risk component must be reliably measurable.

20. However, staff think there could be circumstances in which it would be consistent with the objectives of Phase 2 if entities were able to designate an alternative benchmark rate as a non-contractually specified risk component even if the component is not separately identifiable at the time. For example, a regulator

might instruct an entity to modify financial instruments that are designated in hedging relationships in order to accelerate the transition to alternative benchmark rates, which would require the entity to amend the hedging relationships as well. If at that time, the alternative benchmark rate would not satisfy the requirement in IFRS 9 or IAS 39 to be considered separately identifiable (for example because at that time there is not yet sufficient liquidity in the particular market), the entity might have to designate the entire fair value or all cash flows in a hedging relationship that might not be consistent with how the entity manages the risk (and the hedge would potentially fail the effectiveness requirements as described in paragraph 18) or the entity might have to discontinue the hedging relationship solely because of IBOR reform. This could be the case even if the entity has a reasonable expectation that the alternative benchmark rate will satisfy the separately identifiable requirement within a relatively short period of time.

21. The staff do not think that such an outcome would be consistent with the objectives of Phase 2. We therefore recommend that the Board propose temporary relief for hedging relationships that are amended to reflect modifications directly required by the reform so that a component is considered to satisfy the separately identifiable requirement 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 component within the particular market structure within 12 months from the date it is designated as a risk component for hedge accounting purposes; and

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

22. The staff highlight that the temporary relief described in paragraph 21 of this paper will be only from the separately identifiable requirement, not the reliably measurable requirement. Therefore, if the component cannot be reliably measured, it cannot be designated as a risk component in a hedging relationship. Similarly, if the hedging relationship fails to meet any other qualifying criteria as set out in IFRS 9 or IAS 39 (including the effectiveness requirements), either at the date the alternative benchmark rate is designated or throughout the 12-month period, hedge accounting must be discontinued.

23. The staff also highlight that an entity's ability to conclude that an interest rate benchmark is a separately identifiable component in accordance with paragraph 6.3.7(a) of IFRS 9 and paragraph 81 of IAS 39, requires a continuous assessment over the duration of the hedging relationship. The temporary relief will apply to these assessments performed during the qualifying 12-month period.

24. The staff acknowledge that 12 months might seem like an arbitrary period. However, we believe there should be a clearly defined end point for such temporary relief. The staff also considered that 12 months from the planned finalisation of any amendments resulting from Phase 2 (ie Q3 2020) will be close to the general target date for some interest rate benchmarks to be discontinued. Therefore, the staff considered that a period of 12 months from the date a change to the hedging relationship is made is sufficient to provide entities the opportunity to act upon IBOR reform and comply with any regulatory requirements without being hampered in the short-term as the liquidity of the rates increases.

Question for the Board

Question for the Board
1) Does the Board agree with the staff recommendation to provide temporary relief so that a component is considered to satisfy the separately identifiable requirement if and only if: (a) the entity reasonably expects that the alternative benchmark rate will satisfy the requirements in IFRS 9 and IAS 39 to be a separately identifiable component within the particular market structure within 12 months from the date it is designated as a risk component for hedge accounting purposes; and (b) the component can be reliably measured from the date it is designated as the risk component?