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Comment letter on EFRAG Draft Comment Letter on the IASB ED/2019/1 Interest rate Benchmark Reform (proposed amendment to IFRS 9 and IAs 39)

Dear Mr. Gauzès,

Thank you for the opportunity to comment on the EFRAG draft comment letter.

Erste Group agrees with the EFRAG's assessment that the IASB proposals are an appropriate solution in addressing hedge accounting issues arising due to uncertainties existing in the period before transiting to new benchmark interest rates.

Erste Group also welcomes the EFRAG's call that the IASB addresses the issues in the second phase of the project as soon as possible and in parallel to the finalisation of the first phase.

Please find our comments to the questions raised in the EFRAG draft comment letter.

Question to constituents
42 The Amendments require entities to cease applying the relief when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and amount of the interest rate benchmark-based cash flows. The assessment of when uncertainty ceases to exist requires the exercise of judgement.
43 Do constituents believe that the level of judgement involved in this assessment would deserve additional discipline? For example, should the IASB add a clarification that this assessment has to be done by management using all the available information applicable to the specific facts and circumstances?

Yes, we agree that the IASB should clarify that the assessment of when to cease applying the relief has to be done by management using all the available information applicable to the specific facts and circumstances. This is because, as illustrated in paragraphs BC34 – BC40 of the exposure draft, there are different scenarios how the uncertainty regarding the timing and amount of the interest rate benchmark-based cash flows is removed ranging from contractual amendments to actions by central authorities. As a result, the determination of whether the uncertainty is no longer present may involve exercising adequate professional judgement.

Question to Constituents
25 In addition to the fact patterns above, are there different patterns of IBOR transition that the IASB should consider when dealing with the replacement issues? Please describe.

We consider that the description could also include the transition from CHF LIBOR to SARON rates since Switzerland participates in the European single market.

Question to Constituents
31 EFRAG has been informed that, during the period while the relief is ongoing, it will be necessary to have clarity on the outcome of not only the prospective assessment of a cash flow hedge relationship under IAS 39, but also of the retrospective assessment. This in order to determine, at the end of each reporting period, how much of the value difference between the hedged item and the hedging instrument is assigned to other comprehensive income and which amount is assigned to profit or loss. As such, the retrospective assessment at the beginning of the cash flow hedge relationship should be able to be carried forward during the period of the relief solely for the purpose of determining the cash flow hedge reserve. 32 In your view, are there particular circumstances in which a relief of the retrospective test is needed applying IAS 39? If so, please describe the reasons why as well as the specific fact patterns it would apply to.

Regarding the retrospective assessment in IAS 39, as discussed in paragraph BC23 of the exposure draft, the IASB decided not to propose any exception since the assessment is based on the actual results (or changes in fair values based on actual market movements) of the hedging relationship.

We note that the ‘lower of test’ determining how much of the hedging derivative revaluation is recognised in the cash flow hedge reserve in paragraph 6.5.11(a) of IFRS 9 refers to present value of the cumulative change in the hedged *expected future cash flows*. Similar wording is used in paragraph 96(a) of IAS 39. The values determined in this test are often also used for measuring the retrospective hedge effectiveness for hedges under IAS 39.

The proposed amendments focus on hedge accounting requirements which require forward-looking analysis (see e.g. paragraph BC4 of the exposure draft). We consider that the term *expected future cash flows* also includes a similar forward-looking aspect. In the area of cash flows hedges of interest risk the expected future cash flows are determined by using forward interest rates (usually included as one leg of hypothetical derivatives replicating the hedged cash flows). The time horizon of such expected future cash flows can span over the benchmark rates reform time point in which case they would be affected by the new rates after the reform takes place.

We understand that the retrospective assessment and the 'lower of test' are based on the actual results. But we consider that, in order to avoid misunderstanding, the IASB should explain how future expected cash flows should be understood in the context of the proposed amendments. In our view, similarly to other areas addressed in the exposure draft, the future expected cash flows should be analysed assuming that the interest rate benchmark on which the hedged cash flows are based is not altered. This clarification should be part of the phase one of the project.

Further, we would like to note that the transition to new benchmark changes may have valuation impacts resulting from discounting. For example, for fair value hedges of interest risk Erste Group uses 3M or 6M Euribor or Libor curves for discounting hedged items whereas hedging instruments are discounted using O/N curves. Different transition patterns for these rates might result in valuation outcomes of hedging relationships falling outside the effectiveness corridor. This may concern both retrospective and prospective effectiveness.

We believe that the IASB should consider providing a relief that one-off valuation effects resulting from the transition to the new benchmark rates should not disqualify hedging relationships from meeting the hedge effectiveness requirements. I.e. they should not lead to discontinuation of hedges. When saying this we acknowledge that the economics of the hedging relationship should be captured by recognising the ineffectiveness through standard hedge accounting measurement requirements.

Question to Constituents

48 In your view which of the above topics should be addressed by the IASB when dealing with the replacement issues? Please explain the reasons why and your suggested accounting treatment.

49 In addition to the topics listed above, do you have any other matters that the IASB should consider when dealing with the replacement issues? Please describe.

We consider that the topics capture the accounting issues which entities will face when the current benchmark interest rates have been replaced. However, we have certain notes to some of the topics discussed in Appendix II of the EFRAG draft comment letter.

Topic 8: IFRS – SPPI criterion should also include discussion of SPPI compliance of backward-looking rates which may serve as benchmark or fall-back rates after the replacement. With this backward-looking solution short term rates replacing the old -IBOR rates with term structure up to 12 months would be determined based on a compounding new overnight risk-free rates such as €STR or SONIA.

For example, a 6-month Euro interest rate would be determined as a compounded €STR rate over the 6-month interest cash flow period. As a result, such an interest would be known only at the end of the interest period (the backward-looking aspects). We consider that in such a case the instrument could be viewed as bearing current overnight interest rates which are technically paid, including interest on the 'deferred interest', every 6 months in arrears. Such an instrument would not have non-SPPI features, in our view.

However, in order for the contract parties to know the interest rate already at the start of the period the compounded term rate may be determined in advance and relate to a prior period. In the simplest case a 6-month Euro rate would be calculated as a compounded €STR over a prior 6-month period ending on the last day preceding the current 6-month period. At the start of the current 6-month period the resulting rate would be applied for the entire period. Also other alternatives for knowing the rates (compounding overnight rates) at the start of the period are possible. All of such 'in advance' solutions would involve certain SPPI challenges because the interest may not include a consideration for the time value of money. The IASB should discuss their SPPI treatment within the interest rate benchmark reform context. These issues may be relevant not only at the transition to the new rates but would also affect the treatment of the instruments after the reform.

The issues discussed in *Topic 12: Collateralised derivatives discounted using €STR* relate to modification and derecognition which are addressed in topics 1 and 2. The CSA case could be mentioned as a specific example in those topics.

Further, the reference to the loan commitment exception in IFRS 9.2.1(g) in paragraph 47 of the draft comment letter is confusing. Paragraph IFRS 9.2.1(g) brings a scope exemption for loan commitments and it is not related to classification and measurement of the CSA at amortised cost. In our view, the CSA collateral is an on-balance financial receivable or a financial liability based on whether the cash collateral is posted or received. As a result, the amortised cost measurement is the typical measurement for CSA without the need to make the reference. Moreover, we do not understand the issue discussed in paragraph 46.

If you have any questions to our comments please do not hesitate to contact Martin Svitek martin.svitek@erstegroup.com or me.

Yours sincerely,

Manfred Schmid
Head of Group Accounting and Group Controlling