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Need to know

IASB issues *Interest Rate Benchmark Reform—Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)*

Contents

This *Need to know* addresses the amendments to IFRS 9 *Financial Instruments*, IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 7 *Financial Instruments: Disclosures*, IFRS 4 *Insurance Contracts* and IFRS 16 *Leases* that have been published by the International Accounting Standards Board (Board). The amendments are titled *Interest Rate Benchmark Reform—Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)*.

This is the second part of the two-phase project on *Interest Rate Benchmark Reform* undertaken by the Board. In September 2019, the Board published the first set of amendments (Phase 1), see details in our previous *Need to know*.

- The amendments enable entities to reflect the effects of transitioning from benchmark interest rates, such as interbank offer rates (IBORs) to alternative benchmark interest rates without giving rise to accounting impacts that would not provide useful information to users of financial statements.
- The amendments affect many entities and in particular those with financial assets, financial liabilities or lease liabilities that are subject to interest rate benchmark reform and those that apply the hedge accounting requirements in IFRS 9 or IAS 39 to hedging relationships that are affected by the reform.
- The amendments apply to all entities and are not optional.
- The amendments are effective for annual periods beginning on or after 1 January 2021 with early application permitted.
- The amendments are applied retrospectively and include reinstatement of hedge relationships that were discontinued solely due to changes directly required by the reform.
- Entities applying IFRS 9 as an accounting policy choice under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* will be subject to the IFRS 9 amendments once endorsed for use in the EU. Entities applying IAS 39 as an accounting policy choice under FRS 102 will be subject to the IAS 39 amendments once introduced into FRS 102. The disclosure requirements under FRS 102 in respect of interest rate benchmark reform are yet to be finalised but are expected to be less substantial than the new IFRS 7 disclosures.

Background

Interest rate benchmarks such as IBORs play a key role in global financial markets and index the equivalent of trillions of US dollars in financial products. Work is underway in many jurisdictions to transition to alternative benchmark interest rates in response to systemic risk concerns. The Financial Stability Board (FSB) undertook a fundamental review of major interest rate benchmarks and published its recommendations for reform. As a result, public authorities have selected new benchmark interest rates in key currencies with the objective that such rates will be based on liquid underlying market transactions, and not be dependent on submissions based on expert judgement. The aim is that these new rates are more reliable and provide a robust alternative interest rate for products and transactions that do not need to incorporate the credit risk premium embedded in existing benchmark interest rates.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

Observation
The amendments address issues that might affect financial reporting when an existing interest rate benchmark is replaced with analternative benchmark interest rate, i.e. replacement issues.

The accounting issues arising before an existing interest rate benchmark is replaced with an alternative risk free rate, i.e. prereplacement issues, have been considered previously by the Board and were addressed in *Interest Rate Benchmark Reform (Amendments to IFRS 9, IAS 39 and IFRS 7),* published in September 2019. These amendments provide temporary exceptions to specific hedge accounting requirements, so that entities apply these hedge accounting requirements assuming that the interest rate benchmark is not altered as a result of interest rate benchmark reform. These exceptions were put in place to avoid entities having to discontinue hedging relationships solely due to the uncertainty arising from the reform. The Phase 2 amendments compliment, notsupersede, the Phase 1 amendments. Please refer to the *Need to know* for details on the Phase 1 amendments.

The amendments

The objective of the second phase of the Board's project was to assist entities in providing useful information about the effects of the transition to alternative benchmark rates and support preparers in applying the requirements of IFRS Standards when changes are made to contractual cash flows or hedging relationships as a result of the transition to an alternative benchmark interest rate. The amendments affect the following key areas: changes in the basis for determining the contractual cash flows as a result of benchmark interest rate reform, hedge accounting and disclosures. These areas are summarised in turn.

Changes in the basis for determining the contractual cash flows as a result of interest rate benchmark reform

The amendments provide specific guidance on how to treat financial assets and financial liabilities where the basis for determining the contractual cash flows changes as a result of interest rate benchmark reform. This can include cases where the contractual terms are amended, cases where the contractual terms are not amended but for example where the method for calculating the interest rate benchmark is altered, and cases where an existing contractual term is activated such as when a fallback clause is triggered.

As a practical expedient, the amendments require an entity to apply IFRS 9:B5.4.5, such that the change in the basis for determining the contractual cash flows is applied prospectively by revising the effective interest rate. This practical expedient only applies when the change in the basis for determining the contractual cash flows is necessary as a direct consequence of interest rate benchmark reform and the new basis for determining the contractual cash flows is economically equivalent to the previous basis (i.e. the basis immediately preceding the change).

The amendments provide a non-exhaustive list of examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis:

a. The replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financialliability with an alternative benchmark rate or implementation of a reform of an interest rate benchmark by changing the method usedto calculate the interest rate benchmark, with the addition of a fixed spread necessary to compensate for the basis difference between the existing interest rate benchmark and the alternative benchmark rate;

b. Changes to the reset period, reset dates or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and

c. The addition of a fallback provision to the contractual terms of a financial asset or financial liability to enable any of the changes described in a. and b. above to be implemented.

Observation
The Board acknowledges in the Basis for Conclusions that changes that give rise to a new basis for determining the contractual cash flows are likely to vary significantly across jurisdictions, product types and contracts. Consequently, the Board notes that the examples included are not exhaustive. The Board included the examples to assist preparers: if the changes are limited to those in the examples, the entity would not be required to analyse these changes further to conclude that the changes are economically equivalent.

Other changes to contractual terms may be agreed as part of renegotiating bilateral contracts with the counterparty. Care is required to determine whether those changes are a direct consequence of interest rate benchmark reform and whether the new basis for determining the contractual cash flows is economically equivalent.

When multiple changes are made to a financial asset or a financial liability, the entity first applies the practical expedient in IFRS 9:B5.4.5 to those changes required by interest rate benchmark reform. The applicable requirements of IFRS 9 are then applied to the other changes.For example, if the basis of interest of a financial liability is changed from a benchmark interest rate to a new alternative benchmark interest rate, that change is in the scope of the practical expedient and is accounted for prospectively applying IFRS 9:B5.4.5. Any other modifications to the contractual terms that are not necessary as a direct consequence of interest rate benchmark reform are not subject to the practical expedient and the appropriate accounting is determined applying IFRS 9. For example, in the case of a financial liability, if having applied the practical expedient to changes required by interest rate benchmark reform, an entity determines that other changes were effected that do not result in derecognition of the financial liability, it applies IFRS 9:B5.4.6, and recognises an immediate gain or loss in the statement of profit or loss.

Observation
The Board notes in the Basis for Conclusions to the amendments that because alternative benchmark interest rates are intended to be nearly risk-free while many existing interest rate benchmarks they replace are not, often a fixed spread will be added to compensate for that difference. If this is the only change effected, the Board considers that it would be unlikely that the transition to the alternative benchmark interest rate alone would result in derecognition of the financial instrument. Hence, the focus of the Board's work was to assess whether the existing requirements would lead to useful information to users of financial statements.
As the existing requirements generally lead to a gain or loss in profit or loss because the modified cash flows are discounted using the original effective interest rate, the Board decided to introduce the practical expedient to avoid this and instead require the effective interest rate to be updated on a prospective basis. The Board reached that decision because it considers that it would not be meaningful to recognise future interest income or expense based on the original effective interest rate, particularly in the case of floating interest rates that no longer exist.

Modifications of lease liabilities
Given the similarity of financial liabilities in IFRS 9 and lease liabilities in IFRS 16, the Board has provided a similar practical expedient in IFRS 16. The practical expedient applies when the interest rate benchmark on which lease payments are based is changed as a direct consequence of interest rate benchmark reform and the change is done on an economically equivalent basis. Like the practical expedient in IFRS 9, the change in the contractual cash flows is applied prospectively by applying IFRS 16:42. If additional modifications are made to lease contracts that are not required by interest rate benchmark reform, a lessee shall apply the applicable requirements in IFRS 16 to account for all lease modifications made at the same time, including those required by interest rate benchmark reform.

Observation
The Board decided not to amend the requirements for accounting for lease modifications from the lessor's perspective. For a financelease, the lessor is required to apply IFRS 9 (including the amendments) to lease modifications. For operating leases, the Boardconsiders that the current requirements in IFRS 16 will provide useful information about the modification in terms and conditions required by the reform in the light of the mechanics of the operating lease accounting model.

Hedge accounting

An entity may apply the hedge accounting requirements of either IFRS 9 or IAS 39 and therefore both Standards have been amended. The amendments to IFRS 9 and IAS 39 introduce an exception to the existing requirements so that changes in the formal designation and documentation of a hedge accounting relationship that are needed to reflect the changes required by interest rate benchmark reform do not result in the discontinuation of hedge accounting or the designation of a new hedging relationship. These changes to the hedge relationship must be made by the end of the reporting period during which a change required by interest rate benchmark reform occurs.

The exception applies to the changes to the hedge designation that are limited to one or more of the following changes:

a. Designating an alternative benchmark rate (contractually or non-contractually specified) as a hedged risk;

b. Amending the description of the hedged item, including the description of the designated portion of the cash flows or fair value being hedged; or

c. Amending the description of the hedging instrument; and

d. For those applying IAS 39, amending the description of how the entity will assess hedge effectiveness.

Observation
Respondents to the Exposure Draft noted that for point c. above, market participants may facilitate the transition of hedging instruments to an alternative benchmark interest rate using different approaches, for example by entering into an equal and offsetting derivative to economically cancel the original derivative and entering into a new benchmark interest rate derivative on an economically equivalent basis as the original derivative. The Board concluded that such a technique is deemed to be the same as amending the description of the hedging instrument in c. above.

If changes are made in addition to those changes required by interest rate benchmark reform to the financial asset or financial liability designated in a hedging relationship or if changes are made to the hedging designation other than those listed above, the entity first applies the requirements of IFRS 9 to determine if those additional changes result in hedge discontinuation; if the additional changes do not result in the discontinuation of the hedge, the entity applies the exception introduced by the amendments.

Fair value hedge
It is common for entities to fair value hedge the change in fair value of all, or a designated portion of, cash flows of a fixed rate debt instrument for changes in a benchmark interest rate, such as the London Inter-bank Offered Rate (LIBOR). When an entity changes the designation to an alternative benchmark interest rate, and that rate is not a separately identifiable component at the date it is designated, the separately identifiable requirement is deemed to be met at that date if the entity reasonably expects the rate will be separately identifiable within a period of 24 months from the date it is designated. The 24-month period applies to each alternative benchmark interest rate separately (i.e. on a rate-by–rate basis) and starts from the date the entity designates the alternative benchmark interest rate as a non-contractually specified risk component for the first time.

If, subsequently, it is no longer reasonable to expect the alternative benchmark interest rate to be separately identifiable within 24 months from the date it was designated as a risk component, hedge accounting is discontinued prospectively from the date of that reassessment to all hedging relationships in which the alternative benchmark interest rate was designated as a risk component.

The 24-month provision also applies to new hedging relationships in which an alternative benchmark interest rate is designated as a non-contractually specified risk component when, because of interest rate benchmark reform, that risk component is not separately identifiable at the date it is designated.

Cash flow hedges
The amount accumulated in the cash flow hedge reserve at the date that the entity amends the description of the hedged item is deemed to be based on the alternative benchmark interest rate on which the hedged future cash flows are determined.

For hedge relationships that have been discontinued, when the interest rate benchmark on which the hedged future cash flows were based is changed as required by interest rate benchmark reform, the amount accumulated in the cash flow hedge reserve is deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

Observation
The provisions for cash flow hedges ensure that amounts previously recognised in the cash flow hedge reserve are not immediately reclassified to profit or loss simply because of interest rate benchmark reform.

For example, an entity may have entered into a forward starting swap to receive fixed, pay-LIBOR as a cash flow hedge of a highly probable forecast debt issuance. The entity derecognised the swap in a prior period and so ceased hedge accounting. Amounts accumulated in the cash flow hedge reserve were not reclassified to the profit or loss when hedge accounting ceased because the entity still expected to issue debt and therefore continues to be exposed to LIBOR interest rates on the future issued debt. If the entity now considers that its exposure to LIBOR is no longer expected to occur only because LIBOR is replaced with an alternative benchmark interest rate as a result of interest rate benchmark reform, the entity does not reclassify amounts from the cash flow hedge reserve to profit or loss. However, if instead the entity assesses that the hedged risk is not expected to occur because it is not expecting to issue debt at all, the amounts in the cash flow reserve are reclassified to profit or loss.

Groups of items
If an entity hedges a group of items and amends the hedge designation to reflect the changes required by interest rate benchmark reform, the entity allocates the hedged items to subgroups based on the benchmark rate being hedged and designates that rate as the hedged risk. Each sub-group is assessed separately to determine whether it meets the requirement to be an eligible hedged item. If any subgroup fails to be an eligible hedged item, the entity discontinues hedge accounting prospectively for the hedging relationship in its entirety. The entity should also account for hedge ineffectiveness relating to the hedging relationship in its entirety.

Highly effective test in IAS 39
For the purposes of assessing the retrospective effectiveness of a hedging relationship on a cumulative basis, an entity may elect to reset the cumulative fair value changes of the hedged item and hedging instrument to zero. This election is made separately for each hedging relationship (i.e. on an individual hedging relationship basis). This election was introduced to minimise the risk that entities would fail the retrospective effectiveness assessment of a hedging relationship when they transition to alternative benchmark interest rates.

Financial instruments disclosures
The amendments to IFRS 7 require that an entity provide disclosures that enable a user to understand the nature and extent of risks rising from interest rate alternative benchmark reform, how the entity is managing those risks, its progress in completing the transition from interest rate benchmarks to alternative benchmark interest rates and how it is managing the transition. To achieve this objective, an entity is required to disclose:

- How it is managing the transition to alternative benchmark rates, its progress at the reporting date and the risks to which it is exposed arising from financial instruments because of the transition;
- Disaggregated by significant interest rate benchmark subject to interest rate benchmark reform, quantitative

information about financial instruments that have yet to transition to an alternative benchmark rate as at the end of the reporting period, showing separately: nonderivative financial assets, non-derivative financial liabilities and derivatives; and
- If the reform has resulted in changes to an entity's risk management strategy, a description of those changes.

Insurance contracts accounted for under IFRS 4
The amendments to IFRS 4 require insurers who apply the temporary exemption from IFRS 9 to apply the amendments in IFRS 9 for changes in the basis for determining the contractual cash flows of a financial asset or financial liability that are a result of interest rate benchmark reform. In other words, even though an insurer is applying IAS 39 instead of IFRS 9, for the purpose of accounting for financial assets and financial liabilities that change in response to the reform, it applies the relevant paragraphs in IFRS 9. This ensures that all entities, including insurers, are accounting for the impact of the reform using the same requirements.

End of application
The Board did not include a fixed date when the requirements introduced by the amendments cease to apply as the amendments are associated with the point at which changes to financial instruments or hedging relationships occur as a result of interest rate benchmark reform. Therefore, by design, the application of the amendments has a natural end.

Transitional provisions and effective date
The amendments to IFRS 9, IAS 39, IFRS 7, IFRS 16 and IFRS 4 apply for annual periods beginning on or after 1 January 2021, with earlier application permitted. The amendments apply to all entities and are not optional. Restatement of prior periods is not required, however, the entity may restate prior periods if, and only if, it is possible without the use of hindsight.

The amendments are applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* Hedge relationships that were discontinued are reinstated if, and only if, the discontinuation arose solely due to changes directly required by interest rate benchmark reform and if at the beginning of the reporting period in which an entity first applies these amendments, the hedging relationship meet the qualifying criteria for hedge accounting.

FRS 102 reporters applying IAS 39 or IFRS 9
Entities applying IFRS 9 as an accounting policy choice under FRS 102 will be subject to the IFRS 9 amendments once endorsed for use in the EU. Entities applying IAS 39 as an accounting policy choice under FRS 102 will be subject to the IAS 39 amendments once formally introduced into FRS 102. The amendments to IFRS 7 are not applicable for FRS 102 reporters. The disclosure requirements under FRS 102 in respect of interest rate benchmark reform are yet to be finalised but are expected to be less substantial than the new IFRS 7 disclosures.

Further information
If you have any questions about the Interest *Rate Benchmark Reform* amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 please speak to your usual Deloitte contact.