



Need to know

Interest Rate Benchmark Reform amendments to IFRS 9 and IAS 39

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This *Need to know* addresses the proposed amendments to IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* set out in Exposure Draft ED/2019/1 *Interest Rate Benchmark Reform* (Proposed amendments to IFRS 9 and IAS 39) (the 'ED') that has been published by the International Accounting Standards Board (IASB) in May 2019.

- The ED, if finalised, will affect entities that apply the hedge accounting requirements of IFRS 9 or IAS 39 to hedges of interest rate risk affected by interest rate benchmark reform.
- The ED modifies specific hedge accounting requirements, so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark is not altered as a result of interest rate benchmark reform.
- The proposed changes, if finalised, will mandatorily apply to all hedging relationships of interest rate risk that are affected by interest rate benchmark reform.
- The proposed amendments are not intended to provide relief from any other consequences arising from interest rate benchmark reform. If a hedging relationship no longer meets the requirements for hedge accounting for reasons other than those specified by the ED, then discontinuation of hedge accounting is still required.
- The proposed effective date for the amendment will be annual periods beginning on or after 1 January 2020, with earlier application permitted.
- Comments on the proposals are requested by 17 June 2019.

Background

Interest rate benchmarks such as interbank offer rates (IBORs) have a key role in financial markets and underpin trillions of dollars in financial products. However, work is underway in multiple jurisdictions to transition to alternative risk free rates (RFRs) as soon as 2020. Several reasons have driven this move. Systemic risk concerns have been raised due to instances of fraudulent submissions by banks and the underlying markets not being sufficiently active for some of the IBORs, together with the key reliance of financial transactions on these rates. Panel banks that provide submissions that contribute to IBOR are less comfortable providing

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those submissions when the volume of underlying transactions is low, due to potential litigation risks. All of these factors could lead to manipulation of rates and raise concerns over how these rates are determined in stressed market conditions.

Against this background, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest rate benchmarks. Following the review, the FSB published a report setting out its recommendations to reform some major interest rate benchmarks such as IBORs. As a result, alternative RFRs have been, or are in the process of being, selected in key currency jurisdictions by working groups, with the objective that such rates will be based on liquid underlying market transactions, and not dependent on submissions based on expert judgement. This will result in rates that are more reliable and provide a robust alternative for products and transactions that do not need to incorporate the credit risk premium embedded in the IBORs. This has led to uncertainty about the long-term viability of some existing interest rate benchmarks.

Observation

The transition from IBORs to RFRs gives rise to a number of accounting issues relating to hedge accounting, derecognition, modification accounting and valuation. These issues are discussed in more detail at [Thinking Allowed - IBOR replacement](#) which predates the publication of this ED. The IASB's response to some of our observations on hedge accounting are reflected in the ED.

The proposals set out in the ED address only the hedge accounting issues arising before IBOR is replaced with an alternative RFR, i.e. the pre-replacement issues. This has been referred to Phase I of the project. The ED considers the implications for specific hedge accounting requirements in IFRS 9 and IAS 39, which require forward looking analysis and provides a relief during this period of uncertainty. IASB has not yet considered whether and, if so, how to address any issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative interest rate, i.e. replacement issues, Phase II of the project.

The proposed amendments

The ED proposes amendments to the hedge accounting requirements of both IFRS 9 and IAS 39 because entities have an accounting policy choice under IFRS 9 as to whether to continue to apply the hedge accounting model in IAS 39 or IFRS 9. In addition some insurance companies have not adopted IFRS 9 as they are deferring the application until they apply IFRS 17 Insurance Contracts so they continue to apply IAS 39 in its entirety.

The IASB is proposing to modify specific hedge accounting requirements so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark on which the hedged cash flows and cash flows of the hedging instrument are based is not altered as a result of interest rate benchmark reform. The proposed changes apply to all hedging relationships of interest rate risk that are affected by interest rate benchmark reform.

The proposed amendments affect the following areas:

1. *Highly probable requirement for cash flow hedges (IFRS 9 and IAS 39):*

The issue: Under IFRS 9 and IAS 39, to achieve hedge accounting for a forecast transaction, the transaction needs to be highly probable. Where interest rate swaps and other derivatives are designated in cash flow hedges of IBOR cash flows, the expected replacement of IBOR could mean those cash flows are no longer highly probable for the term of the hedge, resulting in hedge accounting being discontinued. Also, with uncertainty around what will replace some of the IBORs, and exactly when this will be from, it could mean alternative designations of RFRs are also not eligible.

Relief proposed: If the hedged item is a forecast transaction, an entity shall determine whether the forecast transaction is highly probable assuming that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of interest rate benchmark reform.

Observation: The uncertainty around the timing and amount of IBOR cash flows arising from IBOR reform will not affect whether designated IBOR cash flows are highly probable until the relief provided ends.

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2. Reclassification of the amount in the cash flow hedge reserve to profit or loss (IFRS 9 and IAS 39):

The issue: Entities that have applied cash flow hedge accounting for IBOR risk would have deferred derivative gains and losses in the cash flow hedge reserve. These deferred amounts would be reclassified to profit or loss in the same period in which the hedged IBOR cash flows affect the profit or loss. However, if those IBOR cash flows are no longer expected to occur IFRS 9 and IAS 39 requires the deferred amounts to be immediately reclassified to profit or loss. The expected replacement of IBOR by RFR could mean that the amounts deferred in the cash flow hedge reserve relating to hedged future IBOR cash flows are required to be immediately reclassified because the hedged future IBOR cash flows are no longer expected to occur.

Relief proposed: To determine whether the hedged cash flows are no longer expected to occur, an entity shall assume that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of interest rate benchmark reform.

Observation: Until the relief ends, the uncertainty around the timing and amount of IBOR cash flows arising from IBOR reform will not affect whether future IBOR cash flows are expected to occur and therefore will not be a trigger for immediately reclassifying amounts from the cash flow hedge reserve to profit or loss. This issue may also be considered as part of Phase II as to whether further relief should be provided from reclassifying the deferred amounts when IBOR is replaced by RFR and the uncertainty around timing and amount of cash flows is no longer present.

3. Assessment of the economic relationship between the hedged item and the hedging instrument (IFRS 9)/ Prospective assessment (IAS 39):

The issue: A hedging relationship qualifies for hedge accounting only if there is an economic relationship between the hedged item and the hedging instrument (IFRS 9) or the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk (IAS 39). Entities must demonstrate this prospective assessment on a regular basis, which will be based on future cash flows. The uncertainties around future IBOR cash flows could therefore affect these assessments and at worst cause the hedge relationship to fail.

Relief proposed: An entity shall assume that the interest rate benchmark on which the hedged cash flows are based, and/or the interest rate benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of interest rate benchmark reform.

Observation: The prospective assessment of hedge effectiveness will not be affected by the uncertainty around the timing and amount of IBOR cash flows arising from IBOR reform until the relief ends. However, any ineffectiveness arising from measuring the hedged item or hedging instrument will continue to be recognised and under the retrospective assessment required by IAS 39 could be subject to failing hedge accounting. It is expected, although not explicit in the ED, that the measurement of the hedged item for this purpose will be based on the designated hedged cash flows and designated hedged risk and therefore will be unaffected by the uncertainties of IBOR reform until the relief ends.

4. Designation of a component of an item as a hedged item (IFRS 9 and IAS 39):

The issue: An entity may designate a risk component of an item as a hedge item only if it is separately identifiable and reliably measurable. For example an entity may designate the IBOR risk component of fixed rate debt in a fair value hedge. The IBOR reform could impact the assessment of whether the designated IBOR risk component is separately identifiable for the term of the designated hedge and cause the hedged risk to fail the eligibility requirements and cause the hedge to be discontinued.

Relief proposed: For a hedge of a benchmark component of interest rate risk that is affected by interest rate benchmark reform, an entity shall apply the specific requirement in IFRS 9/ IAS 39, to determine whether the risk component is separately identifiable, only at the inception of the hedging relationship.

Observation: Where an entity has designated a hedge relationship with IBOR as the hedged risk component, this relief will require an assessment of whether it is separately identifiable only at inception of the hedge. The ED does not provide a relief over the reliable measurement requirement and therefore if IBOR is not reliably measurable for the term of the hedge, the designated IBOR risk will not be eligible.

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5. End of application (IFRS 9 and IAS 39):

The issue: At some point the uncertainties around IBOR reform will no longer exist and the relief will no longer be necessary. However, this will not be at a fixed date in all markets and selecting a fixed date for the end of the relief could mean the relief ends too soon.

Relief proposed: The ED proposes under which circumstances an entity shall prospectively cease applying each of the requirements set out in 1 to 4 above. For points 1 to 3, it is proposed that the relief is applicable until the earlier of when the uncertainty around the timing and the amount of the cash flows arising from IBOR reform is no longer present and when the hedging relationship is discontinued. For point 4, the relief will end on termination of the hedging relationship.

Observation: The IASB's view is that the uncertainty regarding timing and amount of cash flows arising from IBOR reform is eliminated when the underlying contracts are required to be amended to specify the timing and amount of cash flows based on the alternative interest rate but note that contract amendment may not eliminate the uncertainty. To illustrate when the uncertainty may be eliminated a number of scenarios are provided in the Basis for Conclusions.

6. Disclosures (IFRS 9 and IAS 39):

The issue: The proposed relief will not apply to all reporters and will cease to apply at different points in time depending not only on the timing of the reform but also on the actions of an entity to change its risk management strategy and any contracts linked to IBOR.

Relief proposed: Disclosures will be required around the extent to which an entity has applied the amendments. An entity shall disclose separately the information required by paragraphs 24A(a), 24A(c)–(d), 24B(a)(i)–(ii), 24B(a)(iv) and 24B(b) of IFRS 7 Financial Instruments: Disclosures for hedging relationships to which the entity applies any of the requirements introduced by the ED.

Observation: The disclosure proposed will provide information about the carrying amounts and gains and losses arising from IBOR hedges in scope of the relief.

Observation

The proposals aim to avoid disruption to existing cash flow and fair value hedge accounting relationships of interest rate risk that in the absence of such proposals would result in hedge ineffectiveness and potential hedge accounting failures as result of IBORs being replaced by alternative RFRs. It does this for cash flow hedges by requiring that an entity continues to assume, for the purposes of the hedged item, that IBOR-based cash flows will continue beyond the period when they could potentially be replaced by an alternative RFR. Similarly, for fair value hedges, the proposals require that for the hedged item the IBOR designated risk continues even though it could potentially be replaced by an alternative RFR. Should the hedged item and interest rate swap be modified so it is contractually based on the alternative RFR, instead of IBOR, then the relief ceases, as at this point the proposals deem there is no longer uncertainty about IBOR being replaced. At this point an entity may have the ability to designate the interest rate swap based on RFR with the RFR based hedged item. It is expected that the IASB will consider the accounting implications of this new designation when it deliberates Phase II of the project.

Transitional provisions, effective date and comment period

The IASB proposes that an entity applies the amendments to IFRS 9 and IAS 39 for annual periods beginning on or after 1 January 2020, with early application permitted. The amendments would be applied retrospectively. The IASB requests comments on the ED by 17 June 2019.

Further information

For further information about this topic please see the Deloitte website: [LIBOR transition](#), [IBOR reform](#) and the [Thinking Allowed - IBOR replacement publication](#). If you have any questions about the Interest Rate Benchmark Reform amendments to IFRS 9 and IAS 39, please speak to the following contacts.

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