



Need to know

IASB proposes Interest Rate Benchmark Reform—Phase 2: Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16

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This *Need to know* addresses the proposed 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* set out in Exposure Draft ED/2020/1 *Interest Rate Benchmark Reform—Phase 2: Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16* (the 'ED') published by the International Accounting Standards Board (IASB) in April 2020.

This is the second part of the two-phase project on Interest Rate Benchmark Reform (IBOR reform) undertaken by the IASB. In September 2019, the IASB published the first set of amendments (Phase 1), see details in a previous [Need to know](#).

- The ED, if finalised, will enable entities to reflect the effects of transitioning from interbank offered rates (IBOR) to alternative risk free rates (RFRs) without giving rise to accounting impacts that would not provide useful information to users of financial statements.
- The proposed amendments will affect many entities and in particular those with financial assets, financial liabilities or lease liabilities that are subject to IBOR reform and those that apply the hedge accounting requirements in IFRS 9 or IAS 39 to hedging relationships that are affected by the IBOR reform.
- The proposed amendments will apply mandatorily.
- The proposed effective date for the amendment will be annual periods beginning on or after 1 January 2021 with early application permitted.
- The proposed amendments are applied retrospectively and include reinstating hedge relationships that were discontinued solely due to changes directly required by IBOR reform.
- Comments on the proposals are requested by 25 May 2020.

For more information please see
the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

Background

Interest rate benchmarks such as IBORs play a key role in global financial markets and index trillions of dollars in financial products. Work is underway in many jurisdictions to transition to RFRs 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 RFRs in key currencies with the objective that such rates will be based on liquid underlying market transactions, and not 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 IBORs.

Observation

The proposed amendments relate to issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative RFR, i.e. replacement issues.

The accounting issues arising before an existing interest rate benchmark is replaced with an alternative risk free rate, i.e. pre-replacement issues, have been considered previously by the IASB 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 the IBOR reform. These exceptions were put in place to avoid entities having to discontinue hedging relationships solely due to the uncertainty arising from IBOR reform. Please refer to the [Need to know](#) for details.

The proposed amendments

The objective of the second part of the project is to assist entities to provide 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 RFR. The ED proposes amendments to the following key areas: modifications of financial assets, financial liabilities and lease liabilities, hedge accounting and disclosures. These areas are summarised in turn.

Modifications of financial assets and financial liabilities

The ED proposes specific guidance on how to treat financial assets and financial liabilities that are modified, or have existing contractual terms activated that change the basis for determining the contractual cash flows, as a result of IBOR reform. The proposals regard a modification as a change in the basis for determining the contractual cash flows occurring after initial recognition. This can include cases where the financial instrument is not actually amended, but the basis of calculation of the reference interest rate changes.

As a practical expedient, the IASB proposes that instead of applying the existing modification requirements¹, the entity instead applies IFRS 9:B5.4.5, such that the change to the contractual cash flows is applied prospectively by revising the effective interest rate. This practical expedient only applies when the modification is required 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 modification). The practical expedient also applies when the contract is not modified, but an existing contractual term (such as a fallback provision) is activated resulting in the basis for determining the contractual cash flows changing. As with modifications, to be eligible for the practical expedient, the activation of the term must be a direct consequence of the interest rate benchmark reform and the new basis for determining the contractual cash flows must be economically equivalent to the previous basis.

¹ IFRS 9:5.4.3 for financial assets and IFRS 9:B5.4.6 for financial liabilities

Observation

The IASB provides examples of modifications that may be considered as being required by interest rate benchmark reform. Examples include changes that are limited to:

- (a) the replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an RFR (for example, replacing LIBOR with an alternative RFR) or effecting such a reform of an interest rate benchmark by changing the method used to calculate the interest rate benchmark;
- (b) the addition of a fixed spread to compensate for a basis difference between an existing interest rate benchmark and an alternative RFR;
- (c) changes to the reset period, reset dates, or the number of days between coupon payment dates that are necessary to effect the reform of an interest rate benchmark; and
- (d) 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)-(c) above to be effected.

The ED acknowledges that the above examples are not exhaustive.

The IASB's examples illustrate that modifications are only a direct consequence of the IBOR reform when those modifications are introduced in order to replace an IBOR with an RFR. Other changes to contractual terms may be agreed as part of renegotiating bilateral contracts with the counterparty. Care is required to identify the changes to terms that are a direct consequence of IBOR reform and those that are not.

When other modifications arise at the same time as modifications that are a direct consequence to IBOR reform, an entity applies the practical expedient first to those modifications that result from the reform. The applicable requirements of IFRS 9 are then applied to those other modifications. For example, if the basis of interest of a financial liability is changed from LIBOR to a new RFR, 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 a direct consequence of the IBOR reform are not subject to the practical expedient and the appropriate accounting is determined applying IFRS 9. For example, if the entity determines that the modification does not result in derecognition of the financial liability, applying IFRS 9:B5.4.6, it recognises an immediate modification gain or loss in the profit or loss.

Observation

The IASB notes in paragraph BC23 of the ED that because RFRs are intended to be risk-free and the IBORs 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 an RFR alone would result in derecognition of the financial instrument. Hence, the focus of the IASB work was on assessing whether the existing modification requirements would lead to useful information to users of financial statements. As the existing modification requirements generally lead to a modification gain or loss because the modified cash flows are discounted by the original effective interest rate, the IASB decided to introduce the practical expedient to avoid this happening and instead update the effective interest rate on a prospective basis. The IASB reached that decision because it considers 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 IASB is proposing 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 IBOR 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, 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 practical expedient for leases only applies to lessees, not to lessors. The IASB did not believe an amendment to IFRS 16 was necessary for lessors given a lessor is required to apply the requirements in IFRS 9 to a lease modification. The proposed amendments described in the preceding section would apply when those modifications are required by the interest rate benchmark reform. For operating leases, the IASB considered that the current requirements of IFRS 16 for lessors adequately reflect the modification in terms and conditions required by the reform in the light of the mechanics of the operating lease accounting model.

Hedge accounting

The ED proposes amendments to IFRS 9 and IAS 39 to introduce an exception to the existing requirements so that changes in the hedge documentation necessary to reflect modifications to the hedged item, hedging instruments or hedged risk that are required as a direct consequence of IBOR reform and are done on an economically equivalent basis, do not result in the discontinuation of hedge accounting or the designation of a new hedging relationship.

Observation

An entity will need to amend its hedge documentation to reflect any modifications to the financial asset or financial liability designated in a hedging relationship. Under the existing requirements this would generally require an entity to de-designate the hedging relationship. The proposed amendments require that changes to the documentation as a direct consequence of the IBOR reform and done on an economically equivalent basis are deemed to be a continuation of the existing hedge. These modifications are limited to one or more of the following changes:

- (a) designating an alternative benchmark rate as a hedged risk;
- (b) amending the description of the hedged item so that it refers to an alternative RFR;
- (c) amending the description of the hedging instrument so that it refers to an alternative RFR; or
- (d) amending the description of how the entity will assess hedge effectiveness (IAS 39 only).

Fair value hedges

The ED proposes that when the hedge designation in a fair value hedge, under IFRS 9 or IAS 39, has been amended due to IBOR reform, an entity shall:

- remeasure the hedging instrument based on the alternative RFR and recognise a corresponding gain or loss in profit or loss; and
- remeasure the carrying amount of the hedged item based on the alternative RFR designated as the hedged risk and recognise a corresponding gain or loss in profit or loss.

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 LIBOR. The ED states that when an entity changes the designation to a new RFR, and that RFR is not a separately identifiable component at the date it is designated, it shall be deemed to have met the separately identifiable requirement 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. If subsequent to designation, it is no longer reasonable to expect the RFR 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.

Cash flow hedges

The ED proposes that when the hedge designation in a cash flow hedge, under IFRS 9 or IAS 39, has been amended due to IBOR, the cash flow hedge reserve is remeasured to the lower of the following:

- the cumulative gain or loss on the hedging instrument calculated based on the alternative RFR; and
- the cumulative change in fair value of the hedged item calculated based on the alternative RFR.

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

When there is a change in the basis for determining the contractual cash flows of a financial asset or a financial liability previously designated as a hedged item in a hedging relationship that has been discontinued, the amount accumulated in the cash flow hedge reserve for a discontinued hedging relationship is deemed to be based on the alternative RFR on which the contractual cash flows will be based.

Groups of items

The ED proposes that if an entity hedges a group of items and amends the hedge designation due to IBOR reform, the entity shall allocate the hedged items to subgroups based on the benchmark rate being hedged, and designate that rate as the hedged risk. An entity shall assess whether the change in fair value for each individual item in the subgroup is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items, for each subgroup separately.

Highly effective test in IAS 39

The first set of amendments issued in September 2019 introduced an exception in IAS 39 such that an entity is not required to discontinue a hedging relationship during the period of uncertainty arising from interest rate benchmark reform solely because the actual results of the hedge are not highly effective, i.e. are outside the range of 80–125% when applying the retrospective assessment. The ED proposes to amend IAS 39 to cease application of this exception at the earlier of when the uncertainty arising from interest rate benchmark reform is no longer present and when the hedging relationship is discontinued.

Financial instruments disclosures

The IASB is proposing that an entity should provide disclosures that enable a user to understand the nature and extent of risks arising from the IBOR reform, how the entity is managing those risks, its progress in completing the transition from interest rate benchmarks to alternative RFRs and how it is managing the transition. To achieve this objective, an entity would be required to disclose:

- how it is managing the transition from interest rate benchmarks to alternative benchmark rates and the progress made at the reporting date, and the risks arising from this transition;
- disaggregated by significant interest rate benchmark, the carrying amount of non-derivative financial assets, the carrying amount of non-derivative financial liabilities and the nominal amount of derivatives, each shown separately, that continue to reference interest rate benchmarks subject to interest rate benchmark reform;
- for each significant alternative RFR to which the entity is exposed, a description of how the entity determined the base rate and relevant adjustments to that rate, including any significant judgements the entity made to assess whether it met the conditions necessary to apply the practical expedient for modifications of financial instruments; and
- to the extent that interest rate benchmark reform has resulted in changes to an entity's risk management strategy, a description of those changes and how the entity is managing these risks.

Insurance contracts accounted for under IFRS 4

The ED proposes to amend IFRS 4 to require insurers that apply the temporary exemption from IFRS 9 to apply the amendments proposed in IFRS 9 in accounting for modifications directly required by the IBOR reform.

End of application

The IASB is not proposing to 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 IBOR reform. Therefore, by design the application of the proposed amendments have a natural end.

Transitional provisions, effective date and comment period

The IASB proposes that an entity applies the amendments to IFRS 9, IAS 39, IFRS 7, IFRS 16 and IFRS 4 for annual periods beginning on or after 1 January 2021, with early application permitted. The proposed amendments would be applied retrospectively to items that existed at the beginning of the reporting period in which an entity first applies the proposed amendments. 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. Hedge relationships that were discontinued before the entity applies the proposed amendments solely due to changes directly required by the reform would be reinstated. The proposed amendments would be applied mandatorily.

The IASB requests comments on the ED by 25 May 2020.

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.

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