## IFRS accounting challenges and considerations

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# Introduction

The transition from Interbank Offered Rates (IBORs) to so-called Risk-free Rates (RFRs) raises many issues and challenges for companies across industries and jurisdictions. One key area to consider is the impact on financial accounting and reporting and, most importantly, on hedge accounting. At their meeting on 20 June 2018, the International Accounting Standards Board (IASB) "noted the urgent need for IBOR reform and added a research project on the topic to their agenda."[1] The findings from this project will be discussed at future IASB meetings, with the potential to change accounting standards.

Regulators across the globe are encouraging the move from IBOR to RFRs in response to dwindling transactions in the interbank wholesale funding markets; the extensive use of IBORs in derivatives markets where an RFR is more appropriate; the use of expert judgment in IBOR submissions; and the potential risk of misconduct. Currently, the financial markets are attempting to navigate the uncertain environment raised by the anticipated transition from IBOR interest rate benchmarks (such as London Interbank Offered Rates or LIBORs and Euro Offered Rates or EURIBORs) to alternative RFRs. Trillions of dollars of financial instruments reference IBOR benchmarks. Transition from IBORs to alternative RFRs will affect a broad range of product types across multiple market segments. What this transition would mean in practice is that both new and legacy transactions (including over-the-counter (OTC) derivatives, exchange-traded derivatives (ETDs), securitized products, loans, bonds and mortgages) that currently reference an IBOR benchmark will, in most cases, need to reference a new RFR. This also applies to transactions not directly referencing an IBOR benchmark, but valued using one as an input (for example, discounting cash flows now would need to be valued using an alternative RFR benchmark).

In the UK, the Financial Conduct Authority (FCA) has stated that it no longer will require banks to provide LIBOR quotes beyond 2021 and that LIBOR submission will become a voluntary process. Some jurisdictions have established RFR Working Groups (WGs) to identify RFRs that may be used as alternative benchmarks. Although there has been some progress in establishing these RFRs in the US, UK, Japan and Switzerland, it is still unclear what the final outcome will be for global jurisdictions.

As certain types of transaction, in particular derivatives, move to alternative RFRs, the use of IBORs as benchmark rates and their liquidity, is anticipated to decline, further weakening their relevance and viability as benchmarks. Nevertheless, changing contractual terms may present insurmountable operational and legal challenges for certain types of transactions, such that IBORs cannot be phased out altogether, at least in the short term.

While the remainder of this document focuses on 2021 as the deadline for the end of IBORs, actual timelines for the termination or phase out may differ across jurisdictions.

[1] **June 2018 IASB update**

## What does this mean for companies?

It is clear that most companies (not just banks) will be affected to some extent by the transition from IBOR. Despite the uncertainties around the end state and the timing of the transition, any company with loans, derivatives, bonds or products referencing an IBOR as a rate, is likely to be affected. The operational changes required also will impact many areas within the organization. For financial services firms, activities such as sales and trading, treasury, risk management, legal and operations will be affected, and most companies will see some impact on their accounting and financial reporting functions.

There are specific accounting challenges, which we describe in detail below, not only for hedge accounting but also valuations. The systems, processes and controls surrounding these activities also will be affected, but are outside of the scope of this document.

## Accounting challenges

### Hedge accounting — time critical issues

Two key issues for hedge accounting need to be addressed before transition from IBOR: cash flow hedges and amendment to documentation.

#### 1. Cash flow hedges

Are the designated cash flows beyond 2021 still highly probable? If not, hedge accounting may need to end. And, if the cash flows are no longer probable, the amounts currently deferred in the cash flow hedge reserve may need to be released to profit or loss immediately.

While there will still be variable cash flows beyond 2021, it is unclear at this stage whether those future cash flows  will reference an overnight RFR, a term RFR or an IBOR. International Accounting Standards (IAS) 39 paragraph 88 sets out five criteria to achieve hedge accounting. In summary:

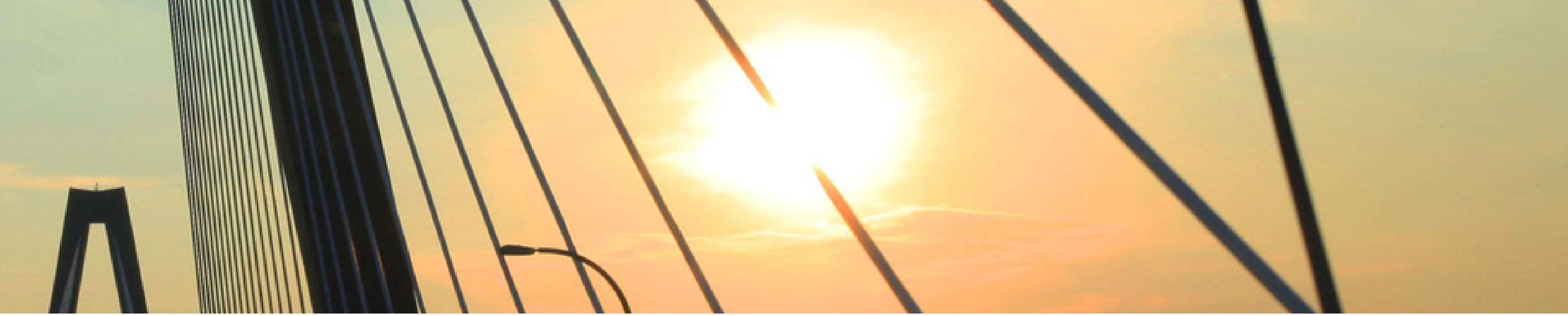
a. There must be a formal designation of the hedge relationship, including "identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness."

b. The hedge is expected to be highly effective, consistent with the method set out in the documented designation.

c. For cash flow hedges, the forecast transaction must be highly probable.

d. The effectiveness can be measured reliably.

e. The hedge is assessed regularly to show that it has been highly effective.



Cash flow hedge accounting is likely to continue as long as the variable cash flows that are the subject of the hedge remain highly probable

IFRS 9 paragraph 6.4.3 (b) is substantially the same as IAS 39.88 (a). Paragraphs 6.3.2 and 6.3.3 are the same as 39.88 (c) and (d). Only 39.88 (b) and (e) disappear, to be replaced by the much looser requirement in 6.4.3 (c) that "there is an economic relationship between the hedged item and the hedging instrument."

If the current hedge designation is, for example, of a 3-month LIBOR, then it might be argued that it is no longer possible for the existing designation to apply equally if the 3-month LIBOR were replaced by an RFR, that the designated cash flows are highly probable, or that the hedge effectiveness can be measured reliably. It follows, therefore, that it may not be possible to determine today whether existing relationships meet hedge accounting criteria.

So far, companies reporting under IFRS* are not following this approach. The derivatives market for cash flows beyond 2021 is still largely dominated by IBOR and is highly liquid. IBOR will be the reference rate for many floating rate products for a number of years. Beyond that, today's best estimate of the rates based on RFRs is viewed by the market as equivalent to rates based on IBOR.

Cash flow hedge accounting is likely to continue as long as the variable cash flows that are the subject of the hedge remain highly probable. The effectiveness of a hedge of IBOR risk can be measured reliably, and hedges are considered to be highly effective. Meanwhile, as long as the cash flows are expected to occur and hedge accounting continues, there is no need to recycle the cash flow hedge reserve in other comprehensive income (OCI).

The bigger concern is that at some stage in the future IBOR (before it is replaced) will no longer be the main basis for the interest rate market. Thus, it would no longer be possible to assert that future floating rate cash flows are equivalent to those based on IBOR, and the liquid market for IBOR derivatives would cease.

The hope is that, if the IASB concludes that hedge accounting is no longer possible for variable cash flows beyond 2021 based on the existing requirements of IAS 39 (and IFRS 9), an amendment to the standards will allow hedge accounting to continue for this specific case. This is not dissimilar to the limited amendment to IAS 39 (and IFRS 9) relating to the novation of hedging derivatives to central clearing parties in 2013. It should be noted, however, that the Board will need to follow due process, so this could take the best part of a year.

* International Financial Reporting Standards

### 2. Amendment to documentation

Does an amendment of the hedge documentation to anticipate a change in the designated benchmark rate give rise to designation or re-designation of the hedge relationship?

Entities may seek to amend their hedge documentation to anticipate a possible replacement of IBOR by a new benchmark. The key question here is whether this amendment to the documented hedged risk would give rise to a de-designation of the original hedge relationship and designation of a new one. The implication of a de-designation and re-designation is that the new hedge relationship would include a derivative that has a non-zero fair value, which introduces a potentially significant new source of hedge ineffectiveness for cash flow hedges. This is an area we would expect the IASB to consider as part of their research project. It may also require an amendment to the standard.

## Other hedge accounting issues

A second challenge may be the extent to which the hedged item and hedging instrument's reference rate do not transition at the same time, so that there is a mismatch. This mismatch will be an unavoidable source of hedge ineffectiveness, until it can be remedied.

Also, the new RFRs are overnight rates and it is not yet clear to what extent users of floating rate cash instruments, such as borrowers, will be prepared to move to overnight benchmarks or would prefer term benchmarks (such as three months SONIA*). Therefore, another source of potential ineffectiveness would arise when the hedged item and the hedging instrument reference different rates after transition; for example, the hedged item continues to reference IBOR and the hedging instrument transitions to an RFR, or, alternatively, the hedged item and hedging instrument transition to different RFRs, such as a 3-month term reference rate and a compounded overnight rate.

Another concern regarding potential ineffectiveness is that not all RFRs are expected to be determined on the same basis. For instance, the US rate will be a collateralized rate while the UK rate will not. Consequently, IBOR reform will lead to changes in the foreign currency basis. Although IFRS 9 allows this to be treated as a cost of hedging, such a change will result in increased complexity, and may result in some ongoing ineffectiveness.

* Sterling Overnight Index Average

## Other accounting challenges

1. Valuation (Fair Value)

If IBOR quotations are maintained after 2021 and are used to price legacy instruments, there is a risk that these would be classified as level 3 for the purposes of IFRS 13 *Fair Value Measurement*, and disclosed as such, if they are not quoted in an active market. IBOR may also become less liquid and therefore less reliable for valuation purposes. Even before 2021, it may prove challenging to value derivatives if IBOR forward curves can no longer be generated for the life of the instrument. This also has a secondary impact on regulatory capital by way of impacting Prudential Valuation Adjustment (PVA), Article 105 of Regulation (EU) No 575/2013.

Wherever entities have used IBOR curves as a proxy for RFRs to value financial instruments, adoption of an overnight rate will require a change of process and a different valuation. A change in value would be viewed most likely as a change in estimate, reflected in profit or loss.

As an example, the effect of changes in own credit risk on the fair values of liabilities designated at fair value through profit or loss may have been calculated by comparison to IBOR. The consequence of replacing IBOR with an overnight rate is that the incremental credit spread above the benchmark is likely to increase, so the effect of changes in own credit spread will need to be recalculated.

Another potential impact is far broader than financial instrument valuation. When applying accounting standards that use discounted cash flow valuations (for example IAS 36: *Impairment of Assets*), if the discount rate is based on IBOR there may be changes in fair values, with potential profit and loss implications on transition.

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### 2. Modification

On transition to a new rate, when the terms of existing cash instruments and derivatives are modified, a key accounting question will be whether the change in terms is sufficiently substantial to result in de-recognition of the old instrument and recognition of a new one.

IFRS 9 and IAS 39 both state that, for a liability, a 10% change in the present value of the cash flows, applying the original effective interest rate as a discount factor, points toward a substantial modification. In addition, even if the change does not exceed 10%, qualitative changes in the terms of an instrument may be sufficient to be viewed as substantial. Some entities apply a similar approach to financial assets.

Entities will have to exercise judgement to establish whether a change to the new benchmark would result in de-recognition, considering whether the change is seen as a substantial modification to the basis of interest calculation or (for instruments that are or might be liabilities) "the 10% test." However given the nature of the change in benchmark, it seems unlikely that this would result in de-recognition in many cases.

### 3. Classification (IFRS 9 only)

**SPPI* criterion**

There is a significant possibility that interest on overnight products will be calculated using a compounded daily rate, to be paid on a quarterly (periodic) basis. To make this operable, it is possible that the period over which the interest is calculated could start as much as five days before the beginning of the quarter or period and end five days before the end. There is a risk that, for an asset that pays a daily compounded overnight rate, this non-alignment could lead to the assessment that the interest does not compensate the lender for the time value of money and credit risk. If so, such a cash instrument may not be eligible to be recorded at amortized cost.

This risk is relatively small, since IFRS 9 permits what it describes as a modified time value of money to still be eligible for amortized cost, if the effect is not significant in many cases.

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* Solely Payments of Principal and Interest

### Business model criterion (IFRS 9 only)

There is also a risk that in the run up to transition to the new rate, if an entity acquires floating rate financial assets that it expects to derecognize on transition to the new rate, it will not be possible to assert that the asset is held for collection of cash flows. If that is the case it may need to be recorded at fair value through profit or loss (although gains and losses may be modest on floating rate assets).

IFRS 9 paragraph BC4.145 refers to the specific instance where the entity is required to consider the reasons for any sales activity when determining the applicability of the hold to collect business model. An example is given where a change in regulatory treatment of a particular type of financial asset may cause an entity to undertake a significant rebalancing of its portfolio in a particular period. Given its nature, the selling activity in that example would likely not change the entity's overall assessment of its business model if the selling activity is an isolated (i.e., one-time) event. Also, if the asset is derecognized, it will be because it will have been deemed to have expired and replaced by a new one. Therefore, it is possible to argue that the asset was still held to its revised maturity.

## What should companies be doing now?

There are a number of issues for IFRS preparers to consider. As part of their IBOR transition program, they should identify long-dated hedge accounting transactions that might be affected by a change in the designated benchmark. An impact assessment should be undertaken to determine the technical accounting considerations and potential impact on hedge accounting relationships.

For any new financial instruments issued in the transition period (or until further clarity is achieved), entities should consider amending the wording in their hedge documentation to include reference to a "replacement benchmark rate" so as to avoid the interruption of cash flow hedge accounting for this portion of the population.

Companies should also think about the broader organization-wide implications for the determination of fair value, modifications and classification of financial instruments, including secondary impacts on regulatory capital such as through prudential valuation.

Companies should also consider the implications for processes and controls which, though not covered in this document, should not be underestimated.

# How we can help you

**EY can assist with:**

- Accounting guidance and support
- Technical training
- Guidance on key IBOR transition topics
- Perspectives on industry trends and regulatory developments
- Project planning, organization and governance structure
- Broad assessment of impacts
- Formulation of the implementation road map

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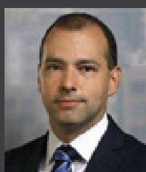

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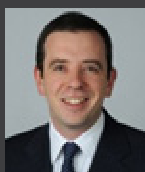

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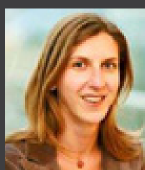

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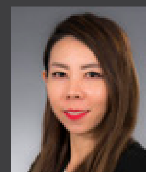

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