Issue 144 / February 2019

IFRS Developments

IBOR reform: the IASB's proposals

What you need to know

- At its February meeting, the IASB decided to amend IAS 39 and IFRS 9 to provide relief to allow hedge accounting to continue despite the expected transition from IBOR to RFRs.
- The Board plans to publish an Exposure Draft in April or May 2019.
- The final amendments are expected to be published in November / December 2019

Introduction

In December 2018, the International Accounting Standards Board (IASB or the Board) added a project to assess the effects of Interbank Offered Rates (IBOR) reform on financial reporting. The project has two phases: the first focuses on issues leading up to IBOR reform. The IASB plans to issue an Exposure Draft in April or May, with an accelerated comment period, which would allow for final amendments to be published in late 2019. The second phase will focus on issues arising once the IBOR has undergone reform, such as the consequences of amending a hedge designation.

The IASB's decisions

At its meeting on 8 February 2019, the IASB tentatively decided to make the following changes to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial instruments*:

- To provide relief solely from the effects of IBOR reform uncertainties on the 'highly probable' hedge accounting requirement, i.e., any potential amendments to the hedged item due to IBOR reform may be ignored when assessing whether the forecast transaction is highly probable.[1] This relief will also apply when determining whether cash flows are still expected to occur, for cash flow hedge relationships that have already been discontinued for reasons other than IBOR reform and amounts remain in the cash flow hedge reserve.

[1] The Staff Paper written for the Board meeting notes that the uncertainties arising from IBOR reform could affect the 'highly probable' requirement, regardless of whether an entity designates the IBOR risk component of a floating-rate debt or the entire debt instrument as the hedged item.

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- To provide relief under IAS 39 to require entities to consider only the existing contractual terms of the hedging instrument and hedged item to demonstrate whether a cash flow hedge or a fair value hedge is expected to be highly effective. Similarly, under IFRS 9, to consider only the existing contractual terms in assessing whether there is an economic relationship between the hedging instrument and the hedged item.
- Board members stressed the need for the amendments to set out specific requirements to ensure that the relief is as narrow as intended. For instance, the reference to 'the existing contractual terms' would need to be clarified, so as to avoid reference to existing general fall-back arrangements designed to deal with market disruption to IBOR.
- The Board agreed that the relief will be given only to those hedges that previously met the IAS 39 and IFRS 9 requirements. Otherwise, the Board decided that there is no need to provide relief from the IFRS 9 requirement that a designated hedge component should continue to be separately identifiable within the context of the particular market structure. The Staff Paper also proposes not to provide relief to designate a Risk Free Rate (RFR) risk component if it is not contractually specified in the hedged item and is not yet separately identifiable within the context of the market structure.
- The relief will cease to be available once the uncertainties related to IBOR reform cease. The details of when relief will terminate will be discussed in more detail at a later meeting.
- Also to be discussed further, is whether the relief will be optional or mandatory.
- The Board agreed to require specific disclosures about the extent to which application of the reliefs have affected hedge accounting.
- The Board also agreed that the proposed effective date should be for annual periods beginning on or after 1 January 2020, with earlier application permitted.

Background

As a result of the reforms mandated by the Financial Stability Board following the financial crisis, regulators are pushing for IBORs to be replaced by new benchmark rates, known as RFRs. For instance, in the UK, the new official benchmark will be the reformed Sterling Overnight Interest Average (SONIA) and banks will no longer be required to quote LIBOR beyond the end of 2021. Progress in replacing IBORs, the timing of when replacement might occur and the precise nature of the new RFRs, varies by jurisdiction. It is not clear to what extent IBOR may persist as a private sector initiative, meaning that not all floating rate instruments will necessarily switch to the RFRs. Further, it is not yet clear whether, or to what extent, floating rate instruments will move to an overnight RFR (such as SONIA) or to a term RFR (e.g. 3-month SONIA). A term RFR would give borrowers certainty of their cash flows at the next interest payment date. However, how a term RFR would be derived is unclear.

Prior to the financial crisis, IBOR and overnight rates were closely aligned. For instance, the spread between 3m GBP LIBOR and overnight rates was historically of the order of only 10 basis points (0.1%). However, with the crisis, the spread became volatile and substantial, peaking at over 300 BP when Lehman Brothers declared itself bankrupt. The GBP basis has since rarely returned to pre-crisis levels and has fluctuated, exceeding 50 BP during the Euro area crisis in 2012/13 and some 30 BP after the UK EU referendum. The volatile spread between IBOR and overnight rates helps illustrate why IBOR does not represent a good benchmark rate. It also implies that there is a significant difference between IBOR and an RFR, which raises the question of whether the movements in IBOR and an RFR can be regarded as sufficiently equivalent, and not pose a risk to the continuity of hedge accounting.

Nevertheless, even if future cash flows may not be IBOR cash flows, there will still be variable cash flows. Also, it is possible under both IAS 39 and IFRS 9 to designate a benchmark (e.g., IBOR) component of a debt instrument, even though the terms of the instrument make no reference to IBOR. IFRS 9 permits such a risk component to be designated as the hedged item if it is implicit in the fair value of the cash flows of the hedged item and is separately identifiable and measurable within what is termed 'the context of the market structure'.

As debt instruments are currently priced by reference to, or are indexed to, IBOR and there is a liquid market for IBOR-based interest rate swaps for maturities that extend significantly beyond the possible IBOR replacement date, in our view, IBOR is a risk component that is implicit in the context of the market structure. Also, longer-term instruments experience considerably less volatility of spread between RFRs and IBOR than is seen in the short-term market. Hence, RFR cash flows beyond the transition date can currently be viewed as *equivalent* to IBOR cash flows. Moreover, it is expected that the transition from IBOR to RFRs will be managed in the major markets so that there will be no immediate transfer of value. Hence, in our view, until IBOR is no longer the dominant driver in the interest rate market for the major currencies, it can be designated as a hedged risk component of longer-term interest rates and the designated hedged items can still be viewed as highly probable. It also follows that hedge effectiveness can still be reliably measured.

The concern is that, as the use of RFR-based instruments increases, there may come a time when IBOR is no longer the driver of the interest rate market, while closer to transition, the short-term variability of the spread between IBOR and RFRs will become a bigger source of ineffectiveness. IBOR would therefore no longer be an eligible risk component for hedging purposes and the designated hedged items will no longer be highly probable.

This raises the following accounting issues:

- If forecast IBOR cash flows, or IBOR components of cash flows, become no longer highly probable, this implies that cash flow hedge accounting must cease.
- If IBOR cash flows, or IBOR components of cash flows, become no longer probable, this implies that amounts previously recorded in the cash flow hedge reserve must be recycled immediately to profit or loss.
- If it becomes no longer possible to assess whether an IAS 39 hedge relationship will be highly effective, hedge accounting should cease.

How we see it

We are pleased that the Board has commenced this project and has proposed these reliefs. As identified by Board members, these amendments will require careful wording so as to have the intended narrow scope and to be clear.

We note that the decision to amend IFRS 9 in respect of assessing whether there is an economic relationship, potentially provides guidance on how this assessment should be made. However, IFRS 9 is not clear on whether the bar to considering whether there is an economic relationship is so high currently that it would be difficult to assert that there is still an economic relationship between IBOR and future variable interest rates, despite the uncertainties arising from IBOR reform.

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EYG No. 000538-19Gbl

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