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IFRS Developments

IBOR reform: the IASB's proposals, part 2

What you need to know

- At its March meeting, the IASB progressed its work to amend IAS 39 and IFRS 9 to provide relief to allow hedge accounting to continue, despite the uncertainty resulting from transition from IBOR to RFRs.
- The Board plans to publish an Exposure Draft for the first phase of its two phase project in April or May 2019, with a 45-day comment period.
- The final amendments are expected to be published by the end of 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; phase one focuses on issues leading up to IBOR reform. The IASB plans to issue an Exposure Draft (ED) in April or May, with final amendments published in late 2019. Phase two will focus on issues arising once the IBOR has undergone reform, such as the consequences of amending a hedge designation.

At its meeting in February 2019, the IASB tentatively agreed to amend IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial instruments* to provide relief to allow hedge accounting to continue despite the uncertainty resulting from transition from IBOR to Risk Free Rates (RFRs). Our *IFRS Developments 144* summarises the decisions reached at this meeting and provides some background to the IBOR reforms, and how we see it.

The IASB's decisions

At its March 2019 meeting, the IASB tentatively decided to make the following changes to IAS 39 and IFRS 9:

- To require mandatory application of the relief to all hedges for which there is uncertainty arising from IBOR reform. The relief will only be applicable to those hedging relationships for which IBOR reform contributes uncertainty to the cash flows of the hedging instrument and/or the hedged item.

- Entities should stop applying the proposed relief at the earlier of:
  - When the uncertainty regarding the timing and amount of the cash flows is no longer present

    Or
  - The termination of the hedging relationship

The amendments will contain supporting examples illustrating this, including how IBOR-related contractual terms of instruments will normally need to be amended for the uncertainty to end.

- Separate amendments will be made for two situations where contractual amendments will not end uncertainty:
  - When the designated hedged item is a separately identifiable risk component, relief will end only when the hedge relationship is terminated, (an example of this would be a fair value hedge of the IBOR risk of a fixed rate bond).
  - For a future transaction that is not yet recognised on the balance sheet, relief will end when the uncertainties regarding IBOR reform are no longer present.
- No amendments are planned to the retrospective effectiveness test or other measurement aspects of hedge accounting. At the meeting, the Board clarified that no relief is required as these will continue to be based on the existing contractual cash flows and relevant fair value information available in the market, (i.e. until the hedged item is amended, effectiveness should continue to be assessed and measured by assuming that the hedged cash flows will be based on IBOR).
- There will be a 45-day comment period for the ED. The IASB staff will now start to draft the amendments.
- The IASB considers that it can only start phase two of the project once the nature of the RFRs that will replace IBOR has been determined by regulators. Once this is clear, the IASB will be able to assess the potential impact on financial reporting and whether any relief is required.

Background

At its February 2019 meeting the IASB tentatively decided that[1]:

- Regarding the 'highly probable' requirement, IFRS 9 and IAS 39 should be amended to provide relief from the effects of uncertainties around the general conditions (timing and specifics) of the potential replacement of IBOR. In particular, when assessing the likelihood that a forecast transaction will occur, an entity can assume the IBOR-based contractual terms will remain unchanged.
- Regarding the existence of an economic relationship (as required by IFRS 9) and the expectation that a hedge will be highly effective in achieving offsetting (as required by IAS 39), IFRS 9 and IAS 39 should be amended to provide relief from uncertainties around the general conditions (timing and specifics) of the potential replacement of IBOR. In particular, when performing these assessments, an entity should base such assessments on existing contractual cash flows from the hedging instrument and the hedged item.

[1] Based on the description of the decisions in the *IASB Update*, February 2019.

- An entity should be allowed to continue hedge accounting when an IBOR risk component meets the separately identifiable requirement at the inception of the hedging relationship, although identification maybe affected by IBOR reform in the future. In addition, the Board tentatively decided that relief should not be provided for risk components that are not separately identifiable at the inception of a hedging relationship.
- An entity should cease to apply the proposed relief when the nature and timing of designated future cash flows are certain.
- An entity should provide specific disclosures about the extent to which it applies the proposed relief.
- An entity should apply the proposed amendments retrospectively. The proposed effective date of the amendments is 1 January 2020 with earlier application permitted.

How we see it

The decisions taken at the March meeting complete the IASB's initial discussions of the phase one issues. Once finalised, the resulting amendments will allow hedge accounting to continue (subject to entities meeting the other hedge criteria), until the uncertainties arising from IBOR reform have ended.

Having progressed phase one, the IASB should start phase two and consider whether any relief is required for the financial reporting implications of the contractual amendments arising from IBOR reform. The Board is reluctant to start phase two until regulators have agreed what the new RFRs will be (including whether there will be 'term' RFRs such as 3-month rates). Unfortunately, different regulators are moving at different speeds and some entities may wish to amend their hedged items to reflect 'overnight' RFRs without waiting to see whether term RFRs emerge. There is a risk that until the uncertainties associated with phase two issues are addressed, entities could be discouraged from progressing their IBOR reform activities due to the associated ongoing financial reporting uncertainty.

The Board has decided that relief will end at the earlier of when the uncertainty of timing and amount of cash flows ends and when the hedge relationship is terminated. This raises the question of what happens if the hedged item is a group of items (such as in a portfolio hedge), some of which have been amended (so that the uncertainty of cash flows ends) and some that have not.

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ED None