IFRS in Focus

IASB proposes Interest Rate Benchmark Reform amendments to IFRS 9 and IAS 39

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This *IFRS in Focus* 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 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 proposals set out in the ED address only the issues arising before IBOR is replaced with an alternative RFR (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, being Phase II of the project.

The proposed amendments

The ED proposes amendments to the hedge accounting requirements of both the 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 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):* 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.

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

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

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

5. *End of application (IFRS 9 and IAS 39):* The ED determines under which circumstances an entity shall prospectively cease applying each or the requirements set out in 1 to 4 above.

6. *Disclosures (IFRS 9 and IAS 39):* 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 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 an 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 that 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 an 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

If you have any questions about the Interest Rate Benchmark Reform amendments to IFRS 9 and IAS 39, please speak to your usual Deloitte contact or get in touch with a contact identified in this *IFRS in Focus*.

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