IBOR reform and effects on financial reporting - update

Objective

1 The objective of this session is to provide EFRAG Board members with an update on the IASB project relating to the IBOR (Interbank Offered Rate) reform and its effects on financial reporting.

Project plan and timeline

2 The IASB staff has foreseen the following project plan:

Timeline	**Project plan**
March 2019	Board finishes deliberations, including the comment period, due process steps and permission to ballot. Proceed with drafting those amendments.
May 2019	Publish an Exposure Draft with a comment period of 45 days
June/July 2019	Comment period ends
September/October 2019	Board re-deliberations
November/December 2019	Issue final amendments

3 Given the short comment period, and the uncertainty about the exact date when the Exposure Draft will be issued, it is not clear whether it will be necessary to arrange conference calls of the EFRAG Board and EFRAG TEG to approve the draft comment letter or whether the draft comment letter can be approved at the joint meeting of the EFRAG Board and EFRAG TEG on 4 June.

Background information

4 Recent market developments have brought into question the long-term viability of some interbank offered rates (IBORs). IBORs are reference interest rates which are used as benchmarks for a broad range of financial products and contracts. References rates such as EURIBOR (Euro Interbank Offered Rate) and LIBOR (London Interbank Offered Rate) are based on unsecured interbank term lending and borrowing. In this context, the G20 asked the Financial Stability Board to undertake a fundamental review of major interest benchmarks and develop plans for reform to ensure that these benchmarks are robust and appropriately used by market participants.

5 In some jurisdictions, there is already a clear move towards replacing the IBORs by alternative, nearly risk-free rates (RFR), which are generally based on transaction data. This is the case, for example, for:

(a) the Secure Overnight Funding Rate (SOFR) in the US;

(b) the reformed Sterling Overnight Index Average (SONIA) in the UK; and

(c) SARON (the Swiss Average Rate Overnight) in Switzerland.

6 The European Central Bank (ECB), the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission have established the industry-led ESTER working group on euro risk-free rates to identify risk-free rates that could serve as an alternative to current benchmarks used in the euro area.

7 On 13 September 2018 the group recommended the use of ESTER as the risk-free rate for the euro area. ESTER is a euro short-term rate based on data already available to the Eurosystem. It will reflect the wholesale euro unsecured overnight borrowing costs of euro area banks and will complement existing benchmark rates produced by the private sector.

8 ESTER will replace EONIA (euro overnight index average) and the use of EONIA will be restricted starting from 1 January 2020 with a transition period until the end of 2021.

9 Regarding EURIBOR, a hybrid approach is now being considered where the methodology is supported by transactions whenever available and relies on other related market pricing sources when necessary. During 2019 the responsible authorities will continue to assess the feasibility of this method.

IASB staff analysis of market implications of transition from IBOR to RFR

10 The IASB staff analysis of market implications of transition from IBOR to RFR has identified challenges such as:

(a) The need to amend legacy contracts to replace an IBOR by its respective RFR;

(b) Dealing with the pricing gap between IBOR (which includes bank credit risk) and the respective RFR, which are nearly risk-free; and

(c) The lack of a term structure as many of the alternative RFRs reflect the overnight transactions rate.

11 The market implications associated with transition can be classified as valuation issues and basis risk.

Valuation issues

12 The differences between IBOR and RFR will arise mainly because:

(a) IBORs include a bank credit risk premium while RFRs are nearly risk-free; and

(b) RFRs are primarily overnight rates whereas IBORs are available in different tenors.

13 Contractual amendments to legacy positions may vary across products, especially between derivatives and cash instruments.

(a) In the case of derivatives, the International Swaps and Derivatives Association (ISDA) expects to use a standardised process to facilitate amendments to legacy positions. However, the specific conditions for the contractual amendments have not been defined as yet.

(b) In the case of cash instruments (i.e. financial instruments that are not derivatives), there is no central organisation such as ISDA that can create standard protocols. Therefore, negotiation between parties on a contract-by-contract basis is likely to be required.

Basis risk

14 Due to the inherent complexities associated with the transition, market participants are concerned with basis risk being introduced in the system. This could emerge if:

(a) derivatives and the cash products they hedge transition to alternative RFRs under different timelines, which could leave market participants with basis risk for an undefined period; and

(b) cash products reference term versions of the alternative RFRs while derivatives reference the overnight alternative RFRs.

IASB project: analysis of accounting implications of transition from IBOR to RFR

Phases of the project

15 At its December 2018 meeting, the IASB decided to divide the project into two phases:

(a) The first phase will focus on issues affecting financial reporting leading up to IBOR reform. These issues are more urgent because they might affect financial reporting before IBOR reform is enacted.

(b) The second phase will focus on issues that affect financial reporting when IBOR reform is enacted. As there is uncertainty about how market participants will approach issues related to amendments of legacy positions and whether value transfers will occur, the IASB has decided to monitor developments.

16 The first phase of the project will cover hedge accounting under IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement*.

17 The ESTER working group raised similar issues to the ones identified by the IASB. However, this working group noted that there are potential effects beyond IAS 39 and IFRS 9. In their view other areas of accounting where the accounting principles provide for the use of a risk-free rate may be impacted. Examples are IAS 19 *Employee Benefits*, IAS 36 *Impairment of Assets*, IAS 37 *Provisions*, *Contingent Liabilities and Contingent Assets,* IAS 40 *Investment Property*, IFRS 16 *Leases* and IFRS 17 *Insurance Contracts*. It is unclear whether the impact on other accounting standards will be addressed by the IASB in the second phase of the project.

Hedge accounting

18 The IASB identified the following areas in hedge accounting that might be impacted by uncertainties arising from IBOR reform:

(a) Highly probable requirement;

(b) Prospective assessments; and

(c) Risk components.

Highly probable requirement

19 When a forecast transaction is designated as a hedged item in a cash flow hedge, that transaction must be highly probable under both IFRS 9 and IAS 39. The question is whether forecast IBOR cash flows would meet the highly probable requirement when the hedged item is designated in terms of forecast IBOR cash flows and these cash flows will occur after IBOR reform.

20 In practice, hedging relationships are commonly designated whereby the IBOR component of a financial instrument is documented as the hedged risk. In this context, IFRS 9 states that, when designating a risk component as a hedged item, the hedge accounting requirements apply to that risk component in the same way as they apply to other hedged items that are not risk components. Consequently, it might be difficult to demonstrate that, at some point in the future, the designated

IBOR cash flows are highly probable given the effects of IBOR reform. IAS 39 contains the same requirements in this area.

21 Therefore, as uncertainty from IBOR reform increases and transition approaches, it is possible that, at some point, these designated forecast cash flows will no longer be highly probable.

22 Failure to meet the highly probable requirement will have a significant impact on financial reporting and key accounting ratios for many preparers. This is because discontinuation of hedge accounting would result in reclassification of the cash flow hedge reserve to profit or loss, and derivatives that would otherwise qualify for hedge accounting purposes would be treated as trading derivatives and measured at fair value through profit or loss.

Prospective assessments

23 Prospective assessments apply to both fair value and cash flow hedges. Under IFRS 9, a hedging relationship qualifies for hedge accounting only if there is an economic relationship between the hedged item and the hedging instrument. An economic relationship exists when there is an expectation that the value of the hedging instrument and the value of the hedged item will move in opposite directions in response to the hedged risk.

24 A forward-looking prospective assessment is also required for hedging relationships designated under IAS 39.

25 The prospective assessments provide evidence that an economic relationship (IFRS 9) or expectation that the hedge will be highly effective in achieving offsetting (IAS 39). These assertions are part of the qualifying criteria in order to apply hedge accounting.

26 Demonstrating the existence of an economic relationship require the estimation of future cash flows because the assessment is prospective in nature. For those hedging relationships going beyond the expected replacement of IBOR, as time to transition approaches, the prospective assessments could be affected as they are performed on a forward-looking basis, and potentially result in discontinuation of hedge accounting.

27 In addition, while entities might re-designate the same derivatives in new hedging relationships, these derivatives could still fail the prospective assessments as they are performed on a forward-looking basis.

Risk components

28 An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. Both IFRS 9 and IAS 39 require a risk component to be separately identifiable and reliably measurable (SIRM). The SIRM requirement applies to both cash flow and fair value hedges.

29 When designating risk components as hedged items, an entity considers whether the risk component is explicitly specified in a contract or whether it is implicit in the fair value or the cash flows of an item of which they are a part. The assessment of whether a risk component is separately identifiable may be straight forward when the component is explicitly specified in a contract.

30 Identifying a non-contractually specified risk component is more difficult. It requires an assessment of facts and circumstances around the particular market structure to which the risks relate. For example, assume that IBOR reform impacts market liquidity to such an extent that there is no available term structure of zero-coupon interest rate for either IBOR or RFR benchmarks. Such a scenario could affect the assessment of whether non-contractually specified IBOR and RFR components are eligible as a hedged item in a hedging relationship.

31 It should be noted that risk components that are separately identifiable are generally discussed both in IFRS 9 and IAS 39 in the context of designation at inception of the hedging relationship. There is no explicit requirement for a continuous assessment. Therefore, non-contractually specified IBOR components designated in existing hedging relationships would not be impacted by IBOR reform and neither would new designations as long as IBOR continues to be separately identifiable. This significantly reduces the scope of the potential concerns involving new relationships where the entity wants to designate a non-contractually specified risk component.

32 The concerns will arise in two scenarios:

(a) When an entity wishes to designate the alternative RFR as a risk component and a term structure of zero rates is available for IBOR but has not yet developed for RFR; or

(b) When an entity wishes to designate IBOR as a risk component but the market has transitioned away from IBOR to the alternative RFR and a term structure of zero rates is no longer available for IBOR.

33 According to the IASB staff analysis, it unlikely that in any given period neither IBOR nor RFR is separately identifiable and there would be no term structure of zero-coupon interest rate for either IBOR and RFR.

IASB's tentative decisions

34 In its February 2019 meeting the IASB's tentative decisions included:

(a) regarding the 'highly probable' requirement, that 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.

(b) regarding the existence of an economic relationship (IFRS 9) and the expectation that a hedge will be highly effective in achieving offsetting (IAS 39), that 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.

(c) 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 may be affected by IBOR reform in the future. The IASB tentatively decided that relief should not be provided for risk components that are not separately identifiable at the inception of a hedging relationship.

(d) an entity should apply the proposed amendments retrospectively. The proposed effective date of the amendments is 1 January 2020 with earlier application permitted.

35 In the March 2019 meeting, the IASB tentatively decided that:

(a) the application of the relief, where applicable, should be mandatory.

(b) entities should cease to apply the relief when the earlier of the following occurs:

(i) uncertainty regarding timing and amount of the resulting cash flows is no longer present; and

(ii) the hedging relationship terminates.

(c) end of relief, before the termination of the hedge relationship, is not applicable for separately identifiable risk components.

EFRAG TEG and EFRAG FIWG comments

36 EFRAG TEG had insufficient time at its March meeting to discuss IBOR reform. The topic will be discussed at the April meeting to gather preliminary views for inclusion in the draft comment letter.

37 EFRAG FIWG discussed the IBOR reform project in its March meeting and provided the following comments, which will be considered carefully by EFRAG TEG in preparing the draft comment letter.

Scope

38 The delineation between the two phases of the IBOR project was considered unclear. Not only were the issues to be addressed in the second phase unspecified, but there was also a concern that the second phase could address the issues too late. It was suggested to treat the second phase simultaneously with the first phase or to expand the first phase.

Issues raised in relation to the tentative IASB decisions on hedge accounting

39 When IBOR and RFR changed (for both hedged items and hedging instruments), relief should be provided so that this change would not result in discontinuation of existing hedge relationships. This view was held because the transition from IBOR to RFR was an overall market reform and the old and new rates were both market interest rates.

40 It was unclear whether the transition was considered to be a single moment in time or as a continuous event as individual hedges transitioned to new RFRs, which affected the possibility to benefit from the proposed relief.

41 In case of modifications that lead to derecognition of an existing financial asset and recognition of a new financial asset it was unclear whether this would affect the business model. As the IBOR transition was a one-off event, EFRAG FIWG members thought this should not be the case. However, it was noted that entities might take the opportunity of the transition to change contractual characteristics other than the interest rate.

Endorsement process

42 The urgency of a timely endorsement was emphasised. Clarity was needed by the end of 2019 or early January 2020 allowing entities to use the amendments.

Question for the EFRAG Board

43 Does EFRAG Board have any comments at this stage in the project?