Interest Rate Benchmark Reform - Phase 2
Issues Paper

Objective

1 The EFRAG Secretariat became aware of additional potential issues that were reported by some industry experts in the context of the proposed amendments on IBOR Phase 2.

2 The objective of this paper is to analyse the conclusions of the feedback received from EFRAG FIWG members on the particular issues raised and whether these should also be included in EFRAG's final comment letter.

Issue 1: Historical fallback terms

3 Paragraph 6.9.5 proposes that the practical expedient is applied to the activation of existing fallback terms as long as the new basis for determining contractual cash flows is 'economically equivalent' to the previous basis. Some members are concerned that not all historical fallback terms will have been amended before transition takes place, and that these historical fallbacks will not qualify for the practical expedient since the new cash flows may not be economically equivalent.

4 An example would be if the interest rate reference would be switched to the most recent available LIBOR rate. If the practical expedient is not available, a modification gain or loss would be recognised under IFRS 9.5.4.3. The problem with this is that such historical fallbacks were only designed to be temporary fixes, and reporting a gain or loss calculated on an assumption that the arrangement will persist for the remainder of the life of the financial instrument would be spurious and would not result in a faithful representation. There continues to be uncertainty arising from benchmark reform but the phase 1 relief cannot be applied, as the previous benchmark is no longer available. Some recommend that the practical expedient is extended to address such situations, where the use of the fallback will be temporary.

The EFRAG Secretariat analysis

5 The EFRAG Secretariat notes that, considering the proposed definition of a modification, activation of a historical fallback term could mean that the "basis for determining the contractual cash flows is changed after the initial recognition of the financial instrument" (paragraph 6.9.2).

6 While activation of historical fallback terms will not effect a change from IBOR to an alternative benchmark rate but instead to a fallback rate, it is unclear to the EFRAG Secretariat why this would fail the requirement of economic equivalence.

7 Assuming there was economic equivalence between the original rate and the fallback rate (which could usually be expected), the EFRAG Secretariat acknowledges that activation of historical fallback terms would in many cases require a (second) modification to apply a robust fallback rate based on an alternative benchmark rate. However, when the original rate can no longer be used because it was subject to the IBOR reform and therefore the historical fallback term

is activated on an economically equivalent basis, then the requirements in paragraph 6.9.3 should be met and the practical expedient would apply.

8 The EFRAG Secretariat notes that there is no sufficient information to assess whether and to which extent historical fallback terms would not be economic equivalent. The EFRAG Secretariat therefore suggests not to include this issue into the final comment letter without a sufficiently robust basis to assess the issue.

EFRAG FIWG comments:

9 EFRAG FIWG members suggested raising the issue of historical fallback rates to EFRAG TEG and EFRAG Board whether it should be proposed in the EFRAG comment letter that the IASB should clarify in the Basis for Conclusions of the final amendments that economic equivalence should be assessed when the fallback clause is included in the contract and not at the time when it is triggered.

Questions for EFRAG Board and EFRAG TEG members:

10 Do you share the analysis of the EFRAG Secretariat?

11 Do you have evidence whether historical fallback terms would not be economically equivalent to the original rate?

12 Do you support the suggestion to propose to the IASB to clarify in the Basis for Conclusions of the final amendments that economic equivalence can be assessed when the fallback clause is included in the contract and not at the time when it is triggered?

(please note this is the same question is also in the analysis of comment letters)

Issue 2 - Positioning of modifications guidance

13 The phase 1 amendments related only to hedge accounting, so naturally were made to chapter 6 of IFRS 9 as section 6.8. The phase 2 amendments have a broader impact than hedge accounting and so should not all be included in chapter 6.

14 For entities applying IAS 39 hedge accounting, the modification amendments will not be available if they are included in chapter 6 of IFRS 9. The amendments proposed in paragraphs 6.9.1 to 6.9.6 should therefore be included in Chapter 3 *Recognition and Derecognition* as a new section 3.4. Those amendments which relate to hedge accounting would remain in section 6.9.

The EFRAG Secretariat analysis

15 The EFRAG Secretariat shares the above analysis because paragraph 7.2.21 of IFRS 9 says "When an entity first applies this Standard, it may choose as its accounting policy to continue to apply the hedge accounting requirements of IAS 39 *instead of the requirements in Chapter 6 of this Standard*." (emphasis added).

16 Against this background, the EFRAG Secretariat **suggests including this issue** to the final comment letter.

EFRAG FIWG comments:

17 EFRAG FIWG suggested to clarify both the scope of the proposed requirements on modifications of financial assets and financial instruments and the applicability of those requirements to entities that apply the hedge accounting requirements in IAS 39 rather than those in section 6 of IFRS 9 by relocating the proposed requirements on modifications to section 5.4 of IFRS 9 on amortised cost measurement.

18 The final comment letter proposed for discussion to EFRAG Board and EFRAG TEG has been modified to reflect the above.

Issue 3 - Amendments to hedging documentation

19 Paragraph 6.9.4 examples (b) to (d) illustrate the kind of amendments that may be required in order to achieve benchmark reform, in addition to the replacement of the interest rate benchmark as described in 6.9.4 (a). There is risk that because 6.9.7 and 102O use the term 'refers to an alternative benchmark rate' without also including the language of 6.9.4 (b) to (d), they can be read to permit only the changes contemplated by 6.9.4 (a). Some therefore recommend that 6.9.7 and 102O should be amended to refer also to changes to hedging documentation including the examples in 6.9.4 (b) to (d). Paragraph 6.9.8 and 102P should also refer to changes as described in paragraph 6.9.4 as well as 6.9.3 and 6.9.5.

The EFRAG Secretariat analysis

20 While the EFRAG Secretariat acknowledges that the wording in the standard may not be entirely clear, reference to "change in the description … so that it refers to an alternative benchmark rate" should be understood in a way that reference to an alternative benchmark rate is a requirement to apply the proposed amendments, but this does not mean that other necessary changes made to achieve reference to an alternative benchmark rate (such as those described in paragraph 6.9.4(b)-(d) were to be excluded. On the contrary, such further changes may be inevitably necessary to transition to an alternative benchmark rate, i.e. it would not be feasible to exclude such changes. Thus, these changes also affect the characteristics of the hedging instrument or hedged item respectively and hence must be included when the description is amended.

21 Against this background, the EFRAG Secretariat **does not propose to include** this issue in the final comment letter.

EFRAG FIWG comments:

22 EFRAG FIWG shared the conclusions of the EFRAG Secretariat.

Issue 4 - Ability to update the designation of the hedged risk

23 For cash flow hedges, the concern is that additional ineffectiveness could arise if it is not permitted to amend the hypothetical derivative representing the hedged item whilst the actual hedged item, such as a floating rate loan, has not yet transitioned from IBOR to an RFR. This ineffectiveness would be spurious, as it is not expected that the hedged item will remain referenced to IBOR for the remainder of its life. It may also be necessary to designate an RFR component (including any relevant spread as described in paragraph 6.9.4(b)) as the hedge of a floating rate. Similarly, for a hedge of a highly probable forecast transaction or planned extension to an existing floating rate instrument, it would be desirable to amend the hedged item to be the alternative benchmark component of the floating rate (including any relevant spread as described in 6.9.4(b)), once the hedging derivative is modified, even though it is not yet certain whether the floating rate will initially be based on IBOR or the RFR. This concern could be removed by providing more explicit guidance that the hedge relationship can be amended to designate a revised hedged risk before there is an end to the uncertainty for the hedged item.

The EFRAG Secretariat analysis

24 The EFRAG Secretariat does not share this concern. Imputing RFR into the hypothetical derivative albeit the hedged item is still based on IBOR, would mean imputing terms that do not exist. Paragraph B6.5.5 of IFRS 9 is clear that "[t]he hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach […]

Consequently, a 'hypothetical derivative' cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (but not in the hedged item)." In addition, the actual ineffectiveness would be obscured.

25 Against this background, the EFRAG Secretariat **does not propose to include** this issue in the final comment letter.

EFRAG FIWG comments:

26 EFRAG FIWG shared the conclusions of the EFRAG Secretariat.

Issue 5 - Specification of an RFR as the hedged risk

27 Consistent with the amendments permitted by paragraph 6.9.4, the identification of a non-contractually specified risk component would need to include also the addition of a fixed spread to compensate for a basis difference between LIBOR and the RFR. Otherwise, there will be a mismatch between the modified hedging instrument and the designated risk component. Some recommend that paragraph 6.9.16 is amended to reflect this.

28 Some recommend an additional indicator in the context of IBOR reform, that an RFR is considered separately identifiable if the authority responsible for managing the transition from IBOR to RFR, has deemed an RFR to be an eligible replacement of an IBOR, since in this context the RFR is accepted as a risk free rate component relevant for pricing and valuing all financial instruments. Where this is the case, it could be a rebuttable presumption that the RFR is separately identifiable.

The EFRAG Secretariat analysis

29 When designating a risk component based on a benchmark rate as described in 6.9.16, the underlying item is usually a fixed rate instrument where the benchmark rate is not contractually specified. If so, it is unclear in which way a fixed spread to compensate for the difference between LIBOR and RFR would be included because the fixed rate agreed between the borrower and the lender would not be affected by the IBOR reform at all and hence no changes to the contractual terms are made. Instead, when an entity decides to hedge a particular non-contractually specified risk component within a fixed rate instrument, this is reflected in its own risk management and hedge documentation.

30 Against this background, the EFRAG Secretariat **does not propose to include** this issue in the final comment letter.

EFRAG FIWG comments:

31 EFRAG FIWG shared the conclusion of the EFRAG Secretariat.

Issue 6 - Disclosure of prior period information

32 Some recommend that it should be made clear that the disclosures suggested by paragraph 24J(b) of IFRS 7 should not require comparative information upon initial adoption of the amendments.

33 For prior periods, the effect of reinstating hedges that have failed as a direct result of IBOR reform is reflected as an adjustment to opening retained earnings in the current period. Whilst it may be appropriate to describe how the adjustment to opening retained earnings has been calculated, it should not be necessary to provide the same level of disclosure for the prior period as the current period.

The EFRAG Secretariat analysis

34 The EFRAG Secretariat observes that the proposed transition requirements in the exposure draft provide that:

(a) an entity is not required to restate prior periods to reflect the application of the proposed amendments (IFRS 9.7.2.38); and

(b) that in the reporting period in which an entity first applies the proposed amendments, an entity is not required to present the quantitative information required by paragraph 28(f) of IAS 8. (IFRS 7.44II).

35 However, these transition requirements do not address the issue of comparatives as described in paragraphs 36 and 37. **The EFRAG Secretariat therefore proposes to include** this issue in the penultimate paragraph on Question 6 in the final comment letter: "*EFRAG observes that the disclosures suggested by paragraph 24J(b) of IFRS 7 should not require comparative information upon initial adoption of the amendments because such comparative information is of limited relevance to users given current progress of the IBOR reform."*

EFRAG FIWG comments:

36 EFRAG FIWG members shared the conclusions of the EFRAG Secretariat.

37 The final comment letter proposed for discussion to EFRAG Board and EFRAG TEG has been modified to reflect the above.

Issue 7 – No application by analogy, negative examples

38 Some have suggested encouraging the IASB to clearly exclude the possibility that the proposed amendments can be applied by analogy to circumstances other than those for which they were developed and to include, in addition to those proposed in paragraph 6.9.4, examples of modifications of a financial asset or financial liability which would not meet the conditions described in paragraph 6.9.3. This could reduce diversity in practice and improve the understandability and enforceability of these provisions.

The EFRAG Secretariat analysis

39 The EFRAG Secretariat observes that including examples that would not meet the conditions in paragraph 6.9.3, i.e. constituting a modification being a direct consequence of the IBOR reform occurring on an economically equivalent basis, would effectively mean that the IASB provided examples to which the usual requirements to modifications of financial instruments in IFRS 9.5.4 should apply. This would go beyond the scope of the IASB's IBOR project by introducing guidance on fact pattern that do not relate to IBOR reform. The EFRAG Secretariat observes that the proposed requirements together with the positive list of examples should already be sufficiently clear to prevent application by analogy to other fact pattern that are not related to the IBOR reform. As potential unintended consequences cannot be sufficiently analysed within the constraints of the due process, the EFRAG Secretariat **does not support** this suggestion.

Question for EFRAG Board and EFRAG TEG members:

40 Do you share the analysis of the EFRAG Secretariat?