POSITION PAPER

EFRAG DCL on the IASB Exposure Draft on IBOR

ESBG (European Savings and Retail Banking Group)

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ESBG

ESBG welcomes the opportunity to comment on the EFRAG Draft Comment letter on the Interest Rate Benchmark Reform Exposure Draft (ED) issued by the IASB on 3 May 2019.

We overall agree with the DCL on the IASB ED related to the Proposed Amendments to IFRS 9 and IAS 39 due to the Interest Rate Benchmark Reform. We fully support the IASB initiative to provide limited relief regarding financial instruments qualifying for hedge accounting as long as uncertainty due to IBOR reform exists.

We understand that there remain some uncertainties around the timing and precise changes of the IBORs reform. The IASB has to address the topic worldwide while different solutions are being prepared across jurisdictions and at different speeds. Even when the IASB is able to address the issues through a fast procedure, according to the foreseen calendar of this first phase, final amendments are planned to be issued by the end of 2019. We support the IASB decision of phasing the analysis on the impacts derived from IBOR reform, prioritising those related to forward-looking hedge-accounting requirements. However, since broad solutions of the IBOR reform are already known and are progressing quickly, we consider that the IASB would be in the position to start to deal with the second phase issues so as to be ready with accounting solutions soon as possible when IBOR reform begins to take effect.

We would like to note a key point that is of particular importance to ESBG. As stated in Appendix II of EFRAGs DCL, EURIBOR is not transitioning to a new benchmark index. Instead, some changes to its calculation methodology are being undertaken to ensure compliance of the index with the Benchmark Regulation. Hence, we consider there is no replacement and then there would not exist uncertainties affecting the timing and amount of the interest rate benchmark-based cash flows arising from the hedge item or the hedging instrument. And so, the exceptions of the ED would not be applicable. However, if the Euribor were to be replaced by a new term-rate based on €ster, the exposure draft would be applicable.

Below you will find our answers and comments to the questions raised in your Draft Comment Letter.

<u>EFRAG Question to constituents</u>

- The Amendments require entities to cease applying the relief when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and amount of the interest rate benchmark-based cash flows. The assessment of when uncertainty ceases to exist requires the exercise of judgement.

- Do constituents believe that the level of judgement involved in this assessment would deserve additional discipline? For example, should the IASB add a clarification that this assessment has to be done by management using all the available information applicable to the specific facts and circumstances?

We fully agree that the exceptions proposed in the ED must be applied to all hedging relationships that are affected by the uncertainties arising from interest rate reform, without permitting voluntary application that might lead to a selective discontinuation of hedging relationships.

The Basis for Conclusions of the proposed amendments specify a number of scenarios in which a contract is amended in anticipation of interest rate benchmark reform. These scenarios illustrate when uncertainties due to IBOR reform will end. Main conclusion appears to be that, in most cases, when a contract is amended to specify both what the new benchmark will be and when it will take effect, uncertainty ceases to exist and hence proposed reliefs would no longer be applied. However, under certain circumstances, a deeper analysis may be necessary beyond the amended terms of the contract to determine the economic link between the hedge item and the hedging instrument, and management should apply judgement to determine whether or not uncertainties have ceased. For that reason it would be positive that the IASB adds further clarification regarding the assessment that should be performed by management on specific circumstances.

<u>EFRAG Question to Constituents</u>

- **In addition to the fact patterns above, are there different patterns of IBOR transition that the IASB should consider when dealing with the replacement issues? Please describe.**

The transition patterns described in the Draft Comment Letter summarize fairly how the reform is affecting the different indexes used in the European Economic Area (EURIBOR, EONIA and LIBOR). We consider that the description could also include the transition from CHF LIBOR to SARON rate since Switzerland participates in the European single market.

As noted above, we would like to emphasize the particular situation of EURIBOR with respect to other IBORs. EURIBOR is not being replace but there is just an evolution in its estimation methodology. We consider that a change in calculation methodology is not a change in the benchmark, and therefore amendments to IFRS 9 and IAS 39 would not be applicable. We suggest that the amendments should clearly state that proposed reliefs are not applicable in cases of modification of methodology and hence, preparers would maintain its current accounting.

<u>EFRAG Question to Constituents</u>

- **EFRAG has been informed that, during the period while the relief is ongoing, it will be necessary to have clarity on the outcome of not only the prospective assessment of a cash flow hedge relationship under IAS 39, but also of the retrospective assessment. This in order to determine, at the end of each reporting period, how much of the value difference between the hedged item and the hedging instrument is assigned to other comprehensive income and which amount is assigned to profit or loss. As such, the retrospective assessment at the beginning of the cash flow hedge relationship should be able to be carried forward during the period of the relief solely for the purpose of determining the cash flow hedge reserve.**

- **In your view, are there particular circumstances in which a relief of the retrospective test is needed applying IAS 39? If so, please describe the reasons why as well as the specific fact patterns it would apply to.**

We understand and support the reasons illustrated on BC23 of the ED that the IASB has evaluated for not proposing any relief for the effects of the IBOR reform on the retrospective assessment that is required by IAS 39. However, we would like to bring to the IASB attention that under particular circumstances during the transition period to IBOR replacement or once the reform is in progress, a relief of the retrospective test would be needed to avoid that certain hedges fail the hedge accounting only because they are temporarily outside the 80-125% range. Following are the examples of potential ineffectiveness as a result of the IBOR reform:

- New RFR hedges under IAS 39 for which there would not be historical data available that permits to perform the retrospective assessment properly. We would suggest either a temporary exemption to perform the test or the possibility to assume that IBOR historical data is an acceptable proxy to new RFR.
- Mismatch in cash flows of the hedged item and the hedging instrument if current IBOR is replaced with the new RFR at different times. In that case we believe there should be a relief that permits the continuation of hedge accounting when hedge effectiveness fails only because both instruments have transitioned to new RFR at different times.
- Valuation effects resulting from development of new curves used for discounting. The discounting effects may also affect the prospective effectiveness assessment.

Although not all ESBG members are applying IAS 39, we would support that the IASB introduces relief on the retrospective but also prospective assessment to avoid that preparers applying IAS 39 would be penalized compared to ones under IFRS 9.

When saying this we acknowledge that the economics of the hedging relationship should be captured by recognising the ineffectiveness through standard hedge accounting measurement requirements.

Further, we would like to note that the 'lower of test' determining how much of the hedging derivative revaluation is recognised in the cash flow hedge reserve in paragraph 6.5.11(a) of IFRS 9 refers to present value of the cumulative change in the hedged expected future cash flows. Similar wording is used in paragraph 96(a) of IAS 39. The values determined in this test are often also used for measuring the retrospective hedge effectiveness for hedges under IAS 39.

The proposed amendments focus on hedge accounting requirements which require forward-looking analysis (see e.g. paragraph BC4 of the exposure draft). We consider that the term expected future cash flows also includes a similar forward-looking aspect. In the area of cash flows hedged of interest risk the expected future cash flows are determined by using forward interest rates (usually included as one leg of hypothetical derivatives replicating the hedged cash flows). The time horizon of such ex-pected future cash flows can span over the benchmark rates reform time point in which case they would be affected by the new rates after the reform takes place.

We understand that the retrospective assessment and the 'lower of test' are based on the actual re-sults. But we consider that, in order to avoid misunderstanding, the IASB should explain how future expected cash flows should be understood in the context of the proposed amendments. In our view, similarly to other areas addressed in the exposure draft, the future expected cash flows should be analysed assuming that the interest rate benchmark on which the hedged cash flows are based is not altered. This particular clarification should be part of the phase one of the project.

EFRAG Question to Constituents

- **In your view which of the above topics should be addressed by the IASB when dealing with the replacement issues? Please explain the reasons why and your suggested accounting treatment.**

- **In addition to the topics listed above, do you have any other matters that the IASB should consider when dealing with the replacement issues? Please describe.**

We agree with EFRAGs view that IBOR reform creates more accounting issues than the ones addressed in phase one, and as previously mentioned, we are on the view that they should be addressed as soon as possible. We also share with EFRAG that main topics that need to be considered when dealing with replacement issues are the ones described in Appendix II of the DCL. However, and without the aim of discarding the other topics described in the Appendix, we would like to highlight the accounting issues that we consider represent main challenges that should be addressed by preparers once the replacement has taken place:

- Hedge Accounting: Once IBORs have been replaced by a new RFR, it would be useful to preparers to continue with hedge accounting and avoid discontinuation which might otherwise arise, either as a consequence of a change in hedge documentation or as a consequence of differences in fair value between hedging instruments and hedge items that would give rise to hedge ineffectiveness. Relief should be provided so that when hedge documentation refers to IBOR as the benchmark risk, subsequent amendment to new RFR should not trigger dedesignation of hedge accounting.
- Financial Instruments whose cash flows are tied to IBORs: If it is concluded that the modification of contract terms for transitioning from IBOR to RFR is substantial the asset/liability on the balance sheet should be derecognised and difference between the carrying values being immediately recognised in the income statement. If it is not deemed a substantial modification, a modification gain or loss may arise. We would propose to the IASB to introduce a relief so that the change from IBOR to RFR stand alone does not result in derecognition of financial instruments. We also consider that the most appropriate way to account for a change in the reference variable

rate due to IBOR replacement in a cash instrument, would be by updating the effective interest rate. This would minimise the impact on the carrying amount of the asset or liability and on PL.

Beside the topics described above and the ones included in Appendix II, we would support that the IASB provides guidance with respect disclosures that are expected to be provided by preparers when dealing with the replacement issues, to provide useful information to users of financial statements.

Below we comment on two topics in Appendix II of the DCL.

Topic 8: IFRS – SPPI criterion should also include discussion of SPPI compliance of backward looking rates which may serve as a fall-back or standard rates after the replacement. With this backward looking solution short term rates replacing the old IBOR rates with term structure up to 12 months would be determined based on a compounding new overnight risk-free rates such as €STR, SONIA or SARON.

For example a 6-month Euro interest would be determined as a compounded €STR rate over the 6-month interest cash flow period. As a result, such an interest would be known only at the end of the interest period (the backward-looking aspects). We consider that in such a case the instrument could be viewed as bearing current overnight interest rates which are technically paid, including interest on the "deferred interest", every 6 months in arrears. Such an instrument would not have non-SPPI features, in our view.

However, in order for the contract parties to know the interest rate already at the start of the period the compounded term rate may be determined in advance and relate to a prior period. In the simplest case a 6-month Euro rate would be calculated as a compounded €STR over a prior 6-month period ending on the last day preceding the current 6-month period. At the start of the current 6-month period the resulting rate would be applied for the entire period. Also other alternatives for knowing the rates (compounding overnight rates) at the start of the period are possible. All of such "in advance" solutions would involve certain SPPI challenges because the interest may not include a consideration for the time value of money. The IASB should discuss their SPPI treatment within the interest rate benchmark reform context. These issues may be relevant not only at the transition to the new rates but would also affect the treatment of the instruments after the reform.

The issue discussed in Topic 12: Collateralised derivatives discounted using €STR relate to modification and derecognition which are addressed in topics 1 and 2. Rather than being included separately, the CSA case could be mentioned as a specific example in those topics. Further, the reference to the loan commitment exception in IFRS 9.2.1(g) in paragraph 47 of the draft comment letter is confusing. Paragraph IFRS 9.2.1(g) brings a scope exemption for loan commitments and it is not related to classification and measurement of the CSA at amortised cost. In our view, the CSA collateral is an on-balance financial receivable or a financial liability based on whether the cash collateral is posted or received. As a result, the amortised cost measurement is the typical measurement for CSA without the need to make the reference. Moreover, we do not understand the issue of CSA measured at fair value through profit or loss discussed in paragraph 46.

<u>Other comments</u>

We support the relief proposed on the separately identifiable requirement that would permit to perform this assessment only at inception of the hedging relationship. However we would like to highlight that during the period of time that IBORs and new RFR will co-exist, and IBORs become less liquid, it would be possible that the "reliably measure" requirement could not be fulfilled. Hence, since the "reliably measure" criteria and the "separately identifiable" criteria are normally stated as twins in IAS 39 and IFRS 9 we believe that the IASB should at least discuss in the BCs how the "reliably measurable" criterion should be understood in the context of the relief provide for the "separately identifiable" criterion.

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