ERSTE

ERSTE GROUP

Mr. Jean-Paul Gauzès
EFRAG Board President
35 Square de Meeûs
1000 Brussels
Belgium

Erste Group Bank AG
Am Belvedere 1
1100 Vienna

Head office: Vienna
Commercial Court of Vienna
Commercial Register No.: 33209 m
DVR 0031313
Bank Code: 20100

Group Accounting
Tel.: +43 (0) 50100 - 19200
manfred.schmid@erstegroup.com

14.05.2020

Comment letter on EFRAG Draft Comment Letter on the IASB ED/2020/1 Interest rate Benchmark Reform-Phase 2 (Proposed amendment to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)

Dear Mr. Gauzès,

Thank you for the opportunity to comment on the EFRAG draft comment letter (DCL).

Erste Group agrees with the EFRAG's general support of the exposure draft. We also agree with the detailed comments in the DCL. We would welcome if you could consider three additional issues in your comment letter which are important for continuing with existing accounting practices when the interest rate benchmark reform takes place.

Please find below our comments on these issues and answer to the question to constituents raised in the EFRAG's DCL.

SPPI benchmark test issue for 'in advance' rates

Paragraphs BC37 and BC38 of the ED discuss other classification and measurement issues. Regarding the SPPI assessment the IASB concluded that IFRS 9 provides an adequate basis for assessing the contractual cash flow characteristics of a financial asset, i.e. for concluding whether the new rate is SPPI compliant or not. We believe that not all peculiarities of the situation were considered in reaching the conclusion.

For certain new benchmark rates and types of instruments there may be no other alternative than using rates which have interest mismatch features. This may be relevant for benchmark rates where authorities decide that no forward looking term rates will be officially provided. Regarding types of instruments, for retail loan business it may be necessary, due to consumer protection, that the rates are known in advance at the start of the interest period. The reason would be that this 'in advance' feature was naturally part of the original loan terms since current benchmark rates are generally forward-looking rates.

A specific example would be floating rate loans linked to CHF LIBOR. For the CHF rates the National Working Group on Swiss Franc Reference Rates stated that a robust forward-looking term rate based on SARON derivatives is unlikely to be feasible. Instead they recommend using a compounded SARON. SARON rate as the new reference rate represents overnight market quotes. Term rates derived based on SARON use averages of the overnight SARON rates over certain periods. Loans with 'in advance' rates would need to use averaging over a past period before the interest period start. But such a rate would be a candidate for the SPPI benchmark test assessing significance of the interest mismatches because there is a time lag between the time the rate effectively relates to and the start of the interest period.

For example, for a 6-month CHF LIBOR rate the new 6-month 'in advance' SARON rate would have an average 3-month time lag to the start of the interest period due to the rate calculated as an average over the previous 6-month period. Moreover, no official forward-looking CHF term rates relating directly to the interest period start are likely to exist, as it is currently the case with LIBOR rates. As a result, the rate to be applied in the ideal instrument used in the SPPI benchmark test would probably be the 6-month SARON 'in arrears' rate (i.e. known at the end of the interest period which will be used for other types of instruments such as bonds and derivatives where the need for knowing the rates in advance does not arise). This would lead to a 6-month time lag considered in the benchmark test which would be prone to failing the SPPI assessment.

We believe that in such cases the IASB could consider a relief for the SPPI benchmark test similar to what was agreed when developing the IFRS 9 for regulated rates. The relief in paragraph B4.1.9E of IFRS 9 cannot be used directly, in our view, since this case does not result from the government or a regulatory authority setting interest rates. However, similar to the regulated rates, these cases result in no other realistic alternative than using rates with interest mismatches. As a result, we consider that there are valid reasons for extending this type of relief. Without the relief loans resulting from standard banking business could be measured at fair value through profit or loss just due to the interest rate benchmark reform which would not lead a faithful presentation.

Adding basis swaps in the hedge designation (question 2 of the ED)

The proposed requirements in the ED address necessary changes to a hedge designation and documentation which are directly required by the interest rate benchmark reform. They relate to designating an alternative benchmark rate, amending the description of the hedged item or the hedging instrument so that it refers to an alternative benchmark rate and, for entities applying IAS 39 for hedge accounting, to changes in the effectiveness assessment (see proposed paragraphs IFRS 9.6.9.7 and IAS 39.102O of the ED). Other changes are not allowed.

However, the reform will often result in cases when the benchmark rates on the hedging instrument and the hedged item side will not be aligned. For example, floating retail loans and mortgages may use interest rates which are known to clients in advance. For this purpose so called 'last reset' calculation methodology would apply. It would calculate the rate based on averages of (compounded) overnight alternative benchmark rates over the previous interest period.[1]

[1] The 6-month 'in advance' SARON rate mentioned in the *SPPI benchmark test issue for 'in advance' rates* part would be calculated on this basis.

As regards fallback provisions for ISDA-based hedging derivatives it is expected that the overnight rate will be compounded in the relevant interest period in arrears over the tenor of the IBOR rate (e.g., 1 month, 3 month). Then, a spread adjustment will be added to the compounded rate. Also for technical reasons, there would be some delay in the interest payment of up to a few days (i.e. a backward-looking term structure with payment delay).

The solution could be to include a basis swap in the hedging relationship which will offset the difference between the different types of the alternative term benchmark rates. E.g. for a hedge of a floating mortgage loan containing the last-reset backward-looking term structure methodology that is hedged by an ISDA derivative containing the payment delay backward-looking term structure methodology, a basis swap offsetting the difference between the two methodologies would be included in the hedge documentation.

Based on the proposed requirements adding any derivative as a hedging instrument would lead to the hedge discontinuation since this would represent a change in addition to those changes required by the interest rate benchmark reform (see paragraphs IFRS 9.6.9.8 and IAS 39.102P of the ED).

We consider that the IASB should allow adding derivatives in existing hedging relationships which address solely differences between alternative benchmark rates used for the hedging instrument and the hedged item arising directly as a result of the reform.

Rest to zero requirement for cumulative effectiveness assessment

Paragraph IAS 39.102S of the ED proposes that for the purpose of assessing the retrospective effectiveness as required by IAS 39, an entity shall reset to zero the cumulative fair value changes of the hedged item and hedging instrument when the benchmark rates are replaced (i.e. when the relief in paragraph IAS 39.102G as provided by the IASB in phase I of the IBOR project ceases to apply).

The proposed requirement does not distinguish between the types of methods used for the retrospective effectiveness assessment. It would apply always when the effectiveness is assessed on a cumulative basis.

It would be helpful for entities applying the cumulative dollar offset method. However, it would be confusing when the regression analysis is used for assessing the hedge effectiveness. Data points in the regression could be based on historical differences in FV changes spanning over more periods. In such a case the regression method could also be viewed to be set up on a cumulative basis. But the reset to zero requirement does not generally fit to the regression analysis logic.

There are clear benefits in applying the regression analysis over the dollar offset method. However, with the proposed requirement entities which would like to continue using the regression analysis retrospective effectiveness assessment method could be challenged.

In our view, the issue of potential negative impacts on entities assessing the effectiveness by other techniques than the dollar could be solved in the following way. The requirement in paragraph 102S of IAS 39 of resetting the cumulative fair value changes to zero:

- could be made optional; and/or

- it could be clarified that it is applicable for entities using the cumulative dollar offset method.

In this regard, we would also like to point to paragraph 49 of the DCL which provides arguments why it makes sense to change the method for assessing hedge effectiveness, as proposed in the ED (IFRS 9.6.9.7(c) and IAS 39.102O(d)). It mentions the regression analysis as an example for the change because the available historical information for the alternative benchmark rate might not be sufficient to perform the analysis.

However, the issue of mixed data combining the old and new benchmark rates until sufficient data series for the new benchmark rate environment develop could be addressed in practice. For example, the data reflecting the old benchmark rates could be reconstructed by adjusting the old benchmark curves for the spread between the old and new benchmark rates. As a result, we would appreciate if the regression analysis was not used as an example where the change in the effectiveness method may be necessary. Otherwise the paragraph could lead to unnecessary questions towards entities which will continue using the regression.

Question to constituents raised by EFRAG

92 Do you have concerns about the level of details required in paragraph 24J(b) of IFRS 7? Can this disclosures be prepared without undue costs and efforts, considering the timeline of these Amendments?

Answer: The required information about the carrying amount of non-derivative financial asset, non-derivative financial liabilities and the nominal amount of derivatives, disaggregated by significant interest rate benchmark, that continue to reference interest rate benchmarks subject to the reform would be feasible to prepare by our bank. This data is tracked as part of Erste Group IBOR reform project.

If you have any questions to our comments please do not hesitate to contact Martin Svitek martin.svitek@erstegroup.com or me.

Yours sincerely,

Manfred Schmid
Head of Group Accounting and Group Controlling