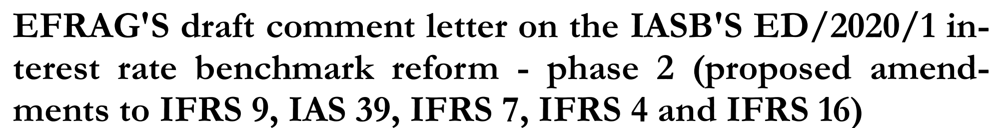
POSITION PAPER



EFRAG'S draft comment letter on the IASB'S ED/2020/1 interest rate benchmark reform - phase 2 (proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)

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ESBG

ESBG welcomes the opportunity to comment on this topic. This letter sets out the most critical issues identified by interested stakeholders involved in ESBG's due process.

ESBG welcomes the proposed draft comment letter. We are of the opinion that it contributes to provide relevant and useful information about financial instruments and hedging transactions presented in the financial statements by avoiding unexpected accounting consequences that the IBOR reform could have caused under the current standards.

When saying this, we would also like to note that we have suggestions for a few important improvements which are discussed more in detail in our answers.

APPENDIX - EFRAG's responses to the questions raised in the ED
Question 1: (paragraphs 6.9.1–6.9.6 of the [Draft] amendments to IFRS 9, paragraphs 20R–20S and 50–51 of the [Draft] amendments to IFRS 4 and paragraphs 104–106 and C1A–C1B of the [Draft] amendments to IFRS 16)

ESBG Answer: We agree with the decision to limit the scope of the amendment to the modifications requested by the IBOR reform. We agree with the EFRAG response as it appears to be a pragmatic solution to the issues raised by any modifications related to the IBOR reform.

However, we would like to highlight an important issue related to the classification and measurement part of the ED which is not part of the questions asked by the IASB. 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 rate as the new reference rate which 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, it 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.

Question 2: Amendments to hedging relationships (paragraphs 6.9.7–6.9.10 of the [Draft] amendments to IFRS 9 and paragraphs 102O–102R of the [Draft] amendments to IAS 39)

ESBG Answer: The proposed amendments will avoid discontinuing hedging relationships when the hedged items and hedging instruments are modified and the related hedging documentation is amended accordingly due to the sole IBOR reform. We therefore agree with the proposed EFRAG answer to the amendments to IFRS 9 and IAS 39 as it provides an adequate solution and useful information.

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]

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 a 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 the differences between alternative benchmark rates used for the hedging instrument and the hedged item arising directly as a result of the reform.

[1] The 6-month 'in advance' SARON rate mentioned in the answer to question 1 would also be calculated on this basis.

Question 3: Accounting for qualifying hedging relationships and groups of items (paragraphs 6.9.11–6.9.15 of the [Draft] amendments to IFRS 9 and paragraphs 102S–102X of the [Draft] amendments to IAS 39)

ESBG Answer: We agree with the proposed amendments in relation to hedges of groups of items and portfolio hedges because these amendments are consistent with the objective to continue hedging relationships when transitioning from IBOR to an alternative benchmark rate. We also agree that the effects of the benchmark rate replacements should be included in the measurement of the hedging instrument and the hedged item and should affect hedge ineffectiveness recognition since this captures the actual economic effects of the reform. Further, we share the view that for discontinued hedges the cash flow hedge reserve would be reclassified to profit or loss in the same period during which the originally hedged cash flows based on the alternative benchmark rate affect profit or loss. This would avoid unnecessary one-off reclassifications.

However, we consider that the paragraph IAS 39.102S of the ED is a candidate for an improvement. It proposes that for the purpose of assessing the retrospective 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.[2]

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.

Question 4: Designation of risk components and portions (paragraphs 6.9.16–6.9.18 of the [Draft] amendments to IFRS 9 and paragraphs 102Y–102Z1 of the [Draft] amendments to IAS 39)

[2] It might be argued that the regression is not suitable after the benchmark rates are replaced until sufficient data series reflecting the new benchmark rate environment exist. However, the issue of mixed data combining the old and new benchmark rates 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.

ESBG Answer: We agree with the proposal to provide a relief on the separately identifiable criterion and with the EFRAG response.

Question 5: Effective date and transition (paragraphs 7.1.9 and 7.2.36–7.2.38 of the [Draft] amendments to IFRS 9 and paragraphs 108H–108J of the [Draft] amendments to IAS 39)

ESBG Answer: We agree with the IASB's proposal on effective date and transition requirements. We agree that the proposed amendments should be mandatory in order to increase comparability across entities. We agree that no specific end of application requirements need to be specified, because this allows application of the proposed amendments under the different transition paths of the IBOR reforms.

Question 6: Disclosures (paragraphs 24I–24J and paragraphs 44HH–44II of [Draft] amendments to IFRS 7 Financial Instruments - Disclosures)

ESBG Answer: In the light of an overall analysis of their cost/benefit trade-off, the extent and relevance of the proposed disclosures constitute a concern as some of them may appear of little interest to users while exceedingly difficult to provide, especially as the requested information may not be available in the accounting systems. Therefore, we would be in favour of amending those requirements to strike a more balanced cost/benefit equilibrium. We share the same observation that the proposed disclosures in paragraph 24J(c) of IFRS 7 may be less helpful to users of financial statements because the disclosures are expected to be less entity specific. We support the comment the IASB should consider a cross-reference to the risk disclosures section of IFRS 7 as new disclosure requirements refer not only to hedge accounting.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.

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