ICAEW
REPRESENTATION 27/20

INTEREST RATE BENCHMARK REFORM—PHASE 2: PROPOSED AMENDMENTS TO IFRS 9, IAS 39, IFRS 7, IFRS 4 AND IFRS 16

Issued 22 May 2020

ICAEW welcomes the opportunity to comment on ED/2020/1 Interest Rate Benchmark Reform—Phase 2: Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 published by the IASB in April 2020, a copy of which is available from this link.

We support the objectives of Phase 2 to assist entities with providing useful information to users of financial statements and to support preparers in applying IFRS Standards when changes are made to contractual cash flows or hedging relationships, as a result of the transition to alternative benchmark rates. We agree with the IASB that it remains important to finalise and issue the amendments on a timely basis.

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KEY POINTS

SUPPORT FOR THE PROPOSALS

1. We strongly supported the IASB adding to its agenda as a priority the accounting issues arising from the effects of interest rate benchmark reform on an entity's financial statements. We continue to support the objective of Phase 2 to assist entities with providing useful information to users of financial statements and to support preparers in applying IFRS Standards when changes are made to contractual cash flows or hedging relationships, as a result of the transition to alternative benchmark rates. IAS 39 and IFRS 9 were not drafted with these changes in mind and amendments are required to the standards so that these objectives can continue to be achieved. We agree with the IASB that it remains important to finalise and issue the amendments on a timely basis.

2. We note that the IASB decided to limit their interpretation of what constitutes a 'modification' of a financial asset or liability to the circumstances of the interest rate benchmark reform. We believe that it is unnecessary to make such an interpretation in order to achieve the objective of the amendments. A simpler way of getting to the same conclusion would be by applying the practical exemption to all financial assets and financial liabilities that are modified, or have changes in the basis for determining their contractual cash flows, as a result of benchmark reform, so paragraph 6.9.2 is not necessary. Nevertheless, we support the IASB in getting these amendments completed on a timely basis. Any decision to revisit the definition of a modification should be part of a separate project.

ANSWERS TO SPECIFIC QUESTIONS

Question 1: Modifications of financial assets and financial liabilities (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)

Paragraphs 6.9.2–6.9.6 of the draft amendments to IFRS 9 propose that:

(a) a financial asset or financial liability would be modified if the basis for determining the contractual cash flows is changed after the initial recognition of the financial instrument. In this context, a modification can arise even if the contractual terms of the financial instrument are not amended.

(b) an entity would apply paragraph B5.4.5 of IFRS 9 as a practical expedient to account for a modification of a financial asset or financial liability that is required by interest rate benchmark reform.

(c) a modification is required by interest rate benchmark reform if and only if
   - ***(i) it is required as a direct consequence of interest rate benchmark reform; and***
   - ***(ii) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the modification).***

(d) an entity would also apply the practical expedient proposed in paragraph 6.9.3 if an existing contractual term is activated that results in a change in the basis for determining the contractual cash flows of a financial asset or a financial liability, and particular other conditions are met.

Paragraphs BC10–BC36 of the Basis for Conclusions describe the Board's reasons for these proposals.

(e) The Exposure Draft proposes to make corresponding amendments to IFRS 4 that would require insurers applying the temporary exemption from IFRS 9 to apply the same practical expedient as described above.

(f) The Exposure Draft proposes amendments to IFRS 16 that would require entities to apply paragraph 42 of IFRS 16 to account for a lease modification that is required by interest rate benchmark reform.

Paragraphs BC39–BC41 and paragraphs BC118–BC125 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

3. We note that the IASB decided to limit their interpretation of what constitutes a 'modification' of a financial asset or liability to the circumstances of the interest rate benchmark reform. We believe that it is unnecessary to make such an interpretation in order to achieve the objective of the amendments. A simpler way of getting to the same conclusion would be by applying the practical exemption to all financial assets and financial liabilities that are modified, or have changes in the basis for determining their contractual cash flows, as a result of benchmark reform, so paragraph 6.9.2 is not necessary. Nevertheless, we support the IASB in getting these amendments completed on a timely basis. Any decision to revisit the definition of a modification should be part of a separate project.

4. We note that BC16 states that there could be a diversity of application in practice with regard to determining whether a modification of a financial asset or liability has occurred. We believe that market practice is consistent on this issue, where entities require a change in contractual terms before a modification assessment is made. We do not, therefore, believe that this matter requires a separate narrow-scope amendment to the requirements in IFRS 9 for all modifications as suggested in BC20.

5. If retained, we understand paragraph 6.9.2 would also apply to references to IBOR which have been imputed for accounting purposes. For example, a floating rate instrument (eg, a constant maturity swap bond) may have had the embedded derivative separated from the hybrid with an IBOR leg imputed into the host contract and the embedded derivative. At some point, this reference to IBOR will need to be changed in order to continue to account for the host and the embedded derivate using an available floating rate. While there is no contractual change because the IBOR leg is imputed, a change to the interest rate is required. As this change is related to the reform, we believe it can be accounted for using the practical expedient outlined in the ED.

6. It is possible that not all historical fallback terms will have been amended before transition takes place and that, as a consequence, these historical fallbacks will not qualify for the practical expedient if the new cash flows are not considered to be economically equivalent. If the practical expedient is not available, a modification gain or loss would be recognised. We think that the practical expedient ought to be extended to address situations where the use of the fallback will be temporary.

7. We assume that the amendment to IFRS 16 *Leases* results in any changes to future lease payments as a result of a change to a risk free rate (RFR) being treated as a one off change in the lease liability and ROU asset, calculated using a revised discount rate, if that is necessary to reflect changes in the floating interest rate. It would be helpful to include a worked example to ensure the expected accounting can be clearly understood.

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)

Paragraphs 6.9.7–6.9.10 of the draft amendments to IFRS 9 and paragraphs 102O–102R of the draft amendment to IAS 39 propose that an entity would amend the formal designation of the hedging relationship only to make one or more of the changes specified in paragraph 6.9.7 and paragraph 102O as and when uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and/or the timing and the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument.

Paragraphs BC42–BC50 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

8. While we agree with the proposal, we suggest that the scope of acceptable changes for the hedged item in paragraph 6.9.7 (b) should be wider in order to address all situations where the description of the hedged item needs to be amended as a direct consequence of the reform. Hedged items may be described in different ways in existing hedge documentation so consequential amendments, in addition to changing the reference to the interest rate, may be needed. The drafting could be as follows: 'amending the description of the hedged item so that it refers to an alternative benchmark <u>together with other amendments to the description of the hedged item that are required by the reform</u>'.

9. Central clearing houses may facilitate the transition to RFR using mechanisms that result in the termination and replacement of trades on an economically equivalent basis. It is unclear whether the amendments would allow a hedging relationship to continue in these circumstances. It would be helpful if the amendments were clear that the termination and replacement of trades with a central clearing house on an economically equivalent basis were treated for hedge accounting purposes as if the contracts were modified ie, the amendments should address this circumstance.

10. We note that a literal interpretation of the proposal to only change hedge documentation when uncertainty ends might result in severe operational challenges. When uncertainty ends there could be an unusually large volume of changes to prepare for over a relatively short time period, and the application of the proposals would be more practicable if a reasonable period of time was allowed to make operational changes and changes to hedge documentation.

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)

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 propose that:

(a) the requirements in IFRS 9 and IAS 39 would be applied when the designation of a hedging relationship is amended to remeasure the hedging instrument and the hedged item based on the alternative benchmark rate and recognise any resulting ineffectiveness in profit or loss.

(b) the amount accumulated in the cash flow hedge reserve at the date the entity amends the description of the hedged item would be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

(c) When there is a change in the basis for determining the contractual cash flows of a financial asset or a financial liability previously designated as a hedged item in a hedging relationship that has been discontinued, the amount accumulated in the cash flow hedge reserve for the discontinued hedging relationship would be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

(d) when applying paragraph 6.9.7 or paragraph 102O to groups of items designated as hedged items, the hedged items would be allocated to sub-groups within the same hedging relationship based on the benchmark rate to which they are referenced and that the proportionality test would be applied to each sub-group separately.

(e) for the purpose of assessing retrospective effectiveness as required by IAS 39, the cumulative fair value changes of the hedged item and hedging instrument would be reset to zero when paragraph 102G of IAS 39 ceases to apply.

Paragraphs BC51–BC79 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

11. While we agree with the proposals, we are concerned with the proposed wording in paragraph 102S of IAS 39. Paragraph 102S requires entities to reset cumulative changes in fair value to zero, which may unintentionally cause hedge accounting relationships to fail if there is market volatility during the initial period following the reset, as this precludes an entity from using data prior to the reset date even if this shows that the hedge accounting relationship is effective over a longer time horizon. We suggest that the proposed wording is amended to permit, but not require, entities to reset cumulative effectiveness, which would allow entities to continue to use a longer time frame where appropriate.

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)

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 propose that:

(a) an* alternative *benchmark rate designated as a non-contractually specified risk component that is not separately identifiable at the date it is designated, would be deemed to have met that requirement at that date, if and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within a period of 24 months from the date the alternative benchmark rate is designated as a risk component.

(b) if subsequently, an entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months from the date it was designated as a risk component, an entity would cease applying the requirement in paragraph 6.9.16 and paragraph 102Y and discontinue hedge accounting prospectively from the date of that reassessment.

Paragraphs BC87–BC97 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

12. We agree with most of the proposal. However, we are concerned with the proposed wording in BC87 which seems to create a higher threshold for users of IAS 39 than we believe is currently in the standard. The wording seems to suggest that an available term structure of zero coupon interest rates is required for a benchmark to be considered separately identifiable. This is not stated in IAS 39, and is not aligned to the clear market practice that has developed where rates such as OIS are universally accepted to be separately identifiable risk components, despite there being no market for floating rate products referencing OIS. We suggest that if generally accepted market practice deems a rate to be risk free, then it should be available to be designated as a separately identifiable risk component, as a rate so defined would necessarily be considered a building block of any contractually specified rate in that currency.

13. We also question whether 24 months is sufficient for markets to develop sufficiently, particularly now in light of the Covid-19 pandemic. It would be an unfortunate and unhelpful outcome if the IASB and its constituents were required to spend additional time, at a later date, developing and issuing a further amendment just to extend this deadline.

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)

(a) The Exposure Draft proposes that the amendments would have an effective date of annual periods beginning on or after 1 January 2021. Earlier application would be permitted.

(b) The Exposure Draft proposes that the amendments would be applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, except as specified in (ii) below. An entity would:

(i) reinstate a discontinued hedging relationship if and only if the entity discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and, therefore, the entity would not have been required to discontinue that hedging relationship if the amendments had been applied at that time.

(ii) not be required to restate prior periods to reflect the application of these amendments. However, the entity may restate prior periods if, and only if, it is possible without the use of hindsight.

Paragraphs BC110–BC115 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

14. We agree with the proposals, except for those requiring the reinstatement of discontinued hedge accounting relationships that have failed solely due to the impact of IBOR reform. The

wording of the requirements is not entirely clear, but it could be read as requiring reinstatement even where the hedging instrument has been terminated, managed within a trading mandate or has been designated in a new hedge accounting relationship. There seems little point in reinstating a new hedge relationship having applied the requirements in the ED to, for example, change hedge documentation, if the hedge will immediately be discontinued because the hedging instrument no longer exists.

15. Similarly, if the hedging instrument has been used in a new hedge relationship there seems little point in reinstating an old hedge relationship and causing the new relationship to fail. If the derivative has been moved to the trading book, restating the trading position does not seem to provide users with appropriate information. We suggest that paragraphs 108I of IAS39 and.7.2.37 of IFRS 9 be updated to clarify when reinstatement could apply and permit but not require reinstatement of hedge accounting relationships in these circumstances. Such an option should be set out as all hedge accounting relationships must be reinstated or none are reinstated.

16. In addition, the wording of the requirement could be amended to say that where a LIBOR hedge is amended to reflect the changes noted in para 6.9.4, resulting in discontinuation of the original hedge and the start of a new hedge, retrospective application may be applied to treat such hedges as continuing hedges. Such retrospective application should be applied to all such hedges.

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

The Exposure Draft proposes that entities provide specific disclosures in order to provide information about:

(a) the nature and extent of risks arising from interest rate benchmark reform to which the entity is exposed, and how it manages those risks; and

(b) the entity's progress in completing the transition from interest rate benchmarks to alternative benchmark rates, and how the entity is managing that transition.

Paragraphs BC105–BC109 of the Basis for Conclusions describe the Board's reasons for this proposal.

Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you propose and why.

17. While we agree with the proposals, we recommend that comparative information should not be required for the disclosures in 24J(b) on initial adoption of the amendments. Such comparative information is of less value in the context of the ongoing benchmark reform and its collection for prior periods would be onerous, particularly where early adoption is desired.

18. We also note that paragraph 24J(c) of IFRS 7 is likely to only elicit boilerplate disclosure, particularly where changes to contracts are made under market-wide, arms' length terms.

Additional drafting suggestions

19. We support the change proposed in IAS 39 102M to reflect that relief should apply at the hedging relationship level. In addition, we note that in BC86, the IASB proposes to clarify the end of relief for the Phase 1 exception from the separately identifiable requirement as set out in IAS 39 102H and IFRS 9 6.8.7. We agree with the proposals, however suggest that this is incorporated in the main body of the accounting standard, rather than within the Basis for Conclusions.