ICAEW
REPRESENTATION 66/19

INTEREST RATE BENCHMARK REFORM

Issued 17 June 2019

ICAEW welcomes the opportunity to comment on the *Interest Rate Benchmark Reform – Proposed amendments to IFRS 9 and IAS 39* published by IASB in May 2019, a copy of which is available from this link.

ICAEW welcomes the proposed amendments to IFRS 9 *Financial instruments* and IAS 39 *Financial Instruments: Recognition and Measurement.* We believe it is important for these amendments to be put in place on a timely basis to avoid the adverse consequences of hedge accounting being discontinued or prevented as a result only of the uncertainties arising from the interest rate benchmark reform (pre-replacement issues). We are also strongly of the view that further standard setting activity is urgently required to address replacement issues arising from interest-rate benchmark reform.

This response of 17 June 2019 has been prepared by the ICAEW Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

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KEY POINTS

SUPPORT FOR THE PROPOSALS

1. ICAEW welcomes the proposed amendments to IFRS 9 *Financial instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* which aim to address certain of the financial reporting issues that might arise in the period before the replacement of an existing interest rate benchmark with an alternative interest rate (pre-replacement issues).
2. While we broadly support the proposals we have identified some areas where further consideration and/or clarification would be helpful. Where we believe this involves changes or additions to the proposals in the exposure draft to ensure that they operate as intended, we have included comments in the answers to the specific questions. Where there are further issues which need to be considered to facilitate a smooth transition in the market to the alternative interest rates, these are included in the appendix.

OVERALL APPROACH

3. While we understand hedge accounting is not in itself principles-based, if it were possible to address the financial reporting issues which arise from the whole replacement process in a manner that resulted in interpretations of the existing standards, this would not involve as much standard setting activity and therefore less time pressure on all those involved. It might also have been an approach better aligned to that of the Financial Accounting Standards Board (FASB). If such an approach is no longer possible, then these amendments need to be finalised on a timely basis and the replacement issues also need to be addressed expeditiously.
4. Notwithstanding the comment in BC3 that the IASB has not considered whether and how to address replacement issues, we are strongly of the view that consideration of the further issues is urgently required. We suggest that the IASB should reconsider their approach as they work on the replacement issues. Given the complexity of the issues, the different approach in different jurisdictions to amending rates and contracts and the different hedge accounting practices, it may not be possible to predict and cater for all such issues in advance. The existing standards cannot be expected to address these unique issues. IASB will need to consider how best to mitigate the risk of inappropriate and inconsistent accounting arising as a result of unintended consequences from applying standards to these unique situations. Clear objectives for this further standard setting activity could be helpful in mitigating some of the risk.
5. Setting out a clear objective in this set of amendments could also help in applying the proposed reliefs to specific fact patterns which are not specifically addressed at this stage or issues that arise before the next phase is in place.

TIMING AND ADDITIONAL ISSUES TO BE ADDRESSED

6. We agree with the proposed timescale for introducing the amendments outlined in the exposure draft. Indeed, we believe it is important for the amendments to be put in place on a timely basis to avoid the adverse consequences of hedge accounting being discontinued or prevented as a result only of the uncertainties arising from the interest rate benchmark reform. Indeed, if these amendments were to be delayed, it is possible that divergence could arise with some entities deciding to discontinue hedge accounting, which would otherwise have been preserved by the mandatory application of the amendments. Since hedge accounting is often based on forward looking views, we agree that developing proposals to deal with pre-replacement issues, as discussed in the exposure draft, is the immediate priority.

7. However, in our view, many of the other issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative rate (replacement issues) are equally pressing. Although occurring at different speeds, in each jurisdiction greater clarity is developing as to how the changes to contractual terms will operate, deep and liquid markets will develop for the new risk free rates (RFR) and interbank offer rate (IBOR) market activity will reduce before the old rates are no longer provided. As a result, risk management strategies will need to be able to gradually transition to the new RFR in support of the developments in the business. In the absence of addressing these unique issues where accounting consequences are uncertain or seem inappropriate, entities may be put in the position of having to take the steps necessary for the new RFR markets to continue to develop in the absence of an understanding of the accounting implications, which could result in the adverse accounting consequences which this exposure draft seeks to avoid. In some jurisdictions, such as the UK and the US, these developments are happening more quickly than in others. Therefore, without leading to any delay in the finalisation of the proposals outlined in the exposure draft, we believe the IASB should also develop additional proposals to deal with these replacement issues to ensure financial reporting meets its objectives during this period. Issues that will need to be addressed are set out in the appendix to this letter.
8. We note that the FASB is considering the effect of the interest rate reform on US GAAP. While IFRS is not identical, there are similarities and often similar approaches and interpretations are applied. It might be helpful for the IASB to track the FASB’s work in this area to maintain alignment where possible, which would benefit both preparers and users of the financial statements.

ANSWERS TO SPECIFIC QUESTIONS

Question 1: Highly probable requirement and prospective assessments

For hedges of interest rate risk that are affected by interest rate benchmark reform, the Board proposes amendments to IFRS 9 and IAS 39 as described below.

(a) For the reasons set out in paragraphs BC8–BC15, the Board proposes exceptions for determining whether a forecast transaction is highly probable or whether it is no longer expected to occur. Specifically, the Exposure Draft proposes that an entity would apply those requirements assuming that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of interest rate benchmark reform.

(b) For the reasons set out in paragraphs BC16–BC23, the Board proposes exceptions to the hedge accounting requirements in IFRS 9 and IAS 39 so that an entity would assume that the interest rate benchmark on which the hedged cash flows are based, and/or the interest rate benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of interest rate benchmark reform when the entity determines whether:

(i) there is an economic relationship between the hedged item and the hedging instrument applying IFRS 9; or
(ii) the hedge is expected to be highly effective in achieving offsetting applying IAS 39.

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 instead and why.

9. Yes**,** we broadly agree with the proposals but set out some additional points below.

Basis of Conclusions

10. We note that the Basis for Conclusions seems to envisage a process where changes to contractual terms will be made at some future point and that the possibility of such changes can be assumed not to exist. This is in contrast to the actual text of the amendments which requires the entity to assume that the interest rate benchmark is not (yet) altered as a result of its reform. In the text in the amendment, the assumption of no change can be made whether or not the contractual terms of the instruments have actually been changed to facilitate transition by incorporating the new interest rate benchmark, provided the uncertainty as to the timing and amount of interest rate benchmark-based cash flows resulting from the change remains. However, the Basis of Conclusions explains that, in assessing whether hedged cash flows are highly probable, 'the entity would assume that no amendments will be made…to the hedged item's contractual terms.' It may well be the case that changes have in fact been made to contracts but uncertainty remains regarding the timing and the amount of interest rate benchmark-based cash flows so the exceptions remain applicable. Although this is acknowledged in the discussion of the end of application, it would be desirable for the language in the Basis for Conclusions to better support the text in the standard in this respect.

11. In addition, we note that BC23 seems to provide guidance on how to apply the 'retrospective assessments' required by IAS 39. This suggests that cash flows would be determined based on contractual terms, ignoring the effect of any changes to contractual terms which remain uncertain, and market inputs. Therefore, the fair values of the hedged items and the hedging instruments would not reflect contractual changes which have uncertain impacts. This may not be entirely consistent with IFRS 13 requirements. It would be helpful if the impacts of contractual uncertainty on measurement and therefore on the 80-125% effectiveness threshold could be made explicitly in the standard and not just in the Basis for Conclusions. For both new and existing hedges, with respect to IAS 39, if there is a difference in timing between when changes are made to the hedged item and the hedging instrument with respect to the transition from IBOR to RFRs, the 80-125% effectiveness threshold could be breached causing hedge accounting to fail. Relief may be needed to facilitate hedge accounting in these circumstances, such as a temporary disapplication of the 80-125% test. We note that the ineffectiveness as a result of the timing difference could be determined by performing the calculations with and without the change as a result of the interest rate reform so can be readily excluded from considering whether the threshold has otherwise been breached.

Designation of groups of items as hedged items

12. With a few exceptions, the exposure draft addresses the main adverse consequences to hedge accounting that may occur before new contractual terms come into force. However, what seems to be missing from the exposure draft is addressing the implications of the hedged item being a pool of items. For example, IAS 39 paragraph 83, which permits the designation of groups of items as hedged items where the individual assets or liabilities in the group share the risk exposure that is designated as being hedged and the change in fair value attributable to the hedged risk for each individual item is expected to be approximately proportional to the overall change in fair value attributed to the hedged risk of the group of items. It may be necessary to provide relief for the proportionality test since various items in the pool may exhibit potentially different behaviour in the run-up to transition, depending on when and how their contractual terms are changed and when the changes come into force. In addition, it would be helpful to have greater clarity for determining the end of relief for

pools of items. While this may presumably be when there is no longer uncertainty attached to any of the items in the pool, this could be made explicit in the exposure draft.

Other

13. In addition, the wording of the amendment could be improved to refer to all hedge accounting relationships which are affected by interest rate benchmark reform; for example for hedge accounting relationships designated for multiple risks, including interest rate risk as just one of the risks. Consideration should be given as to whether paragraph 102F is sufficient or whether, for the purposes of applying IAS 39 paragraph AG105(a) reference should also be made to assuming that the hedged risk is unchanged as a result of interest rate benchmark reform with consequential amendments to IAS 39 paragraph 102J. Paragraphs 6.8.8, 102F and BC11 could also benefit from a reference to fair values as well as cash flows, which would remove doubts over whether the proposed amendments apply to both fair value hedge accounting and cash flow hedge accounting. In the absence of these additions, there could be hedge accounting arrangements which are inadvertently omitted from the scope of the relief. For example, hedges involving cross currency swaps, inflation swaps and hedges of all the interest cash flows where the hedged risk is the benchmark interest rate.

Question 2: Designating a component of an item as the hedged item

For the reasons set out in paragraphs BC24–BC27, the Board proposes amendments to the hedge accounting requirements in IFRS 9 and IAS 39 for hedges of the benchmark component of interest rate risk that is not contractually specified and that is affected by interest rate benchmark reform. Specifically, for such hedges, the Exposure Draft proposes that an entity applies the requirement—that the designated risk component or designated portion is separately identifiable—only at the inception of the hedging relationship.

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

14. Yes, but it would be helpful to clarify that the relief is available for new hedging relationships, for IBOR risk identified at the inception of the relationship, as well as for existing hedges. In addition, consideration should be given to re-designation for entities that operate the macro cash flow hedge accounting and fair value hedge accounting models under IAS 39 and frequently de-designate and re-designate hedges but maintain the same underlying portfolio as the hedged item. Additional temporary relief may be needed for dynamic macro hedges, so that, while uncertainty remains, the re-designation of IBOR related new hedges satisfies the IAS 39 separately identifiable requirement, where the hedges are entered into as part of a macro hedge accounting model.

Question 3: Mandatory application and end of application

(a) For the reasons set out in paragraphs BC28–BC31, the Board proposes that the exceptions are mandatory. As a result, entities would be required to apply the proposed exceptions to all hedging relationships that are affected by interest rate benchmark reform.

(b) For the reasons set out in paragraphs BC32–BC42, the Board proposes that the exceptions would apply for a limited period. Specifically, an entity would prospectively cease applying the proposed amendments at the earlier of:

(i) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows; and

(ii) when the hedging relationship is discontinued, or if paragraph 6.8.9 of IFRS 9 or paragraph 102I of IAS 39 applies, when the entire amount accumulated in the

> ***cash flow hedge reserve with respect to that hedging relationship is reclassified to profit or loss.***

(c) For the reasons set out in paragraph BC43, the Board is not proposing an end of application in relation to the separate identification requirement.

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 instead and why.

15. Yes, but we note that the question appears to be more restrictive than the proposed wording in the exposure draft. We agree with the exposure draft, which applies the uncertainty notion to both the hedging instrument and the hedged item. In addition, it would be helpful to clarify that the uncertainty notion would continue to apply when the replacement rate has been identified but that the spread over the replacement rate has not yet been determined. That is, the relief continues until the RFR is effective. To this end, paragraph BC35 should be amended.
16. It would also be helpful if the example was clarified to relate to the more common situation where the hedging instrument will be amended in advance of the hedged item. This could help illustrate that the relief is not intended to apply to the hedge relationship as a whole but to the components separately.
17. We also note that the illustrative examples in BC35-39 assume that contractual amendments to the hedged item is the point at which the relief ends for that component. However, there may be no contractual amendments needed for forecast transactions in fixed rate issuances. Consideration will need to be given to when the relief should end in this situation.

Question 4 – Disclosures

For the reasons set out in paragraph BC44, the Board proposes that entities provide specific disclosures about the extent to which their hedging relationships are affected by the proposed amendments.

Do you agree with these proposed disclosures? Why or why not? If not, what disclosures would you propose instead and why?

18. We consider that entities should provide qualitative disclosure on their risk management strategies to manage the transition to the new benchmark interest rates. This would be addressed by existing risk disclosure requirements so would not require additional standard setting activity. Otherwise, we question the benefit of requiring additional disclosure and their alignment to the objective of the amendments. The objective of the amendments is to preserve hedge accounting in this period of uncertainty when the IASB has determined that discontinuation of hedge accounting in these circumstances would not provide useful information to users of financial statements. Disclosure could be further considered when the replacement issues are addressed.

Question 5 - Effective date and transition

For the reasons set out in paragraphs BC45–BC47, the Board proposes that the amendments would have an effective date of annual periods beginning on or after 1 January 2020. Earlier application would be permitted. The Board proposes that the amendments would be applied retrospectively. No specific transition provisions are proposed.

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

19. Yes, we agree with the proposed effective date and transition arrangements. It is not entirely straight forward to refer to amendments being applied retrospectively for hedge accounting, particularly as hedges that were previously discontinued that would have been preserved by the amendments cannot be reinstated. We question whether reinstatement should in fact be required, although we acknowledge that this is not ideal. The relief should therefore be applicable to all hedge relationships in existence at the date of initial application of the relief, as well as for all new hedge accounting relationships subsequent to the application of the relief. It would be preferable to ensure that the proposals are finalised on a timely basis so that they can be applied immediately.

20. We assume that IAS 8.28(f) would not be applicable since there is no ‘adjustment’ as a result of applying the amendments in either the current or prior periods. If that is not the case, it would be necessary to provide relief for this disclosure requirement to avoid entities having to determine the effect of discontinuing hedge accounting just for disclosure.

21. The appendix to this letter sets out some additional areas where we believe further consideration is needed to ensure a smooth transition.

APPENDIX

The following issues need to be addressed by the IASB, preferably at the same time as finalising the ED:

Issues resulting from changes in contractual terms and new contractual terms

22. Changes to contractual terms are currently being contemplated and new instruments referring to the new RFRs are being issued. Therefore, there are issues arising at present. A distinction between pre and post transition is unclear and perhaps unhelpful. Particularly where the effect of new contractual terms is uncertain when they are included in the contracts before the new RFRs are sufficiently developed and used in practice. Given the number of questions which arise, we disagree with the assertion in BC4 that IFRS 9 and IAS 39 provide a clear basis to account for these uncertainties.

23. The insertion of permanent fall back arrangements to facilitate transition into contracts may result in no immediate change to the expected cash flows since these arrangements are not yet in force. It may also be difficult to anticipate how the arrangements will operate until they come into force. Permanent fall back arrangements may contain several variables such as:

    - The trigger for the alternative benchmark rate coming into force, which could be a stated discontinuance event, a determination by certain participants or agents or sufficient new instruments being issued using the alternative benchmark.
    - The replacement reference rate, which could be a rate agreed between the participants, or based on a waterfall of options ranging from a new term rate, a compound rate, an overnight rate, or a rate agreed between the participants.
    - Whether or not negative, affirmative or any consent is required.

24. Nevertheless, contractual terms have been modified which would require consideration as to whether the financial asset or liability should be derecognised and a new instrument recognised in accordance with section 3.2 or 3.3 of IFRS 9. It may not be clear how and when the cash flows will be changed as a result of the modification, making a quantitative test difficult. If the modification is limited to facilitating the alternative benchmark rate and therefore is not intended to transfer value, it may be possible to conclude that there is not a substantial modification. It would be helpful for the IASB to confirm this is the case, which would not only reduce operational burden in trying to assess the effect of the contractual modification before there is sufficient certainty but help preserve hedge accounting in circumstances where the exposure draft would already operate to do so.

25. If the instrument is not derecognised, and the modification is assessed in accordance with IFRS 9 5.4.3, then it may also be difficult to calculate a modification gain or loss since the amount and timing of the modified contractual cash flows is uncertain. The modification gain or loss could become sufficiently certain to be measureable sometime after the contractual modification. Similarly, if it were necessary to apply IFRS 9 B5.4.6 (AG8), in theory, any modification gain or loss in accordance with paragraph 5.4.3 has already been recognised so revised estimates of payments or receipts could change the carrying amount of the financial instrument by discounting the revised estimated contractual cash flows at the original effective interest rate. Such a calculation could take place every period as better estimates of the cash flows become available. This may not provide useful information for instruments otherwise recognised at amortised cost until the uncertainty is resolved and transition takes place. This would also not result in useful information if the original effective interest rate (EIR) relates to LIBOR, since LIBOR would be replaced, meaning that the original EIR doesn't exist anymore. For floating-rate financial instruments it is unclear whether IFRS 9 B5.4.5 (AG7) is relevant or how it would be applied when there is a fundamental change in the basis for determining the floating rate, especially when the new rate becomes certain. It

would result in more reliable and useful information if IFRS 9 B5.4.5 (AG7) is considered the correct approach.

26. In addition, changes to certain benchmark interest rates may not require explicit contractual changes. For example, the EONIA calculation methodology will change on 2 Oct 2019 from its current approach to ESTR plus fixed spread, but will still be called EONIA. If this is accompanied without changes to contractual terms does this mean that the change in calculation methodology has no accounting consequences, even though it may change the economics of the contract? Or should it result in a de-recognition assessment of underlying financial instruments referencing EONIA due to potentially significant changes in expected cash flows or the application of IFRS 9 B5.4.6 since there could be a revision to the estimated contractual cash flows? In the absence of further guidance from the IASB, entities will need to reach their own judgement in these circumstances. It would then seem anomalous for different accounting outcomes to result, depending on the mechanics of the transition to RFRs and individual judgements applied.

27. New instruments are currently being contemplated which refer to cash flows based on overnight risk free rates (either compounded daily or averaged over the coupon period) at periodic intervals other than daily (e.g. monthly, quarterly, semi-annually, etc). It is unclear whether such contractual terms provide consideration for the time value of money or are modified in a way that does not meet the solely payments of principal and interest requirements of IFRS 9 B4.1.9B. This may be particularly problematic since the new risk free rate may be the only rate available, making it difficult to determine the ‘benchmark cash flows’ in accordance with IFRS 9 B4.1.9C. Similarly, if such terms are included in the permanent fall back provisions of a modified contract, would this cause the contract to fail SPPI when the clause is inserted? For financial liabilities, similar questions arise as to whether such contractual terms could constitute an embedded derivative.

Facilitating hedge accounting during transition

28. The exposure draft is limited to maintaining current hedge accounting during the period of uncertainty. However, to fully facilitate the market transition to the new rates, the impact of the change on overall hedging strategies will need to be thought through, together with how such strategies should be reflected in the financial statements. The application of accounting standards needs to be adapted to this unique situation and must facilitate the transition to RFR as required by regulators. Uncertainty in the accounting implications of making necessary changes to the business should be avoided or reduced to the extent possible. In the absence of providing a route for continuity of hedge accounting during this period, hedge accounting would stop when the relief ends and new hedge relationships, if possible, would need to be entered into. This would not properly reflect the risk management strategies, which seek continuity, and could leave some entities with the inability to apply hedge accounting, if hedges are stopped before new RFR hedges can be started. This could occur, for example, if the relief is no longer applicable for a forecast hedged item but the market in the new RFR is not sufficiently deep and liquid to support the assertion that the new RFR is separately identifiable and reliably measurable. Such an outcome would have implications for the cost of funding of the entities concerned and for the market as a whole. While the economic effect and any new risks arising, such as basis risk, should be identified and reflected in the effectiveness of the hedges, we believe a ‘stop/start’ approach should be avoided where this would result only from transition.

29. In anticipation of the application of new benchmark interest rates, it will be necessary for entities to enter into new hedge accounting relationships where the hedging instruments and hedged items can be either IBOR or RFR. To facilitate a smooth transition, amendments to IAS 39 and IFRS 9 may be necessary to facilitate this approach and allow new

documentation to refer to either (before and after transition) or both the IBOR and its equivalent RFR replacement for the hedging instrument, the hedged item and the hedged risk.

30. In addition, it may be difficult for entities to assess whether a new RFR hedge is highly effective at inception in accordance with IAS 39 AG105 [and B6.4.6] if there are insufficient historical data points to compare past changes in the fair value of cash flows of the hedged item that are attributable to the hedge risk with past changes in the fair value or cash flows of the hedging instrument. Relief may be needed to facilitate hedge accounting in these circumstances.

31. Consideration should also be given to how the standards could be amended to facilitate amending existing IBOR hedge documentation for the new risk free rates without requiring the stopping of IBOR hedges and the creation of new RFR hedges. This would help avoid a ‘stop/start’ approach which may not work in practice or properly reflect the gradual change in market structures and risk management. Similar to new hedge documentation, it would be helpful for existing hedge documentation to be amended to replace the hedging instrument, the hedged item and the hedged risk with either or both the IBOR and its equivalent RFR replacement.

32. In addition, hedge documentation may need to be amended to facilitate the measurement of hedge ineffectiveness where the IBOR reform is creating sources of ineffectiveness which did not exist at the inception of the hedge. Once the hedged item is reformed, the hypothetical derivative may need to be recalculated, but in this scenario, it should not be required to have a zero fair value at inception. Lastly, consideration should be given as to how cumulative gains and losses on hedging instruments recognised in OCI should be reclassified when the forecast transaction is still expected to occur, but will reflect the benchmark interest rate reform.