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IBOR reform – Possible changes to support hedge accounting

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Potential amendments to IFRS 9 and IAS 39 as benchmark interest rates undergo reform

Highlights

- Aims to provide relief from effects of IBOR reform on some hedge accounting requirements
- Focuses on the 'highly probable' requirement, prospective assessments and risk components
- May reduce need for de-designations and early recycling of cash flow hedge reserves
- Effective date and next steps – exposure draft expected Q2 2019; proposed effective date is January 2020.

Standard setters are beginning to consider the effects of unprecedented reform of interbank offered rates (IBOR) – the benchmark interest rates that underpin the measurement of many financial instruments – on existing financial reporting requirements.

As part of the first phase of its project on *IBOR Reform and its Effects on Financial Reporting*, the International Accounting Standards Board (the Board) tentatively decided at the February meeting to propose that the hedge accounting requirements of IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* should be amended in response to the impacts of **IBOR reform**.

"We welcome the Board's efforts to maintain the relevance of hedge accounting in the light of IBOR reform. It will be critical to ensure that reliefs are delivered quickly and targeted accurately."

Chris Spall,
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What are the potential changes?

IBOR reform will have wide-ranging impacts on financial reporting. The proposed amendments would aim to address its impact on forward-looking requirements for hedge accounting.

The Board stated its intention to provide targeted relief to preparers for hedges of interest rate risk only, by amending both IFRS 9 and IAS 39 in three areas:

- the 'highly probable' requirement;
- prospective assessments of hedging relationships; and
- previously qualifying risk components.

If adopted, the proposed amendments would allow companies to disregard some of the uncertainties related to IBOR reform when applying these requirements.

The proposals are expected to be finalised by the end of 2019.

The staff recommended not providing any relief for retrospective effectiveness assessments under IAS 39.

What's the focus?

'Highly probable' requirement

Both IFRS 9 and IAS 39 require that a forecast transaction must be 'highly probable' if it is to qualify as a hedged item in a cash flow hedge.[1]

IBOR reform puts pressure on the 'highly probable' requirement, since there may be significant uncertainty around when a new alternative benchmark rate will become effective and – in some jurisdictions – what the new benchmark rate will be.

The aim of the proposed amendments would be to allow companies to focus on the existing IBOR-based contractual cash flows of a hedged item and ignore potential future modifications related to uncertainties associated with IBOR reform that could change those hedged cash flows. The staff indicated that they would provide further analysis related to fall-back clauses in contracts – e.g. a clause that specifies what will happen if an IBOR index ceases to be available.

Additionally, companies may be able to apply similar relief when assessing whether IBOR cash flows that were previously hedged in discontinued cash flow hedges are still 'expected to occur'.[2] If such cash flows were no longer 'expected to occur'. then the related cash flow hedge reserve would be reclassified to profit or loss immediately.

Prospective assessments

IBOR reform may create uncertainties regarding a company's prospective assessments for fair value and cash flow hedges.

Under IFRS 9, the prospective assessment requires a company to demonstrate an economic relationship between the hedging instrument and the hedged item. Under IAS 39, a company needs to demonstrate an expectation that the hedge will be highly effective.

The proposed relief may also allow companies' prospective assessments to consider the existing IBOR-based contractual terms of the hedging instrument and hedged item and ignore possible future changes related to IBOR reform uncertainties. For highly probable forecast transactions, potential future amendments to contracts related to IBOR reform uncertainties may similarly not affect the prospective assessment.

Risk components

Under IAS 39 and IFRS 9, a relationship can qualify for hedge accounting only if the hedged item is separately identifiable and reliably measurable.

The Board tentatively indicated that, if a hedge of IBOR risk had previously qualified as a hedge of a separately identifiable and reliably measurable risk component, then IBOR-reform uncertainties related to future IBOR cash flows need not lead to the risk component being disqualified as no longer being separately identifiable. However, Board members discussed that hedge accounting would not be possible if the hedged item was no longer reliably measurable.

Impact and expiry of relief

The proposals may reduce the need for de-designations and early recycling of cash flow hedge reserves.

The Board tentatively agreed that in principle the proposed reliefs would no longer be available when uncertainties associated with IBOR reform had ceased to exist.

1. Paragraph 6.3.3 of IFRS 9 and paragraph 88(c) of IAS 39.
2. Paragraph 6.5.12(a) of IFRS 9 and paragraph 101(c) of IAS 39.

Issues affecting financial reporting after new benchmark rates are in effect will be addressed in the second phase of the Board's project.

Effective date, disclosures and transition

The proposed effective date would be for annual periods beginning on or after 1 January 2020 with earlier application permitted. The relief would be applied retrospectively.

Companies would be required to disclose information about hedge relationships to which relief is applied.

Next steps

The IASB staff will proceed with drafting the formal record of the Board's tentative decisions and formulating more detailed proposals for discussion at the Board's March meeting. This will include considering whether the proposed reliefs would be optional or mandatory.

The Board intends to publish an exposure draft in April/May 2019 and issue final amendments at the end of this year.

Please watch this space for further updates and speak with your usual KPMG contact to find out more about the Board's deliberations

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