How is a hedge of interest rate risk impacted by a payment holiday?

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What’s the issue?

Payment holidays may be granted in times of economic uncertainty to relieve pressure on borrowers – e.g. as a result of the impact of the events in Ukraine on companies that have direct or indirect exposure to Russia and Ukraine. A ‘payment holiday’ is when a borrower and a lender agree to adjust the principal and/or interest cash flows on a loan. This can take the form of deferrals (rescheduling cash flows to a later date) or forgiveness (permanently waiving cash flows). The adjustment may affect the amortised cost carrying amount of the loan under IFRS 9 Financial Instruments, either through the application of paragraph 5.4.3 (modification of the contractual terms) or paragraph B5.4.6 (revision of cash flows under the contract) or through a partial derecognition or write-off. Modifications of contracts to adjust the cash flows for payment holidays may also be substantial enough to cause the entire original loan to be derecognised and a new loan to be recognised.

If a payment holiday occurs on a loan that is designated as a hedged item in a hedge of benchmark interest rate risk, then the company needs to consider:

− the impact of modification/derecognition accounting on the hedged item; and
− the impact of the payment holiday on the hedging relationship.

There can be interaction between the two. There are some general issues to consider for all hedging relationships in which payment holidays affect the hedged item. However, depending on the nature of the hedge and the nature of the payment holiday, the implications for modification and hedge accounting may be different. The flowchart (next page) gives an overview of the main considerations.

Getting into more detail

Does a payment holiday indicate impairment or an increase in credit risk that causes hedge failure?

Regardless of the type of hedge, if a payment holiday occurs on a financial asset that is designated as a hedged item, then a company needs to consider whether the payment holiday indicates that the financial asset either is credit-impaired or has undergone a significant increase in credit risk. (See our web article Has the impact of increased economic uncertainty on credit risk been appropriately considered?)

The impact of a payment holiday on a hedging relationship will vary depending on the nature of the payment and the type of hedge.

1. This article assumes that the hedged item is a loan/debt asset measured at amortised cost and the hedged risk is a benchmark interest rate. However, the guidance in this article is also generally applicable when the hedged item is a financial liability, although references to IFRS Standards and terminology may differ. The discussion is framed in the context of a hedge of a specific financial instrument; elements of the analysis may differ if the hedge relates to a group or portfolio of items. For example, a hedge designated as the ‘first [x amount] of highly probable forecast interest cash flows to occur’ may not be affected by a payment holiday if other hedged cash flows specified in the hedge documentation that are not impacted by the payment holiday can cover the hedged amount in the same period.
Under IFRS 9’s hedge accounting model, a hedging relationship is required to be discontinued if the effect of credit risk dominates the value changes resulting from the economic relationship. Consequently, it appears that if a hedged asset becomes credit-impaired then, in many circumstances, the current hedge accounting relationship should be discontinued.

A significant increase in credit risk may also be an important indicator to consider in assessing hedge effectiveness, but it does not automatically mean that credit risk dominates the economic relationship. This is because the assessment of a significant increase in credit risk is a relative assessment, rather than an absolute one. [Insights 7.9.815]

Similarly, for companies still applying IAS 39 Financial Instruments: Recognition and Measurement hedge accounting, in our view in many circumstances when a hedged asset has become credit-impaired the current hedge accounting relationship should be discontinued. Generally, this is because when there is a change in the estimated recoverable cash flows of the hedged asset due to credit impairment, the hedge is no longer expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk that are consistent with the originally documented risk management strategy for the particular hedging relationship. [Insights 7I.7.730]

**Does the effect of a payment holiday otherwise cause a hedge to fail to meet effectiveness or other requirements?**

A hedging relationship may need to be discontinued for reasons other than the effect of credit risk. Broadly, a payment holiday may impact the hedge in one or both of the following ways.

- **For a cash flow hedge**, there is a change in the amount or timing of forecast cash flows that are considered to be highly probable.

- **For a fair value hedge**, there is a change in the timing or amount of the cash flows of the hedged financial asset that impacts how changes in interest rates affect its fair value.
The greater the impact of the payment holiday on the cash flows of the hedged item, the more likely that the hedge effectiveness requirements will be failed, requiring the hedging relationship to be discontinued.

**Has the impact of a payment holiday on the highly probable criterion been considered?**

If a hedged item is a forecast transaction in a cash flow hedge, then that transaction needs to be highly probable. [IFRS 9.6.3.3, IAS 39.78]

This is relevant to a cash flow hedge of future interest receipts. Setting aside the effect of credit risk discussed above, a payment holiday will generally only impact the probability of certain cash flows, not the probability of all of the hedged cash flows. If only some cash flows are no longer highly probable, then judgement will be required in ascertaining whether the hedge can continue. The analysis may depend on the exact nature of the documented hedged risk management strategy and the specifics of the hedge designation. For example, it will be necessary to establish whether the hedge designation is of:

- a specific cash flow that was originally scheduled to occur but is now delayed but still highly probable; or
- a cash flow scheduled to occur in a specified period that is no longer scheduled to occur in that period and therefore no longer highly probable in accordance with the designation.

When a hedged cash flow is still considered to be highly probable to occur, it will nevertheless be impacted by **hedge effectiveness** considerations.

In addition, IFRS 9’s hedging requirements prescribe ‘partial discontinuation’ of hedging relationships if a part of the hedging relationship no longer meets the qualifying criteria. For example, in a cash flow hedge of forecast interest payments, if some of those interest payments are no longer highly probable to occur then a partial discontinuation of the hedging relationship may be required rather than a full discontinuation of the whole hedge. The practical benefit of this may be limited, however. Although some individual hedged cash flows might be removed from the hedging relationship, it is not possible to designate a part (other than a strict proportion) of a derivative in a hedging relationship – so a partial discontinuation would be likely to lead to an ongoing imbalance between the remaining hedged cash flows and the hedging instrument. Meanwhile, IAS 39’s hedging requirements do not permit partial discontinuation. [IFRS 9.6.2.4, B6.5.27, Insights 79.950.10]

**Has the impact of a payment holiday on the hedge effectiveness criterion been considered?**

A change in the timing or amount of the cash flows of the hedged item may impact the hedge effectiveness assessment in various ways. Careful examination of the hedge documentation is required, because the impact may depend on the exact nature of the hedge designation.

A hedge effectiveness failure that can be attributed to certain specific cash flows (or lack thereof) may require only a **partial discontinuation**.

If the hedge continues to meet the effectiveness requirements, then any ineffectiveness arising from the payment holiday will have to be recognised in profit or loss.

**If a hedging relationship is discontinued**

If a company determines that a hedging relationship needs to be discontinued due to a payment holiday on the hedged item, then the entire hedging relationship will generally be discontinued. However, a partial discontinuation of the hedging relationship can also sometimes happen under IFRS 9, as mentioned above.
Discontinuation of fair value hedge accounting

If a fair value hedge is discontinued, then the company ceases to adjust the carrying amount of the hedged item for the change in fair value arising from the hedged risk from the date of discontinuation. The carrying amount of the hedged item continues to reflect the hedge accounting adjustments that were made before discontinuation. If amortisation of the hedge adjustments has not started, then it will need to start based on a revised effective interest rate (EIR), reflecting the hedge adjustments at the date hedge accounting ceases. [Insights 7.9.960.20, IFRS 9.6.5.10, IAS 39.92]

If a modification gain or loss on the hedged financial asset needs to be calculated due to the payment holiday, then it will be the difference between:

- the present value of the modified contractual cash flows (discounted at the EIR revised as above to reflect the accumulated hedge adjustments); and
- the old gross carrying amount, including the accumulated hedge adjustments that were made before discontinuation.

If the hedged item needs to be derecognised, then the hedge adjustment is immediately recognised in profit or loss as part of the gain or loss on derecognition. [IFRS 9.5.4.3, B5.4.6, B5.5.252]

Discontinuation of cash flow hedge accounting

If a cash flow hedge is discontinued, then the company accounts for the amount accumulated in the cash flow hedge reserve as follows.

- If the hedged future cash flows are still expected to occur, then that amount remains in the cash flow hedge reserve until the future cash flows occur. This is more likely to be the case when the payment holiday has the effect of deferring the cash flows of the hedged item to a future date, but will still require judgement based on the exact nature of the previously designated hedge. For example, if the hedged item was defined as interest receipts scheduled to occur in a specific period, then the company could not argue that the hedged future cash flows are still expected to occur if the cash flows have been rescheduled to occur outside that specific period as a result of the payment holiday.

- If a hedged future cash flow is no longer expected to occur, then that amount is immediately reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment. This is more likely to be the case when the payment holiday permanently forgives the hedged cash flows. In this case, the amount in the cash flow hedge reserve related to the forgiven hedged cash flows will be reclassified to profit or loss. Amounts in the cash flow hedge reserve associated with future cash flows that continue to be highly probable to occur remain in the cash flow hedge reserve. [IFRS 9.6.5.12(a)–(b), IAS 39.101(b)–(c)]

The revision of future cash flows may be subject to uncertainty – e.g. the exact repayment dates of delayed cash flows may not be known at the date the payment holiday is arranged. In this case, judgement will be required in assessing whether the previously hedged cash flows continue to be highly probable.

The calculation of any modification gain or loss or derecognition gain or loss on the hedged financial asset arising from the payment holiday is not affected by hedge accounting, because there is no hedge adjustment to the financial asset when cash flow hedge accounting is applied.

If the payment holiday is not a substantial modification and a hedging relationship is not discontinued

If a company determines that a payment holiday does not result in a substantial modification of the hedged financial asset, then derecognition of the asset is not required. In this situation, the impact on hedge accounting and the accounting
for the payment holiday will depend on the type of hedge and the nature of the payment holiday. The changes in the timing and/or amount of the cash flows of the hedged item will, however, need to be reflected in the hedge effectiveness assessment.

The hedge is a fair value hedge

When the company calculates a modification gain or loss on the hedged financial asset, it needs to consider whether amortisation of the hedge adjustment has started. This determines whether the gross carrying amount of the modified asset is measured using the original EIR or a revised EIR reflecting the accumulated hedge accounting adjustments.

If amortisation has not started, then the new gross carrying amount of the hedged financial asset is calculated as the present value of the modified contractual cash flows that are discounted at the hedged item’s original EIR (i.e. unadjusted for hedge accounting effects). The modification gain or loss will be the difference between this new gross carrying amount and the old gross carrying amount of the hedged item excluding any hedge adjustments. In addition, the company needs to recalculate the cumulative hedge adjustment based on the modified cash flows. The recalculated hedge adjustment may be calculated as the difference between:

- the hedged portion of the modified cash flows discounted at the hedged benchmark interest rate at the inception of the hedge; and
- the hedged portion of the modified cash flows discounted at the current benchmark interest rate.

The change in the hedge adjustment is recognised in profit or loss, leading to recognition of ineffectiveness. If amortisation has started, then the new gross carrying amount of the hedged financial asset is calculated as the present value of the modified contractual cash flows discounted at the revised EIR (i.e. adjusted for hedge accounting effects). The modification gain or loss will be the difference between this new gross carrying amount and the old gross carrying amount of the hedged financial asset including any hedge adjustments. [IFRS 9.5.4.3, B5.4.6, 6.5.10, IAS 39.92]

This numerical example (PDF 98 KB) illustrates these calculations.

The hedge is a cash flow hedge

Similar to a fair value hedge, the company may need to calculate a modification gain or loss on the hedged financial asset due to the payment holiday. However, there is no hedge adjustment to the hedged financial asset and its EIR is not affected by hedge accounting.

The impact of the payment holiday needs to be considered when measuring hedge ineffectiveness. If the cash flow hedge continues to meet the qualifying criteria, then the cash flow hedge reserve is adjusted to the lower of:

- the cumulative gain or loss on the hedging instrument from inception of the hedge; and
- the cumulative change in fair value (present value) of the hedged item from inception of the hedge.

The payment holiday will impact the cumulative change in fair value (present value) of the hedged item from inception of the hedge. For example, if the hypothetical derivative method was used to measure the change in value of the hedged item for this purpose, then the terms of the hypothetical derivative would need to be updated to reflect the modified cash flows of the hedged item resulting from the payment holiday. The update in value of the hypothetical derivative arising as a result of the change in terms may give rise to hedge ineffectiveness recognised in profit or loss. [IFRS 9.6.5.11, IAS 39.96]
If the payment holiday is a substantial modification

If a hedged financial asset is derecognised as a result of a payment holiday, then the modified financial asset is initially recognised as a new asset at its fair value. In this case, a hedging relationship designated with respect to that specific financial asset will generally need to be discontinued.

The hedge is a fair value hedge

When the hedged financial asset is derecognised and the new asset is recognised, the fair value hedge adjustment is immediately recognised in profit or loss as part of the gain or loss on derecognition.

The hedge is a cash flow hedge

The company derecognises the old hedged financial asset and recognises the modified asset as a new asset at its fair value.

If a hedged item is derecognised, then the cash flow hedge reserve is immediately reclassified to profit or loss to the extent that the hedged future cash flows are no longer expected to occur. Therefore, the company has to consider whether there are forecast cash flows that were designated in the original hedge that are still expected to occur. See Discontinuation of cash flow hedge accounting above for more guidance.

Restarting hedge accounting

Certain derecognition events as noted above lead to a hedging relationship having to stop. However, it is important to note that it may be possible to designate a new hedging relationship with respect to the new asset in the future. If a new hedging relationship is redesignated with the new asset and the previous hedging instrument, then it is possible, depending on the designation, that there may be ineffectiveness in the hedge because the cash flows of the hedged item and hedging instrument will not match as a result of the payment holiday. Care should be taken that all relevant requirements are met for a new hedging relationship.

Actions for management

In the event of a payment holiday occurring, management needs to consider:

- whether credit risk dominates the hedging relationship in such a way that discontinuation of the hedging relationship is required;
- whether the impact of a payment holiday on the hedged item causes a failure of the hedge effectiveness requirements;
- whether the impact of the payment holiday on the highly probable criterion has been considered;
- whether a partial discontinuation of the hedging relationship is required in a cash flow hedge;
- whether a fair value hedge adjustment needs to be amortised or requires immediate reclassification to profit or loss;
- when and how a cash flow hedge reserve needs to be reclassified to profit or loss;
- whether a modification gain or loss has been calculated with an appropriate effective interest rate;
- whether any cumulative fair value hedge adjustments need to be recalculated; and
- whether the terms of a hypothetical derivative in a cash flow hedge need to be updated to reflect the payment holiday.

References to ‘Insights’ mean our publication Insights into IFRS®