Interest Rate Benchmark Reform
FIWG Discussion – for Background only

Objective

1 The objective of this issues paper is to provide feedback to EFRAG TEG on the conclusions reached by FIWG members on two changes of the wording between the exposure draft and the final amendments issued on 27 August on IBOR Phase 2.

Issue 1: Terminology used to address changes in contractual cash flows

2 EFRAG Secretariat observes that the terminology used to address changes in contractual cash flows has changed between the exposure draft (ED/2020/1 *Interest Rate Benchmark Reform—Phase 2 Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16*) and the final amendments (*Interest Rate Benchmark Reform—Phase 2 Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16*).

3 In the exposure draft, it reads:

4 [Proposed IFRS 9:6.9.2] "For the purpose of applying paragraphs 6.9.3–6.9.4 and 6.9.6, a financial asset or financial liability is **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."

5 [Proposed IFRS 9.6.9.3] "[…] a **modification** is required by interest rate benchmark reform if and only if both of the following conditions are met:

(a) the modification is required as a direct consequence of interest rate benchmark reform; and

(b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the modification).

6 [Proposed IFRS 9.6.9.5] "An entity shall also apply the practical expedient in paragraph 6.9.3 if the following conditions are met **even though these changes do not meet the description of a modification** in paragraph 6.9.2 (see also paragraph 6.9.6):

(a) the entity revises its estimates of future cash payments or receipts because an existing contractual term is activated and that contractual term changes the basis for determining the contractual cash flows (for example, an existing fallback clause is triggered);

(b) that activation of an existing contractual term that changes the basis for determining the contractual cash flows is required as a direct consequence of interest rate benchmark reform; and

(c) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the activation)."

7 [Proposed IFRS 16.105] "As a practical expedient, a lessee shall apply paragraph 42 to account for a **lease modification** that is required by interest rate benchmark reform. This practical expedient applies only to such modifications. For this purpose, a lease modification is required by interest rate benchmark reform if and only if both of the following conditions are met:

(a) the modification is required as a direct consequence of interest rate benchmark reform; and

(b) the new basis for determining the lease payments is economically equivalent to the previous basis (ie the basis immediately preceding the modification).

8 **In the final amendments, the wording used in IFRS 9 changed while the wording in IFRS 16 remained the same as proposed in the ED.**

9 The final amendments read:

10 [IFRS 9.5.4.5] "An entity shall apply paragraphs 5.4.6–5.4.9 to a financial asset or financial liability if, and only if, the **basis for determining the contractual cash flows of that financial asset or financial liability changes** as a result of interest rate benchmark reform."

11 [IFRS 9.5.4.6] "The basis for determining the contractual cash flows of a financial asset or financial liability can change:

(a) by amending the contractual terms specified at the initial recognition of the financial instrument (for example, the contractual terms are amended to replace the referenced interest rate benchmark with an alternative benchmark rate);

(b) in a way that was not considered by—or contemplated in—the contractual terms at the initial recognition of the financial instrument, without amending the contractual terms (for example, the method for calculating the interest rate benchmark is altered without amending the contractual terms); and/or

(c) because of the activation of an existing contractual term (for example, an existing fallback clause is triggered).

12 [IFRS 9.5.4.7] "[…] a **change in the basis for determining the contractual cash flows** is required by interest rate benchmark reform if, and only if, both these conditions are met:

(a) the change is necessary as a direct consequence of interest rate benchmark reform; and

(b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the change)."

13 [IFRS 16.105] "As a practical expedient, a lessee shall apply paragraph 42 to account for a **lease modification** required by interest rate benchmark reform. This practical expedient applies only to such modifications. For this purpose, a lease modification is required by interest rate benchmark reform if, and only if, both of these conditions are met:

(a) the modification is necessary as a direct consequence of interest rate benchmark reform; and

(b) the new basis for determining the lease payments is economically equivalent to the previous basis (ie the basis immediately preceding the modification)."

EFRAG Secretariat analysis

14 EFRAG Secretariat observes that the change in terminology used in IFRS 9 aligns the population to which the practical expedient is applied (i.e. modifications and "other changes"), and simplifies the wording. While the exposure draft addressed modifications and other changes (in particular activation of fallback rates) in separate paragraphs, this is now combined in the amendments to IFRS 9 and addressed together as "changes in the basis for determining the contractual cash flows".

15 In addition, the new terminology used seems to avoid the discussion of whether a modification actually exists when the method for calculating the interest rate benchmark is altered without amending the contractual terms. This "clarification" was an issue being discussed at length at EFRAG, and it was noted in the comment letter to the ED that an assessment of the impact of this clarification was not possible within the limited timeframe on a general basis.

16 While the term "modification" is used in IFRS 9 without definition (which allows referring to "changes" in the context of IBOR reform without the need to discuss whether particular changes constitute a modification), IFRS 16 Appendix A includes a definition for lease modifications as follows: "A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term)."

17 It follows, as outlined in IFRS 16.BC267D, that "[a]pplying IFRS 16, modifying a lease contract to change the basis for determining the variable lease payments [e.g. to replace IBOR by an alternative benchmark rate] meets the definition of a lease modification because a change in the calculation of the lease payments would change the original terms and conditions determining the consideration for the lease."

18 **EFRAG Secretariat concludes that the wording used in the final amendments to IFRS 9 is both helpful in clarifying the scope of the practical expedient and also in terms of avoiding potential differences in interpretation between IBOR-related modifications and other modifications to which the general requirements in IFRS 9 apply.**

19 **EFRAG Secretariat observes that the practical expedients both in IFRS 9 and IFRS 16 are intended to apply for the same set of circumstances under the same conditions, i.e. the modification/change has to be necessary as a direct consequence of the IBOR reform and the cash flows have to be economically equivalent.**

20 **Against this background, EFRAG Secretariat concludes that the different use of terminology does not have an impact on the assessment of the final amendments against the endorsement criteria as proposed in the draft endorsement advice, in particular in terms of comparability. As a consequence, no changes are needed to the DEA other than to reflect the terminology used in IFRS 9 which does not a change in the substance of the opinion exposed for comments.**

Feedback from EFRAG FIWG:

21 EFRAG FIWG members shared the EFRAG Secretariat's conclusions in paragraphs 18 to 20.

Issue 2: Transition and retrospective reinstatement

22 EFRAG Secretariat observes that the wording for transition and retrospective reinstatement differs between the ED and the final amendments.

23 In the ED, it reads:

24 [Proposed IFRS 9.7.2.36] "An entity shall apply [draft] Interest Rate Benchmark Reform—Phase 2 **retrospectively** in accordance with IAS 8, except as specified in paragraph 7.2.38."

25 [Proposed IFRS 9.7.2.37] "Applying paragraph 7.2.36, an entity shall **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**."

26 In the final amendments, it reads:

27 [IFRS 9.7.2.43] "An entity shall apply Interest Rate Benchmark Reform—Phase 2 **retrospectively** in accordance with IAS 8, except as specified in paragraphs 7.2.44–7.2.46.

28 [IFRS 9.7.2.44] "An entity shall designate a new hedging relationship (for example, as described in paragraph 6.9.13) only prospectively (ie an entity is prohibited from designating a new hedge accounting relationship in prior periods). However, an entity shall **reinstate** a discontinued hedging relationship if, and only if, these conditions are met:

(a) the entity had discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and the entity would not have been required to discontinue that hedging relationship **if these amendments had been applied at that time**; and

(b) **at the beginning of the reporting period** in which an entity first applies these amendments (**date of initial application of these amendments**), that discontinued hedging relationship meets the qualifying criteria for hedge accounting (**after taking into account these amendments**).

EFRAG Secretariat analysis

29 EFRAG Secretariat understands that the wording now used in paragraph 44 applies only to those hedging relationships that have been discontinued in reporting periods before the date of initial application of the amendments. In contrast, if a hedging relationship had to be discontinued before the date of initial application, paragraph 43 applies, and through retrospective application the hedging relationship is accounted for as if it never had been discontinued.

30 To illustrate, assuming the amendments would be available for year-end 2020, the date of initial application would be 1 January 2020 (or the beginning of an interim period, if applicable). If a hedging relationship was discontinued as a direct consequence of the IBOR reform…

(a) …during 2020, paragraph 43 would apply and the hedging relationship would be accounted for applying the amendments, i.e. treated as continued hedging relationship at year-end because it never has been presented as discontinued in a financial statement.

(b) …in 2019, i.e. before the date of initial application 1 January 2020, paragraph 44 would apply and the hedging relationship would be reinstated if it met the qualifying criteria for hedge accounting after taking into account the amendments on 1 January 2020.

31 Hence, the term “reinstatement” refer to reporting periods before the date of initial application under the specific requirements outlined in paragraph 44 (a) and (b). At the same time, paragraph 43 requires an entity to “unwind” hedging relationships that had to discontinued during the reporting period and treat those hedging relationships are continuing. In other words, paragraphs 43 and 44 both have the effect that all hedging relationships that had to be discontinued absent the amendments but would meet all relevant criteria after taking into account the amendments would be treated as continuing hedging relationships in the annual financial statements for year-end 2020.

32 **EFRAG Secretariat therefore concludes that the change in wording between the ED and the final amendments does not have an impact on the assessment of the final amendments against the endorsement criteria.**

33 **As a consequence, EFRAG secretariat considers that no changes are needed to the wording**

Feedback from EFRAG FIWG:

34 EFRAG FIWG members shared the EFRAG Secretariat’s conclusions in paragraphs 32 and 33.