

IBOR reform – Possible changes to support hedge accounting

March 2019

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 (IASB) tentatively decided at its 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 reform¹.

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

Highlights

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



What are the potential changes?

IBOR reform will have wide-ranging impacts on financial reporting. The proposed amendments aim to address the 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 hedge effectiveness 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. Staff recommended not providing any relief for retrospective effectiveness assessments under IAS 39.

We noted a concern raised by some stakeholders in the market in respect of the IASB’s proposal to not provide any relief for retrospective effectiveness assessments under IAS 39. In practice, many entities use the same test for both prospective and retrospective assessment of hedge effectiveness. It is unclear how unintended consequences of the retrospective test would be avoided if the relief only applies to the prospective effectiveness test.



¹ Source: IASB Staff Paper “IBOR Reform and its Effects on Financial Reporting”, *Issues leading up to IBOR reform* dated February 2019

What's the focus?

Risk components

- Under IAS 39 and IFRS 9, a relationship can qualify for hedge accounting only if a risk component that is designated as the hedged item is **separately identifiable** and **reliably measurable**.
- The IASB 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, relief should **not** be provided for risk components that are not separately identifiable at the inception of a hedging relationship.

'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.²
- 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. Staff at the IASB indicated that they would provide further analysis related to **fall-back clauses** in contracts. Fall-back clauses specify what happens 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'**.³ 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, such as adding specified fallback provisions, may similarly not affect the prospective assessment.

² Paragraph 6.3.3 of IFRS 9 and paragraph 88(c) of IAS 39.

³ Paragraph 6.5.12 of IFRS 9 and paragraph 101(c) of IAS 39.

Impact and expiry of relief

The proposals may reduce the need for discontinuing hedge accounting and early recycling of cash flow hedge reserves. The IASB tentatively agreed that, in principle, the proposed reliefs would no longer be available when uncertainties associated with IBOR reform had ceased to exist. Issues affecting financial reporting after new benchmark rates are in effect will be addressed in the second phase of the project.

Effective date 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.

What to expect next?

This proposal is part of IASB's first phase of its IBOR-reform related project. The IASB staff will proceed with drafting the formal record of tentative decisions and formulating more detailed proposals for discussion at the IASB's March meeting. This will include considering whether the proposed reliefs would be optional or mandatory. The IASB intends to publish an exposure draft in April/May 2019 and issue final amendments by the end of this year.

The IASB will launch the second phase of the project to focus on issues affecting financial reporting when IBOR reform is enacted (i.e., when contracts are actually amended). It is expected that the IASB will issue more consultation papers and guidelines regarding the transition from IBOR to another reference rate in this respect. There are certain key issues from a hedge accounting perspective when entities amend the existing IBOR-linked hedging instrument that need to be addressed in Phase 2:

Some stakeholders have raised a question on the retrospective application. The apparent reason for recommending this kind of transition was that it was used in the 2013 amendment to IAS 39 'Novation of Derivatives and Continuation of Hedge Accounting'. However, that was a different context because it dealt with the sensitive issue of entities not having identified novation as a trigger for derecognition of a hedging instrument. Using the same design for the IBOR-related amendments would imply that the discontinuation of such hedging relationships might already be required now, in which case the relief would come too late. This is particularly so because the IASB also stated that entities cannot reinstate discontinued relationships. Therefore, we expect further discussions will be conducted in this respect.



Discontinuation of hedge accounting due to changes of critical terms

A change in the critical terms of a derivative may result in its derecognition for accounting purposes (and recognition as a new instrument), causing a discontinuation of the associated hedging relationship. Entities need to evaluate whether a change of the underlying reference interest rate would trigger derecognition of the hedging instrument, which may result in a need to discontinue the hedging relationship, which may then result in unexpected income statement volatility.



Hedge documentation in respect of change of the effectiveness test method (applicable to IAS 39 only)

In practice, hedge effectiveness is often assessed using a statistical method such as a regression analysis. When the new underlying reference interest rate of the hedging instrument is determined, an entity may not have sufficient transaction volume at the time of transition. While there are other common methods that can be used to assess hedge effectiveness, it is unlikely that the hedge documentation would have envisaged this situation. Under IAS 39, changing or updating the effectiveness testing method documented upon the initial assessment is not allowed, otherwise the entity will need to discontinue the hedging relationship.

Contact us



Tom Jenkins

Partner, Head of Financial Risk Management
KPMG China
T: +852 2143 8570
E: tom.jenkins@kpmg.com



Michael Monteforte

Partner, Financial Risk Management
KPMG China
T: +852 2847 5012
E: michael.monteforte@kpmg.com



Marie Gervacio

Partner, Financial Risk Management
KPMG China
T: +852 2685 7880
E: marie.gervacio@kpmg.com



Martin Friedhoff

Partner, Department of Professional Practice
KPMG China
T: +852 2913 2975
E: martin.friedhoff@kpmg.com



Desmond Yu

Associate Director, Financial Risk Management
KPMG China
T: +852 2913 2591
E: desmond.yu@kpmg.com



Tatjana Schaefer

Manager, Financial Risk Management
KPMG China
T: +852 3927 5735
E: tatjana.schaefer@kpmg.com

kpmg.com/cn

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2019 KPMG Advisory (Hong Kong) Limited, a Hong Kong limited liability company and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo are registered trademarks or trademarks of KPMG International.