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FINANCIAL REPORTING CHANGES IN PHASE 2 OF THE INTEREST RATE BENCHMARK REFORM

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INTRODUCTION

On 9 April 2020 the International Accounting Standards Board (IASB) published an Exposure Draft (ED), Interest Rate Benchmark Reform – Phase 2, Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16.

The Exposure Draft is a follow up to the Phase 1 amendments made to IFRS 9, IAS 39 and IFRS 7, in September 2019 to provide specific accounting relief, as global financial supervisory boards undertake to substitute existing Interbank Offered Rates (IBORs) with alternative benchmarks for risk-free rates (RFRs). Potential RFRs that are been considered across the globe include, inter alia, the EONIA in the Eurozone, SOFR in US, and SORA in Singapore. The substitution of IBORs for these RFRs have important implications for accounting. Although the amendments have not been finalised, being only in ED stage, the final amendments are expected to be made effective in less than half a year from the date of writing, by 1 January 2021, with earlier application permitted, underlining its urgency for affected companies. This article aims to provide a high-level overview of the issues and the proposals in the ED.

MODIFICATION OF FINANCIAL INSTRUMENTS

A wide variety of financial instruments rely on IBORs as a basis for determining interest costs, including insurance, loan and lease contracts, as well as other financing instruments.

With the IBOR reform, it is expected that these will transition from IBORs to RFRs at some point. Unfortunately, the process is unlikely to be a straightforward substitution of one rate for another. This is because the RFRs are intended to be nearly risk-free, in many cases representing an overnight rate, whereas the IBORs are not nearly as risk-free and can represent various lending terms from overnight to 1 year. It is likely that some other aspect of the contract will have to change to make up for the different risk profiles represented by IBORs vs RFRs. For example, a fixed spread may be added to compensate for the additional risks previously captured by IBOR, or the interest reset periods/ reset dates could be changed.

In the absence of any specific relief, these changes are likely to be accounted for as either asset modification, or derecognition followed by re-recognition of a new replacement asset. In either case, changes to the carrying value of the existing instrument on the balance sheet may result.

The ED attempts to resolve this matter by offering a practical expedient to allow such contractual changes to be treated similarly to changes in floating interest rates arising from market interest movements, which means that the differences in interest costs are simply charged to income with no significant impact on the carrying amount of the instrument on the balance sheet.

For some contracts, fallback provisions may have already been pre-built into the contracts, with a hard-coded hierarchy of interest rate benchmarks that the contract will successively fall back on if a designated benchmark cannot be applied for any reason. The activation of such fallback provisions as a result of the IBOR reform, will also qualify for the above practical expedient.

In practice, the application of this expedient may, in our view, be complicated by the requirement in the ED that the expedient can only be applied to contractual changes that are determined on an "economically equivalent" basis as the previous contractual terms based on IBORs. Any additional changes over and above those considered to be "economically equivalent", should be accounted for in accordance with existing requirements (i.e. as modifications that may or may not result in derecognition, which may alter existing book values).

In practice, the new contractual terms will be a result of economic re-negotiations between the parties involved, and some accounting judgment may be required to differentiate "economically equivalent" contractual changes, which will not impact book value of the underlying debt contract, from the others which can impact book value.

The practical expedient is also expected to apply to insurance contracts that are exempted from IFRS 9 by the provisions of IFRS 4, as well as to IBOR-based lease contracts under IFRS 16.

HEDGING

The most extensive impact arising from the IBOR reforms is expected in hedge accounting.

Firstly, with the changes made to previously IBOR-based hedging instruments and/or hedged items, the hedge documentation and designation will have to be updated for existing hedges, including a redefinition of the hedged risk from IBOR to RFR for interest risk hedges. Application of existing rules under either IFRS 9 or IAS 39 may result in hedge discontinuation. The ED proposes a relief by allowing hedge accounting to continue despite such changes to the hedge designation, arising from the IBOR reform.

Secondly, for hedges that still qualify to be designated under IAS 39 rules, retrospective quantitative effectiveness tests may fail the 80% to 125% thresholds as a result of market movements arising from the expected IBOR reform and associated uncertainty. The Phase 1 amendments have provided a temporary relief on this requirement, but that relief ends once the uncertainty surrounding IBOR reform has cleared. The Phase 2 ED attempts to resolve this issue, by requiring cumulative fair value changes to be reset to zero for purposes of retrospective effectiveness tests that are conducted on a cumulative basis. However, actual hedge ineffectiveness will still be fully recognised in profit and loss.

Thirdly, for interest rate instruments that are hedged as a group, the contractual transition date of each instrument from IBORs to RFRs may differ, which may result in the group failing the proportionality test under both IFRS 9 and IAS 39. The proportionality test needs to be satisfied in order for the items to be hedged as a group, and requires that the expected change in fair value attributable to the hedged risk for each item in the group, to be approximately proportional to the overall change in fair value of the entire group. However, this may not be the case if different instruments in the group are based on different interest rate benchmarks. This situation will occur if some instruments in the group have contractually transitioned to RFRs but others have not. To resolve this, the ED allows the proportionality test to be performed separately for each sub-group referencing a different benchmark rate.

The final hedge accounting exemption that will be discussed in this article is in respect of the hedging of identifiable risk components. Certain risk strategies involve hedging risks against a risk component even though that risk component is not contractually specified in the hedged item. Where such a hedge is conducted, IFRS 9 requires an evaluation of the pricing within the relevant market structure, in order to ascertain whether the risk involved is separately identifiable within that market. For example, the fair value hedge of a fixed rate debt against a benchmark rate is permitted when the price of fixed-rate debt instruments is observed to vary directly in response to changes in the benchmark rate. This is the case even though the debt contract did not specify the benchmark rate. However, such observation and evaluation requires sufficient volume and liquidity of market transactions against the benchmark rate. Upon initial transition to RFR, such volume and liquidity may not be available as time is needed to establish the impact of RFR on the market structure. In the absence of specific relief, this may preclude hedge accounting from being applied to RFR as a separately identifiable risk component in this situation.

To resolve this, the ED proposes a relief that allows entities, upon designation of the hedge, to assume that the separately identifiable requirement is met, provided that there is a reasonable expectation that the RFR risk component is expected to become separately identifiable within the next twenty-four months.

CONCLUSION

This article has attempted to highlight the key proposals in the ED in relation to IBOR reform. The above discussions are not exhaustive and are only meant to provide a high-level overview. Although the ED aims to simplify financial reporting issues that arise from the IBOR reform, however, financial instruments accounting is, at the core, a complex topic, and care will be required in examining the interactions of the ED simplifications with existing complex requirements. Transition issues also needs to be examined. For example, the ED has required that hedging relationships that were discontinued due to the IBOR reform, before the ED takes effect, to be reinstated. This can be challenging, potentially requiring the maintenance of a separate set of hedging records, and needs to be planned for.

Finally, thought should be given to the changes that were not addressed by the ED. For example, if RFRs should prove to be a less liquid interest rate benchmark than IBORs, RFR-based instruments may have to be transferred to a lower fair value hierarchy within IFRS 13, with possible consequential risk capital implications for regulated financial reporters. As with all financial reporting changes, early preparation and planning is crucial.

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