



# In brief

## A look at current financial reporting issues

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### Amendments to IFRS 9, IAS 39 and IFRS 7 – interest rate benchmark reform

#### At a glance

The IASB has issued amendments to IFRS 9, IAS 39 and IFRS 7 that provide certain reliefs in connection with interest rate benchmark reform. The reliefs relate to hedge accounting and have the effect that IBOR reform should not generally cause hedge accounting to terminate. However, any hedge ineffectiveness should continue to be recorded in the income statement. Given the pervasive nature of hedges involving IBOR-based contracts, the reliefs will affect companies in all industries.

#### What is the issue?

Following the financial crisis, the replacement of benchmark interest rates such as LIBOR and other inter-bank offered rates ('IBORs') has become a priority for global regulators. Many uncertainties remain but the roadmap to replacement is becoming clearer. Given the pervasive nature of IBOR-based contracts among both financial institutions and corporates, there are significant potential impacts of these changes on financial reporting under IFRS.

The IASB has a two-phase project to consider what, if any, reliefs to give from the effects of IBOR reform. Phase 1, which considers reliefs to hedge accounting in the period before the reform, has led to these amendments.

Phase 2 of the IASB's project will address issues that arise once the existing interest rate is replaced with an alternative interest rate. The IASB plans to discuss Phase 2 over the coming months and is then expected to issue an exposure draft of proposed Phase 2 amendments for comment.

#### What is the impact and for whom?

As discussed in more detail below, the Phase 1 amendments provide temporary relief from applying specific hedge accounting requirements to hedging relationships directly affected by IBOR reform. The reliefs have the effect that IBOR reform should not generally cause hedge accounting to terminate. However, any hedge ineffectiveness should continue to be recorded in the income statement under both IAS 39 and IFRS 9. Furthermore, the amendments set out triggers for when the reliefs will end, which include the uncertainty arising from interest rate benchmark reform no longer being present.

### **'Highly probable' requirement**

Cash flow hedge accounting under both IFRS 9 and IAS 39 requires the future hedged cash flows to be 'highly probable'. Where these cash flows depend on an IBOR (for example, future interest payments on a forecast issuance of a LIBOR-based debt hedged with an interest rate derivative), a question arises as to whether they can be considered 'highly probable' beyond the date at which the relevant IBOR might cease being published.

The relief provided by the amendments requires an entity to assume that the interest rate on which the hedged cash flows are based does not change as a result of the reform. Hence, where the hedged cash flows may change as a result of IBOR reform (for example, where the future interest payments on a hedged forecast debt issuance might be SONIA + X% rather than GBP LIBOR + Y%), this will not cause the 'highly probable' test to be failed.

### **Prospective assessments (economic relationship and 'highly effective' hedge)**

Both IAS 39 and IFRS 9 require a forward-looking prospective assessment in order to apply hedge accounting. IAS 39 requires the hedge to be expected to be highly effective, whereas IFRS 9 requires there to be an economic relationship between the hedged item and the hedging instrument.

Cash flows under IBOR and IBOR replacement rates are currently expected to be broadly equivalent, which minimises any ineffectiveness. However, as the date of the reform gets closer, this might no longer be the case. This could give rise to hedge ineffectiveness in the prospective assessment, in particular where the replacement of the benchmark rate is expected to occur at different times in the hedged item and the hedging instrument.

Under the amendments, an entity assumes that the interest rate benchmark on which the cash flows of the hedged item, hedging instrument or hedged risk are based is not altered by IBOR reform.

### **IAS 39 retrospective effectiveness test exception**

The uncertainties described above in the context of prospective assessments could also affect IAS 39's retrospective effectiveness requirement. In particular, IBOR reform might cause a hedge to fall outside the required 80–125% range. IAS 39 has therefore been amended to provide an exception to the retrospective effectiveness test such that a hedge is not discontinued during the period of IBOR-related uncertainty solely because the retrospective effectiveness falls outside this required 80–125% range. However, the other requirements for hedge accounting, including the prospective assessment, would still need to be met.

### **Risk components**

In some hedges, the hedged item or hedged risk is a non-contractually specified IBOR risk component. An example is a fair value hedge of fixed-rate debt where the designated hedged risk is changes in the fair value of the debt attributable to changes in an IBOR. In order for hedge accounting to be applied, both IFRS 9 and IAS 39 require the designated risk component to be separately identifiable and reliably measurable. Under the amendments, the risk component only needs to be separately identifiable at initial hedge designation and not on an ongoing basis. In the context of a macro hedge, where an entity frequently resets a hedging relationship, the relief applies from when a hedged item was initially designated within that hedging relationship.

### **Disclosures**

The amendment requires disclosure of the nominal amount of hedging instruments to which the reliefs are applied, any significant assumptions or judgements made in applying the reliefs, and qualitative disclosures about how the entity is impacted by IBOR reform and is managing the transition process.

### **When does it apply?**

These amendments should be applied for annual periods beginning on or after 1 January 2020. Earlier application is permitted. The amendments are subject to endorsement in Europe, and the EU is following an accelerated process with a view to endorsement in time for use for December 2019 year ends.

### **Where do I get more details?**

For more information, please contact Sandra Thompson ([sandra.j.thompson@pwc.com](mailto:sandra.j.thompson@pwc.com)), Mark Randall ([mark.b.randall@pwc.com](mailto:mark.b.randall@pwc.com)) or Elizabeth Dicks ([elizabeth.a.dicks@pwc.com](mailto:elizabeth.a.dicks@pwc.com)).

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