Snapshot

by Capital Markets & Accounting Advisory Services

October 2019

How does IASB's amendments to IFRS 9, IAS 39(*) and IFRS 7 on interest rate benchmark reform impact hedge accounting?

Applicable IFRS	Amendments to IFRS 9 *Financial Instruments*, IAS 39 *Financial Instruments: Recognition and Measurement(*)* and IFRS 7 *Financial Instruments: Disclosures* - Interest Rate Benchmark Reform
Effective date	Annual periods beginning on or after 1 January 2020. *(At the date of publication, the Malaysian Accounting Standards Board has not yet issued these amendments.)*

What is the issue?

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

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 the issuance of 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.

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What is the impact and for whom?

LIBOR is being gradually replaced across the globe. Both financial institutions and corporates in Malaysia with USD denominated or LIBOR-based debt instruments and derivative contracts will be impacted by the reform. Other than impacts on hedge accounting and disclosure, there are other longer-term financial reporting considerations such as impact to profit or loss as a result of changes to reference rates in the contract and changes to inputs used in fair valuing financial instruments.

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/MFRS 139(*) and IFRS 9/MFRS 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.

What are the key provisions?

'Highly probable' requirement

Cash flow hedge accounting under both IFRS 9/MFRS 9 and IAS 39/MFRS 139(*) requires the future hedged cash flows to be 'highly probable'. Where these cash flows depends 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 Sterling Overnight Index Average ('SONIA') + X% rather than LIBOR + Y%), this will not cause the 'highly probable' test to be failed.

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What are the key provisions? (continued)

Prospective assessment (economic relationship and 'highly effective' hedge)
Both IAS 39/MFRS 139(*) and IFRS 9/MFRS 9 require a forward-looking prospective assessment in order to apply hedge accounting. IAS 39/MFRS 139(*) requires the hedge to be expected to be highly effective, whereas IFRS 9/MFRS 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/MFRS 139(*) retrospective effectiveness test exception
The uncertainties described above in the context of prospective assessments could also affect the retrospective effectiveness requirement in IAS 39/MFRS 139(*). In particular, IBOR reform might cause a hedge to fall outside the required 80-125% range. IAS 39/MFRS 139(*) 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/MFRS 9 and IAS 39/MFRS 139(*) 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.

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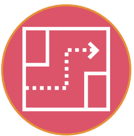

What are the transition provisions?

An entity shall apply the amendments retrospectively. This retrospective application applies only to the following:

- hedging relationships that existed at the beginning of the reporting period in which an entity first applies those amendments or were designated thereafter; and
- the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies those requirements.

Guidance note

(*) When entity first applied IFRS 9/MFRS 9, it may choose as its accounting policy to continue to apply the hedge accounting requirements of IAS 39/MFRS 139 instead of the requirements in Chapter 6 of IFRS 9/MFRS 9. Accordingly, the hedging rules in IAS 39/MFRS 139 remain relevant.

Do you have any further questions on this topic?	Contact: Michelle Loh Assurance Director from PwC Malaysia CMAAS Email: michelle.s.loh@pwc.com Tel: +60 (3) 2173 0858
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