In depth

A look at current financial reporting issues

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Practical guide to Phase 1 amendments IFRS 9, IAS 39 and IFRS 7 for IBOR reform

At a glance

Following the financial crisis, the replacement of benchmark interest rates such as LIBOR and other interbank offered rates ('IBORs') has become a priority for global regulators. Many uncertainties remain but the roadmap to replacement is becoming clearer. The IASB has embarked on a two-phase project to consider what, if any, reliefs to give from the effects of IBOR reform. For Phase 1, the IASB has issued amendments to IFRS 9, IAS 39 and IFRS 7 that provide temporary relief from applying specific hedge accounting requirements to hedging relationships directly affected by IBOR reform. Given the pervasive nature of hedges involving IBOR-based contracts, the reliefs could affect companies in all industries. This publication provides guidance on how to apply the amendments to various scenarios.

What's inside?

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Background

Benchmark interest rates are a core component of global financial markets. Retail and commercial loans, corporate debt, derivatives markets and many other financial markets, and bilateral contracts, all rely on these benchmark interest rates for pricing contracts and for hedging interest rate and other risks.

The London Interbank Offered Rate ('LIBOR') is one of the most common series of benchmark interest rates, referenced by contracts measured in trillions of dollars across global currencies. Following the financial crisis, calls grew to reform the process used to generate LIBOR (including USD LIBOR, JPY LIBOR, CHF LIBOR and GBP LIBOR), other IBORs such as Euribor, and other benchmark interest rates.

The resulting reforms aim to achieve a shift away from individual trader quotes to observed transaction rates and to increase the population on which those rates are based.

Since the changes are market driven, there remains significant uncertainty around their timing and precise nature. However a summary of the position, at the time of writing (November 2019), for some of the most used benchmark rates is as follows:

					
Selected Alternative Rate	SOFR Secured Overnight Financing Rate	SONIA Reformed Sterling Overnight Index Average	€STR* Euro Short-Term Rate	SARON Swiss Average Rate Overnight	TONA Tokyo Overnight Average rate
Working Group	Alternative Reference Rates Committee (ARRC)	Working Group on Sterling Risk-Free Rates	Working Group on Euro RFR	National Working Group on Swiss Franc reference rates (NWG)	Cross-Industry Committee on JPY Interest Rate Benchmarks
Administrator	Federal Reserve Bank of NY	Bank of England	European Central Bank	SIX Swiss Exchange	Bank of Japan
Key Features	• Fully transaction-based • Overnight rate • Secured	• Fully transaction-based • Overnight rate • Unsecured	• Fully transaction-based • Overnight rate • Unsecured	• Based on transactions and binding quotes • Overnight rate • Secured	• Fully transaction-based • Overnight rate • Unsecured

** See considerations regarding EONIA and Euribor on page 4*

Who might IBOR replacement affect and how?

Entities that might be affected range from corporate entities with IBOR-based debt funding, or that have hedged debt (fixed or floating) with derivatives that reference an IBOR, to financial institutions such as banks and insurers that issue products that reference an IBOR. Even if an entity does not have any contracts referencing an IBOR, it might still use an IBOR in constructing certain discount rates used in financial reporting, such as in calculating an asset's 'value in use' when assessing it for impairment or fair values in accordance with IFRS 13, and so it might still be affected by these changes. Major global banks are likely to be most affected by IBOR replacement, given the significant extent of their direct exposure to IBOR-linked financial instruments. However, IBOR reform might also be a significant issue for corporates, due to the pervasiveness of IBOR-based contracts in practice.

The impacts of IBOR replacement are potentially wide-ranging, and they are likely to include all of risk management, legal, IT and financial reporting. As a result, entities might need to form a multi-disciplinary team to assess the broader implications of IBOR reform and to manage the business implications of the transition to the replacement rates. This publication focuses on only one aspect of the reforms, namely the implications for financial reporting under IFRS. For publications on the latest developments in IBOR replacement, and for further reading on other aspects of IBOR replacement, visit our [LIBOR reference rate and reform insights page].

What do the Phase 1 amendments address?

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

PwC Observation

The IASB has provided the reliefs, because discontinuing hedge accounting solely due to IBOR reform would not provide useful information to the users of financial statements.

Phase 2 of the IASB's project will address issues that arise once an existing interest rate is replaced with an alternative interest rate. The IASB started its discussions of Phase 2 in September 2019 and expects these discussions to continue into the first half of 2020, after which it is expected to issue an exposure draft of proposed Phase 2 amendments for comment.

Scope of the amendments

The amendments apply to all hedging relationships that are directly affected by IBOR reform.

A hedging relationship is directly affected only if the IBOR reform gives rise to uncertainties about:

- a contractually or non-contractually specified interest rate benchmark that has been designated as a hedged risk; and/or
- the timing or the amount of IBOR-based cash flows of the hedged item or the hedged instrument.

PwC Observation

- The reliefs apply to hedges of interest rate risk, including hedges of issued or held debt instruments and of forecast debt issuances. The amendments apply to both contractually and non-contractually specified interest rate benchmarks, and so they include hedges of both floating- and fixed-rate debt instruments.
- However, the scope is broader than only hedges of interest rate risk. It includes some foreign currency hedges– in particular, hedges with cross-currency interest rate swaps where one or both of the legs of the swap references an IBOR. However, a hedge of foreign currency risk with an instrument such as a currency forward, where neither the cash flows of the hedging instrument nor the hedged risk reference an IBOR, is outside the scope of the reliefs.
- The reliefs also include hedging relationships in which interest rate risk is not the only hedged risk. For example, hedging relationships where an entity designates a cross-currency interest rate swap to hedge exposure to foreign currency and IBOR interest rate risk are in the scope of the reliefs.
- The reliefs apply to the market-wide reform of an interest rate benchmark, such as that resulting from the recommendations set out in the Financial Stability Board's July 2014 report 'Reforming Major Interest Rate Benchmarks'. However the reliefs are not limited to only the jurisdictions noted in that report. A market-wide reform is required, and so the reliefs do not apply to changes that are only specific to the two parties to a contract. They also do not apply to interest rate benchmarks that are not subject to reform or replacement.
- The reliefs might apply to only some items in a hedge relationship. For example, in a hedging relationship where the hedged item references an IBOR that is subject to reform but the hedging instrument references the replacement benchmark rate (that is not subject to reform), the reliefs will apply to the hedged item, because its future cash flows are uncertain but not to the hedging instrument.
- Furthermore, if the only impact of the reform is that the fair values of the items that comprise the hedging relationship are affected only by general uncertainty due to the IBOR reform, the reliefs will not apply, because there is only an 'indirect effect'.
- The amendments only provide exceptions from certain aspects of hedge accounting that arise from uncertainties over the timing or amount of cash flows in the period to when the reforms occur. The IASB's Phase 2 project will consider other issues including hedge designations when these uncertainties are no longer present and the accounting treatment to be applied to any changes to the terms of contracts.

PwC Observation

Changes to EONIA

During the second half of 2019, the methodology for calculating EONIA was modified to be redefined as €STR plus a fixed spread of 8.5pbs for a transition period that will end on 31 December 2021. After that time, it is envisaged that EONIA will cease to be published and will transition to be €STR although, at the time of writing (November 2019), there is still some uncertainty over the precise details of the transition.

The reliefs could not be applied for reporting dates where the financial statements were released before the amendments were published – which includes most June 2019 or earlier reporting dates. For 30 September 2019 and later reporting dates, the reliefs can be applied to contracts that reference EONIA and that extend beyond 31 December 2021, because there is uncertainty as to what the benchmark rate will be for the period after 31 December 2021. Where contracts mature before 31 December 2021 the reliefs cannot be applied, since there is no remaining uncertainty for these contracts (€STR+8.5bps will apply for the remaining term of the contract).

Changes to Euribor

At the time of writing (November 2019), Euribor was in the process of being transitioned from a quote-based methodology to a hybrid methodology. The reliefs could be applied to Euribor during this transitional period when there remains uncertainty around the outcome. However, once the transition period ends (scheduled to be by the end of 2019), the reliefs could no longer be applied unless the entity believes that there is still uncertainty as to whether Euribor will have to be further amended to comply with the reforms.

Key reliefs provided by the amendments

The Phase 1 amendments provide temporary relief from applying specific hedge accounting requirements to hedging relationships directly affected by IBOR reform. The key reliefs provided by the amendments relate to:

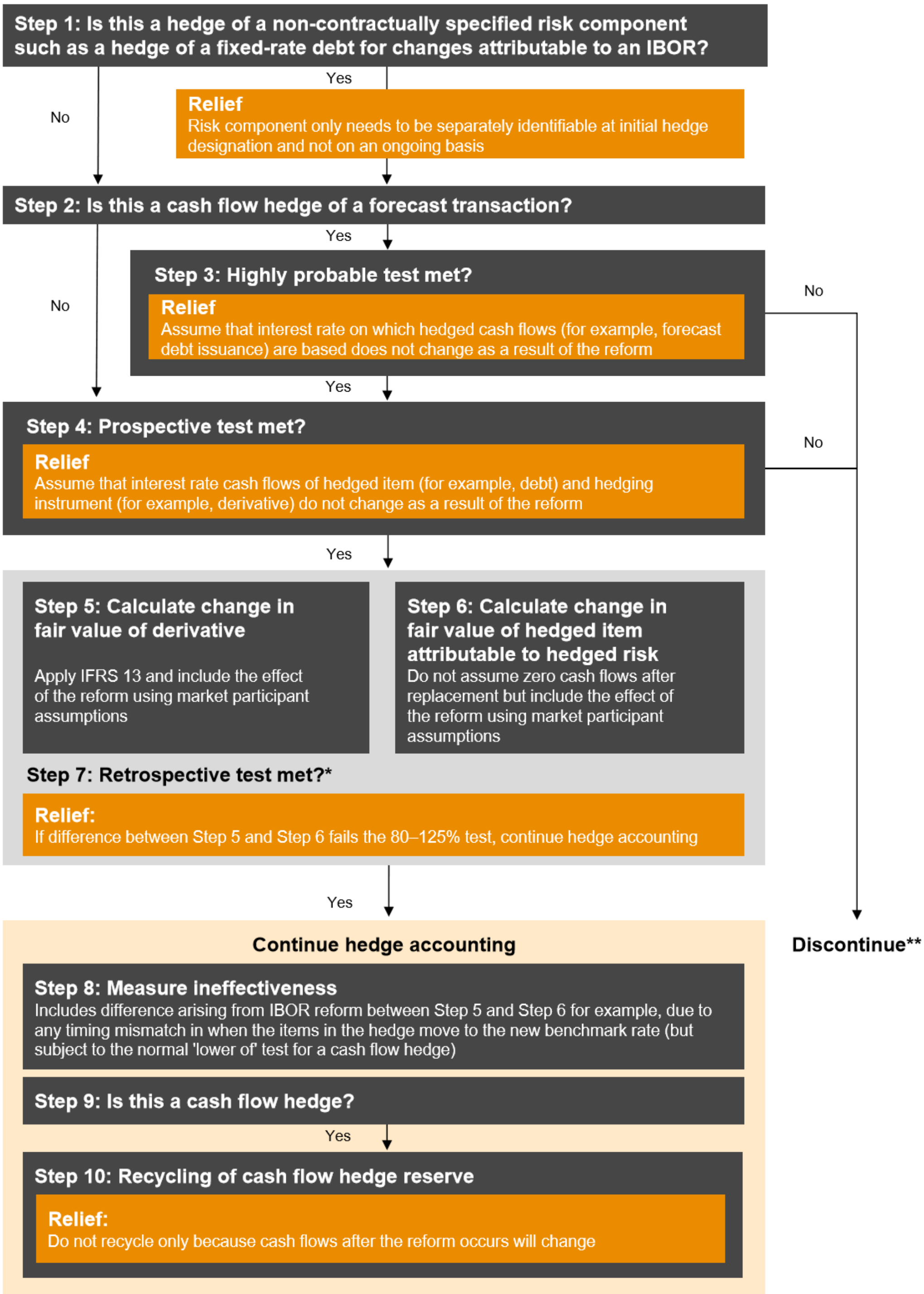
1. Risk components.
2. 'Highly probable' requirement.
3. Prospective assessments (economic relationship or expected to be 'highly effective').
4. IAS 39 retrospective effectiveness test.
5. Recycling of the cash flow hedging reserve.

The flowchart below summarises the reliefs, after which we give a more detailed explanation. In addition, Appendix 1 illustrates the application of the reliefs to a specific fact pattern (a hedge of interest rate risk on issued debt).

This publication provides a number of examples that explain the reliefs in different situations. For illustrative purposes, we have based the examples on GBP LIBOR changing to SONIA, but the same principles apply to other benchmark interest rates subject to IBOR reform.

Flowchart

The following flowchart illustrates the typical steps that an entity could follow in applying the hedge accounting requirements in IAS 39 and IFRS 9, and how the reliefs provided by the amendments will apply at each step.



* Retrospective test is only required under IAS 39
** The relief in Step 10 still applies even if hedge accounting is discontinued

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, a non-contractually specified risk component only needs to be separately identifiable at initial hedge designation and not on an ongoing basis. For example, in hedging relationships where an entity designates an interest rate swap as a hedge of exposure to changes in GBP LIBOR for a fixed-rate debt, and the market structure moves over time from being GBP LIBOR to SONIA (so the GBP LIBOR risk component is no longer separately identifiable), hedge accounting of the risk attributable to changes in GBP LIBOR can continue (subject to the other requirements for hedge accounting still being met).

PwC Observation

- There is no relief from performing an ongoing assessment of 'reliably measurable' this is because, if an entity cannot reliably measure the hedged risk component, it will not be able to measure and recognise any ineffectiveness.
- A practical effect of this is that, if IBOR quotes are no longer available such that the hedged component is no longer reliably measurable, this will lead to the discontinuance of hedge accounting. For this reason, the IASB is expected to consider, as part of its Phase 2 discussions, the possibility of re-designating the hedged risk component without discontinuing hedge accounting.
- How this relief for risk components applies to a dynamic macro hedge or a hedge of a group of items is discussed under 'Group hedges' below.

'Highly probable' requirement

Cash flow hedge accounting under both IAS 39 and IFRS 9 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 (or a fallback provision triggers a change in the benchmark rate).

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 might change as a result of IBOR reform (for example, where the future interest payments on a hedged forecast GBP debt issuance might be SONIA+X% rather than GBP LIBOR+Y%), this will not cause the 'highly probable' test to be failed.

However, if the highly probable test is failed for other reasons (for example, if it is no longer highly probable that the entity will go ahead with the forecast debt issuance whether due to uncertainty arising from the reforms or for any other reasons), hedge accounting will still need to be discontinued.

Prospective assessments (economic relationship or expected to be 'highly effective')

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.

At the time of writing (November 2019), cash flows under IBOR and IBOR replacement rates are 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.

PwC Observation

- One effect of this relief is that an entity assumes that any fallback clauses will not be triggered by the reforms.
- A hedging relationship might still fail the prospective assessment for other reasons. An example is a variable-rate debt denominated in one currency that is hedged with an interest rate swap denominated in a different currency but that is pegged to the currency of the debt. If the two currencies subsequently cease to be pegged, the prospective assessment would likely fail and hedge accounting would have to be discontinued.
- If, at a particular reporting date, the hedging instrument has moved to the alternative benchmark rate but the hedged item remains on the previous benchmark rate, the reliefs require an entity to assume that all of the future cash flows on the hedged item remain based on the previous benchmark rate, even if it is expected that the hedged item will move to the alternative benchmark rate in the near future. This is illustrated under 'Effect of the reliefs at 31 December 2021' in Appendix 1 below. Depending on the size of the impact, this

could have the effect that the hedge is no longer expected to be highly effective, in which case the hedge relationship would need to be discontinued despite the hedge relationship receiving relief from the retrospective effectiveness test.

- In addition, IBOR reform could have other implications for the prospective effectiveness test that entities will need to carefully consider. These include that:
  - where an entity uses critical terms match as a method to assess prospective effectiveness, the critical terms of the hedging instrument might no longer match those of the hedged item (in particular, in the case where the hedging instrument has moved to the alternative benchmark rate but the hedged item has not); and
  - where an entity uses regression analysis to assess prospective effectiveness, there might initially be a lack of directly observable data points for the replacement rate.
- Under IFRS 9, an entity determines whether prospectively, there continues to be an economic relationship between the hedging instrument and hedged item. If, prospectively, there is no longer such an economic relationship, the hedge relationship must be discontinued.

IAS 39 retrospective effectiveness test

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 for hedge accounting to continue.

PwC Observation

- An entity does not need to identify why the hedge failed the 80–125% retrospective effectiveness test. Even if this is for non-IBOR related reasons, the relief still applies. The reason is so that entities do not have to split any hedge ineffectiveness into the amount caused by IBOR reform and the amount caused by other factors. Such a split could be difficult to do in practice, and it would require an additional calculation to that required to measure any ineffectiveness.
- However, entities will still need to measure the change in fair value of the hedging instrument and the hedged item, since ineffectiveness must still be measured and reported in the income statement in the usual way. Therefore, if a hedge is only 75% effective, whilst the entity can continue hedge accounting, the 25% ineffectiveness must be recognised in the income statement (subject to the normal 'lower of' test for a cash flow hedge).
- Furthermore, if the prospective effectiveness assessment is failed at any reporting date, hedge accounting would need to be discontinued. Hence, it is important that entities have a robust prospective effectiveness test, since there is no longer the 'safety net' of potentially failing the retrospective test.

Recycling of the cash flow hedging reserve

The relief from recycling the cash flow hedging reserve follows a similar rationale to that for the 'highly probable' requirement. Under IAS 39 and IFRS 9, entities are required to recycle a cash flow hedge reserve if the hedged cash flows are no longer expected to occur. Where a hedged debt instrument depends on an IBOR (for example, a variable-rate debt that pays GBP LIBOR+X%), IBOR reform might have the effect that GBP LIBOR cash flows are not expected over the full term of the debt, because the contractual cash flows might switch to SONIA in the future. The relief 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. Therefore, if an entity expects the cash flows on a hedged variable-rate debt to change from, say, GBP LIBOR+X% to SONIA+Y%, this will not trigger recycling of the cash flow hedge reserve.

PwC Observation

- As noted above, if the outcome of a prospective test is that the hedge is not expected to be highly effective under IAS 39, or an entity determines that there is no longer an economic relationship between the hedging instrument and hedged item under IFRS 9, hedge accounting would need to be discontinued. However, in both cases, the balance of the cash flow hedge reserve would not be recycled through the income statement immediately, because the relief related to such recycling continues to apply. Rather, the balance of the cash flow hedge reserve will continue to be recycled to the income statement when the hedged cash flows impact the income statement.

Measuring ineffectiveness

The IASB has not provided any exception to the measurement of hedged items or hedging instruments. This is The IASB has not provided any exception to the measurement of hedged items or hedging instruments. This is because such an exception would be inconsistent with the decision not to change the requirements to measure and recognise hedge ineffectiveness.

PwC Observation

The fair value of derivatives designated as hedging instruments will continue to be measured using assumptions that market participants would use when pricing that derivative, as required by IFRS 13, 'Fair Value Measurement'. This will include any effect of IBOR reform that market participants would include when pricing that derivative. Unlike the prospective effectiveness assessment, the entity does not assume that the current benchmark rate will remain unchanged.

Similar principles apply when calculating the change in fair value of the hedged item for the purposes of measuring hedge ineffectiveness. So, for a fair value hedge, the change in fair value of the hedged item attributable to the hedged risk will include any effect of IBOR reform that market participants would include when pricing the hedged item for such changes in fair value. This includes any premium for uncertainty inherent in the hedged risk that a market participant would include. For a cash flow hedge, many entities use a hypothetical derivative method to measure the change in fair value of the hedged item attributable to the hedged risk. (A hypothetical derivative is a derivative whose terms match those of the designated hedged item for the designated hedged risk.) The fair value of the hypothetical derivative will similarly include any effect of IBOR reform that market participants would include when pricing a 'real' derivative that had the same cash flows on the variable leg as the hedged item.

An entity does not assume zero cash flows after the expected date of the replacement of the IBOR with an alternative benchmark. Rather, it includes the effect of the reform in the measurement using market participant assumptions. A market participant might factor in the effect of the reform in a number of ways including:

- assuming IBOR cash flows for the remaining life of the hedge but including an adjustment to the discount rate that reflects both (a) the market expectation of a change in the hedged item's benchmark rate in the future, and (b) the uncertainty associated with that change (for example, over the timing of the change, or what the new benchmark rate or spread will be, and the effect of any pre-existing fall back clauses); or
- Assuming IBOR cash flows for a certain number of remaining years and then assuming modification of the contract to the replacement benchmark rate, discounted using a discount rate that reflects only (b) above – that is, only the uncertainty associated with the change. A practical challenge with this approach is determining the cash flows in the period after the replacement, in particular the additional spread that is expected to be charged on the change to the new benchmark rate.

Under either approach, an entity might consider modelling a number of possible scenarios and probability weighting them. Other approaches could potentially be used, and the approach used by market participants could also change over time as the market evolves. However, any approach would need to reflect a market participant view of (a) the expectation/likelihood that the rate will change to the new benchmark (since this would be factored into the market's fair value measurement of the hedged item), and (b) the uncertainties associated with the change.

Sources of ineffectiveness

If there are any differences in how the hedged item and the hedging instrument transition to the new benchmark rate, this will likely give rise to ineffectiveness. Such differences could include the following:

- *Overnight versus term alternative benchmark rate:* For example, the hedging instrument moves to an overnight alternative benchmark rate (such as SONIA) but the hedged item moves to a term version of the same alternative benchmark rate (such as a three-month SONIA).
- *Timing of transition:* For example, if the hedging instrument transitions to the alternative benchmark rate before the hedged item, there will be a period when the hedged item references the current benchmark rate and the hedging instrument references the replacement rate. This will give rise to ineffectiveness both in the period when they reference different rates and in periods before either transitions. Furthermore, it is expected that a spread adjustment between the current benchmark rate and the alternative benchmark rate will be needed to achieve economic equivalence. If the hedging instrument transitions to the alternative benchmark rate before or after the hedged item, it is likely that the spread at each date will be different.
- *Fallback clauses:* It is possible that the fallback clauses in the hedging instrument (possibly following a protocol, such as one prescribed by ISDA) and the hedged item (agreed bilaterally between contract counterparties) will be different.

End of reliefs

The amendments prescribe when each of the reliefs will prospectively cease. In general, the reliefs end at the earlier of (a) when there is no longer uncertainty arising from IBOR reform over the timing or amount of the IBOR-based cash flows of the relevant item, and (b) when the hedging relationship to which the relief is applied is discontinued. More specifically the reliefs cease as follows:

- The 'highly probable' requirement – at the earlier of (a) when there is no longer uncertainty arising from IBOR reform over the timing or amount of the IBOR-based cash flows of the hedged item, and (b) when the hedging relationship of which that the hedged item is part is discontinued.
- Recycling of the cash flow hedge reserve – at the earlier of (a) when there is no longer uncertainty arising from IBOR reform over the timing or amount of the IBOR-based cash flows of the hedged item, and (b) when the entire amount in the cash flow hedge reserve for a discontinued hedging relationship has been recycled to profit or loss.
- Prospective assessments (expected to be highly effective or economic relationship) – for each of the hedging instrument and the hedged item: when there is no longer uncertainty arising from IBOR reform over the timing or amount of the IBOR-based cash flows or hedged risk of the hedged item or hedging instrument. This means that the relief could end at different times for the hedging instrument and the hedged item. However, if the hedging relationship is discontinued earlier than this date, this relief ceases to apply at the date of hedge discontinuation.
- Retrospective effectiveness test (IAS 39 only) – at the earlier of (a) when there is no longer uncertainty arising from IBOR reform over the hedged risk and the timing and amount of the IBOR-based cash flows, of both the hedged item and the hedging instrument, and (b) when the hedging relationship to which the relief is applied is discontinued.
- There is no end date for the relief on risk components.

PwC Observation

The basis of conclusions to the amendments provides examples of where the reliefs would cease to apply in various different scenarios. Generally, for uncertainty to be eliminated, the underlying contracts are required to be amended to specify the timing and amount of cash flows based on the alternative benchmark rate:

- Scenario A: Where a contract is amended to include a clause that specifies the date when the benchmark rate will be replaced, the alternative benchmark rate on which the cash flows will be based and the relevant spread adjustment between the current benchmark rate and the alternative benchmark rate (for example, 'GBP LIBOR will be replaced with SONIA+1.5% on 30 June 2021'). Uncertainty about both the timing and amount are removed when the contract is amended so the reliefs cease to apply to that contract (although they might continue for other contracts included in the hedge relationship that have not been similarly amended).
- Scenario B: Where a contract is amended to include a clause that states that modifications of cash flows will occur but neither a date for replacement nor the benchmark rate is specified (for example, 'GBP LIBOR will be replaced with an alternative benchmark rate at a date to be mutually agreed by the parties to the contract'). In this case, uncertainty has not been removed and reliefs continue to apply.
- Scenario C: Where a contract is amended to include a clause that states that conditions specifying the amount and timing of benchmark cash flows will be determined by a central authority at some point in the future (for example, 'GBP LIBOR will be replaced by the replacement rate determined by the Central Bank X when that replacement rate becomes effective'). Uncertainty will exist until the central authority specifies when the replacement of the benchmark will become effective, and what the alternative benchmark rate and any related spread adjustment will be, so the reliefs continue to apply.
- Scenario D: Where a contract is amended to include a clause in anticipation of the reform that specifies the date when the benchmark will be replaced and any spread adjustment between the benchmark and the alternative benchmark rate will be determined (for example 'GBP LIBOR will be replaced with an alternative benchmark rate on 30 June 2021. Any spread adjustment between GBP LIBOR and the alternative benchmark rate will be determined on 30 June 2021'). The alternative benchmark rate is not stated, nor is the spread adjustment. In this case, uncertainty about timing has been removed but uncertainty about the amount remains, so the reliefs continue to apply.
- Scenario E: Where a contract is amended to include a clause in anticipation of the reform that specifies the alternative benchmark rate on which the cash flows will be based and the spread adjustment between the benchmark and the alternative benchmark rate, but does not specify the date from which the amendment to the contract will become effective (for example, 'GBP LIBOR will be replaced with SONIA+1.5% to take effect from a date to be mutually agreed'). Uncertainty about the amount has been eliminated but uncertainty with respect to timing remains, so the reliefs continue to apply.
- Scenario F: Where in preparation for the reform, a central authority in its capacity as the administrator of an interest rate benchmark undertakes a multi-step process to replace a benchmark with an alternative benchmark rate (for example, the second stage of the reforms of EONIA that will take effect beyond 2021). The administrator introduces an interim benchmark rate and determines a fixed spread adjustment based on the difference between the interim benchmark rate and the current benchmark (for example, EONIA has been set as €STR plus 8.5% bps until the end of 2021). Uncertainty about the timing or the amount of the alternative

benchmark rate-based cash flows will not be eliminated during the interim period, because this is a temporary measure during the process to benchmark replacement, and the reliefs continue to apply. There is no uncertainty about the timing or amount of cash flows on contracts which mature before the end of 2021, although uncertainty remains for contracts with longer maturities.

The effect of the above is that the reliefs might end at different times for the hedged item and the hedging instrument. This is considered further under 'Cash flow hedge of interest rate risk on issued debt' in Appendix 1 below.

If a cash flow hedge is discontinued (for example, if the prospective effectiveness test is failed or the entity disposes of the hedging instrument) but there remains uncertainty over the timing or amount of the IBOR-based cash flows of the hedged item, the relief from recycling the cash flow hedge reserve will still apply.

Redesignation of the hedged risk

Under both IAS 39 and IFRS 9, when the reliefs cease to apply to a hedged item because it has moved to the alternative benchmark rate, and the hedged risk was designated in terms of the previous benchmark rate, the hedged risk must be redesignated (unless the entity's hedge designation allowed for IBOR reform). This will cause hedge accounting to be discontinued. Whilst an entity might be able to designate a new hedge using the same hedging instrument and hedged item, the fact that the derivative will typically have a non-zero fair value when that new hedge is designated will give rise to ineffectiveness.

Furthermore, certain paragraphs in the amendments suggest that, when the reliefs cease to apply to the hedged item, the balance of the cash flow hedge reserve will need to be recycled.

It is expected that the IASB will consider both of these issues as part of Phase 2 of its project on IBOR reform, and whether to provide additional reliefs to avoid this outcome.

Group hedges (including macro hedges)

This section deals with the effect of the amendments on hedges where either the hedging instrument or the hedged item (or both) comprises more than one contract or transaction. This includes:

- macro fair value hedges accounted for using the specific requirements for fair value portfolio hedges of interest rate risk in IAS 39 paras AG114–AG132;
- macro cash flow hedges (for example, as illustrated in IAS 39 IG F6.2 and F6.3);
- other hedges of groups of assets, liabilities, firm commitments or forecast transactions (see IAS 39 para 78, IFRS 9 para 6.3.1(b) and 6.6.1), including, under IFRS 9, hedges of a net position (see IFRS 9 para B6.6.1–B6.6.10);
- hedges of aggregated exposures (see IFRS 9 para 6.3.4); and
- hedges where the hedging instrument comprises two or more derivatives or proportions of them (see IAS 39 para 77, IFRS 9 para 6.2.5).

For such hedges, it is possible that IBOR reform will affect the items that make up either the hedging instrument or the hedged item at different times or in different ways. For example:

- where the hedged item is a group of variable-rate loans, some of the loans in the group might move to the new benchmark rate sooner than others;
- where the hedging instrument is a combination of instruments (for example, a cross-currency interest rate swap and an interest rate swap, or two interest rate swaps in different currencies), one swap might be amended to the replacement benchmark rate before the other;
- in a macro fair value hedge of a portfolio of loans where there is frequent de-designation and re-designation of the hedged item, at the time when a previously designated loan is re-designated, the interest rate risk that is separately identifiable might have changed from IBOR to the replacement benchmark rate.

The amendments include specific guidance on how to apply the amendments in such cases. More specifically, the guidance requires:

- Where the hedged item is a group of items or the hedging instrument is a combination of financial instruments, the requirements for when the reliefs end apply to each item or financial instrument separately. Thus, in the example above, where the hedged item is a group of variable-rate loans, if some of the loans in the group move to the new benchmark rate sooner than others, the relief for assessing prospective effectiveness will end at different times for the various loans in the group. Similarly, in the example above, where the hedging instrument is a combination of a cross-currency interest rate swap and an interest rate swap, or more than one interest rate swap, if one swap is amended to the replacement benchmark rate before the other, the relief for assessing prospective effectiveness will end at different times for the two swaps.
- In a macro fair value hedge, for the purpose of applying the relief for determining if an IBOR risk component is separately identifiable, an entity determines whether a particular IBOR risk component is separately identifiable only when it initially designates a hedged item (that is, an individual loan) in the macro fair value hedge. This is illustrated in the example below.

Example of the application of the separately identifiable relief to a macro fair value hedge

Entity B, a UK bank with a sterling fixed-rate mortgage portfolio, has designated changes in fair value of the mortgages attributable to GBP LIBOR in a macro fair value hedge relationship under IAS 39's specific requirements for such hedges. Consistent with Entity B's hedge documentation, the hedge frequently resets (that is, there is frequent de-designation and re-designation of the hedging instruments and hedged items to reflect changes in the underlying mortgage pool as mortgages prepay and new mortgages are originated).

The amendments require Entity B to determine whether GBP LIBOR is a separately identifiable risk component only when it designates a hedged item (that is a mortgage) in the macro fair value hedge for the first time. Without this relief, Entity B would be required to assess whether the GBP LIBOR risk component of all existing mortgages is separately identifiable, on an ongoing basis, each time a mortgage is redesignated as part of the hedged item. Hence, if there comes a time when GBP LIBOR is no longer separately identifiable (for example,. as the market for SONIA becomes more established and replaces GBP LIBOR as the market rate used for pricing and hedging new mortgages), a mortgage that had been previously included in the macro hedge and then de-designated could not be re-designated as part of the same macro hedge. The reliefs have the effect that such a mortgage could be re-designated as part of the same macro hedge.

PwC Observation

- In practice, some entities do not designate individual items in a macro fair value hedge. Rather, they designate an amount drawn from a portfolio of items, as permitted by IAS 39 para 114(c). In this kind of designation, the relief described above (to assess 'separately identifiable' only at initial designation of a hedged item) would not be needed.
- There is no end date on the relief for the 'separately identifiable' requirements. However, as noted above, there might come a time when the market structure has changed such that the replacement benchmark rate (that is, SONIA in the example above) rather than the 'old' IBOR (that is, GBP LIBOR in the example above) is now the only separately identifiable benchmark rate risk component. Any new items that are designated in the macro hedge for the first time after the old IBOR is no longer separately identifiable (for example, as new loans are originated) cannot be included in the old macro hedge. However, an entity could start a new macro hedge, with the risk component designated in terms of the replacement rate (for example, changes in fair value attributable to SONIA) for these loans.
- Under Phase 2 of the amendments to IFRS, the IASB are expected to consider whether to allow an entity to change the hedged benchmark rate (for example, from GBP LIBOR to SONIA) without discontinuing hedge accounting. If the IASB were to provide this additional relief, entities might not need to create a new macro fair value hedge as described above.

Disclosures

The amendments require disclosure of:

- the significant interest rate benchmarks to which the entity's hedging relationships are exposed;
- the extent of the risk exposure that the entity manages that is directly affected by the interest rate benchmark reform;
- how the entity is managing the process of transition to alternative benchmark rates;
- a description of significant assumptions or judgements that the entity made in applying the reliefs (for example, assumptions or judgements about when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows); and
- the nominal amount of the hedging instruments in those hedging relationships.

PwC Observation

- Users are likely to be interested in disclosures of how the entity is managing the transition process, since this will give information about the extent to which management is prepared for the transition. For example, if fallback provisions differ significantly between the hedged item and the hedging instrument, this might be a relevant aspect of the transition process to explain.
- The amendments require disclosure of the extent of the risk exposure that the entity manages that is directly affected by the interest rate benchmark reform. The amendments are not clear whether this disclosure could be provided on a qualitative basis; however, numerical disclosures might provide more useful information to users.
- In addition to the disclosures specifically required by the amendments, entities should consider the impact of IBOR reform on other required disclosures. For example, accounting policies relating to hedge accounting will be need to be updated for the reliefs and disclosures under IFRS 13, Fair value measurement might be impacted due to transfers between levels in the fair value hierarchy as markets become more / less liquid.

- The IASB's non-mandatory practice statement, 'Management commentary', recommends that management's commentary should be entity-specific, including principal risks and management's plans for managing those risks. Entities should therefore consider whether further disclosure of the impending replacement of IBOR and associated considerations should also be provided in other parts of the annual report. Local reporting regulations might require companies to disclose this information as part of the risks and uncertainties facing a company, for example, in the 'front half' of the annual report or in management's discussion and analysis ('MD&A').
- As more information is known about Phase 2 of the IASB's amendments to IFRS for IBOR reform, entities should consider disclosing the anticipated impacts of those amendments, in particular where there are critical accounting judgements or estimates.
- See Appendix 2 below for two examples of the disclosures required by the amendments.

Effective date

The amendments are mandatory and should be applied for annual periods beginning on or after 1 January 2020. Earlier application is permitted.

The amendments are subject to endorsement in the EU/EEA, and the EU is following an accelerated process with a view to endorsement in time for use for December 2019 year ends.

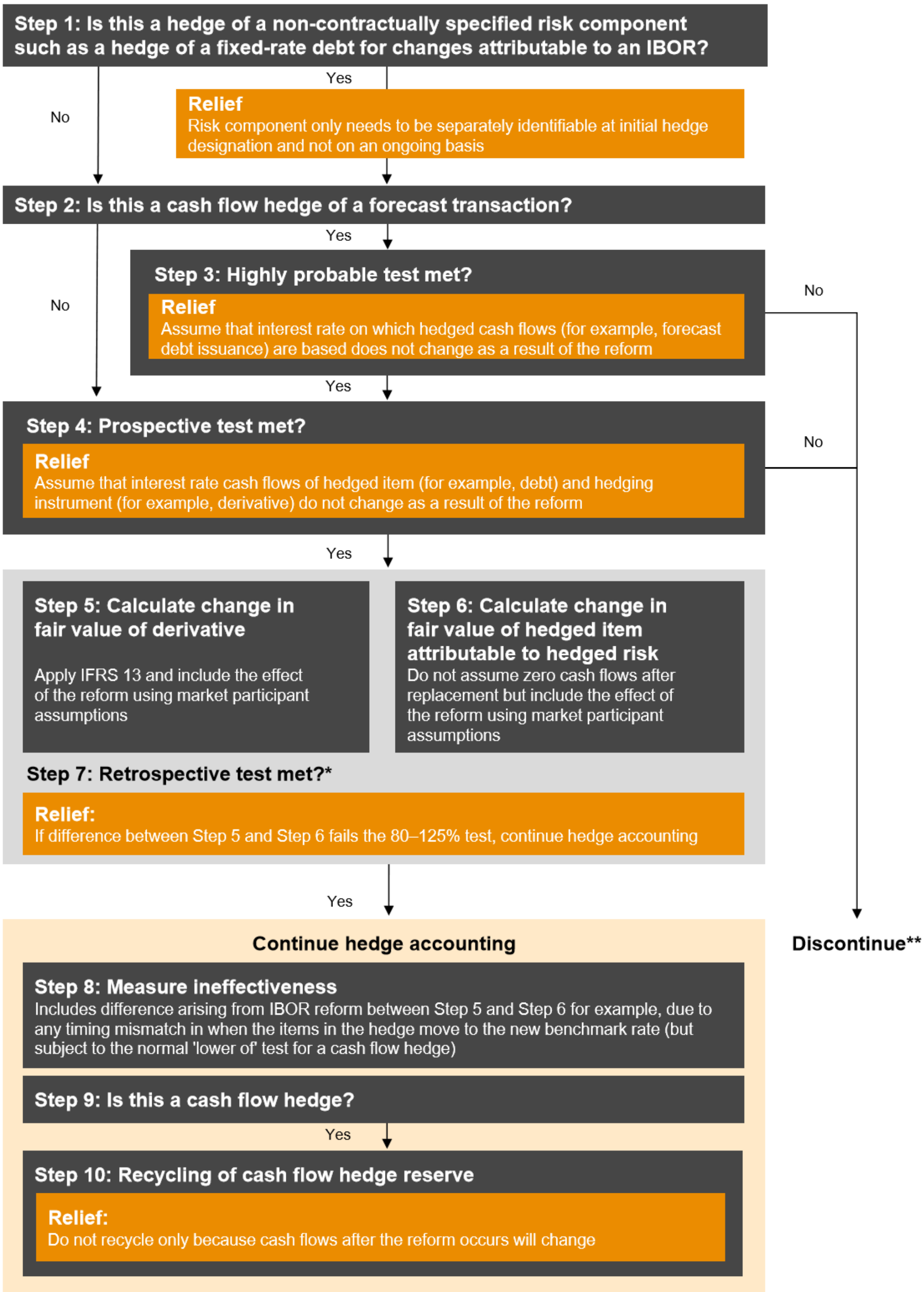
PwC Observation

- We expect that many entities will choose to early adopt the amendments as soon as possible, to ensure that hedge accounting can continue to be applied and avoid the need to perform the analysis that would otherwise be required.
- The amendments can be early adopted at both annual and interim reporting periods (subject to any local endorsement requirements).
- An entity that early adopts the amendments for its 31 December 2019 year end will apply the amendments retrospectively to hedging relationships that existed at the beginning of the reporting period in which the entity first applies the amendments or were designated thereafter, and to the amount recognised in the cash flow hedge reserve at the start of the reporting period.
- However, the amendments do not allow entities to reinstate hedge accounting that has already been discontinued. So, if an entity discontinued hedge accounting in an interim period due to IBOR uncertainty, it cannot reinstate hedge accounting for that hedge relationship in its annual financial statements by early adopting the amendments. The entity might be able to designate a new hedge to which the reliefs would apply (assuming that the entity has adopted the amendments). However, hedge accounting can only be applied from the date when any such new hedge is designated (that is, the amendments do not allow designation in hindsight, because doing so would be inconsistent with the general requirement for hedge accounting to be applied prospectively). In practice, we have not seen entities terminating hedge relationships due to IBOR uncertainty at the time of publication (November 2019), so this might not be a major issue for entities that choose to early adopt the amendments.
- If an entity does not early adopt the amendments, it will need to perform an analysis for the relevant benchmarks, to demonstrate whether it is still appropriate to continue hedge accounting in light of the uncertainty arising from the reform. This is likely to become more challenging as the date of the reform moves closer, but the implications might vary for different benchmark exposures, given the different speed at which IBOR reform is advancing in different jurisdictions.

Appendix 1 – Reliefs in action

Flowchart

The following flowchart illustrates the typical steps that an entity could follow in applying the hedge accounting requirements in IAS 39 and IFRS 9 and how the reliefs provided by the amendments will apply at each step.



* Retrospective test is only required under IAS 39

** The relief in Step 10 still applies even if hedge accounting is discontinued

Cash flow hedge of interest rate risk on issued debt

The example illustrates how the reliefs would apply in practice to four reporting periods. The facts are explained in detail below; in summary, they are:

	Dec 2019	**Dec 2020**	**Dec 2021**	**Dec 2022**
Hedged item - Floating-rate debt	GBP LIBOR	GBP LIBOR	GBP LIBOR	SONIA
Hedging instrument - Interest rate swap	GBP LIBOR	GBP LIBOR	SONIA	SONIA
Level of uncertainty relating to change to alternative benchmark rate	Significant uncertainty around the mechanism to replace GBP LIBOR with SONIA and the timing of the replacement.	Mechanism to replace GBP LIBOR with SONIA, and the timing of the replacement has become much clearer.	Hedging instrument has moved to SONIA. Some uncertainty remains for the hedged item.	No remaining uncertainty, since hedged item has moved to SONIA.
Expected timing of GBP LIBOR replacement	2021 for the hedging instrument. 2022 for the hedged item.	June 2021 for the hedging instrument. Mid 2022 for the hedged item.	June 2022 for the hedged item.	n/a

Facts

On 1 October 2015 Entity A issued 10-year floating-rate debt of GBP10,000 on which the interest rate is 3 month GBP LIBOR+1%. The debt is measured at amortised cost. At the same time as when it entered into the debt (1 October 2015) Entity A entered into a 10-year interest rate swap (the 'hedging instrument') on which it pays a fixed rate (3%) and receives 3 month GBP LIBOR+1%. Entity A simultaneously designated the swap in a cash flow hedge of the variability in cash flows of the debt, due to changes in 3 month GBP LIBOR (the 'hedged item'). The entity performs prospective effectiveness testing at inception of the hedge and at each reporting date using scenario analysis. All of the critical terms of the hedging instrument (the interest rate swap) match those of the hedged debt at the inception of the hedge in 2015. For retrospective effectiveness testing, Entity A measures the change in fair value of the hedged debt using a hypothetical derivatives method. Since the inception of the hedge, the hedge has continued to be highly effective, with changes in fair value of the hedging instrument (to the extent that the hedge was effective) recognised in other comprehensive income and deferred in the cash flow hedge reserve within equity. Both the debt and the interest rate swap do not include any fallback clauses indicating what the replacement rate will be if GBP LIBOR is discontinued.

The debt is prepayable by Entity A at par plus accrued interest. For all of the periods illustrated below Entity A has no intention to prepay the debt. Also there is no significant change in credit risk relating to the hedging instrument and the hedged item throughout the periods presented.

Entity A has a 31 December year end and has elected to apply IAS 39 hedge accounting. Since the IFRS 9 reliefs are broadly aligned with the IAS 39 reliefs (albeit with reference to IFRS 9 terminology), this example also illustrates application of the IFRS 9 reliefs. Any differences between IAS 39 and IFRS 9 reliefs are captured within 'PwC Observations' below.

Entity A is considering the impacts of IBOR reform on its hedge relationship and the reliefs available to it under IAS 39 from 31 December 2019 through to 31 December 2022. Entity A does not prepare IFRS compliant interim financial statements.

Effect of the reliefs at 31 December 2019

Additional facts at 31 December 2019

As at 31 December 2019, neither the hedging instrument (the interest rate swap) nor the hedged debt has been amended as a result of IBOR reform. Significant uncertainty exists around the mechanism to replace GBP LIBOR with SONIA. Management considers that the most likely scenario is that the hedging instrument and hedged debt will move to the same SONIA rate (the replacement rate for GBP LIBOR) and with the same adjustment to the spread during 2021 and 2022 respectively. The timing mismatch between the hedging instrument and the hedged item moving to SONIA will affect the measurement of ineffectiveness during each reporting period until both have moved to SONIA.

Assume that Entity A early adopts the amendments to IAS 39 for its 31 December 2019 year end.

On 31 December 2019, Entity A uses the flowchart to assess the effect of the reliefs on the hedge relationship as follows:

Step 1: Is this a hedge of a non-contractually specified risk component such as a hedge of a fixed-rate debt for changes attributable to an IBOR?

No, the floating-rate GBP LIBOR cash flows are contractually specified; continue to Step 2.

Step 2: Is this a cash flow hedge of a forecast transaction?

The hedged debt is a recognised liability with committed cash flows. However, the debt is prepayable, so Entity A needs to assess the effect of the prepayment option.

Step 3: Highly probable test met?

Entity A has no intention to prepay the debt. Accordingly, it assumes that all GBP LIBOR cash flows continue through to the maturity of the debt in October 2025. In particular, it does not assume zero cash flows after the expected move to SONIA in 2022.

Step 4: Prospective test met?

Entity A considers the prospective effectiveness of the hedge relationship using scenario analysis. Entity A assumes that both the hedging instrument (that is, the swap) and the hedged debt continue to have GBP LIBOR cash flows for the full term of the hedge, and thus their critical terms will continue to match. Hence, under all scenarios, the hedge relationship remains prospectively highly effective. For similar reasons, if the entity applied IFRS 9 rather than IAS 39, there would continue to be an economic relationship between the swap and the hedged debt.

Step 5: Calculate change in fair value of derivative

The fair value of the hedging instrument (that is, the swap) is determined under IFRS 13, 'Fair Value Measurement', using market participant assumptions. This will include any effect of the reform that market participants would take into account in light of the expected move to SONIA in 2021, the resulting adjustment to the spread, and the uncertainties associated with these and the other aspects of the reform that have not yet been finalised.

Step 6: Calculate change in fair value of hedged item attributable to hedged risk

At the inception of the hedge, Entity A constructed a hypothetical derivative whose terms reflect the relevant terms of the hedged item. Since Entity A hedges interest rate risk of the long-term debt, the relevant hypothetical derivative is an interest rate swap for the hedged amount (GBP10,000), maturing on the date on which the long-term loan is due for repayment (30 September 2025), with a floating leg of GBP LIBOR+1% and a fixed leg determined at inception to give a fair value of zero. Even though GBP LIBOR replacement in the loan is expected during 2022, the hypothetical derivative does not assume zero cash flows after 2022. However, the valuation of the hypothetical derivative will include any effect of the reform that market participants would include in an actual derivative with terms and expectations that match those of the hedged item -i.e. a derivative that is expected to move to SONIA in 2022, the resulting adjustment to the spread, and the uncertainties associated with these and the other aspects of the reform that have not yet been finalised.

Step 7: Retrospective test met?

Entity A considers the retrospective effectiveness of the hedge relationship calculating the change in the fair value of the derivative (Step 5) and the hedged item (Step 6). Assume for illustrative purposes that due to the high level of uncertainty, GBP LIBOR and SONIA curves are broadly equivalent and the retrospective effectiveness test is passed.

Step 8: Measure ineffectiveness

Since the fair value of the derivative includes assumptions about the timing of GBP LIBOR replacement that do not match those on the hypothetical derivative, this timing mismatch is expected to give rise to ineffectiveness. Ineffectiveness might also arise from the uncertainties associated with both the timing and the other aspects of the reform that have not yet been finalised to the extent that these might have a different impact on the derivative and on the hedged debt. The resulting ineffectiveness must be recognised immediately in the income statement (subject to the normal 'lower of' test). The change in fair value of the hedging instrument (that is, the swap), to the extent that the hedge is effective, is recognised in other comprehensive income and deferred in the cash flow hedge reserve.

Step 9: Is this a cash flow hedge?

Yes; continue to Step 10.

Step 10: Recycling of cash flow hedge reserve

The change in fair value of the hedging instrument (that is, the swap) relating to the effective portion of the hedge relationship is recognised in other comprehensive income and deferred in the cash flow hedge reserve. Entity A does not recycle the cash flow hedge reserve for the portion of the reserve that relates to cash flows of the hedged debt after the expected GBP LIBOR replacement during 2022.

Effect of the reliefs at 31 December 2020

Additional facts at 31 December 2020

During 2020, the mechanism to replace GBP LIBOR with SONIA (the replacement rate for GBP LIBOR in the UK) has become much clearer. As a result, at 31 December 2020 it is clearer how the replacement will be calculated and it is possible to estimate a range for the likely additional spread that market participants will require at the time of the change. The timing of the replacement for the interest rate swap has become clearer and it is now expected to be June 2021. The expected timing of the replacement for the hedged debt is now mid-2022. Management still considers that the most likely scenario is that the swap and the hedged debt will move to the same SONIA rate and with the same adjustment to the spread.

On 31 December 2020, Entity A uses the flowchart to assess the effect of the reliefs on the hedge relationship as follows:

Step 1: Is this a hedge of a non-contractually specified risk component such as a hedge of a fixed-rate debt for changes attributable to an IBOR?

No the floating-rate GBP LIBOR cash flows are contractually specified; continue to Step 2.

Step 2: Is this a cash flow hedge of a forecast transaction?

The hedged debt is a recognised liability with committed cash flows. However, the debt is prepayable, so Entity A needs to assess the effect of the prepayment option.

Step 3: Highly probable test met?

Entity A has no intention to prepay the debt. Accordingly, it assumes that all GBP LIBOR cash flows continue through to the maturity of the debt in October 2025. In particular, it does not assume zero cash flows after the expected move to SONIA in mid-2022.

Step 4: Prospective test met?

At 31 December 2020, Entity A considers the prospective effectiveness of the hedge relationship using scenario analysis. Entity A assumes that both the hedging instrument (that is, the swap) and the hedged debt continue to have GBP LIBOR cash flows, and thus their critical terms will continue to match. Hence, under all scenarios, the hedge relationship remains prospectively highly effective. For similar reasons, if the entity applied IFRS 9 rather than IAS 39, there would continue to be an economic relationship between the swap and the hedged debt.

Step 5: Calculate change in fair value of derivative

The fair value of the hedging instrument (that is, the swap) is determined under IFRS 13, 'Fair Value Measurement', using market participant assumptions. This will include any effect of the reform that market participants are including, given the expected move of the derivative to SONIA in June 2021, the resulting adjustment to the spread, and the uncertainties associated with these and the other aspects of the reform that have not yet been finalised.

Step 6: Calculate change in fair value of hedged item attributable to hedged risk

At the inception of the hedge, Entity A constructed a hypothetical derivative whose terms reflected the relevant terms of the hedged item. Since Entity A hedges interest rate risk of the long-term debt, the relevant hypothetical derivative is an interest rate swap for the hedged amount (GBP10,000), maturing on the date on which the long-term loan is due for repayment (October 2025), with a floating leg of GBP LIBOR+1% and a fixed leg determined at inception to give a fair value of zero. Even though GBP LIBOR replacement for the loan is expected during mid-2022, the hypothetical derivative does not assume zero cash flows after mid-2022. However, the valuation of the hypothetical derivative will include any effect of the reform that market participants would include in an actual derivative with terms and expectations that match those of the hedged item - i.e. a derivative that is expected to move to SONIA in mid-2022, the resulting adjustment to the spread, and the uncertainties associated with these and the other aspects of the reform that have not yet been finalised.

Step 7: Retrospective test met?

Entity A considers the retrospective effectiveness of the hedge relationship, calculating the change in the fair value of the derivative (Step 5) and the hedged item (Step 6).

Since the fair values of the derivative and the hypothetical derivative reflect the expected replacement of GBP LIBOR, including the different times when each of the derivative and the hedged debt are expected to move to SONIA, the 'timing mismatch' gives rise to ineffectiveness. Assume for illustrative purposes that Entity A has determined that the hedge relationship does not remain retrospectively effective – that is, the actual results of the hedge do not fall within the required 80–125% effectiveness range. This might be due solely to the effect of the reforms and the timing difference noted above, or it might be due to a combination of the reforms and other factors (such as an increase in the credit risk of the interest rate swap). Nevertheless, Entity A continues the hedge relationship, as required by the reliefs given at 31 December 2020; there remains uncertainty relating to benchmark reform, and all other hedge accounting criteria are met.

Step 8: Measure ineffectiveness

Since the fair value of the derivative includes assumptions about the timing of GBP LIBOR replacement that do not match those on the hypothetical derivative, this timing mismatch is expected to give rise to ineffectiveness. Ineffectiveness might also arise from the uncertainties associated with both the timing and the other aspects of the reform that have not yet been finalised to the extent that these might have a different impact on the derivative and on the hedged debt. The resulting ineffectiveness must be recognised immediately in the income statement (subject to the normal 'lower of' test). The change in fair value of the hedging instrument (that is, the swap), to the extent that the hedge is effective, is recognised in other comprehensive income and deferred in the cash flow hedge reserve.

Step 9: Is this a cash flow hedge?

Yes; continue to Step 10.

Step 10: Recycling of cash flow hedge reserve

As noted in Step 8, the change in fair value of the hedging instrument relating to the effective portion of the hedge relationship is recognised in other comprehensive income and deferred in the cash flow hedge reserve. Entity A does not recycle the cash flow hedge reserve for the portion of the reserve that relates to cash flows of the hedged debt after the expected GBP LIBOR replacement during 2022.

Effect of the reliefs at 31 December 2021

Additional facts at 31 December 2021

During 2021, the terms of the hedging instrument (that is, the swap) are amended such that Entity A receives SONIA+1.5% (rather than 3 month GBP LIBOR+1%). All of the other terms of the swap remain unchanged. Hence the uncertainty relating to GBP LIBOR replacement has ceased to exist for the hedging instrument, and so Entity A can no longer apply reliefs to the hedging instrument.

The interest rate and all other terms of the hedged debt remain unchanged (that is, it continues to have a contractual interest rate of 3 month GBP LIBOR+1%). There remains uncertainty over when the hedged debt will move to SONIA, what SONIA rate this will be, and the associated adjustment to the spread. Hence Entity A continues to apply reliefs to the hedged debt.

The timing of the replacement for the hedged debt has, however, become clearer, and it is now expected to be June 2022. Management considers that the most likely scenario is that the hedged debt will move to the same SONIA rate and with the same adjustment to the spread as the swap.

Entity A uses the flowchart to assess the effect of the reliefs on the hedge relationship as follows:

Step 1: Is this a hedge of a non-contractually specified risk component such as a hedge of a fixed-rate debt for changes attributable to an IBOR?

No the floating-rate GBP LIBOR cash flows are contractually specified; continue to Step 2.

Step 2: Is this a cash flow hedge of a forecast transaction?

The hedged debt is a recognised liability with committed cash flows. However, the debt is prepayable, so Entity A needs to assess the effect of the prepayment option.

Step 3: Highly probable test met?

Entity A has no intention to prepay the debt. Accordingly, it assumes that all GBP LIBOR cash flows continue through to the maturity of the debt in October 2025. In particular, it does not assume zero cash flows after the expected move to SONIA in June 2022.

Step 4: Prospective test met?

Entity A considers the prospective effectiveness of the hedge relationship, assuming that the benchmark rate specified in the hedged debt is not altered by IBOR reform. As a result, the benchmark cash flows of the hedging instrument are based on SONIA, and those of the hedged item are based on GBP LIBOR. Hence, the critical terms of the hedging instrument and the hedged item no longer match. Assume that the scenario analysis used by Entity A to assess prospective effectiveness demonstrates that the resulting ineffectiveness is sufficiently small that the hedge relationship remains prospectively highly effective.

Given this assumption, if the entity applied IFRS 9 rather than IAS 39, there would likely continue to be an economic relationship between the swap and the hedged debt.

However, if the prospective effectiveness test is failed (under IAS 39) or there is no longer an economic relationship (under IFRS 9), then hedge accounting would need to be discontinued.

Step 5: Calculate change in fair value of derivative

As at 31 December 2020, the hedging instrument is fair valued under IFRS 13, which is based on SONIA cash flows.

Step 6: Calculate change in fair value of hedged item attributable to hedged risk

At the inception of the hedge, Entity A constructed a hypothetical derivative whose terms reflected the relevant terms of the hedged item. Since Entity A hedges interest rate risk of the long-term debt, the relevant hypothetical derivative is an interest rate swap for the hedged amount (GBP10,000), maturing on the date on which the long-term loan is due for repayment (October 2025), with a floating leg of GBP LIBOR+1% and a fixed leg determined at inception to give a fair value of zero. Even though GBP LIBOR replacement is expected in June 2022, the hypothetical derivative does not assume zero cash flows after June 2022. However, the valuation of the hypothetical derivative will include any effect of the reform that market participants would include in an actual derivative with terms and expectations that match those of the hedged item - i.e. a derivative that is expected to move to SONIA in June 2022, the resulting adjustment to the spread, and the uncertainties associated with these and the other aspects of the change to the terms of the debt that have not yet been finalised.

Step 7: Retrospective test met?

Entity A considers the retrospective effectiveness of the hedge relationship, calculating the change in the fair value of the derivative (Step 5) and the hedged item (Step 6).

The fair value of the hedging instrument is now based on SONIA cash flows, whilst that of the hypothetical derivative reflects both its current GBP LIBOR cash flows and the expected amendment of those cash flows to SONIA in June 2022 (including any uncertainty associated with the expected amendment). The different valuation bases give rise to ineffectiveness. Assume for illustrative purposes that Entity A has determined that the hedge relationship does not remain retrospectively effective – that is, the actual results of the hedge do not fall within the required 80–125% effectiveness range. This might be due solely to the effect of the reforms and the timing difference noted above, or it might be due to a combination of the reforms and other factors (such as an increase in the credit risk of the interest rate swap). Nevertheless, Entity A continues the hedge relationship, as required by the reliefs given at 31 December 2021; there remains uncertainty relating to benchmark reform and all the other hedge accounting criteria are met.

Step 8: Measure ineffectiveness

The resulting ineffectiveness must be recognised immediately in the income statement (subject to the normal 'lower of' test). The change in fair value of the hedging instrument (that is, the swap), to the extent that the hedge is effective, is recognised in other comprehensive income and deferred in the cash flow hedge reserve.

Step 9: Is this a cash flow hedge?

Yes; continue to Step 10.

Step 10: Recycling of cash flow hedge reserve

As noted in Step 8, the change in fair value of the hedging instrument relating to the effective portion of the hedge relationship is recognised in other comprehensive income and deferred in the cash flow hedge reserve. Entity A does not recycle the cash flow hedge reserve for the portion of the reserve that relates to cash flows of the hedged item after the expected GBP LIBOR replacement in June 2022.

Effect of the reliefs at 31 December 2022

Additional facts at 31 December 2022

During 2022, the interest rate of the hedged item is amended to be SONIA+1.5%. No other changes are made to the terms of the hedged debt.

At 31 December 2022, the uncertainty relating to GBP LIBOR replacement has ceased to exist for both the hedging instrument and the hedged item. Entity A can no longer apply the reliefs to either the hedging instrument or the hedged item.

Entity A re-designates the hedged risk (to be SONIA interest rate risk). Under both IAS 39 and IFRS 9, this would cause the hedge to be discontinued. However, it is expected that the IASB will consider, as part of Phase 2 of its project on IBOR reform, whether to provide additional reliefs to avoid this outcome.

Appendix 2 – Illustrative disclosures

Example 1: Corporate IAS 39 hedge disclosures – cash flow hedge

These disclosures illustrate the 'reliefs in action' for the December 2019 year end, and they are limited to the disclosures required by the amendments and other hedge accounting disclosures affected by IBOR reform. See our Illustrative IFRS consolidated financial statements for 2019 year ends for other IFRS 7 hedge accounting disclosures.

Hedge accounting disclosures

Interest rate risk on variable-rate borrowings (cash flow hedge)

Entity A's interest rate risk arises from its 10-year floating-rate debt of GBP10,000 whose interest rate is based on 3 month GBP LIBOR. Entity A's risk management policy is to hedge the variability in cash flows on floating-rate debt using floating-to-fixed interest rate swaps. Therefore Entity A has entered into a 10-year interest rate swap (the 'hedging instrument') on which it pays a fixed rate and receives a variable rate that matches that on the issued debt. The debt is carried at amortised cost.

Amended standards early adopted

Entity A has elected to early adopt the 'Amendments to IAS 39 and IFRS 7 Interest Rate Benchmark Reform' issued in September 2019. In accordance with the transition provisions, the amendments have been adopted retrospectively to hedging relationships that existed at the start of the reporting period or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve at that date.

The 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 continues to be recorded in the income statement. 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.

In summary, the reliefs provided by the amendments that apply to Entity A are[1]:

- When considering the 'highly probable' requirement, Entity A has assumed that the GBP LIBOR interest rate on which our hedged debts are based does not change as a result of IBOR reform.
- In assessing whether the hedge is expected to be highly effective on a forward-looking basis Entity A has assumed that the GBP LIBOR interest rate on which the cash flows of the hedged debt and the interest rate swap that hedges it are based is not altered by IBOR reform.
- Entity A will not discontinue hedge accounting during the period of IBOR-related uncertainty solely because the retrospective effectiveness falls outside the required 80–125% range.
- Entity A has not recycled the cash flow hedge reserve relating to the period after the reforms are expected to take effect.

Note X provides the required disclosures of the uncertainty arising from IBOR reform for hedging relationships for which Entity A applied the reliefs.

Possible sources of ineffectiveness are as follows:

….

(v) the effects of the forthcoming reforms to GBP LIBOR, because these might take effect at a different time and have a different impact on the hedged item (the floating-rate debt) and the hedging instrument (the interest rate swap used to hedge the debt). Further details of these reforms are set out below.

[1] The reliefs illustrated are specific to cash flow hedges. Other disclosures would be required for fair value hedges; see Example 2: Bank IFRS 9 hedge disclosures – fair value hedge.

IFRS7(24H)(a)
IFRS7(24H)(b)
IFRS7(24H)(c)

Effect of IBOR reform

Following the financial crisis, the reform and replacement of benchmark interest rates such as GBP LIBOR and other interbank offered rates ('IBORs') has become a priority for global regulators. There is currently uncertainty around the timing and precise nature of these changes. Entity A's risk exposure that is directly affected by the interest rate benchmark reform is its GBP10,000 10-year floating-rate debt. Entity A has hedged this debt with an interest rate swap, and it has designated the swap in a cash flow hedge of the variability in cash flows of the debt, due to changes in 3 month GBP LIBOR that is the current benchmark interest rate.

It is currently expected that SONIA (Sterling Overnight Index Average) will replace GBP LIBOR. There are key differences between GBP LIBOR and SONIA. GBP LIBOR is a 'term rate', which means that it is published for a borrowing period (such as 3 months), and it is 'forward-looking', because it is published at the beginning of the borrowing period. SONIA is currently a 'backward-looking' rate; it is based on overnight rates from actual transactions, and it is published at the end of the overnight borrowing period. Furthermore, GBP LIBOR includes a credit spread over the risk-free rate, which SONIA does not. To transition existing contracts and agreements that reference GBP LIBOR to SONIA, adjustments for term differences and credit differences might need to be applied to SONIA, to enable the two benchmark rates to be economically equivalent on transition.

At the time of reporting, industry working groups are reviewing methodologies for calculating adjustments between GBP LIBOR and SONIA. The Working Group on Sterling Risk-Free Reference Rates has stated that it anticipates that a term SONIA reference rate could be developed in the first quarter of 2020.

The Board has established a committee to oversee Entity A's GBP LIBOR transition plan. This transition project will include changes to systems, processes, risk and valuation models, as well as managing related tax and accounting implications. Entity A currently anticipates that the areas of greatest change will be amendments to the contractual terms of GBP LIBOR-referenced floating-rate debt and swaps, and updating hedge designations.

PwC Observation

- This disclosure should be repeated for each significant interest rate benchmark to which the entity's hedging relationships are exposed, but it has been given here only for GBP LIBOR for illustrative purposes.
- We have assumed that the interest rate risk of the floating-rate debt is the only IBOR-related risk exposure managed by Entity A. These disclosures will need to be expanded to include entity-specific disclosures of all other IBOR-related risk exposures that are managed by the entity, including how the entity is managing the transition process. In addition to debt instruments and derivatives, these might include leases and other contracts with payments linked to an IBOR.
- As Entity A advances through its transition process, the disclosure above will need to be updated to reflect the latest information specifically relating to Entity A and its transition process.

IFRS7(24A)
IFRS7(24H)(e)

The following table contains details of the hedging instruments used in the Entity A's hedging strategy[2]:

		Carrying amount		Balance sheet line item(s)	Changes in fair value used for calculating hedge ineffectiveness	Nominal amount directly impacted by IBOR reform
	Notional	Assets	Liabilities			
	£'000	£'000	£'000		£'000	£'000
Cash flow hedges						
Interest rate						
Interest rate swaps	10,000	xxx	-	Hedging Derivatives	xxx	10,000

[2] In practice, if an entity has a limited number of hedges, the disclosures could be provided in a narrative form rather than in a table.

IFRS7(24B) The following table contains details of the hedged exposures covered by Entity A's hedging strategies:

	Carrying amount of hedged item		Balance Sheet line item	Change in fair value of hedged item for ineffectiveness assessment	Cash flow hedge reserve	
	Assets	Liabilities			Continuing hedges	Discontinued hedges
	£'000	£'000		£'000	£'000	£'000
Cash flow hedges						
Interest rate						
Floating-rate debt	-	10,000	Borrowings	xxx	xxx	-

IFRS7(24C)(b)(ii) Ineffectiveness of £xxx has been included under 'Other gains or losses' in profit or loss.

IFRS7(24H)(d)

Effect of IBOR reform – significant assumptions

In calculating the change in fair value attributable to the hedged risk of floating-rate debt, Entity A has made the following assumptions that reflect its current expectations:

- The floating-rate debt will move to SONIA during 2022, and the spread will be similar to the spread included in the interest rate swap used as the hedging instrument;
- No other changes to the terms of the floating-rate debt are anticipated; and
- Entity A has incorporated the uncertainty over when the floating-rate debt will move to SONIA, the resulting adjustment to the spread, and the other aspects of the reform that have not yet been finalised by adding an additional spread to the discount rate used in the calculation.

Example 2: Bank IFRS 9 hedge disclosures – fair value hedge

The example disclosures are based on our IFRS 9 for Banks – Illustrative disclosures for interest rate risk on fixed-rate mortgages (fair value hedge). They are given for the period ending 31 December 2019 and are limited to those required by the amendment and other hedge accounting disclosures affected by IBOR reform. The additional disclosures, and associated changes to pre-existing IFRS 7 hedging disclosures, are highlighted in boxes below.

4. Hedge accounting disclosures

Interest rate risk on fixed-rate mortgages (fair value hedge)

IFRS7(22A)(a), (22B)(a)

The Group holds a portfolio of long-term fixed-rate mortgages and therefore is exposed to changes in fair value due to movements in market interest rates. The Group manages this risk exposure by entering into pay fixed / receive floating interest rate swaps.

IFRS7(22A)(b), (22B)(b),

(22C)

Only the interest rate risk element is hedged, and so other risks, such as credit risk, are managed but not hedged by the Group. The interest rate risk component is determined as the change in fair value of the long-term fixed-rate mortgages arising solely from changes in 3-month GBP LIBOR (the benchmark rate of interest). Such changes are usually the largest component of the overall change in fair value. This strategy is designated as a fair value hedge, and its effectiveness is assessed by comparing changes in the fair value of the loans attributable to changes in the benchmark rate of interest with changes in the fair value of the interest rate swaps.

IFRS7(22B)(c), (23D)

The Group establishes the hedging ratio by matching the notional of the derivatives with the principal of the portfolio being hedged. Possible sources of ineffectiveness are as follows: (i) differences between the expected and actual volume of prepayments, since the Group hedges to the expected repayment date, taking into account expected prepayments based on past experience; (ii) differences in the discounting between the hedged item and the hedging instrument, because cash collateralised interest rate swaps are discounted using Overnight Indexed Swaps (OIS) discount curves, which are not applied to the fixed-rate mortgages;

(iii) hedging derivatives with a non-zero fair value at the date of initial designation as a hedging instrument; and

(iv) counterparty credit risk which impacts the fair value of uncollateralised interest rate swaps but not the hedged items.

(v) the effects of the forthcoming reforms to GBP LIBOR, because these might take effect at a different time and have a different impact on the hedged item (the fixed-rate mortgages) and the hedging instrument (the derivatives used to hedge those mortgages). Further details of these reforms are set out on page x below.

IFRS7(23C)

The Group manages the interest rate risk arising from fixed-rate mortgages by entering into interest rate swaps on a monthly basis. The exposure from this portfolio frequently changes due to new loans originated, contractual repayments and early prepayments made by customers in each period. As a result, the Group adopts a dynamic hedging strategy (sometimes referred to as a 'macro' or 'portfolio' hedge) to hedge the exposure profile by closing and entering into new swap agreements at each month-end. The Group uses the portfolio fair value hedge of interest rate risk to recognise fair value changes related to changes in interest rate risk in the mortgage portfolio, and therefore reduce the profit or loss volatility that would otherwise arise from changes in fair value of the interest rate swaps alone.

IFRS7(24D)

Disclosures not illustrated because they are not applicable to the Group

Paragraph 23C of IFRS 7 exempts entities from disclosing the profile of the timing of the nominal amounts and the average price or rate of the hedging instruments for 'macro' hedges – because, in such hedges, entities frequently reset the hedging relationship – and instead requires the disclosure of information included in the illustrative disclosure above. Where the volume of such hedging relationships is unrepresentative of normal volumes during the period (that is, the volume at the reporting date does not reflect the volumes during the period), an entity should disclose that fact and the reason why it believes that the volumes are unrepresentative.

Amended standards early adopted

The Group has elected to early adopt the 'Amendments to IFRS 9, IAS 39 and IFRS 7 Interest Rate Benchmark Reform' issued in September 2019. In accordance with the transition provisions, the amendments have been adopted retrospectively to hedging relationships that existed at the start of the reporting period or were designated thereafter.

The 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. 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.

In summary, the reliefs provided by the amendments that apply to the Group are[3]:

- In assessing whether the hedge is expected to be highly effective on a forward-looking basis, the Group has assumed that the GBP LIBOR interest rate on which the cash flows of the interest rate swap that hedges fixed-rate mortgages is not altered by IBOR reform.
- The Group will not discontinue hedge accounting during the period of IBOR-related uncertainty solely because the retrospective effectiveness falls outside the required 80–125% range.
- The Group has assessed whether the hedged GPB LIBOR risk component is a separately identifiable risk only when it first designates a mortgage as included in its macro hedge and not on an ongoing basis.

Note X provides the required disclosures of the uncertainty arising from IBOR reform for hedging relationships for which the Group applied the reliefs.

Effect of IBOR reform

IFRS7(24H)(a)
IFRS7(24H)(b)
IFRS7(24H)(c)

Following the financial crisis, the reform and replacement of benchmark interest rates such as GBP LIBOR and other interbank offered rates ('IBORs') has become a priority for global regulators. There is currently uncertainty around the timing and precise nature of these changes. The Group's risk exposure that is directly affected by the interest rate benchmark reform is its portfolio of long-term, fixed-rate mortgages of CU23,412. As explained in more detail above, these mortgages are hedged, using a portfolio of interest rate swaps, for changes in fair value attributable to 3-month GBP LIBOR that is the current benchmark interest rate. However, as part of the reforms noted above, the UK Financial Conduct Authority ('FCA') has decided to no longer compel panel banks to participate in the GBP LIBOR submission process after the end of 2021 and to cease oversight of these benchmark interest rates. Regulatory authorities and private sector working groups, including the International Swaps and Derivatives Association ('ISDA') and the Working Group on Sterling Risk-Free Reference Rates, have been discussing alternative benchmark rates for GBP LIBOR.

It is currently expected that SONIA (Sterling Overnight Index Average) will replace GBP LIBOR. There are key differences between GBP LIBOR and SONIA. GBP LIBOR is a 'term rate', which means that it is published for a borrowing period (such as 3 months or 6 months), and it is 'forward looking', because it is published at the beginning of the borrowing period. SONIA is currently a 'backward-looking' rate, based on overnight rates from actual transactions, and it is published at the end of the overnight borrowing period. Furthermore, GBP LIBOR includes a credit spread over the risk-free rate, which SONIA does not. To transition existing contracts and agreements that reference GBP LIBOR to SONIA, adjustments for term differences and credit differences might need to be applied to SONIA, to enable the two benchmark rates to be economically equivalent on transition.

At the time of reporting, industry working groups are reviewing methodologies for calculating adjustments between GBP LIBOR and SONIA. The Working Group on Sterling Risk-Free Reference Rates has stated that it anticipates that a term SONIA reference rate could be developed in the first quarter of 2020.

The Group currently has a significant number of contracts which reference GBP LIBOR and extend beyond 2021. The Board has established a steering committee, consisting of key finance, risk, IT, treasury, legal and compliance personnel and external advisors, to oversee the Group's GBP LIBOR transition plan. This steering committee has put in place a transition project for those contracts which reference GBP LIBOR to transition them to SONIA, with the aim of minimising the potential disruption to business and mitigating operational and conduct risks and possible financial losses. This transition project will include changes to systems, processes, risk management and valuation models, as well as managing related tax and accounting implications. The Group currently anticipates that the areas of greatest change are updating systems and processes which capture GBP LIBOR-referenced contracts, amendments to those contracts, and updating hedge designations. The Group continues to engage with industry participants and the FCA to ensure an orderly transition to SONIA and to minimise the risks arising from transition.

The IASB is currently working through Phase 2 of amendments to IAS 39 and IFRS 9 for IBOR reform, which is expected to focus on, amongst other topics, accounting for modifications for contracts following IBOR reform, and amendments to hedge accounting documentation for IBOR reform. The Group continues to follow the status of the IASB's IBOR reform project, and it will assess the impact for the Group as further information becomes available.

PwC Observation

- This disclosure should be repeated for each significant interest rate benchmark to which the entity's hedging relationships are exposed, but it has been given here only for GBP LIBOR for illustrative purposes.
- We have assumed that the fair value hedge of the interest rate risk of the fixed-rate mortgages is the only IBOR-related risk exposure managed by the Group. These disclosures will need to be expanded to include entity-specific disclosures of all other IBOR-related risk exposures that are managed by the entity, including how the entity is

[3] The reliefs illustrated are specific to fair value hedges. Other disclosures would be required for cash flow hedges (see Example 1 above).

- managing the transition process. In addition to debt instruments and derivatives, these might include leases and other contracts with payments linked to an IBOR.
- As the Group advances through its transition process, the disclosure above will need to be updated to reflect the latest information specifically relating to the Group and its transition process.

IFRS7(24A)
IFRS7(24H)(e)

The following table contains details of the hedging instruments used in the Group's hedging strategies:

		Carrying amount		Balance sheet line item(s)	Changes in fair value used for calculating hedge ineffectiveness	Nominal amount directly impacted by IBOR reform
	Notional	Assets	Liabilities			
	CU'000	CU'000	CU'000		CU'000	CU'000
Fair value hedges						
Interest rate						
Interest rate swaps	23,412	301	612	Hedging Derivatives	(192)	18,186

Of the CU23,412 nominal amount of interest rate swaps above, CU5,226 will mature before the anticipated GBP LIBOR replacement in 2021.

IFRS7(24B)

The following table contains details of the hedged exposures covered by the Group's hedging strategies:

	Carrying amount of hedged item		Accumulated amount of fair value adjustments on the hedged item		Balance Sheet line item	Change in fair value of hedged item for ineffectiveness assessment
	Assets	Liabilities	Assets	Liabilities		
	CU'000	CU'000	CU'000	CU'000		CU'000
Fair value hedges						
Interest rate						
- Fixed-rate mortgages	23,412	-	648	326	Loans and advances to customers	202

IFRS7(24H)(d)

Effect of IBOR reform – significant assumptions

In calculating the change in fair value attributable to the hedged risk for the fixed-rate mortgages, the Group has made the following assumptions that reflect its current expectations:

- The Group has assumed that pre-existing fallback provisions in the mortgages do not apply to IBOR reform;
- Mortgages move to SONIA during 2022, and the spread will be similar to the spread included in the interest rate swaps used as hedging instruments; and
- No other changes to the terms of the hedged mortgages are anticipated.
- The Group has incorporated the uncertainty over the timing of the move to SONIA for the mortgages by probability weighting three different timing scenarios. For each scenario, the Group has reflected the other uncertainties associated with the reforms (principally, the resulting adjustment to the spread) by adding an additional spread to the discount rate used in the calculation.

IFRS7(24B)(a)(v)

The accumulated amount of fair value hedge adjustments remaining in the statement of financial position for hedged items that have ceased to be adjusted for hedging gains and losses is CU212,000.

IFRS7(24C)

The following table contains information regarding the effectiveness of the hedging relationships designated by the Group, as well as the impacts on profit or loss and other comprehensive income:

	Gains/(loss) recognised in OCI	Hedge ineffectiveness recognised in P&L	P&L line item that includes hedge ineffectiveness
	CU'000	CU'000	
Fair value hedges			
Interest rate			
Fixed-rate mortgages	n/a	10	Net trading income

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