Comments

IASB Exposure Draft ED/2019/1 "Interest Rate Benchmark Reform – Proposed amendments to IFRS 9 and IAS 39"

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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Preliminary remarks/Key messages

- As the topic is of great importance to us, and to avoid financial instability and undesirable accounting volatility in financial statements, we believe the ED tackles significant accounting issues that may arise in the period before the replacement of an existing interest rate benchmark with an alternative interest rate.
- Although we realise that the IASB has focused on phase 1 and certain issues concerning further effects in the future are unknown, we encourage the Board to accelerate its work on phase 2 of the project.
- Although we basically support the IASB's proposal in the current ED, we believe that the following points are missing or need to be addressed:
    a. We believe that the IASB's proposals do not include relief for the effects of IBOR reform on the retrospective test under IAS 39. We therefore fear that hedging relationships would fail because the retrospective assessment is outside the 80%-125% range due to the uncertainties arising from IBOR reform and therefore suggest that the IASB permit the retrospective assessment on a qualitative basis instead. Such relief would only allow the continuation of hedge accounting and would not allow changing the actual results of the hedge ineffectiveness reflected in the P&L.
    b. We are concerned that the proposed relief is not sufficient for application of dynamic portfolio hedges (i.e. macro hedge accounting under IAS 39). Banks which apply fair value hedge accounting to portfolio hedges of interest rate risk rebalance their portfolios or hedging relationships regularly by de-designation and re-designation. We see the risk of the separately identifiable requirement under IAS 39 not being met when such regular de-/re-designation takes place at a point in time where IBOR is not formally replaced but instead continues to be quoted and has become less liquid because new transactions referencing the new RFR are increasing in volume. Because of this, we would also advocate relief for dynamic macro hedge accounting due to the uncertainties arising from IBOR reform. One option for such relief could be the designation of IBOR-related new hedges fulfilling the requirements on identifiability under IAS 39 until the final replacement of IBOR with the new RFR.
- For our detailed comments, please see the annex

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Annex - Responses to the questions raised in the ED

Question 1 [paragraphs 6.8.4–6.8.6 of IFRS 9 and paragraphs 102D–102F of IAS 39]

Highly probable requirement and prospective assessments

For hedges of interest rate risk that are affected by interest rate benchmark reform, the Board proposes amendments to IFRS 9 and IAS 39 as described below.

(a) For the reasons set out in paragraphs BC8–BC15, the Board proposes exceptions for determining whether a forecast transaction is highly probable or whether it is no longer expected to occur. Specifically, the Exposure Draft proposes that an entity would apply those requirements assuming that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of interest rate benchmark reform.

(b) For the reasons set out in paragraphs BC16–BC23, the Board proposes exceptions to the hedge accounting requirements in IFRS 9 and IAS 39 so that an entity would assume that the interest rate benchmark on which the hedged cash flows are based, and/or the interest rate benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of interest rate benchmark reform when the entity determines whether:

(i) there is an economic relationship between the hedged item and the hedging instrument applying IFRS 9; or

(ii) the hedge is expected to be highly effective in achieving offsetting applying IAS 39.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

We support the proposed amendments regarding the highly probable requirement and prospective assessments.

However, we are concerned that the IASB does not propose relief for the effects of IBOR reform on the retrospective test under IAS 39 (cf. Board's decision in BC23). We believe that relief with regard to the retrospective test requirements under IAS 39 is needed. Otherwise we fear that hedging relationships would fail because the retrospective assessment is outside the 80%-125% range due to the uncertainties arising from IBOR reform. This could happen when IBOR is not formally replaced but instead continues to be quoted and has become less liquid because new loan and derivative transactions referencing the new RFR are conducted. We therefore suggest that the IASB permit the retrospective assessment on a qualitative basis instead. Such relief would only allow the continuation of hedge accounting and would not allow changing the actual results of the hedge ineffectiveness in the P&L. These would continue to be derived from the actual measurement of the hedged item and the hedging instrument based on the market conditions existing on the reporting date.

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Question 2 [paragraph 6.8.7 of IFRS 9 and paragraph 102G of IAS 39]

Designating a component of an item as the hedged item

For the reasons set out in paragraphs BC24–BC27, the Board proposes amendments to the hedge accounting requirements in IFRS 9 and IAS 39 for hedges of the benchmark component of interest rate risk that is not contractually specified and that is affected by interest rate benchmark reform. Specifically, for such hedges, the Exposure Draft proposes that an entity applies the requirement—that the designated risk component or designated portion is separately identifiable—only at the inception of the hedging relationship.

Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you propose instead and why.

We share the IASB's view that "discontinuation of hedging relationships at this stage due to uncertainty arising from interest benchmark reform would not provide useful information" and therefore support the proposed relief in paragraph 6.8.7.

However, we are concerned that this relief is not sufficient as its application to dynamic portfolio hedges (i.e. macro hedge accounting under IAS 39) is not covered. Banks which apply fair value hedge accounting to portfolio hedges of interest rate risk rebalance their portfolios or the hedging relationships regularly by de-designation and re-designation. We see the risk of the separately identifiable requirement under IAS 39 not being met when such regular de-/re-designation takes place at a point in time where IBOR is not formally replaced but instead continues to be quoted and has become less liquid because new transactions referencing the new RFR are increasing in volume. In this case, banks would no longer be able to re-designate their dynamic portfolio hedges for IBOR and would have to discontinue portfolio hedge accounting. Because of this, we would also advocate relief for dynamic macro hedge accounting due to uncertainties arising from IBOR reform. One option for such relief could be the designation of IBOR-related new hedges fulfilling the requirements on identifiability under IAS 39 until the final replacement of IBOR with the new RFR.

Question 3 [paragraphs 6.8.8–6.8.10 of IFRS 9 and paragraphs 102H–102J of IAS 39]

Mandatory application and end of application

(a) For the reasons set out in paragraphs BC28–BC31, the Board proposes that the exceptions are mandatory. As a result, entities would be required to apply the proposed exceptions to all hedging relationships that are affected by interest rate benchmark reform.

(b) For the reasons set out in paragraphs BC32–BC42, the Board proposes that the exceptions would apply for a limited period. Specifically, an entity would prospectively cease applying the proposed amendments at the earlier of:

(i) 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

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(ii) when the hedging relationship is discontinued, or if paragraph 6.8.9 of IFRS 9 or paragraph 102I of IAS 39 applies, when the entire amount accumulated in the cash flow hedge reserve with respect to that hedging relationship is reclassified to profit or loss.

(c) For the reasons set out in paragraph BC43, the Board is not proposing an end of application in relation to the separate identification requirement.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

We basically agree that the exceptions should be mandatory until there is certainty regarding IBOR reform.

Nevertheless, we see a risk concerning the end of application of the relief. We could imagine that – depending on market velocity – the new RFR may become liquid and an entity might be forced to change its hedging approach economically also at short notice and has to amend its application of hedge accounting.

Due to scenario A in BC35 of the ED, it is our understanding that the proposed exceptions would end on the date on which the contract is amended even though the effective date of the amendments in the contract falls on a subsequent future date. We are concerned that this would cause the end of application of the relief at a much earlier point. This would put the application of hedge accounting at risk during the period between the date on which the contract is amended and the date on which the amendments come into effect ("interim period"). We do not believe that this is the IASB's intention and therefore urge the Board to clarify that in Scenario A the relief do not end during the interim period when the hedge documentation is not amended.

Question 4 [paragraph 6.8.11 of IFRS 9 and paragraph 102K of IAS 39]

Disclosures

For the reasons set out in paragraph BC44, the Board proposes that entities provide specific disclosures about the extent to which their hedging relationships are affected by the proposed amendments.

Do you agree with these proposed disclosures? Why or why not? If not, what disclosures would you propose instead and why?

We agree that entities should disclose details about the extent to which their hedging relationships are affected by the proposed amendments.

However, specific disclosure should not impose undue cost and effort on entities, especially on those which apply dynamic macro hedging accounting under IAS 39 because this would require tracking all transactions. Hence, we would advocate simplifying the proposals for macro hedging accounting under IAS 39 in this manner.

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Question 5 [paragraphs 7.1.9 and 7.2.26(d) of IFRS 9 and paragraph 108G of IAS 39] **Effective date and transition** For the reasons set out in paragraphs BC45–BC47, the Board proposes that the amendments would have an effective date of annual periods beginning on or after 1 January 2020. Earlier application would be permitted. The Board proposes that the amendments would be applied retrospectively. No specific transition provisions are proposed. Do you agree with these proposals? Why or why not? If you disagree with the proposals, please explain what you propose instead and why.

We basically agree with these proposals.

Nevertheless, we believe that the IASB's proposal could cause some confusion. As it is stated that "the amendments would be applied retrospectively", there may be a problem with its use under IAS 8 and that intended by the Board in BC46 where "the Board highlights that retrospective application of the amendments would not allow reinstating hedge accounting that has already been discontinued". We read the ED to mean that the proposed relief is to be applied by an entity to existing hedging relationships that are based on IBOR. This will facilitate the ongoing assessments that are required under IAS 39/IFRS 9 during the life of these hedging relationships so that the entity can continue applying hedge accounting despite the uncertainties arising from IBOR reform. We believe that this point could be stated in a simplified manner by not using "retrospective application".