[DRAFT] Endorsement Criteria Assessment: *Interest Rate Benchmark Reform—Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)*

1 Introduction

PURPOSE

1.1 The purpose of this [draft] Endorsement Criteria Assessment (ECA) is to determine whether the UK's statutory requirements for endorsement and adoption of an amended standard are met.

1.2 The International Accounting Standards Board's (IASB) amendments *Interest Rate Benchmark Reform—Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16)* (the Amendments) were published on 27 August 2020.

BACKGROUND TO THE AMENDMENTS

1.3 In 2014, the Financial Stability Board (FSB) set out a series of recommendations for the reform of key interbank offered rates (IBORs)[1]. These reforms were necessitated by the lack of confidence in the reliability and robustness of existing interbank benchmark interest rates arising from attempted manipulation of the rates and the post financial crisis decline in liquidity in interbank unsecured funding markets. IBORs are widely used in the global financial system as interest rate benchmarks for trillions of dollars in financial products and contracts such as loans, bonds and derivatives.

1.4 The report also recommended that the major IBORs be replaced with alternative interest rate benchmarks with the objective that such rates will be based on liquid underlying market transactions, rather than on submissions based on expert judgement, leading to rates that are more reliable and provide robust alternative benchmark rates. For example, in the UK, the Sterling London Interbank Offered Rate (LIBOR) is an extensively used interest rate benchmark and is being replaced by the Sterling Overnight Index Average (SONIA) benchmark.

1.5 To emphasise the importance and urgency of the transition away from LIBOR, in the UK the Financial Conduct Authority, Bank of England and members of the Working Group on Sterling Risk-Free Reference Rates discussed the impact of the coronavirus on firms' LIBOR transition plans and issued a joint statement in March 2020 which confirmed:

"*the central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet. The transition from LIBOR remains an essential task that will strengthen the global financial system.*"[2]

1 Reforming Major Interest Rate Benchmarks, July 2014: https://www.fsb.org/2014/07/r_140722/
2 https://www.fca.org.uk/news/statements/impact-coronavirus-firms-libor-transition-plans

1.6 The Amendments arise solely as a consequence of this global regulatory reform and are a minor part of that overall change. The objective of the Amendments is to give relief from certain existing accounting requirements that arise from the replacement of existing interest rate benchmarks as a direct consequence of the reform of IBOR.

1.7 The Amendments are narrow in scope because the relief only applies to transactions and events that arise as a direct consequence of IBOR reform.

UK STATUTORY REQUIREMENTS FOR ENDORSEMENT AND ADOPTION

1.8 Paragraph 1 of Regulation 7 of the International Accounting Standards and European Public Limited-Liability Company (Amendment etc.) (EU Exit) Regulations 2019 No. 685[3] ("the Regulations") requires that an international accounting standard[4] only be adopted if:

(a) "the standard is not contrary to either of the following principles—

(i) an undertaking's accounts must give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss;

(ii) consolidated accounts must give a true and fair view of the assets, liabilities, financial position and profit or loss of the undertakings included in the accounts taken as a whole, so far as concerns members of the undertaking;

(Abbreviated to "the standard is not contrary to the principle that an entity's accounts/consolidated accounts must give a true and fair view".)

(b) the use of the standard is likely to be conducive to the long term public good in the United Kingdom; and

(c) the standard meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management."

1.9 This document assesses the criteria in paragraph 1.8 in the following order:

(a) Technical criteria assessment—includes:

(i) that the standard meets the criteria of relevance, reliability, comparability and understandability required of the financial information needed for making economic decisions and assessing the stewardship of management (Regulation 7(1)(c)); and

(ii) that the standard is not contrary to the principle that an entity's accounts must give a true and fair view (Regulation 7(1)(a)).

(b) That use of the standard is likely to be conducive to the long term public good in the UK (Regulation 7(1)(b)).

3 http://www.legislation.gov.uk/uksi/2019/685/made

4 This is defined in the Companies Act using Article 2 of the IAS Regulation "…'international accounting standards' shall mean International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and related Interpretations (SIC-IFRIC interpretations), subsequent amendments to those standards and related interpretations, future standards and related interpretations issued or adopted by the International Accounting Standards Board (IASB)."

2 Technical criteria assessment

RELEVANCE, RELIABILITY, COMPARABILITY AND UNDERSTANDABILITY

2.1 A description of each of the criteria is set out below[5].

2.2 Information is **relevant** if it is capable of making a difference in the decision-making of users or in their assessment of the stewardship of management. The information may aid predictions of the future, confirm or change evaluations of the past or both.

2.3 Financial information is **reliable** if, within the bounds of materiality, it:

(a) can be depended on by users to represent faithfully what it either purports to represent or could reasonably be expected to represent;

(b) is complete; and

(c) is free from material error and bias.

2.4 Information is **comparable** if it enables users to identify and understand similarities in, and differences among, items. Information about an entity should be comparable with similar information about other entities and with similar information about the same entity for another period.

2.5 Financial information should be readily **understandable** by users with a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information with reasonable diligence.

3 Key financial reporting issues addressed by the Amendments

3.1 This section describes how the Amendments address the following key issues:

(a) Modifications of financial assets and financial liabilities.

(b) Hedge accounting.

(c) Disclosures and effective date.

MODIFICATIONS OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Issue

3.2 The existing accounting requirements specify that in the event of the contractual cash flows of a financial instrument being renegotiated or otherwise modified; modification accounting is required. If a substantial modification is identified, the existing financial instrument is derecognised and the modified instrument is recognised, with the difference between the carrying values immediately recognised in profit or loss. Where the modification is not substantial, the carrying amount of the financial instrument is recalculated by discounting the

5 These descriptions are based on the qualitative characteristic of financial statements in the *Framework for the Preparation and Presentation of Financial Statements* adopted by the IASB in April 2001. These became part of the criteria for endorsement and adoption of IFRS in the EU's IAS Regulation (1606/2002), and, subsequently, in SI 2019/685.

modified cash flows using the original effective interest rate, with the difference between original and recalculated carrying values being immediately recognised in profit or loss.

3.3 The IASB believes that faithfully applying those existing requirements to a modification required by the interest rate benchmark reform would not reflect the economic substance of this reform when the two conditions set out in 3.4 (a) and (b) below are met. Because alternative benchmark rates are intended to be nearly risk-free while many existing interest rate benchmarks are not, it is likely that a fixed spread will be added to compensate for a basis difference between an existing interest rate benchmark and an alternative benchmark rate in order to avoid a transfer of economic value between the parties to the financial instrument. If this is the only change effected, it would be unlikely that the transition to an alternative benchmark rate alone would result in the derecognition of that financial instrument. Using the original interest rate to calculate interest income or interest expense in this situation would not reflect the economic effects of the modified financial instrument. It could also be difficult to maintain the original effective interest rate, and perhaps impossible, if that rate is no longer available.

Amendments to address the issue

3.4 The IASB has addressed this issue by introducing mandatory requirements, by way of a practical expedient, to give relief from these existing accounting requirements when two conditions are met. They are that the modification arises:

(a) as a direct consequence of the reform of IBOR; and

(b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis.

3.5 These conditions reflect the IASB's view that it is appropriate to modify IFRS only for those circumstances in which benchmark reform is implemented in such a way that it does not lead to value transfers between the counterparties to the financial instrument. This is evidenced by the second condition which requires that the new basis for determining the contractual cash flows is economically equivalent to the previous basis, i.e. the overall contractual cash flows (including the interest rate) of the financial instrument are substantially similar before and after the modification.

3.6 Applying the practical expedient would mean that the change to the contractual cashflows is accounted for prospectively by revising the effective interest rate.

3.7 The Amendments also include a similar practical expedient to:

(a) lease liabilities of a lessee that are modified as a direct consequence of the reform of IBOR; and

(b) to entities in the scope of IFRS 4 *Insurance Contracts* that apply the temporary exemption from IFRS 9 *Financial Instruments* to apply the practical expedient to financial instruments that are modified as a direct consequence of the reform of IBOR.

HEDGE ACCOUNTING

Issue

3.8 The overall objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities when they use financial instruments to manage exposures arising from particular risks and those risks could affect the amounts recognised in the financial statements. The global reform of IBORs, requiring entities to replace their existing IBORs with alternative benchmark rates, is unrelated to the entity's risk management objectives.

3.9 The existing accounting requirements in IFRS 9 and IAS 39 require an entity to discontinue the hedging relationship or designate a new hedging relationship, when it amends the formal designation of a hedging relationship and related hedge documentation. Changes arising from the reform of IBOR would be within the scope of those requirements.

3.10 Faithfully applying those existing requirements would not reflect the economic substance of the reform of IBOR—the changes necessary to hedge documentation to reflect the IBOR reform do not arise from changes in the entity's general risk management objective for hedging underlying risks.

Amendments to address the issue

3.11 The IASB has addressed this issue by introducing an exception to the existing requirements. As a result, changes the hedge documentation to reflect the transition to an alternative benchmark rate on an economically equivalent basis would not lead to the discontinuation of hedge accounting or the designation of a new hedging relationship for financial reporting purposes. The changes are limited to:

(a) designating an alternative benchmark rate as a hedged risk;

(b) amending the description of the hedged item so that it refers to an alternative benchmark rate;

(c) amending the description of the hedging instrument so that it refers to an alternative benchmark rate;

(d) amending the description of the designated portion of the hedged item so that it refers to an alternative benchmark rate; or

(e) (IAS 39 only) amending the description of how the entity will assess hedge effectiveness.

3.12 The designations of hedging relationships are permitted to be changed more than once, reflecting the fact that the IBOR reform may affect the hedged risk, hedged item and hedging instrument at different times.

3.13 Additionally, changes to hedging relationships and hedge documentation are required to have been made by the end of the reporting period during which a change required by the reform of IBOR is made to the hedged risk, hedged item or hedging instrument.

DISCLOSURES AND EFFECTIVE DATE

Disclosures

3.14 The Amendments include additional qualitative disclosures to ensure users' understanding of the nature and extent of risks arising from the reform of IBOR to an entity, how it manages those risks, and its progress in completing the transition to alternative benchmark rates.

3.15 Additional quantitative disclosures are also required relating to the amounts of non-derivative financial instruments and derivative financial instruments that continue to reference each of the IBORs that are going to be replaced.

Effective date

3.16 The effective date of the Amendments is for annual periods beginning on or after 1 January 2021, with earlier application permitted. The effective date and ability to apply the Amendments before that date reflects that much of the global regulatory reform of IBOR is taking place in 2020 and 2021.

4 Assessment against technical criteria

MODIFICATIONS TO FINANCIAL ASSETS AND FINANCIAL LIABILITIES

4.1 Accounting for the transition to alternative benchmark rates as a prospective change to the effective interest rate in financial instruments (by way of a practical expedient) provides users with **relevant and reliable** information by ensuring faithful representation of the underlying economic substance of the modification. Reliability is achieved as maintenance of the original instrument at the original carrying value reflects the economic reality that the change arose solely due to the global reform of IBOR and the new basis for determining contractual cashflows is economically equivalent to the previous basis. Relevance is achieved by updating the existing interest rate with the replacement interest rate thereby aiding predictive value because the replacement interest rate reflects the economic effects of the modified financial instrument.

4.2 The mandatory application of the practical expedient increases **comparability** across entities that are affected by the reform of IBOR. It also maintains comparability within an entity over time as financial instruments transition to alternative benchmark rates at different times.

HEDGE ACCOUNTING

4.3 Accounting for the transition to alternative benchmark rates in hedging relationships as a continuation of the relationship provides users with **relevant and reliable** information. Reliability is achieved as this more faithfully reflects the economic substance of the changes, i.e. the entity's risk management objective is intact because the hedging relationship using an alternative benchmark rate is economically equivalent to the previous IBOR. This change was necessary due to the underlying market reform of IBOR. Relevance is achieved in that financial information on hedge accounting maintains its confirmatory quality, rather than breaking all hedges and introducing possible volatility into the statement of profit or loss.

4.4 Limiting the application of the exception to the changes in the hedging relationships arising as a direct consequence of the reform of IBOR enhances **comparability** across entities that are affected by the reform of IBOR by allowing users to be able to separately identify IBOR reform-related changes from other entity-specific changes.

DISCLOSURES

4.5 The additional disclosure requirements add to the **relevance and reliability of** information because it provides users of financial statements with information about the nature and extent to which an entity is exposed to significant interest rate benchmarks and how it is managing the transition to alternative benchmark rates, its progress at the balance sheet date and the risks arising from the transition.

4.6 The information will also help users to **understand** the entity-specific effects of the reform of IBOR, including entities' progress at the balance sheet date away from IBORs to alternative interest benchmark rates.

4.7 The quantitative information relating to the extent to which an entity holds financial instruments that are yet to transition to the alternative benchmark rates will help ensure information is **comparable** across different entities and enable users to compare entities' readiness to complete the reform of IBOR in accordance with the regulatory timetable.

EFFECTIVE DATE

4.8 The effective date and permitting early application appropriately reflect the importance and urgency of the Amendments.

4.9 Some entities have already commenced the transition to alternative benchmark rates and therefore, need to apply the Amendments early to avoid the potentially significant adverse effects of continuing with the existing accounting requirements. These include accounting for modified financial instruments and a high number of hedge accounting relationships being discontinued which could result in significant volatility in profit or loss. By applying the Amendments in their December 2020 financial statements, entities will be providing **relevant and reliable** information to users. This will also enhance **comparability** with financial statements published later in 2021 and thereafter.

CONCLUSION

4.10 Overall, we conclude that the Amendments meet the criterion of relevance, reliability, comparability and understandability required of the financial information needed for making economic decisions and assessing the stewardship of management, as required by SI 2019/685 (see paragraph 1.8(c)).

5 True and fair view

5.1 This section considers whether the Amendments are not contrary to a true and fair view.

5.2 A true and fair view is an overarching concept, to be applied to an entity's financial statements as a whole. Accounting standards provide for recognition, measurement, presentation and disclosure for transactions and events so that the financial statements reflect the economic substance of those underlying transactions and events, hence, providing a true and fair view.

5.3 The Amendments give relief from modifying financial instruments and from discontinuing hedging relationships or designating new hedging relationships only if the following criteria are met:

(a) the changes arise as a direct consequence of the reform of IBOR; and

(b) the new basis for determining the contractual cash flows is economically equivalent to the previous basis.

5.4 This ensures that the underlying economic substance of the modified financial instruments and hedging relationships are reflected in the financial statements. Where either or both conditions in 5.3(a) and (b) are not met, the normal IFRS requirements continue to apply. This is appropriate because changes would be being made which are not a direct consequence of IBOR reform and/or they are not being made on an economically equivalent basis. The Amendments include additional disclosures to enable users of financial statements understand the nature and extent to which an entity is exposed to the reform of IBOR.

CONCLUSION

5.5 Overall, we conclude that application of the Amendments is not contrary to the principle that an entity's accounts/consolidated accounts must give a true and fair view as required by SI 2019/685 (see paragraph 1.8(a))[6].

[6] This requirement is separate from the requirement in section 393 of the Companies Act 2006, that the "directors of a company must not approve accounts for the purposes of this Chapter unless they are satisfied that they give a true and fair view…"

6 UK long term public good

6.1 This section considers whether the Amendments are likely to be conducive to the long term public good in the UK. Regulation 7(2) of SI 2019/685 includes specific areas in which to consider for this criterion. They are:

(a) whether the use of the standard is likely to improve the quality of financial reporting;

(b) the costs and benefits that are likely to result from the use of the standard; and

(c) whether the use of the standard is likely to have an adverse effect on the economy of the UK, including on economic growth.

IMPROVE THE QUALITY OF FINANCIAL REPORTING

6.2 The objective of the Amendments is to give relief from certain existing accounting requirements, upon the replacement of interest rate benchmarks arising as a direct consequence of the global reform of IBOR.

6.3 Without these Amendments entities would likely report accounting volatility in profit or loss when hedges are amended as a direct consequence of the reform, rather than reflect the fact that the underlying economic hedges remain effective, or continue to recognise interest based on the rates which the reform's objective was to replace.

6.4 The Amendments meet their objective by appropriately addressing the accounting issues arising from the reform of IBOR.

Conclusion

6.5 We conclude that the Amendments improve the quality of financial reporting.

COSTS AND BENEFITS FROM USING THE AMENDMENTS

Introduction

6.6 This section considers the costs and benefits that are likely to result from the use of the Amendments. Care was taken to ensure that the work undertaken is proportionate to the nature and scale of the Amendments and to the population of entities that are affected by them.

6.7 It should be noted that the Amendments:

(a) arise solely as a consequence of the global regulatory reform of IBOR and are a minor part of the overall change faced by entities in scope;

(b) are narrow in scope because the relief only applies to transactions and events that arise as a direct consequence of IBOR reform; and

(c) are minor in nature, aimed at permitting the continuation of the substance of existing financial reporting requirements.

6.8 However, the Amendments will affect a significant number of entities, particularly banks and other financial institutions. IBORs continue to play a key role in global financial markets, with many financial contracts and hedging relationships are affected by this reform. Andrew Bailey, Governor of the Bank of England highlighted during July 2020, "LIBOR rates … directly impact the cash flows and values of an estimated $400trn of financial products globally"[7].

6.9 The initial assessment of costs and benefits of implementing the Amendments are set out below. These assessments will be finalised after considering the comments received.

Costs for preparers

6.10 A large majority of preparers using IFRS to produce their financial statements in the UK are large listed companies. The narrow-scope and nature of the Amendments would suggest minor costs for those preparers implementing them.

6.11 Our outreach with banks also highlighted that the implementation costs of the Amendments for those preparers are likely to be an important but relatively minor part of their much larger, overall project to manage the reform of IBOR. For these reasons, we expect those incremental costs attributable to the Amendments to be minor.

6.12 For other preparers, the costs will depend on the number of financial contracts and hedge accounting relationships within the scope of the IBOR reforms. Again, we understand that they are likely to be an important but relatively minor part of their overall project to manage the reform of IBOR.

Benefits for preparers

6.13 For preparers facing the most significant impact from the IBOR Reforms, i.e. banks, we understand that the benefits of the Amendments relate mainly to avoiding a significant amount of additional work and related costs arising from:

(a) applying modification accounting to financial contracts that have been modified due to the reform of IBOR; and

(b) discontinuing hedge accounting relationships that have been modified due to the reform of IBOR.

6.14 Other benefits of use of the Amendments could include:

(a) Avoiding the accounting volatility in profit or loss arising from not implementing the Amendments.

(b) Avoiding the cost of developing and presenting non-GAAP measures and additional explanatory material for users in order to highlight the anomalies between financial reporting and the underlying economic substance.

6.15 For other preparers, the benefits depend on the significance of the financial impact from not applying the Amendments to their financial contracts and hedging relationships.

6.16 We consider that the benefits of implementing the Amendments are significant, not least because using the Amendments to prepare their financial statements will help ensure entities reflect the underlying economic substance of the reform of IBOR on financial contracts and hedging relationships.

[7] In a speech by Andrew Bailey, Governor of the Bank of England, Bloomberg Webinar, 13 July 2020. It can be accessed here: https://www.bankofengland.co.uk/speech/2020/andrew-bailey-speech-as-part-webinar-hosted-by-the-boe-and-the-frb-of-ny-libor-entering-the-endgame

6.17 Our outreach with preparers highlighted that they support the Amendments and agreed that the objective of giving relief from certain existing accounting requirements directly arising from IBOR reform has been achieved.

Costs and benefits for users

6.18 Users of financial statements, contacted during our outreach, were familiar with the current requirements in IFRS 9 and IAS 39. The Amendments help maintain the accounting status quo for those financial contracts and hedging relationships that are affected by the reform of IBOR. Thus, aside from a small cost in familiarising themselves with requirements in the Amendments, users are unlikely to find the Amendments to be disruptive or costly.

6.19 Users are however likely to benefit from the enhanced usefulness of the accounting information and the additional disclosures, which will help them to understand the nature and extent of the impact of the reform of IBOR on an entity.

6.20 In a similar way to preparers, users will also likely benefit from avoiding the disruption caused by the modification of financial contracts and the discontinuance of hedge accounting and changes to the financial statements due to the lack of implementation of the Amendments. In the absence of the Amendments, users would need to familiarise themselves with the changes to the accounting, including potentially the interpretation of new non-GAAP numbers developed by preparers.

Conclusion

6.21 We conclude that given the limited costs incurred, particularly by banks, and the substantial benefits arising from using these Amendments, the benefits are likely to outweigh the costs. We consider that this conclusion will also apply to a lesser degree to other non-bank entities.

6.22 We also conclude that, overall, users are likely to benefit from the implementation of the Amendments.

LIKELY EFFECT ON THE ECONOMY OF THE UK

6.23 This section addresses whether the use of the Amendments is likely to have an adverse effect on the economy of the UK, including on economic growth.

6.24 We note that the Financial Policy Committee recently stated that:

> "*Recent market volatility has highlighted the long-standing weaknesses of Libor benchmarks, which remain in widespread use. Libor rates — and hence costs for borrowers — rose as central bank policy rates fell, and underlying market activity was low. This has reinforced the importance of completing the transition to alternative rates by end-2021.*"[8]

6.25 The drive in the UK to complete the transition from LIBOR to SONIA by the end of 2021 highlights the importance of moving away from LIBOR and the short timeline in which entities must complete their transition to alternative benchmark rates.

6.26 The sections above explain why the Amendments appropriately address the accounting issues arising from the reform of IBOR and are a minor part of that overall change. Furthermore, the availability of the Amendments and the option for entities to early adopt thereby permits them

[8] Interim Financial Stability Report by the Financial Policy Committee of the Bank of England, May 2020, page 13. It can be accessed here: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/may-2020.pdf

to transition their existing financial contracts and hedging relationships earlier than otherwise. This is likely to help the progress of the reform of IBOR. As stated in the August 2020 Bank of England Financial Stability Report[9]:

"*It is essential to end reliance on Libor benchmarks before end-2021. After that point, Libor benchmarks could cease to be available at short notice.*"

Hence, we believe that the use of the Amendments is **not** likely to have an adverse effect on the economy of the UK.

Conclusion

6.27 We conclude that the Amendments are **not** likely to have an adverse effect on the economy of the UK, including on economic growth.

OVERALL CONCLUSION ON UK PUBLIC GOOD

6.28 In paragraphs 6.2–6.27 we conclude that the Amendments:

(a) will generally improve financial reporting when compared to the unamended requirements of IFRS 9 and IAS 39;

(b) will lead to benefits that exceed the costs; and

(c) are **not** likely to have an adverse effect on the economy of the UK, including on economic growth.

6.29 Overall, we conclude that the Amendments are likely to be conducive to the long term public good in the UK as required by SI 2019/685 (see paragraph 1.8(b)).

9 Page 85: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/august-2020.pdf