IASB documents published to accompany

IAS 39

Financial Instruments: Recognition and Measurement

The text of the unaccompanied standard, IAS 39, is contained in Part A of this edition. Its effective date when issued was 1 January 2005. The text of the Accompanying Guidance on IAS 39 is contained in Part B of this edition. This part presents the following documents:

BASIS FOR CONCLUSIONS

DISSENTING OPINIONS

CONTENTS

Basis for Conclusions on IAS 39 *Financial Instruments: Recognition and Measurement*

This Basis for Conclusions accompanies, but is not part of, IAS 39.

In this Basis for Conclusions the terminology has not been amended to reflect the changes made by IAS 1 Presentation of Financial Statements *(as revised in 2007).*

References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.

IFRS 9 Financial Instruments replaced IAS 39. However, the Board did not reconsider most of the requirements of IAS 39 relating to scope, classification and measurement of financial liabilities or derecognition of financial assets and financial liabilities. Accordingly the following were relocated to IFRS 9: paragraphs BC11C, BC15–BC24Y, BC30–BC79A and BC85–BC104.

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions on revising IAS 39 *Financial Instruments: Recognition and Measurement* in 2003. Individual Board members gave greater weight to some factors than to others.

BC2–BC130 [Deleted]

Hedging

BC131 The Exposure Draft proposed few changes to the hedge accounting guidance in the original IAS 39. The comments on the Exposure Draft raised several issues in the area of hedge accounting suggesting that the Board should consider these issues in the revised IAS 39. The Board's decisions with regard to these issues are presented in the following paragraphs.

Consideration of the shortcut method in SFAS 133

BC132 SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* issued by the FASB allows an entity to assume no ineffectiveness in a hedge of interest rate risk using an interest rate swap as the hedging instrument, provided specified criteria are met (the 'shortcut method').

BC133 The original IAS 39 and the Exposure Draft precluded the use of the shortcut method. Many comments received on the Exposure Draft argued that IAS 39 should permit use of the shortcut method. The Board considered the issue in developing the Exposure Draft, and discussed it in the round- table discussions that were held in the process of finalising IAS 39.

BC134 The Board noted that, if the shortcut method were permitted, an exception would have to be made to the principle in IAS 39 that ineffectiveness in a hedging relationship is measured and recognised in profit or loss. The Board agreed that no exception to this principle should be made, and therefore concluded that IAS 39 should not permit the shortcut method.

BC135 Additionally, IAS 39 permits the hedging of portions of financial assets and financial liabilities in cases when US GAAP does not. The Board noted that under IAS 39 an entity may hedge a portion of a financial instrument (eg interest rate risk or credit risk), and that if the critical terms of the hedging instrument and the hedged item are the same, the entity would, in many cases, recognise no ineffectiveness.

Hedges of portions of financial assets and financial liabilities (paragraphs 81, 81A, AG99A and AG99B)

BC135A IAS 39 permits a hedged item to be designated as a portion of the cash flows or fair value of a financial asset or financial liability. In finalising the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, the Board received comments that demonstrated that the meaning of a 'portion' was unclear in this context. Accordingly, the Board decided to amend IAS 39 to provide further guidance on what may be designated as a hedged portion, including confirmation that it is not possible to designate a portion that is greater than the total cash flows of the asset or liability.

Expected effectiveness (paragraphs AG105–AG113)

BC136 Qualification for hedge accounting is based on expectations of future effectiveness (prospective) and evaluation of actual effectiveness (retrospective). In the original IAS 39, the prospective test was expressed as 'almost fully offset', whereas the retrospective test was 'within a range of 80–125 per cent'. The Board considered whether to amend IAS 39 to permit the prospective effectiveness to be within the range of 80–125 per cent rather than 'almost fully offset'. The Board noted that an undesirable consequence of such an amendment could be that entities would deliberately underhedge a hedged item in a cash flow hedge so as to reduce recognised ineffectiveness. Therefore, the Board initially decided to retain the guidance in the original IAS 39.

BC136A However, when subsequently finalising the requirements for portfolio hedges of interest rate risk, the Board received representations from constituents that some hedges would fail the 'almost fully offset' test in IAS 39, including some hedges that would qualify for the shortcut method in US GAAP and thus be assumed to be 100 per cent effective. The Board was persuaded that the concern described in the previous paragraph that an entity might deliberately underhedge would be met by an explicit statement that an entity could not deliberately hedge less than 100 per cent of the exposure on an item and designate the hedge as a hedge of 100 per cent of the exposure. Therefore, the Board decided to amend IAS 39:

(a) to remove the words 'almost fully offset' from the prospective effectiveness test, and replace them by a requirement that the hedge is expected to be 'highly effective'. (This amendment is consistent with the wording in US GAAP.)

(b) to include a statement in the Application Guidance in IAS 39 that if an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the exposure and shall measure ineffectiveness on the basis of the change in the whole of that designated 85 per cent exposure.

BC136B Additionally, comments made in response to the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* demonstrated that it was unclear how the prospective effectiveness test was to be applied. The Board noted that the objective of the test was to ensure there was firm evidence to support an expectation of high effectiveness. Therefore, the Board decided to amend the Standard to clarify that an expectation of high effectiveness may be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value of cash flows of the hedged item and those of the hedging instrument. The Board noted that the entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

Hedges of portions of non- financial assets and non- financial liabilities for risk other than foreign currency risk (paragraph 82)

BC137 The Board considered comments on the Exposure Draft that suggested that IAS 39 should permit designating as the hedged risk a risk portion of a non- financial item other than foreign currency risk.

BC138 The Board concluded that IAS 39 should not be amended to permit such designation. It noted that in many cases, changes in the cash flows or fair value of a portion of a non- financial hedged item are difficult to isolate and measure. Moreover, the Board noted that permitting portions of non- financial assets and non- financial liabilities to be designated as the hedged item for risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing that the Board has confirmed because the portion could be designated so that no ineffectiveness would ever arise.

BC139 The Board confirmed that non- financial items may be hedged in their entirety when the item the entity is hedging is not the standard item underlying contracts traded in the market. In this context, the Board decided to clarify that a hedge ratio of other than one- to- one may maximise expected effectiveness, and to include guidance on how the hedge ratio that maximises expected effectiveness can be determined.

Loan servicing rights

BC140 The Board also considered whether IAS 39 should permit the interest rate risk portion of loan servicing rights to be designated as the hedged item.

BC141 The Board considered the argument that interest rate risk can be separately identified and measured in loan servicing rights, and that changes in market interest rates have a predictable and separately measurable

effect on the value of loan servicing rights. The Board also considered the possibility of treating loan servicing rights as financial assets (rather than non- financial assets).

BC142 However, the Board concluded that no exceptions should be permitted for this matter. The Board noted that (a) the interest rate risk and prepayment risk in loan servicing rights are interdependent, and thus inseparable, (b) the fair values of loan servicing rights do not change in a linear fashion as interest rates increase or decrease, and (c) concerns exist about how to isolate and measure the interest rate risk portion of a loan servicing right. Moreover, the Board expressed concern that in jurisdictions in which loan servicing right markets are not developed, the interest rate risk portion may not be measurable.

BC143 The Board also considered whether IAS 39 should be amended to allow, on an elective basis, the inclusion of loan servicing rights in its scope provided that they are measured at fair value with changes in fair value recognised immediately in profit or loss. The Board noted that this would create two exceptions to the general principles in IAS 39. First, it would create a scope exception because IAS 39 applies only to financial assets and financial liabilities; loan servicing rights are non- financial assets. Second, *requiring* an entity to measure loan servicing rights at fair value through profit or loss would create a further exception, because this treatment is optional (except for items that are held for trading). The Board therefore decided not to amend the scope of IAS 39 for loan servicing rights.

Whether to permit hedge accounting using cash instruments

BC144 In finalising the amendments to IAS 39, the Board discussed whether an entity should be permitted to designate a financial asset or financial liability other than a derivative (ie a 'cash instrument') as a hedging instrument in hedges of risks other than foreign currency risk. The original IAS 39 precluded such designation because of the different bases for measuring derivatives and cash instruments. The Exposure Draft did not propose a change to this limitation. However, some commentators suggested a change, noting that entities do not distinguish between derivative and non- derivative financial instruments in their hedging and other risk management activities and that entities may have to use a non- derivative financial instrument to hedge risk if no suitable derivative financial instrument exists.

BC145 The Board acknowledged that some entities use non- derivatives to manage risk. However, it decided to retain the restriction against designating non- derivatives as hedging instruments in hedges of risks other than foreign currency risk. It noted the following arguments in support of this conclusion:

(a) The need for hedge accounting arises in part because derivatives are measured at fair value, whereas the items they hedge may be measured at cost or not recognised at all. Without hedge accounting, an entity might recognise volatility in profit or loss for matched positions. For non- derivative items that are not measured at fair value or for which changes in fair value are not recognised in profit or loss, there is generally no need to adjust the accounting of the hedging instrument or the hedged item to achieve matched recognition of gains and losses in profit or loss.

(b) To allow designation of cash instruments as hedging instruments would diverge from US GAAP: SFAS 133 precludes the designation of non- derivative instruments as hedging instruments except for some foreign currency hedges.

(c) To allow designation of cash instruments as hedging instruments would add complexity to the Standard. More financial instruments would be measured at an amount that represents neither amortised cost nor fair value. Hedge accounting is, and should be, an exception to the normal measurement requirements.

(d) If cash instruments were permitted to be designated as hedging instruments, there would be much less discipline in the accounting model because, in the absence of hedge accounting, a non- derivative may not be selectively measured at fair value. If the entity subsequently decides that it would rather not apply fair value measurement to a cash instrument that had been designated as a hedging instrument, it can breach one of the hedge accounting requirements, conclude that the non- derivative no longer qualifies as a hedging instrument and selectively avoid recognising the changes in fair value of the non- derivative instrument in equity (for a cash flow hedge) or profit or loss (for a fair value hedge).

(e) The most significant use of cash instruments as hedging instruments is to hedge foreign currency exposures, which is permitted under IAS 39.

Whether to treat hedges of forecast transactions as fair value hedges

BC146 The Board considered a suggestion made in some of the comment letters received on the Exposure Draft that a hedge of a forecast transaction should be treated as a fair value hedge, rather than as a cash flow hedge. Some argued that the hedge accounting provisions should be simplified by having only one type of hedge accounting. Some also raised concern about an entity's ability, in some cases, to choose between two hedge accounting methods for the same hedging strategy (ie the choice between designating a forward contract to sell an existing asset as a fair value hedge of the asset or a cash flow hedge of a forecast sale of the asset).

BC147 The Board acknowledged that the hedge accounting provisions would be simplified, and their application more consistent in some situations, if the Standard permitted only one type of hedge accounting. However, the Board concluded that IAS 39 should continue to distinguish between fair value hedge accounting and cash flow hedge accounting. It noted that removing either type of hedge accounting would narrow the range of hedging strategies that could qualify for hedge accounting.

BC148 The Board also noted that treating a hedge of a forecast transaction as a fair value hedge is not appropriate for the following reasons: (a) it would result in the recognition of an asset or liability before the entity has become a party to the contract; (b) amounts would be recognised in the balance sheet that do not meet the definitions of assets and liabilities in the *Framework*; and (c) transactions in which there is no fair value exposure would be treated as if there were a fair value exposure.

Hedges of firm commitments (paragraphs 93 and 94)

BC149 The previous version of IAS 39 required a hedge of a firm commitment to be accounted for as a cash flow hedge. In other words, hedging gains and losses, to the extent that the hedge is effective, were initially recognised in equity and were subsequently 'recycled' to profit or loss in the same period(s) that the hedged firm commitment affected profit or loss (although, when basis adjustment was used, they adjusted the initial carrying amount of an asset or liability recognised in the meantime). Some believe this is appropriate because cash flow hedge accounting for hedges of firm commitments avoids partial recognition of the firm commitment that would otherwise not be recognised. Moreover, some believe it is conceptually incorrect to recognise the hedged fair value exposure of a firm commitment as an asset or liability merely because it has been hedged.

BC150 The Board considered whether hedges of firm commitments should be treated as cash flow hedges or fair value hedges. The Board concluded that hedges of firm commitments should be accounted for as fair value hedges.

BC151 The Board noted that, in concept, a hedge of a firm commitment is a fair value hedge. This is because the fair value of the item being hedged (the firm commitment) changes with changes in the hedged risk.

BC152 The Board was not persuaded by the argument that it is conceptually incorrect to recognise an asset or liability for a firm commitment merely because it has been hedged. It noted that for all fair value hedges, applying hedge accounting has the effect that amounts are recognised as assets or liabilities that would otherwise not be recognised. For example, assume an entity hedges a fixed rate loan asset with a pay- fixed, receive- variable interest rate swap. If there is a loss on the swap, applying fair value hedge accounting requires the offsetting gain on the loan to be recognised, ie the carrying amount of the loan is increased. Thus, applying hedge accounting has the effect of recognising a part of an asset (the increase in the loan's value attributable to interest rate movements) that would otherwise not have been recognised. The only difference in the case of a firm commitment is that, without hedge accounting, none of the commitment is recognised, ie the carrying amount is zero. However, this difference merely reflects that the historical cost of a firm commitment is usually zero. It is not a fundamental difference in concept.

BC153 Furthermore, the Board's decision converges with SFAS 133, and thus eliminates practical problems and eases implementation for entities that report under both standards.

BC154 However, the Board clarified that a hedge of the foreign currency risk of a firm commitment may be treated as either a fair value hedge or a cash flow hedge because foreign currency risk affects both the cash flows and the fair value of the hedged item. Accordingly a foreign currency cash flow hedge of a forecast transaction need not be re- designated as a fair value hedge when the forecast transaction becomes a firm commitment.

Basis adjustments (paragraphs 97–99)

BC155 The question of basis adjustment arises when an entity hedges the future purchase of an asset or the future issue of a liability. One example is that of a US entity that expects to make a future purchase of a German machine that it will pay for in euro. The entity enters into a derivative to hedge against possible future changes in the US dollar/euro exchange rate. Such a hedge is classified as a cash flow hedge under IAS 39, with the effect that gains and losses on the hedging instrument (to the extent that the hedge is effective) are initially recognised in equity.[1] The question the Board considered is what the accounting should be once the future transaction takes place. In its deliberations on this issue, the Board discussed the following approaches:

(a) to remove the hedging gain or loss from equity and recognise it as part of the initial carrying amount of the asset or liability (in the example above, the machine). In future periods, the hedging gain or loss is automatically recognised in profit or loss by being included in amounts such as depreciation expense (for a fixed asset), interest income or expense (for a financial asset or financial liability), or cost of sales (for inventories). This treatment is commonly referred to as 'basis adjustment'.

(b) to leave the hedging gain or loss in equity. In future periods, the gain or loss on the hedging instrument is 'recycled' to profit or loss in the same period(s) as the acquired asset or liability affects profit or loss. This recycling requires a separate adjustment and is not automatic.

BC156 It should be noted that both approaches have the same effect on profit or loss and net assets for all periods affected, so long as the hedge is accounted for as a cash flow hedge. The difference relates to balance sheet presentation and, possibly, the line item in the income statement.

BC157 In the Exposure Draft, the Board proposed that the 'basis adjustment' approach for forecast transactions (approach (a)) should be eliminated and replaced by approach (b) above. It further noted that eliminating the basis adjustment approach would enable IAS 39 to converge with SFAS 133.

BC158 Many of the comments received from constituents disagreed with the proposal in the Exposure Draft. Those responses argued that it would unnecessarily complicate the accounting to leave the hedging gain or loss in equity when the hedged forecast transaction occurs. They particularly noted that tracking the effects of cash flow hedges after the asset or liability is acquired would be complicated and would require systems changes. They also pointed out that treating hedges of firm commitments as fair value hedges has the same effect as a basis adjustment when the firm commitment results in the recognition of an asset or liability. For example, for a perfectly effective hedge of the foreign currency risk of a firm commitment to buy a machine, the effect is to recognise the machine initially at its foreign currency price translated at the forward rate in effect at the inception of the hedge rather than the spot rate. Therefore, they questioned whether it is consistent to treat a hedge of a firm commitment as a fair value hedge while precluding basis adjustments for hedges of forecast transactions.

BC159 Others believe that a basis adjustment is difficult to justify in principle for forecast transactions, and also argue that such basis adjustments impair comparability of financial information. In other words, two identical assets that are purchased at the same time and in the same way, except for the fact that one was hedged, should not be recognised at different amounts.

BC160 The Board concluded that IAS 39 should distinguish between hedges of forecast transactions that will result in the recognition of a *financial* asset or a *financial* liability and those that will result in the recognition of a *non-financial* asset or a *non-financial* liability.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability

BC161 For hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability, the Board concluded that basis adjustments are not appropriate. Its reason was that basis adjustments cause the initial carrying amount of acquired assets (or assumed liabilities) arising from forecast transactions to move away from fair value and hence would override the requirement in IAS 39 to measure a financial instrument initially at its fair value.

BC161A If a hedged forecast transaction results in the recognition of a financial asset or a financial liability, paragraph 97 of IAS 39 required the associated gains or losses on hedging instruments to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the

[1] As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

hedged item affects profit or loss (such as in the periods that interest income or interest expense is recognised).

BC161B The Board was informed that there was uncertainty about how paragraph 97 should be applied when the designated cash flow exposure being hedged differs from the financial instrument arising from the hedged forecast cash flows.

BC161C The example below illustrates the issue:

> An entity applies the guidance in the answer to Question F.6.2 of the guidance on implementing IAS 39.[(a)] On 1 January 20X0 the entity designates forecast cash flows for the risk of variability arising from changes in interest rates. Those forecast cash flows arise from the repricing of existing financial instruments and are scheduled for 1 April 20X0. The entity is exposed to variability in cash flows for the three-month period beginning on 1 April 20X0 attributable to changes in interest rate risk that occur from 1 January 20X0 to 31 March 20X0.
>
> The occurrence of the forecast cash flows is deemed to be highly probable and all the other relevant hedge accounting criteria are met.
>
> The financial instrument that results from the hedged forecast cash flows is a five-year interest-bearing instrument.
>
> (a) IFRS 9 *Financial Instruments* deletes the guidance in IAS 39.

BC161D Paragraph 97 required the gains or losses on the hedging instrument to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affected profit or loss. The financial instrument that was recognised is a five- year instrument that will affect profit or loss for five years. The wording in paragraph 97 suggested that the gains or losses should be reclassified over five years, even though the cash flows designated as the hedged item were hedged for the effects of interest rate changes over only a three- month period.

BC161E The Board believes that the wording of paragraph 97 did not reflect the underlying rationale in hedge accounting, ie that the gains or losses on the hedging instrument should offset the gains or losses on the hedged item, and the offset should be reflected in profit or loss by way of reclassification adjustments.

BC161F The Board believes that in the example set out above the gains or losses should be reclassified over a period of three months beginning on 1 April 20X0, and not over a period of five years beginning on 1 April 20X0.

BC161G Consequently, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraph 97 of IAS 39 to clarify that the gains or losses on the hedged instrument should be reclassified from equity to profit or loss during the period that the hedged forecast cash flows affect profit or loss. The Board also decided that to avoid similar confusion paragraph 100 of IAS 39 should be amended to be consistent with paragraph 97.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a non- financial asset or a non- financial liability

BC162 For hedges of forecast transactions that will result in the recognition of a non- financial asset or a non- financial liability, the Board decided to permit entities a choice of whether to apply basis adjustment.

BC163 The Board considered the argument that changes in the fair value of the hedging instrument are appropriately included in the initial carrying amount of the recognised asset or liability because such changes represent a part of the 'cost' of that asset or liability. Although the Board has not yet considered the broader issue of what costs may be capitalised at initial recognition, the Board believes that its decision to provide an option for basis adjustments in the case of non- financial items will not pre- empt that future discussion. The Board also recognised that financial items and non- financial items are not necessarily measured at the same amount on initial recognition, because financial items are measured at fair value and non- financial items are measured at cost.

BC164 The Board concluded that, on balance, providing entities with a choice in this case was appropriate. The Board took the view that allowing basis adjustments addresses the concern that precluding basis adjustments complicates the accounting for hedges of forecast transactions. In addition, the number of balance sheet line items that could be affected is quite small, generally being only property, plant and equipment, inventory and the cash flow hedge line item in equity. The Board also noted that US GAAP precludes basis adjustments and that applying a basis adjustment is inconsistent with the accounting for hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability.

The Board acknowledged the merits of these arguments, and recognised that by permitting a choice in IAS 39, entities could apply the accounting treatment required by US GAAP.

Hedging using internal contracts

BC165 IAS 39 does not preclude entities from using internal contracts as a risk management tool, or as a tracking device in applying hedge accounting for external contracts that hedge external positions. Furthermore, IAS 39 permits hedge accounting to be applied to transactions between entities in the same group in the *separate reporting* of those entities. However, IAS 39 does not permit hedge accounting for transactions between entities in the same group in consolidated financial statements. The reason is the fundamental requirement of consolidation that the accounting effects of internal contracts should be eliminated in consolidated financial statements, including any internally generated gains or losses. Designating internal contracts as hedging instruments could result in non- elimination of internal gains and losses and have other accounting effects. The Exposure Draft did not propose any change in this area.

BC166 To illustrate, assume the banking book division of Bank A enters into an internal interest rate swap with the trading book division of the same bank. The purpose is to hedge the net interest rate risk exposure in the banking book of a group of similar fixed rate loan assets funded by floating rate liabilities. Under the swap, the banking book pays fixed interest payments to the trading book and receives variable interest rate payments in return. The bank wants to designate the internal interest rate swap in the banking book as a hedging instrument in its consolidated financial statements.

BC167 If the internal swap in the banking book is designated as a hedging instrument in a cash flow hedge of the liabilities, and the internal swap in the trading book is classified as held for trading, internal gains and losses on that internal swap would not be eliminated. This is because the gains and losses on the internal swap in the banking book would be recognised in equity[2] to the extent the hedge is effective and the gains and losses on the internal swap in the trading book would be recognised in profit or loss.

BC168 If the internal swap in the banking book is designated as a hedging instrument in a fair value hedge of the loan assets and the internal swap in the trading book is classified as held for trading, the changes in the fair value of the internal swap would offset both in total net assets in the balance sheet and profit or loss. However, without elimination of the internal swap, there would be an adjustment to the carrying amount of the hedged loan asset in the banking book to reflect the change in the fair value attributable to the risk hedged by the internal contract. Moreover, to reflect the effect of the internal swap the bank would in effect recognise the fixed rate loan at a floating interest rate and recognise an offsetting trading gain or loss in the income statement. Hence the internal swap would have accounting effects.

BC169 Some respondents to the Exposure Draft and some participants in the round- tables objected to not being able to obtain hedge accounting in the consolidated financial statements for internal contracts between subsidiaries or between a subsidiary and the parent (as illustrated above). Among other things, they emphasised that the use of internal contracts is a key risk management tool and that the accounting should reflect the way in which risk is managed. Some suggested that IAS 39 should be changed to make it consistent with US GAAP, which allows the designation of internal derivative contracts as hedging instruments in cash flow hedges of forecast foreign currency transactions in specified, limited circumstances.

BC170 In considering these comments, the Board noted that the following principles apply to consolidated financial statements:

(a) financial statements provide financial information about an entity or group as a whole (as that of a single entity). Financial statements do not provide financial information about an entity as if it were two separate entities.

(b) a fundamental principle of consolidation is that intragroup balances and intragroup transactions are eliminated in full. Permitting the designation of internal contracts as hedging instruments would require a change to the consolidation principles.

(c) it is conceptually wrong to permit an entity to recognise internally generated gains and losses or make other accounting adjustments because of internal transactions. No external event has occurred.

(d) an ability to recognise internally generated gains and losses could result in abuse in the absence of requirements about how entities should manage and control the associated risks. It is not the purpose of accounting standards to prescribe how entities should manage and control risks.

[2] As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

(e) permitting the designation of internal contracts as hedging instruments violates the following requirements in IAS 39:

(i) the prohibition against designating as a hedging instrument a non- derivative financial asset or non- derivative financial liability for other than foreign currency risk. To illustrate, if an entity has two offsetting internal contracts and one is the designated hedging instrument in a fair value hedge of a non- derivative asset and the other is the designated hedging instrument in a fair value hedge of a non- derivative liability, from the entity's perspective the effect is to designate a hedging relationship between the asset and the liability (ie a non- derivative asset or non- derivative liability is used as the hedging instrument).

(ii) the prohibition on designating a net position of assets and liabilities as the hedged item. To illustrate, an entity has two internal contracts. One is designated in a fair value hedge of an asset and the other in a fair value hedge of a liability. The two internal contracts do not fully offset, so the entity lays off the net risk exposure by entering into a net external derivative. In that case, the effect from the entity's perspective is to designate a hedging relationship between the net external derivative and a net position of an asset and a liability.

(iii) the option to fair value assets and liabilities does not extend to portions of assets and liabilities.

(f) the Board is considering separately whether to make an amendment to IAS 39 to facilitate fair value hedge accounting for portfolio hedges of interest rate risk. The Board believes that that is a better way to address the concerns raised about symmetry with risk management systems than permitting the designation of internal contracts as hedging instruments.

(g) the Board decided to permit an option to measure any financial asset or financial liability at fair value with changes in fair value recognised in profit or loss. This enables an entity to measure matching asset/liability positions at fair value without a need for hedge accounting.

BC171 The Board reaffirmed that it is a fundamental principle of consolidation that any accounting effect of internal contracts is eliminated on consolidation. The Board decided that no exception to this principle should be made in IAS 39. Consistently with this decision, the Board also decided not to explore an amendment to permit internal derivative contracts to be designated as hedging instruments in hedges of some forecast foreign currency transactions, as is permitted by SFAS 138 *Accounting for Certain Derivative Instruments and Certain Hedging Activities.*

BC172 The Board also decided to clarify that IAS 39 does not preclude hedge accounting for transactions between entities in the same group in individual or separate financial statements of those entities because they are not internal to the entity (ie the individual entity).

BC172A Previously, paragraphs 73 and 80 referred to the need for hedging instruments to involve a party external to the reporting entity. In doing so, they used a segment as an example of a reporting entity. However, IFRS 8 *Operating Segments* requires disclosure of information that is reported to the chief operating decision maker even if this is on a non- IFRS basis. Therefore, the two IFRSs appeared to conflict. In *Improvements to IFRSs* issued in May 2008 and April 2009, the Board removed from paragraphs 73 and 80 references to the designation of hedging instruments at the segment level.

Eligible hedged items in particular situations (paragraphs AG99BA, AG99E, AG99F, AG110A and AG110B)

BC172B The Board amended IAS 39 in July 2008 to clarify the application of the principles that determine whether a hedged risk or portion of cash flows is eligible for designation in particular situations. This followed a request by the IFRIC for guidance.

BC172C The responses to the exposure draft *Exposures Qualifying for Hedge Accounting* demonstrated that diversity in practice existed, or was likely to occur, in two situations:

(a) the designation of a one- sided risk in a hedged item

(b) the designation of inflation as a hedged risk or portion in particular situations.

Designation of a one-sided risk in a hedged item

BC172D The IFRIC received requests for guidance on whether an entity can designate a purchased option in its entirety as the hedging instrument in a cash flow hedge of a highly probable forecast transaction in such a

way that all changes in the fair value of the purchased option, including changes in the time value, are regarded as effective and would be recognised in other comprehensive income. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.

BC172E After considering the responses to the exposure draft, the Board confirmed that the designation set out in paragraph BC172D is not permitted.

BC172F The Board reached that decision by considering the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase (a one- sided risk). The Board noted that the forecast transaction contained no separately identifiable risk that affects profit or loss that is equivalent to the time value of a purchased option hedging instrument (with the same principal terms as the designated risk). The Board concluded that the intrinsic value of a purchased option, but not its time value, reflects a one- sided risk in a hedged item. The Board then considered a purchased option designated in its entirety as the hedging instrument. The Board noted that hedge accounting is based on a principle of offsetting changes in fair value or cash flows between the hedging instrument and the hedged item. Because a designated one- sided risk does not contain the time value of a purchased option hedging instrument, the Board noted that there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk. Therefore, the Board concluded that a purchased option designated in its entirety as the hedging instrument of a one- sided risk will not be perfectly effective.

Designation of inflation in particular situations

BC172G The IFRIC received a request for guidance on whether, for a hedge of a fixed rate financial instrument, an entity can designate inflation as the hedged item. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.

BC172H After considering the responses to the exposure draft, the Board acknowledged that expectations of future inflation rates can be viewed as an economic component of nominal interest. However, the Board also noted that hedge accounting is an exception to normal accounting principles for the hedged item (fair value hedges) or hedging instrument (cash flow hedges). To ensure a disciplined use of hedge accounting the Board noted that restrictions regarding eligible hedged items are necessary, especially if something other than the entire fair value or cash flow variability of a hedged item is designated.

BC172I The Board noted that paragraph 81 permits an entity to designate as the hedged item something other than the entire fair value change or cash flow variability of a financial instrument. For example, an entity may designate some (but not all) risks of a financial instrument, or some (but not all) cash flows of a financial instrument (a 'portion').

BC172J The Board noted that, to be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the fair value or cash flows of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. The Board noted that these principles were important in order for the effectiveness requirements set out in paragraph 88 to be applied in a meaningful way. The Board also noted that deciding whether designated risks and portions are separately identifiable and reliably measurable requires judgement. However, the Board confirmed that unless the inflation portion is a contractually specified portion of cash flows and other cash flows of the financial instrument are not affected by the inflation portion, inflation is not separately identifiable and reliably measurable and is not eligible for designation as a hedged risk or portion of a financial instrument.

Fair value hedge accounting for a portfolio hedge of interest rate risk

Background

BC173 The Exposure Draft of proposed improvements to IAS 39 published in June 2002 did not propose any substantial changes to the requirements for hedge accounting as they applied to a portfolio hedge of interest rate risk. However, some of the comment letters on the Exposure Draft and participants in the round- table discussions raised this issue. In particular, some were concerned that portfolio hedging strategies they regarded as effective hedges would not have qualified for fair value hedge accounting in accordance with previous versions of IAS 39. Rather, they would have either:

(a) not qualified for hedge accounting at all, with the result that reported profit or loss would be volatile; or

(b) qualified only for cash flow hedge accounting, with the result that reported equity would be volatile.

BC174 In the light of these concerns, the Board decided to explore whether and how IAS 39 could be amended to enable fair value hedge accounting to be used more readily for portfolio hedges of interest rate risk. As a result, in August 2003 the Board published a second Exposure Draft, *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, with a comment deadline of 14 November 2003. More than 120 comment letters were received. The amendments proposed in this second Exposure Draft were finalised in March 2004. Paragraphs BC135A–BC136B and BC175–BC220 summarise the Board's considerations in reaching conclusions on the issues raised.

Scope

BC175 The Board decided to limit any amendments to IAS 39 to applying fair value hedge accounting to a hedge of interest rate risk on a portfolio of items. In making this decision it noted that:

(a) implementation guidance on IAS 39[3] explains how to apply cash flow hedge accounting to a hedge of the interest rate risk on a portfolio of items.

(b) the issues that arise for a portfolio hedge of interest rate risk are different from those that arise for hedges of individual items and for hedges of other risks. In particular, the three issues discussed in paragraph BC176 do not arise in combination for such other hedging arrangements.

The issue: why fair value hedge accounting was difficult to achieve in accordance with previous versions of IAS 39

BC176 The Board identified the following three main reasons why a portfolio hedge of interest rate risk might not have qualified for fair value hedge accounting in accordance with previous versions of IAS 39.

(a) Typically, many of the assets that are included in a portfolio hedge are prepayable, ie the counterparty has a right to repay the item before its contractual repricing date. Such assets contain a prepayment option whose fair value changes as interest rates change. However, the derivative that is used as the hedging instrument typically is not prepayable, ie it does not contain a prepayment option. When interest rates change, the resulting change in the fair value of the hedged item (which is prepayable) differs from the change in fair value of the hedging derivative (which is not prepayable), with the result that the hedge may not meet IAS 39's effectiveness tests.[4] Furthermore, prepayment risk may have the effect that the items included in a portfolio hedge fail the requirement[5] that a group of hedged assets or liabilities must be 'similar' and the related requirement[6] that 'the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items'.

(b) IAS 39[7] prohibits the designation of an overall net position (eg the net of fixed rate assets and fixed rate liabilities) as the hedged item. Rather, it requires individual assets (or liabilities), or groups of similar assets (or similar liabilities), that share the risk exposure equal in amount to the net position to be designated as the hedged item. For example, if an entity has a portfolio of CU100 of assets and CU80 of liabilities, IAS 39 requires that individual assets or a group of similar assets of CU20 are designated as the hedged item. However, for risk management purposes, entities often seek to hedge the net position. This net position changes each period as items are repriced or derecognised and as new items are originated. Hence, the individual items designated as the hedged item also need to be changed each period. This requires de- and redesignation of the individual items that constitute the hedged item, which gives rise to significant systems needs.

(c) Fair value hedge accounting requires the carrying amount of the hedged item to be adjusted for the effect of changes in the hedged risk.[8] Applied to a portfolio hedge, this could involve changing the carrying amounts of many thousands of individual items. Also, for any items subsequently de- designated from being hedged, the revised carrying amount must be amortised over the item's remaining life.[9] This, too, gives rise to significant systems needs.

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3 IFRS 9 *Financial Instruments* deleted the guidance on implementing IAS 39.
4 see IAS 39, paragraph AG105
5 see IAS 39, paragraph 78
6 see IAS 39, paragraph 83
7 see IAS 39, paragraph AG101
8 see IAS 39, paragraph 89(b)
9 see IAS 39, paragraph 92

BC177 The Board decided that any change to IAS 39 must be consistent with the principles that underlie IAS 39's requirements on derivatives and hedge accounting. The three principles that are most relevant to a portfolio hedge of interest rate risk are:

(a) derivatives should be measured at fair value;

(b) hedge ineffectiveness should be identified and recognised in profit or loss;[10] and

(c) only items that are assets and liabilities should be recognised as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be recognised in the balance sheet.

Prepayment risk

BC178 In considering the issue described in paragraph BC176(a), the Board noted that a prepayable item can be viewed as a combination of a non- prepayable item and a prepayment option. It follows that the fair value of a fixed rate prepayable item changes for two reasons when interest rates move:

(a) the fair value of the contracted cash flows to the contractual repricing date changes (because the rate used to discount them changes); and

(b) the fair value of the prepayment option changes (reflecting, among other things, that the likelihood of prepayment is affected by interest rates).

BC179 The Board also noted that, for risk management purposes, many entities do not consider these two effects separately. Instead they incorporate the effect of prepayments by grouping the hedged portfolio into repricing time periods based on *expected* repayment dates (rather than contractual repayment dates). For example, an entity with a portfolio of 25- year mortgages of CU100 may expect 5 per cent of that portfolio to repay in one year's time, in which case it schedules an amount of CU5 into a 12- month time period. The entity schedules all other items contained in its portfolio in a similar way (ie on the basis of expected repayment dates) and hedges all or part of the resulting overall net position in each repricing time period.

BC180 The Board decided to permit the scheduling that is used for risk management purposes, ie on the basis of expected repayment dates, to be used as a basis for the designation necessary for hedge accounting. As a result, an entity would not be required to compute the effect that a change in interest rates has on the fair value of the prepayment option embedded in a prepayable item. Instead, it could incorporate the effect of a change in interest rates on prepayments by grouping the hedged portfolio into repricing time periods based on expected repayment dates. The Board noted that this approach has significant practical advantages for preparers of financial statements, because it allows them to use the data they use for risk management. The Board also noted that the approach is consistent with paragraph 81 of IAS 39, which permits hedge accounting for a portion of a financial asset or financial liability. However, as discussed further in paragraphs BC193–BC206, the Board also concluded that if the entity changes its estimates of the time periods in which items are expected to repay (eg in the light of recent prepayment experience), ineffectiveness will arise, regardless of whether the revision in estimates results in more or less being scheduled in a particular time period.

BC181 The Board also noted that if the items in the hedged portfolio are subject to different amounts of prepayment risk, they may fail the test in paragraph 78 of being similar and the related requirement in paragraph 83 that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. The Board decided that, in the context of a portfolio hedge of interest rate risk, these requirements could be inconsistent with the Board's decision, set out in the previous paragraph, on how to incorporate the effects of prepayment risk. Accordingly, the Board decided that they should not apply. Instead, the financial assets or financial liabilities included in a portfolio hedge of interest rate risk need only share the risk being hedged.

Designation of the hedged item and liabilities with a demand feature

BC182 The Board considered two main ways to overcome the issue noted in paragraph BC176(b). These were:

(a) to designate the hedged item as the overall net position that results from a portfolio containing assets and liabilities. For example, if a repricing time period contains CU100 of fixed rate assets and CU90 of fixed rate liabilities, the net position of CU10 would be designated as the hedged item.

[10] Subject to the same materiality considerations that apply in this context as throughout IFRSs.

(b) to designate the hedged item as a portion of the assets (ie assets of CU10 in the above example), but not to require individual assets to be designated.

BC183 Some of those who commented on the Exposure Draft favoured designation of the overall net position in a portfolio that contains assets and liabilities. In their view, existing asset- liability management (ALM) systems treat the identified assets and liabilities as a natural hedge. Management's decisions about additional hedging focus on the entity's remaining net exposure. They observe that designation based on a portion of either the assets or the liabilities is not consistent with existing ALM systems and would entail additional systems costs.

BC184 In considering questions of designation, the Board was also concerned about questions of measurement. In particular, the Board observed that fair value hedge accounting requires measurement of the change in fair value of the hedged item attributable to the risk being hedged. Designation based on the net position would require the assets and the liabilities in a portfolio each to be measured at fair value (for the risk being hedged) in order to compute the fair value of the net position. Although statistical and other techniques can be used to estimate these fair values, the Board concluded that it is not appropriate to assume that the change in fair value of the hedging instrument is equal to the change in fair value of the net position.

BC185 The Board noted that under the first approach in paragraph BC182 (designating an overall net position), an issue arises if the entity has liabilities that are repayable on demand or after a notice period (referred to below as 'demandable liabilities'). This includes items such as demand deposits and some types of time deposits. The Board was informed that, when managing interest rate risk, many entities that have demandable liabilities include them in a portfolio hedge by scheduling them to the date when they *expect* the total amount of demandable liabilities in the portfolio to be due because of net withdrawals from the accounts in the portfolio. This expected repayment date is typically a period covering several years into the future (eg 0–10 years hence). The Board was also informed that some entities wish to apply fair value hedge accounting based on this scheduling, ie they wish to include demandable liabilities in a fair value portfolio hedge by scheduling them on the basis of their expected repayment dates. The arguments for this view are:

(a) it is consistent with how demandable liabilities are scheduled for risk management purposes. Interest rate risk management involves hedging the interest rate margin resulting from assets and liabilities and not the fair value of all or part of the assets and liabilities included in the hedged portfolio. The interest rate margin of a specific period is subject to variability as soon as the amount of fixed rate assets in that period differs from the amount of fixed rate liabilities in that period.

(b) it is consistent with the treatment of prepayable assets to include demandable liabilities in a portfolio hedge based on expected repayment dates.

(c) as with prepayable assets, expected maturities for demandable liabilities are based on the historical behaviour of customers.

(d) applying the fair value hedge accounting framework to a portfolio that includes demandable liabilities would not entail an immediate gain on origination of such liabilities because all assets and liabilities enter the hedged portfolio at their carrying amounts. Furthermore, IAS 39 requires the carrying amount of a financial liability on its initial recognition to be its fair value, which normally equates to the transaction price (ie the amount deposited).[11]

(e) historical analysis shows that a base level of a portfolio of demandable liabilities, such as chequing accounts, is very stable. Whilst a portion of the demandable liabilities varies with interest rates, the remaining portion—the base level—does not. Hence, entities regard this base level as a long- term fixed rate item and include it as such in the scheduling that is used for risk management purposes.

(f) the distinction between 'old' and 'new' money makes little sense at a portfolio level. The portfolio behaves like a long- term item even if individual liabilities do not.

BC186 The Board noted that this issue is related to that of how to measure the fair value of a demandable liability. In particular, it interrelates with the requirement in IAS 39 that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.[12] This requirement applies to all liabilities with a demand feature, not only to those included in a portfolio hedge.

[11] IFRS 9 *Financial Instruments* replaced IAS 39.
[12] IFRS 9 *Financial Instruments* replaced IAS 39.

BC187 The Board also noted that:

(a) although entities, when managing risk, may schedule demandable liabilities based on the expected repayment date of the total balance of a portfolio of accounts, the deposit liabilities included in that balance are unlikely to be outstanding for an extended period (eg several years). Rather, these deposits are usually expected to be withdrawn within a short time (eg a few months or less), although they may be replaced by new deposits. Put another way, the balance of the portfolio is relatively stable only because withdrawals on some accounts (which usually occur relatively quickly) are offset by new deposits into others. Thus, the liability being hedged is actually the forecast replacement of existing deposits by the receipt of new deposits. IAS 39 does not permit a hedge of such a forecast transaction to qualify for fair value hedge accounting. Rather, fair value hedge accounting can be applied only to the liability (or asset) or firm commitment that exists today.

(b) a portfolio of demandable liabilities is similar to a portfolio of trade payables. Both comprise individual balances that usually are expected to be paid within a short time (eg a few months or less) and replaced by new balances. Also, for both, there is an amount—the base level—that is expected to be stable and present indefinitely. Hence, if the Board were to permit demandable liabilities to be included in a fair value hedge on the basis of a stable base level created by expected replacements, it should similarly allow a hedge of a portfolio of trade payables to qualify for fair value hedge accounting on this basis.

(c) a portfolio of similar core deposits is not different from an individual deposit, other than that, in the light of the 'law of large numbers', the behaviour of the portfolio is more predictable. There are no diversification effects from aggregating many similar items.

(d) it would be inconsistent with the requirement in IAS 39 that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, to schedule such liabilities for hedging purposes using a different date. For example, consider a deposit of CU100 that can be withdrawn on demand without penalty. IAS 39 states that the fair value of such a deposit is CU100. That fair value is unaffected by interest rates and does not change when interest rates move. Accordingly, the demand deposit cannot be included in a fair value hedge of interest rate risk—there is no fair value exposure to hedge.

BC188 For these reasons, the Board concluded that demandable liabilities should not be included in a portfolio hedge on the basis of the expected repayment date of the *total balance of a portfolio* of demandable liabilities, ie including expected rollovers or replacements of existing deposits by new ones. However, as part of its consideration of comments received on the Exposure Draft, the Board also considered whether a demandable liability, such as a demand deposit, could be included in a portfolio hedge based on the expected repayment date of the *existing balance of individual deposits*, ie ignoring any rollovers or replacements of existing deposits by new deposits. The Board noted the following.

(a) For many demandable liabilities, this approach would imply a much earlier expected repayment date than is generally assumed for risk management purposes. In particular, for chequing accounts it would probably imply an expected maturity of a few months or less. However, for other demandable liabilities, such as fixed term deposits that can be withdrawn only by the depositor incurring a significant penalty, it might imply an expected repayment date that is closer to that assumed for risk management.

(b) This approach implies that the *fair value* of the demandable liability should also reflect the expected repayment date of the existing balance, ie that the fair value of a demandable deposit liability is the present value of the amount of the deposit discounted from the expected repayment date. The Board noted that it would be inconsistent to permit fair value hedge accounting to be based on the expected repayment date, but to measure the fair value of the liability on initial recognition on a different basis. The Board also noted that this approach would give rise to a difference on initial recognition between the amount deposited and the fair value recognised in the balance sheet. This, in turn, gives rise to the issue of what the difference represents. Possibilities the Board considered include (i) the value of the depositor's option to withdraw its money before the expected maturity, (ii) prepaid servicing costs or (iii) a gain. The Board did not reach a conclusion on what the difference represents, but agreed that if it were to require such differences to be recognised, this would apply to all demandable liabilities, not only to those included in a portfolio hedge. Such a requirement would represent a significant change from present practice.

(c) If the fair value of a demandable deposit liability at the date of initial recognition is deemed to equal the amount deposited, a fair value portfolio hedge based on an expected repayment date is unlikely to be effective. This is because such deposits typically pay interest at a rate that is significantly lower than that being hedged (eg the deposits may pay interest at zero or at very low rates, whereas the interest rate being hedged may be LIBOR or a similar benchmark rate). Hence, the fair value of the deposit will be significantly less sensitive to interest rate changes than that of the hedging instrument.

(d) The question of how to fair value a demandable liability is closely related to issues being debated by the Board in other projects, including Insurance (phase II), Revenue Recognition, Leases and Measurement. The Board's discussions in these other projects are continuing and it would be premature to reach a conclusion in the context of portfolio hedging without considering the implications for these other projects.

BC189 As a result, the Board decided:

(a) to confirm the requirement in IAS 39 that 'the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid',[13] and

(b) consequently, that a demandable liability cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment.

The Board noted that, depending on the outcome of its discussions in other projects (principally Insurance (phase II), Revenue Recognition, Leases and Measurement), it might reconsider these decisions at some time in the future.

BC190 The Board also noted that what is designated as the hedged item in a portfolio hedge affects the relevance of this issue, at least to some extent. In particular, if the hedged item is designated as a portion *of the assets* in a portfolio, this issue is irrelevant. To illustrate, assume that in a particular repricing time period an entity has CU100 of fixed rate assets and CU80 of what it regards as fixed rate liabilities and the entity wishes to hedge its net exposure of CU20. Also assume that all of the liabilities are demandable liabilities and the time period is later than that containing the earliest date on which the items can be repaid. If the hedged item is designated as CU20 of *assets*, then the demandable *liabilities* are not included in the hedged item, but rather are used only to determine how much of the assets the entity wishes to designate as being hedged. In such a case, whether the demandable liabilities can be designated as a hedged item in a fair value hedge is irrelevant. However, if the overall net position were to be designated as the hedged item, because the net position comprises CU100 of assets and CU80 of demandable liabilities, whether the demandable liabilities can be designated as a hedged item in a fair value hedge becomes critical.

BC191 Given the above points, the Board decided that a portion of assets or liabilities (rather than an overall net position) may be designated as the hedged item, to overcome part of the demandable liabilities issue. It also noted that this approach is consistent with IAS 39,[14] whereas designating an overall net position is not. IAS 39[15] prohibits an overall net position from being designated as the hedged item, but permits a similar effect to be achieved by designating an amount of assets (or liabilities) equal to the net position.

BC192 However, the Board also recognised that this method of designation would not fully resolve the demandable liabilities issue. In particular, the issue is still relevant if, in a particular repricing time period, the entity has so many demandable liabilities whose earliest repayment date is before that time period that (a) they comprise nearly all of what the entity regards as its fixed rate liabilities and (b) its fixed rate liabilities (including the demandable liabilities) exceed its fixed rate assets in this repricing time period. In this case, the entity is in a net liability position. Thus, it needs to designate an amount of the *liabilities* as the hedged item. But unless it has sufficient fixed rate liabilities other than those that can be demanded before that time period, this implies designating the demandable liabilities as the hedged item. Consistently with the Board's decision discussed above, such a hedge does not qualify for fair value hedge accounting. (If the liabilities are non- interest bearing, they cannot be designated as the hedged item in a cash flow hedge because their cash flows do not vary with changes in interest rates, ie there is no cash flow exposure to interest rates. However, the hedging relationship may qualify for cash flow hedge accounting if designated as a hedge of associated assets.)

[13] IFRS 9 *Financial Instruments* replaced IAS 39.
[14] see IAS 39, paragraph 84
[15] see IAS 39, paragraph AG101

What portion of assets should be designated and the impact on ineffectiveness

BC193 Having decided that a portion of assets (or liabilities) could be designated as the hedged item, the Board considered how to overcome the systems problems noted in paragraph BC176(b) and (c). The Board noted that these problems arise from designating individual assets (or liabilities) as the hedged item. Accordingly, the Board decided that the hedged item could be expressed as an *amount* (of assets or liabilities) rather than as individual assets or liabilities.

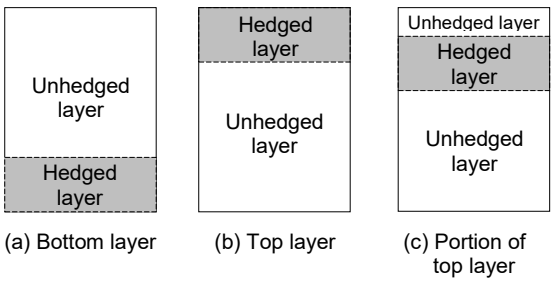
BC194 The Board noted that this decision—that the hedged item may be designated as an amount of assets or liabilities rather than as specified items—gives rise to the issue of how the amount designated should be specified. The Board considered comments received on the Exposure Draft that it should not specify any method for designating the hedged item and hence measuring effectiveness. However, the Board concluded that if it provided no guidance, entities might designate in different ways, resulting in little comparability between them. The Board also noted that its objective, when permitting an amount to be designated, was to overcome the systems problems associated with designating individual items whilst achieving a very similar accounting result. Accordingly, it concluded that it should require a method of designation that closely approximates the accounting result that would be achieved by designating individual items.

BC195 Additionally, the Board noted that designation determines how much, if any, ineffectiveness arises if actual repricing dates in a particular repricing time period vary from those estimated or if the estimated repricing dates are revised. Taking the above example of a repricing time period in which there are CU100 of fixed rate assets and the entity designates as the hedged item an amount of CU20 of assets, the Board considered two approaches (a layer approach and a percentage approach) that are summarised below.

Layer approach

BC196 The first of these approaches, illustrated in figure 1, designates the hedged item as a 'layer' (eg (a) the bottom layer, (b) the top layer or (c) a portion of the top layer) of the assets (or liabilities) in a repricing time period. In this approach, the portfolio of CU100 in the above example is considered to comprise a hedged layer of CU20 and an unhedged layer of CU80.

Figure 1: Illustrating the designation of an amount of assets as a layer



BC197 The Board noted that the layer approach does not result in the recognition of ineffectiveness in all cases when the estimated amount of assets (or liabilities) changes. For example, in a bottom layer approach (see figure 2), if some assets prepay earlier than expected so that the entity revises downward its estimate of the amount of assets in the repricing time period (eg from CU100 to CU90), these reductions are assumed to come first from the unhedged top layer (figure 2(b)). Whether any ineffectiveness arises depends on whether the downward revision reaches the hedged layer of CU20. Thus, if the bottom layer is designated as the hedged item, it is unlikely that the hedged (bottom) layer will be reached and that any ineffectiveness will arise. Conversely, if the top layer is designated (see figure 3), any downward revision to the estimated amount in a repricing time period will reduce the hedged (top) layer and ineffectiveness will arise (figure 3(b)).

Figure 2: Illustrating the effect on changes in prepayments in a bottom layer approach

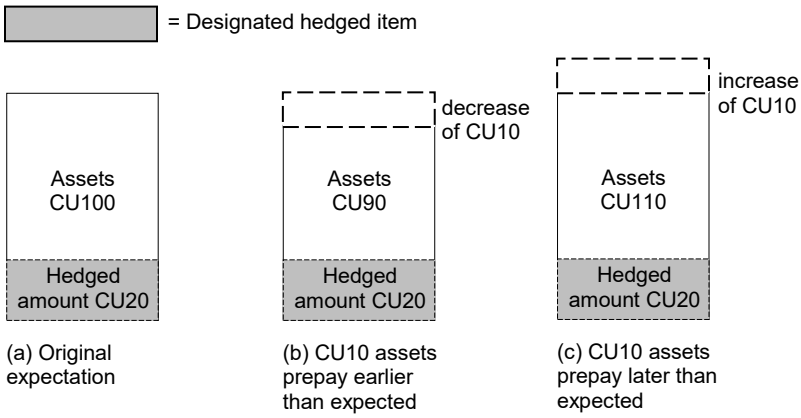
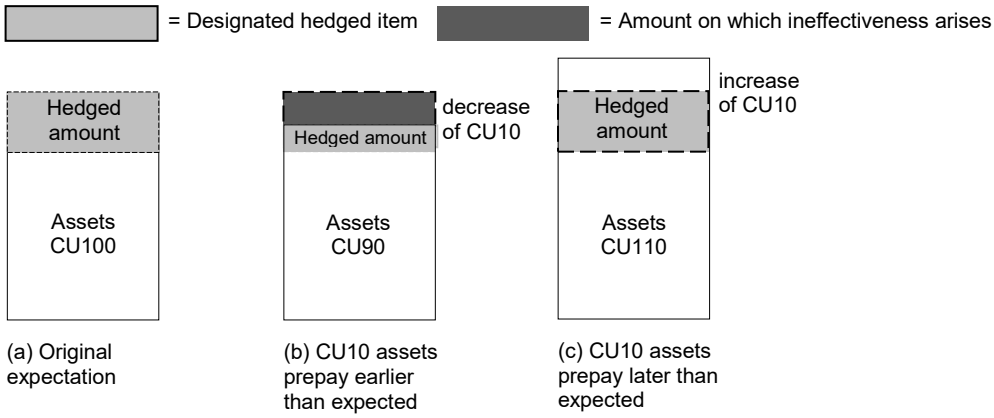


Figure 3: Illustrating the effect on changes in prepayments in a top layer approach

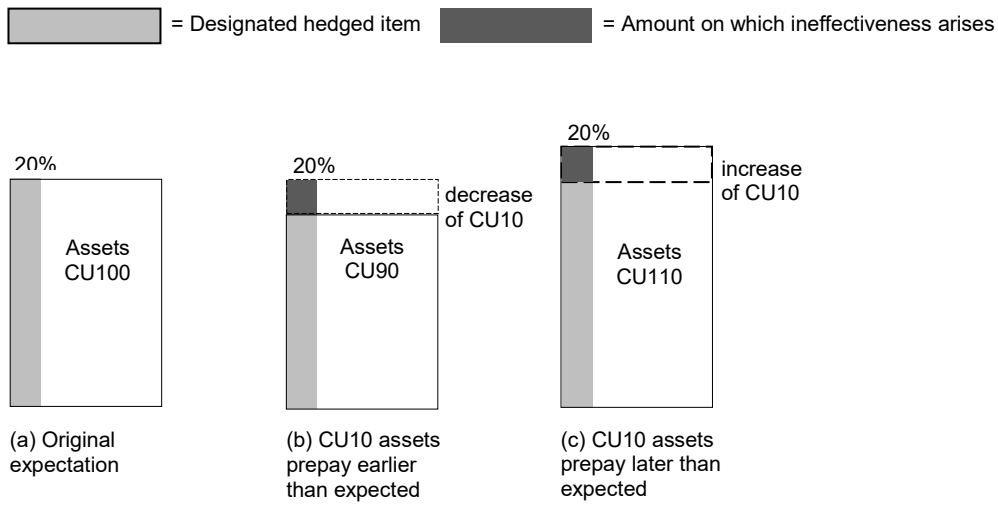


BC198 Finally, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU110, see figures 2(c) and 3(c)), no ineffectiveness arises no matter how the layer is designated, on the grounds that the hedged layer of CU20 is still there and that was all that was being hedged.

Percentage approach

BC199 The percentage approach, illustrated in figure 4, designates the hedged item as a percentage of the assets (or liabilities) in a repricing time period. In this approach, in the portfolio in the above example, 20 per cent of the assets of CU100 in this repricing time period is designated as the hedged item (figure 4(a)). As a result, if some assets prepay *earlier* than expected so that the entity revises *downwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU90, figure 4(b)), ineffectiveness arises on 20 per cent of the decrease (in this case ineffectiveness arises on CU2). Similarly, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU110, figure 4(c)), ineffectiveness arises on 20 per cent of the increase (in this case ineffectiveness arises on CU2).

Figure 4: Illustrating the designation of an amount of assets as a percentage



Arguments for and against the layer approach

BC200 The arguments for the layer approach are as follows:

(a) Designating a bottom layer would be consistent with the answers to Questions F.6.1 and F.6.2 of the Guidance on Implementing IAS 39, which allow, for a cash flow hedge, the 'bottom' portion of reinvestments of collections from assets to be designated as the hedged item.[16]

(b) The entity is hedging interest rate risk rather than prepayment risk. Any changes to the portfolio because of changes in prepayments do not affect how effective the hedge was in mitigating interest rate risk.

(c) The approach captures all ineffectiveness on the hedged portion. It merely allows the hedged portion to be defined in such a way that, at least in a bottom layer approach, the first of any potential ineffectiveness relates to the unhedged portion.

(d) It is correct that no ineffectiveness arises if changes in prepayment estimates cause more assets to be scheduled into that repricing time period. So long as assets equal to the hedged layer remain, there is no ineffectiveness and upward revisions of the amount in a repricing time period do not affect the hedged layer.

(e) A prepayable item can be viewed as a combination of a non- prepayable item and a prepayment option. The designation of a bottom layer can be viewed as hedging a part of the life of the non- prepayable item, but none of the prepayment option. For example, a 25- year prepayable mortgage can be viewed as a combination of (i) a non- prepayable, fixed term, 25- year mortgage and (ii) a written prepayment option that allows the borrower to repay the mortgage early. If the entity hedges this asset with a 5- year derivative, this is equivalent to hedging the first five years of component (i). If the position is viewed in this way, no ineffectiveness arises when interest rate changes cause the value of the prepayment option to change (unless the option is exercised and the asset prepaid) because the prepayment option was not hedged.

BC201 The arguments against the layer approach are as follows:

(a) The considerations that apply to a fair value hedge are different from those that apply to a cash flow hedge. In a cash flow hedge, it is the cash flows associated with the reinvestment of probable future collections that are hedged. In a fair value hedge it is the fair value of the assets that currently exist.

(b) The fact that no ineffectiveness is recognised if the amount in a repricing time period is re- estimated upwards (with the effect that the entity becomes underhedged) is not in accordance with IAS 39. For a fair value hedge, IAS 39 requires that ineffectiveness is recognised both when

[16] IFRS 9 *Financial Instruments* deleted the guidance on implementing IAS 39.

the entity becomes overhedged (ie the derivative exceeds the hedged item) and when it becomes underhedged (ie the derivative is smaller than the hedged item).

(c) As noted in paragraph BC200(e), a prepayable item can be viewed as a combination of a non- prepayable item and a prepayment option. When interest rates change, the fair value of both of these components changes.

(d) The objective of applying fair value hedge accounting to a hedged item designated in terms of an amount (rather than as individual assets or liabilities) is to obtain results that closely approximate those that would have been obtained if individual assets or liabilities had been designated as the hedged item. If individual prepayable assets had been designated as the hedged item, the change in both the components noted in (c) above (to the extent they are attributable to the hedged risk) would be recognised in profit or loss, both when interest rates increase and when they decrease. Accordingly, the change in the fair value of the hedged asset would differ from the change in the fair value of the hedging derivative (unless that derivative includes an equivalent prepayment option) and ineffectiveness would be recognised for the difference. It follows that in the simplified approach of designating the hedged item as an amount, ineffectiveness should similarly arise.

(e) *All* prepayable assets in a repricing time period, and not just a layer of them, contain a prepayment option whose fair value changes with changes in interest rates. Accordingly, when interest rates change, the fair value of the hedged assets (which include a prepayment option whose fair value has changed) will change by an amount different from that of the hedging derivative (which typically does not contain a prepayment option), and ineffectiveness will arise. This effect occurs regardless of whether interest rates increase or decrease—ie regardless of whether re- estimates of prepayments result in the amount in a time period being more or less.

(f) Interest rate risk and prepayment risk are so closely interrelated that it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item. Often the biggest single cause of changes in prepayment rates is changes in interest rates. This close relationship is the reason why IAS 39 prohibits a held- to- maturity asset[17] from being a hedged item with respect to either interest rate risk or prepayment risk. Furthermore, most entities do not separate the two components for risk management purposes. Rather, they incorporate the prepayment option by scheduling amounts based on expected maturities. When entities choose to use risk management practices—based on not separating prepayment and interest rate risk—as the basis for designation for hedge accounting purposes, it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item.

(g) If interest rates change, the effect on the fair value of a portfolio of prepayable items will be different from the effect on the fair value of a portfolio of otherwise identical but non- prepayable items. However, using a layer approach, this difference would not be recognised—if both portfolios were hedged to the same extent, both would be recognised in the balance sheet at the same amount.

BC202 The Board was persuaded by the arguments in paragraph BC201 and rejected layer approaches. In particular, the Board concluded that the hedged item should be designated in such a way that if the entity changes its estimates of the repricing time periods in which items are expected to repay or mature (eg in the light of recent prepayment experience), ineffectiveness arises. It also concluded that ineffectiveness should arise both when estimated prepayments decrease, resulting in more assets in a particular repricing time period, and when they increase, resulting in fewer.

Arguments for a third approach—measuring directly the change in fair value of the entire hedged item

BC203 The Board also considered comments on the Exposure Draft that:

(a) some entities hedge prepayment risk and interest rate risk separately, by hedging to the expected prepayment date using interest rate swaps, and hedging possible variations in these expected prepayment dates using swaptions.

(b) the embedded derivatives provisions of IAS 39 require some prepayable assets to be separated into a prepayment option and a non- prepayable host contract (unless the entity is unable to measure separately the prepayment option, in which case it treats the entire asset as held for

[17] IFRS 9 eliminated the category of held-to-maturity.

trading). This seems to conflict with the view in the Exposure Draft that the two risks are too difficult to separate for the purposes of a portfolio hedge.[18]

BC204 In considering these arguments, the Board noted that the percentage approach described in paragraph AG126(b) is a proxy for measuring the change in the fair value of the *entire* asset (or liability)—including any embedded prepayment option—that is attributable to changes in interest rates. The Board had developed this proxy in the Exposure Draft because it had been informed that most entities (a) do not separate interest rate risk and prepayment risk for risk management purposes and hence (b) were unable to value the change in the value of the entire asset (including any embedded prepayment option) that is attributable to changes in the hedged interest rates. However, the comments described in paragraph BC203 indicated that in some cases, entities may be able to measure this change in value directly. The Board noted that such a direct method of measurement is conceptually preferable to the proxy described in paragraph AG126(b) and, accordingly, decided to recognise it explicitly. Thus, for example, if an entity that hedges prepayable assets using a combination of interest rate swaps and swaptions is able to measure directly the change in fair value of the entire asset, it could measure effectiveness by comparing the change in the value of the swaps and swaptions with the change in the fair value of the entire asset (including the change in the value of the prepayment option embedded in them) that is attributable to changes in the hedged interest rate. However, the Board also decided to permit the proxy proposed in the Exposure Draft for those entities that are unable to measure directly the change in the fair value of the entire asset.

Consideration of systems requirements

BC205 Finally, the Board was informed that, to be practicable in terms of systems needs, any approach should not require tracking of the amount in a repricing time period for multiple periods. Therefore it decided that ineffectiveness should be calculated by determining the change in the estimated amount in a repricing time period between one date on which effectiveness is measured and the next, as described more fully in paragraphs AG126 and AG127. This requires the entity to track how much of the change in each repricing time period between these two dates is attributable to revisions in estimates and how much is attributable to the origination of new assets (or liabilities). However, once ineffectiveness has been determined as set out above, the entity in essence starts again, ie it establishes the new amount in each repricing time period (including new items that have been originated since it last tested effectiveness), designates a new hedged item, and repeats the procedures to determine ineffectiveness at the next date it tests effectiveness. Thus the tracking is limited to movements between one date when effectiveness is measured and the next. It is not necessary to track for multiple periods. However, the entity will need to keep records relating to each repricing time period (a) to reconcile the amounts for each repricing time period with the total amounts in the two separate line items in the balance sheet (see paragraph AG114(f)), and (b) to ensure that amounts in the two separate line items are derecognised no later than when the repricing time period to which they relate expires.

BC206 The Board also noted that the amount of tracking required by the percentage approach is no more than what would be required by any of the layer approaches. Thus, the Board concluded that none of the approaches was clearly preferable from the standpoint of systems needs.

The carrying amount of the hedged item

BC207 The last issue noted in paragraph BC176 is how to present in the balance sheet the change in fair value of the hedged item. The Board noted the concern of respondents that the hedged item may contain many—even thousands of—individual assets (or liabilities) and that to change the carrying amounts of each of these individual items would be impracticable. The Board considered dealing with this concern by permitting the change in value to be presented in a single line item in the balance sheet. However, the Board noted that this could result in a decrease in the fair value of a financial asset (financial liability) being recognised as a financial liability (financial asset). Furthermore, for some repricing time periods the hedged item may be an asset, whereas for others it may be a liability. The Board concluded that it would be incorrect to present together the changes in fair value for such repricing time periods, because to do so would combine changes in the fair value of assets with changes in the fair value of liabilities.

BC208 Accordingly, the Board decided that two line items should be presented, as follows:

(a) for those repricing time periods for which the hedged item is an asset, the change in its fair value is presented in a single separate line item within assets; and

(b) for those repricing time periods for which the hedged item is a liability, the change in its fair value is presented in a single separate line item within liabilities.

[18] IFRS 9 replaced IAS 39.

BC209 The Board noted that these line items represent changes in the fair value of the hedged item. For this reason, the Board decided that they should be presented next to financial assets or financial liabilities.

Derecognition of amounts included in the separate line items

Derecognition of an asset (or liability) in the hedged portfolio

BC210 The Board discussed how and when amounts recognised in the separate balance sheet line items should be removed from the balance sheet. The Board noted that the objective is to remove such amounts from the balance sheet in the same periods as they would have been removed had individual assets or liabilities (rather than an amount) been designated as the hedged item.

BC211 The Board noted that this objective could be fully met only if the entity schedules individual assets or liabilities into repricing time periods and tracks both for how long the scheduled individual items have been hedged and how much of each item was hedged in each time period. In the absence of such scheduling and tracking, some assumptions would need to be made about these matters and, hence, about how much should be removed from the separate balance sheet line items when an asset (or liability) in the hedged portfolio is derecognised. In addition, some safeguards would be needed to ensure that amounts included in the separate balance sheet line items are removed from the balance sheet over a reasonable period and do not remain in the balance sheet indefinitely. With these points in mind, the Board decided to require that:

(a) whenever an asset (or liability) in the hedged portfolio is derecognised—whether through earlier than expected prepayment, sale or write- off from impairment—any amount included in the separate balance sheet line item relating to that derecognised asset (or liability) should be removed from the balance sheet and included in the gain or loss on derecognition.

(b) if an entity cannot determine into which time period(s) a derecognised asset (or liability) was scheduled:

  (i) it should assume that higher than expected prepayments occur on assets scheduled into the first available time period; and

  (ii) it should allocate sales and impairments to assets scheduled into all time periods containing the derecognised item on a systematic and rational basis.

(c) the entity should track how much of the total amount included in the separate line items relates to each repricing time period, and should remove the amount that relates to a particular time period from the balance sheet no later than when that time period expires.

Amortisation

BC212 The Board also noted that if the designated hedged amount for a repricing time period is reduced, IAS 39[19] requires that the separate balance sheet line item described in paragraph 89A relating to that reduction is amortised on the basis of a recalculated effective interest rate. The Board noted that for a portfolio hedge of interest rate risk, amortisation based on a recalculated effective interest rate could be complex to determine and could demand significant additional systems requirements. Consequently, the Board decided that in the case of a portfolio hedge of interest rate risk (and only in such a hedge), the line item balance may be amortised using a straight- line method when a method based on a recalculated effective interest rate is not practicable.

The hedging instrument

BC213 The Board was asked by commentators to clarify whether the hedging instrument may be a portfolio of derivatives containing offsetting risk positions. Commentators noted that previous versions of IAS 39 were unclear on this point.

BC214 The issue arises because the assets and liabilities in each repricing time period change over time as prepayment expectations change, as items are derecognised and as new items are originated. Thus the net position, and the amount the entity wishes to designate as the hedged item, also changes over time. If the hedged item decreases, the hedging instrument needs to be reduced. However, entities do not normally reduce the hedging instrument by disposing of some of the derivatives contained in it. Instead, entities adjust the hedging instrument by entering into new derivatives with an offsetting risk profile.

[19] see paragraph 92

BC215 The Board decided to permit the hedging instrument to be a portfolio of derivatives containing offsetting risk positions for both individual and portfolio hedges. It noted that all of the derivatives concerned are measured at fair value. It also noted that the two ways of adjusting the hedging instrument described in the previous paragraph can achieve substantially the same effect. Therefore the Board clarified paragraph 77 to this effect.

Hedge effectiveness for a portfolio hedge of interest rate risk

BC216 Some respondents to the Exposure Draft questioned whether IAS 39's effectiveness tests[20] should apply to a portfolio hedge of interest rate risk. The Board noted that its objective in amending IAS 39 for a portfolio hedge of interest rate risk is to permit fair value hedge accounting to be used more easily, whilst continuing to meet the principles of hedge accounting. One of these principles is that the hedge is highly effective. Thus, the Board concluded that the effectiveness requirements in IAS 39 apply equally to a portfolio hedge of interest rate risk.

BC217 Some respondents to the Exposure Draft sought guidance on how the effectiveness tests are to be applied to a portfolio hedge. In particular, they asked how the prospective effectiveness test is to be applied when an entity periodically 'rebalances' a hedge (ie adjusts the amount of the hedging instrument to reflect changes in the hedged item). The Board decided that if the entity's risk management strategy is to change the amount of the hedging instrument periodically to reflect changes in the hedged position, that strategy affects the determination of the term of the hedge. Thus, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. The Board noted that this decision does not conflict with the requirement in paragraph 75 that 'a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding'. This is because the entire hedging instrument is designated (and not only some of its cash flows, for example, those to the time when the hedge is next adjusted). However, expected effectiveness is assessed by considering the change in the fair value of the entire hedging instrument only for the period until it is next adjusted.

BC218 A third issue raised in the comment letters was whether, for a portfolio hedge, the retrospective effectiveness test should be assessed for all time buckets in aggregate or individually for each time bucket. The Board decided that entities could use any method to assess retrospective effectiveness, but noted that the chosen method would form part of the documentation of the hedging relationship made at the inception of the hedge in accordance with paragraph 88(a) and hence could not be decided at the time the retrospective effectiveness test is performed.

Transition to fair value hedge accounting for portfolios of interest rate risk

BC219 In finalising the amendments to IAS 39, the Board considered whether to provide additional guidance for entities wishing to apply fair value hedge accounting to a portfolio hedge that had previously been accounted for using cash flow hedge accounting. The Board noted that such entities could apply paragraph 101(d) to revoke the designation of a cash flow hedge and re- designate a new fair value hedge using the same hedged item and hedging instrument, and decided to clarify this in the Application Guidance. Additionally, the Board concluded that clarification was not required for first- time adopters because IFRS 1 already contained sufficient guidance.

BC220 The Board also considered whether to permit retrospective designation of a portfolio hedge. The Board noted that this would conflict with the principle in paragraph 88(a) that 'at the inception of the hedge there is formal designation and documentation of the hedging relationship' and accordingly, decided not to permit retrospective designation.

Novation of derivatives and continuation of hedge accounting

BC220A The IASB received an urgent request to clarify whether an entity is required to discontinue hedge accounting for hedging relationships in which a derivative has been designated as a hedging instrument in accordance with IAS 39 when that derivative is novated to a central counterparty (CCP) due to the introduction of a new law or regulation.[21]

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[20] see paragraph AG105

[21] In this context, the term 'novation' indicates that the parties to a derivative agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty.

BC220B The IASB considered the derecognition requirements of IAS 39 to determine whether the novation in such a circumstance leads to the derecognition of an existing derivative that has been designated as a hedging instrument. The IASB noted that a derivative should be derecognised only when it meets both the derecognition criteria for a financial asset and the derecognition criteria for a financial liability in circumstances in which the derivative involves two-way payments between parties (ie the payments are or could be from and to each of the parties).

BC220C The IASB observed that paragraph 17(a) of IAS 39 requires that a financial asset is derecognised when the contractual rights to the cash flows from the financial asset expire. The IASB noted that through novation to a CCP, a party (Party A) to the original derivative has new contractual rights to cash flows from a (new) derivative with the CCP, and this new contract replaces the original contract with a counterparty (Party B). Thus the original derivative with Party B has expired and as a consequence the original derivative through which Party A has engaged with Party B shall meet the derecognition criteria for a financial asset.[22]

BC220D The IASB also observed that paragraph AG57(b) of IAS 39 states that a financial liability is extinguished when the debtor is legally released from primary responsibility for the liability. The IASB noted that the novation to the CCP would release Party A from the responsibility to make payments to Party B and also would oblige Party A to make payments to the CCP. Consequently, the original derivative through which Party A has transacted with Party B also meets the derecognition criteria for a financial liability.[23]

BC220E Consequently, the IASB concluded that the novation of a derivative to a CCP would be accounted for as the derecognition of the original derivative and the recognition of the (new) novated derivative.

BC220F Taking into account the conclusion of the assessment on the derecognition requirements, the IASB considered paragraphs 91(a) and 101(a) of IAS 39, which require an entity to discontinue hedge accounting prospectively if the hedging instrument expires or is sold, terminated or exercised. The IASB noted that novation to a CCP would require the entity to discontinue hedge accounting because the derivative that was designated as a hedging instrument has been derecognised and consequently the hedging instrument in the existing hedging relationship no longer exists.

BC220G The IASB, however, was concerned about the financial reporting effects that would arise from novations that result from new laws or regulations. The IASB noted that the requirement to discontinue hedge accounting meant that although an entity could designate the new derivative as the hedging instrument in a new hedging relationship, this could result in more hedge ineffectiveness, especially for cash flow hedges, compared to a continuing hedging relationship. This is because the derivative that would be newly designated as the hedging instrument would be on terms that would be different from a new derivative, ie it was unlikely to be 'at-market' (for example, a non-option derivative such as a swap or forward might have a significant fair value) at the time of the novation. The IASB also noted that there would be an increased risk that the hedging relationship would fail to fall within the 80–125 per cent hedge effectiveness range required by IAS 39.

BC220H The IASB, taking note of these financial reporting effects, was convinced that accounting for the hedging relationship that existed before the novation as a continuing hedging relationship, in this specific situation, would provide more useful information to users of financial statements. The IASB also considered the feedback from outreach that involved the members of the International Forum of Accounting Standard Setters (IFASS) and securities regulators and noted that this issue is not limited to a specific jurisdiction because many jurisdictions have introduced, or are expected to mandate, laws or regulations that encourage or require the novation of derivatives to a CCP.

BC220I The IASB noted that the widespread legislative changes across jurisdictions were prompted by a G20 commitment to improve transparency and regulatory oversight of over-the-counter (OTC) derivatives in an internationally consistent and non-discriminatory way. Specifically, the G20 agreed to improve OTC derivatives markets so that all standardised OTC derivatives contracts are cleared through a CCP.

BC220J The IASB also considered the draft requirements of the forthcoming hedge accounting chapter of IFRS 9. The IASB noted that those draft requirements also would require hedge accounting to be discontinued if the novation to a CCP occurs.

BC220K Consequently, the IASB decided to publish, in January 2013, the Exposure Draft *Novation of Derivatives and Continuation of Hedge Accounting* ('ED/2013/2'), which proposed amendments to IAS 39 and IFRS 9. In ED/2013/2, the IASB proposed to amend paragraphs 91(a) and 101(a) of IAS 39 to provide relief from discontinuing hedge accounting when the novation to a CCP is required by new laws or regulations and meets certain criteria. The IASB decided to set the comment period for those proposals to 30 days. The IASB noted that the reduced comment period was necessary because the amendments should be completed urgently because the new laws or regulations to effect CCP clearing of OTC derivatives would come into

[22] IFRS 9 replaced IAS 39.
[23] IFRS 9 replaced IAS 39.

force within a short period; the contents of the proposed amendments were short; and there was likely to be a broad consensus on the topic.

BC220L When developing ED/2013/2, the IASB tentatively decided that the terms of the novated derivative should be unchanged other than the change in counterparty, however, the IASB noted that, in practice, other changes may arise as a direct consequence of the novation. For example, in order to enter into a derivative with a CCP it may be necessary to make adjustments to the collateral arrangements. Such narrow changes that are a direct consequence of or are incidental to the novation were acknowledged in the proposed amendments. However, this would not include changes to, for example, the maturity of the derivatives, the payment dates, or the contractual cash flows or the basis of their calculation, except for charges that may arise as a consequence of transacting with a CCP.

BC220M When developing ED/2013/2, the IASB also discussed whether to require an entity to disclose that it has been able to continue hedge accounting by applying the relief provided by these proposed amendments to IAS 39 and IFRS 9. The IASB tentatively decided that it was not appropriate to mandate specific disclosure in this situation because, from the perspective of a user of financial statements, the hedge accounting would be continuing.

BC220N A total of 78 respondents commented on ED/2013/2. The vast majority of respondents agreed that the proposed amendments are necessary. However, a few respondents expressed disagreement with the proposal on the basis that they disagreed with the IASB's conclusion that hedge accounting would be required to be discontinued as a result of such novations. In expressing such disagreement some noted that IAS 39 expressly acknowledges that certain replacements or rollovers of hedging instruments are not expirations or terminations for the purposes of discontinuing hedge accounting. The IASB noted that this exception applies if '[a] replacement or rollover is part of the entity's documented hedging strategy' (IAS 39.91(a) and IAS 39.101(a)). The IASB questioned whether replacement of a contract as a result of unforeseen legislative changes (even if documented) fits the definition of a replacement that is part of a 'documented hedging strategy'.

BC220O Even though the vast majority of respondents agreed with the proposal, a considerable majority of respondents disagreed with the scope of the proposed amendments. They believed that the proposed scope of 'novation required by laws or regulations' is too restrictive and that the scope therefore should be expanded by removing this criterion. In particular, they argued that voluntary novation to a CCP should be provided with the same relief as novation required by laws or regulations. A few respondents further requested that the scope should not be limited to novation to a central counterparty and that novation in other circumstances should also be considered.

BC220P In considering respondents' comments, the IASB noted that voluntary novation to a CCP could be prevalent in some circumstances such as novation in anticipation of regulatory changes, novation due to operational ease, and novation induced but not actually mandated by laws or regulations as a result of the imposition of charges or penalties. The IASB also noted that many jurisdictions would not require the existing stock of outstanding historical derivatives to be moved to CCPs, although this was encouraged by the G20 commitment.

BC220Q The IASB observed, however, that for hedge accounting to continue voluntary novation to a CCP should be associated with laws or regulations that are relevant to central clearing of derivatives. The IASB noted that while a novation need not be required by laws or regulations for hedge accounting to be allowed to continue, allowing all novations to CCPs to be accommodated was broader than the IASB had intended. In addition, the IASB agreed that hedge accounting should continue when novations are performed as a consequence of laws or regulations or the introduction of laws of regulations but noted that the mere possibility of laws or regulations being introduced was not a sufficient basis for the continuation of hedge accounting.

BC220R Some respondents were concerned that restricting the relief to novation directly to a CCP was too narrow. In considering respondents' comments, the IASB noted that in some cases a CCP has a contractual relationship only with its 'clearing members', and therefore an entity must have a contractual relationship with a clearing member in order to transact with a CCP; a clearing member of a CCP provides a clearing service to its client who cannot access a CCP directly. The IASB also noted that some jurisdictions are introducing a so-called 'indirect clearing' arrangement in their laws or regulations to effect clearing with a CCP, by which a client of a clearing member of a CCP provides a (indirect) clearing service to its client in the same way as a clearing member of a CCP provides a clearing service to its client. In addition, the IASB observed that an intragroup novation also can occur in order to access a CCP; for example, if only particular group entities can transact directly with a CCP.

BC220S On the basis of respondents' comments, the IASB decided to expand the scope of the amendments by providing relief for novations to entities other than a CCP if such novation is undertaken with the objective of effecting clearing with a CCP rather than limiting relief to situations in which novation is directly to a CCP. The IASB decided that in these circumstances the novation had occurred in order to effect clearing

through a CCP, albeit indirectly. The IASB thus decided also to include such novations in the scope of the amendments because they are consistent with the objective of the proposed amendments—they enable hedge accounting to continue when novations occur as a consequence of laws or regulations or the introduction of laws or regulations that increase the use of CCPs. However, the IASB noted that when parties to a hedging instrument enter into novations with different counterparties (for example, with different clearing members), these amendments only apply if each of those parties ultimately effects clearing with the same central counterparty.

BC220T Respondents raised a concern about the phrase 'if and only if' that was used in ED/2013/2 when describing that the relief is provided 'if and only if' the criteria are met. In considering respondents' comments, the IASB noted that ED/2013/2 was intended to address a narrow issue—novation to CCPs—and therefore changing the phrase 'if and only if' to 'if' would target the amendment on the fact patterns that the IASB sought to address. The IASB noted that this would have the effect of requiring an analysis of whether the general conditions for continuation of hedge accounting are satisfied in other cases (for example, as was raised by some respondents, in determining the effect of intragroup novations in consolidated financial statements).

BC220U The IASB decided to make equivalent amendments to the forthcoming chapter on hedge accounting that will be incorporated into IFRS 9, as proposed in ED/2013/2; no respondents opposed this proposal.

BC220V ED/2013/2 did not propose any additional disclosures. The vast majority of respondents agreed with this. The IASB confirmed that additional disclosures are not required. However, the IASB noted that an entity may consider disclosures in accordance with IFRS 7 *Financial Instruments: Disclosures*, which requires qualitative and quantitative disclosures about credit risk.

BC220W The IASB also decided to retain in the final amendments the transition requirements proposed in ED/2013/2 so that the amendments should apply retrospectively and early application should be permitted. The IASB noted that even with retrospective application, if an entity had previously discontinued hedge accounting, as a result of a novation, that (pre-novation) hedge accounting relationship could not be reinstated because doing so would be inconsistent with the requirements for hedge accounting (ie hedge accounting cannot be applied retrospectively).

BC221–BC222 [Deleted]

Amendments for Interest Rate Benchmark Reform (September 2019)

BC223 Interest rate benchmarks such as interbank offered rates (IBORs) play an important role in global financial markets. These interest rate benchmarks index trillions of dollars and other currencies in a wide variety of financial products, from derivatives to residential mortgages. However, cases of attempted market manipulation of some interest rate benchmarks, together with the post-crisis decline in liquidity in interbank unsecured funding markets, have undermined confidence in the reliability and robustness of some interest rate benchmarks. Against this background, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest rate benchmarks. Following the review, the FSB published a report setting out its recommended reforms of some major interest rate benchmarks such as IBORs. Public authorities in many jurisdictions have since taken steps to implement those recommendations. In some jurisdictions, there is already clear progress towards the reform of interest rate benchmarks, or the replacement of interest rate benchmarks with alternative, nearly risk-free interest rates that are based, to a greater extent, on transaction data (alternative benchmark rates). This has in turn led to uncertainty about the long-term viability of some interest rate benchmarks. In these amendments, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark including its replacement with an alternative benchmark rate, such as that resulting from the FSB's recommendations set out in its July 2014 report 'Reforming Major Interest Rate Benchmarks' (the reform).[24]

BC224 In 2018 the Board noted the increasing levels of uncertainty about the long-term viability of some interest rate benchmarks and decided to address as a priority the issues affecting financial reporting in the period before the reform (referred to as pre-replacement issues).

BC225 As part of the pre-replacement issues, the Board considered the implications for specific hedge accounting requirements in IFRS 9 and IAS 39, which require forward-looking analysis. As a result of the reform, contractual cash flows of hedged items and hedging instruments based on an existing interest rate benchmark will likely change when that interest rate benchmark is subject to the reform—in these amendments, contractual cash flows encompass both contractually specified and non-contractually specified cash flows. The same uncertainty arising from the reform regarding the timing and the amount of

[24] The report, 'Reforming Major Interest Rate Benchmarks', is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

future cash flows will likely affect the changes in fair value of hedged items and hedging instruments in a fair value hedge of the interest rate benchmark exposure. Until decisions are made about what the alternative benchmark rate is, and when and how the reform will occur, including specifying its effects on particular contracts, uncertainties will exist regarding the timing and the amount of future cash flows of the hedged item and the hedging instrument.

BC226 The Board noted that the hedge accounting requirements in IFRS 9 and IAS 39 provide a clear basis for accounting for such uncertainties. In applying these requirements, the uncertainties about the timing and the amount of future cash flows could affect an entity's ability to meet those specific forward-looking hedge accounting requirements in the period when uncertainty is created by the reform. In some cases, solely due to such uncertainties, entities could be required to discontinue hedge accounting for hedging relationships that would otherwise qualify for hedge accounting. Also, because of the uncertainties arising from the reform, entities may not be able to designate new hedging relationships that would otherwise qualify for hedge accounting applying IFRS 9 and IAS 39. In some cases, discontinuation of hedge accounting would require an entity to recognise gains or losses in profit or loss.

BC227 In the Board's view, discontinuation of hedge accounting solely due to such uncertainties before the reform's economic effects on hedged items and hedging instruments are known would not provide useful information to users of financial statements. Therefore, the Board decided to publish in May 2019 the Exposure Draft *Interest Rate Benchmark Reform* (2019 Exposure Draft), which proposed exceptions to IFRS 9 and IAS 39 to provide relief during this period of uncertainty.

BC228 The 2019 Exposure Draft proposed exceptions to specific hedge accounting requirements such that entities would apply those requirements assuming the interest rate benchmark on which the hedged risk and/or cash flows of the hedged item or of the hedging instrument are based is not altered as a result of the reform. The proposed exceptions applied only to the hedge accounting requirements specified in that Exposure Draft and were not intended to provide relief from all consequences arising from the reform.

BC229 Almost all respondents to the 2019 Exposure Draft agreed with the Board's decision to address pre-replacement issues. Many highlighted the urgency of these issues, especially in some jurisdictions where there is already clear progress towards the reform or replacement of interest rate benchmarks with alternative benchmark rates.

BC230 In September 2019 the Board amended IFRS 9, IAS 39 and IFRS 7 by issuing *Interest Rate Benchmark Reform*, which confirmed with modifications the proposals in the 2019 Exposure Draft. In the amendments issued in September 2019, the Board added paragraphs 102A–102N and 108G to IAS 39.

BC231 The Board decided to propose amendments to IAS 39 as well as IFRS 9 because when entities first apply IFRS 9, they are permitted to choose as an accounting policy to continue to apply the hedge accounting requirements of IAS 39. The Board understands that a significant number of IFRS preparers—financial institutions in particular—have made such an accounting policy choice.

Scope of the exceptions

BC232 In the 2019 Exposure Draft, the Board noted that the hedge accounting issues being addressed arise in the context of interest rate benchmark reform, and, therefore, the proposed exceptions would apply only to hedging relationships of interest rate risk that are affected by the reform. However, some respondents expressed the view that the scope of the exceptions, as set out in the 2019 Exposure Draft, would not include other types of hedging relationships that may be affected by uncertainties arising from the reform such as hedging relationships in which an entity designates cross-currency interest rate swaps to hedge its exposure to both foreign currency and interest rate risk. These respondents asked the Board to clarify whether the scope of the exceptions was meant to include such hedging relationships.

BC233 In its redeliberations on the 2019 Exposure Draft, the Board clarified that it did not intend to exclude from the scope of the amendments hedging relationships in which interest rate risk is not the only designated hedged risk. The Board agreed with respondents that other hedging relationships could be directly affected by the reform when the reform gives rise to uncertainties about the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. Therefore, the Board confirmed that the exceptions would apply to the interest rate benchmark-based cash flows in these situations. The Board noted that many derivatives, designated in hedging relationships in which there is no uncertainty about the timing or the amount of interest rate benchmark-based cash flows, could be indirectly affected by the reform. For example, this would be the case when the valuation of the derivatives is affected by general uncertainty in the market caused by the reform. The Board confirmed that the exceptions do not apply to these hedging relationships, despite the indirect effect the uncertainties arising from the reform could have on the valuation of derivatives.

BC234 Consequently, the Board clarified the wording in paragraph 102A of IAS 39 to refer to all hedging relationships that are directly affected by interest rate benchmark reform. Paragraph 102A of IAS 39 explains that a hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about the interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk and/or the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. The scope of the exceptions does not exclude hedging relationships in which interest rate risk is not the only hedged risk.

Highly probable requirement

BC235 The Board noted that if an entity designates a forecast transaction as the hedged item in a cash flow hedge, applying paragraph 88(c) of IAS 39, that transaction must be highly probable (highly probable requirement). This requirement is intended to ensure that changes in the fair value of designated hedging instruments are recognised in other comprehensive income only for those hedged forecast transactions that are highly probable to occur. This requirement is an important discipline in applying hedge accounting to forecast transactions. The Board noted that the requirements in IAS 39 provide a clear basis to account for the effects of the reform—that is, if the effects of the reform are such that the hedged cash flows are no longer highly probable, hedge accounting should be discontinued. As set out in paragraph BC227, in the Board's view, discontinuing all affected hedging relationships solely due to such uncertainty would not provide useful information to users of financial statements.

BC236 Therefore, the Board amended IAS 39 to provide an exception to the highly probable requirement that would provide targeted relief during this period of uncertainty. More specifically, applying the exception, if the hedged future cash flows are based on an interest rate benchmark that is subject to the reform, an entity assumes that the interest rate benchmark on which the hedged cash flows are based is not altered when assessing whether the future cash flows are highly probable. If the hedged future cash flows are based on a highly probable forecast transaction, by applying the exception in paragraph 102D of IAS 39 when performing the assessment of the highly probable requirement for that forecast transaction, the entity would assume that the interest rate benchmark on which the hedged cash flows are based will not be altered in the future contract as a result of the reform. For example, for a future issuance of a London Interbank Offered Rate (LIBOR)-referenced debt instrument, the entity would assume that the LIBOR benchmark rate on which the hedged cash flows are based will not be altered as a result of the reform.

BC237 The Board noted that this exception does not necessarily result in an entity determining that the hedged cash flows are highly probable. In the example described in paragraph BC236, the entity assumed that the interest rate benchmark in the future contract would not be altered as a result of the reform when determining whether that forecast transaction is highly probable. However, if the entity decides not to issue the debt instrument because of uncertainty arising from the reform or for any other reason, the hedged future cash flows are no longer highly probable (and are no longer expected to occur). The exception would not permit or require the entity to assume otherwise. In this case, the entity would conclude that the LIBOR-based cash flows are no longer highly probable (and are no longer expected to occur).

BC238 The Board also included an exception for discontinued hedging relationships. Applying this exception, any amount remaining in other comprehensive income when a hedging relationship is discontinued would be reclassified to profit or loss in the same period(s) during which the hedged cash flows affect profit or loss, based on the assumption that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of the reform. If, however, the hedged future cash flows are no longer expected to occur for other reasons, the entity is required to immediately reclassify to profit or loss any amount remaining in other comprehensive income. In addition, the exception would not exempt entities from reclassifying the amount that is not expected to be recovered into profit or loss as required by paragraph 97 of IAS 39.

Effectiveness assessment

BC239 Applying IAS 39, a hedging relationship qualifies for hedge accounting only if the conditions in paragraph 88 are met. Two of the conditions in that paragraph—the prospective assessment and the retrospective assessment—require that the hedging relationship is highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk. If either of these conditions is not met, paragraphs 91(b) and 101(b) require the entity to discontinue hedge accounting prospectively.

Prospective assessment

BC240 When applying paragraph 88(b) of IAS 39, demonstrating that a hedging relationship is expected to be highly effective requires the estimation of future cash flows because the assessment is prospective in nature. Interest rate benchmark reform could affect this assessment for hedging relationships that may

extend beyond the timing of the reform. That is because entities would have to consider possible changes to the fair value or future cash flows of hedged items and hedging instruments in determining whether a hedging relationship is expected to be highly effective. Consequently, at some point in time, it is possible that entities would not be able to meet the condition in paragraph 88(b) of IAS 39 solely because of uncertainties arising from the reform.

BC241 The Board considered the usefulness of the information that would result from the potential discontinuation of hedge accounting for affected hedging relationships and decided to amend the requirement in IAS 39 to provide an exception for the prospective assessment for the same reasons as discussed in paragraph BC227.

BC242 Applying this exception, an entity shall assess whether the hedge is expected to be highly effective in achieving offsetting as required by IAS 39, based on the assumption that the hedged risk or the interest rate benchmark on which the hedged item or the hedging instrument is based is not altered as a result of the reform. Similarly, if an entity designates a highly probable forecast transaction as the hedged item, the entity shall perform the prospective assessment based on the assumption that the interest rate benchmark on which the hedged cash flows are based will not change as a result of the reform.

BC243 The Board noted that an offset between the hedged item and the hedging instrument is a fundamental principle of the hedge accounting model in IAS 39 and, therefore, the Board considered it critical to maintain this principle. The exception addresses only the uncertainties arising from the reform. Therefore, if an entity is unable to demonstrate that a hedging relationship is expected to be highly effective for other reasons, the entity shall discontinue hedge accounting as required by IAS 39.

Retrospective assessment

BC244 When developing the 2019 Exposure Draft, the Board decided not to propose an exception to the retrospective assessment required by paragraph 88(e) and AG105(b) of IAS 39 for the effects of the reform. As described in the 2019 Exposure Draft, that assessment is based on the actual results of the hedging relationship based on the extent to which hedging gains or losses on the hedged item attributable to the hedged risk offset changes in the fair value of the hedging instrument. The Board noted that existing IFRS Standards already provide an adequate basis for measuring ineffectiveness.

BC245 Most respondents disagreed with the Board's decision not to propose an exception to the retrospective assessment. Respondents noted that due to the inherent interaction between the assessment of the forward-looking cash flows of the hedged item and its effect on both prospective and retrospective assessments, the proposed amendments would not achieve their intended effect unless an exception is also provided for the retrospective assessment.

BC246 Furthermore, these respondents expressed the view that the discontinuation of hedge accounting because hedging relationships do not meet the requirements in paragraph AG105(b) of IAS 39, as a result of the temporary ineffectiveness caused by the reform, would not reflect an entity's risk management strategy and, therefore, would not provide useful information to users of financial statements.

BC247 In its redeliberations on the amendments to IAS 39, the Board considered the feedback received. The Board discussed three approaches that it could apply for providing an exception to the retrospective assessment for the impact of the uncertainty arising from the reform.

BC248 The Board observed that one possible approach would be to require entities to assume that the interest rate benchmark is not altered similar to the prospective assessment. Applying this approach would require entities to separate the assessment of retrospective effectiveness from the measurement of hedge ineffectiveness. More specifically, the Board considered that the objective of this approach would be to exclude the uncertainty arising from the reform from the assessment of whether a hedge is considered to be highly effective and that hedge accounting is continued when the results of this assessment are within the range of 80–125 per cent as required in paragraph AG105(b) of IAS 39, even if the measurement of actual ineffectiveness is outside that range. The Board was of the view that even though this approach is consistent with the other exceptions provided in the amendments to IAS 39, the requirement to perform two effectiveness calculations based on different assumptions could be burdensome on preparers. The Board therefore rejected this approach.

BC249 The Board also considered an approach that was recommended by respondents to the 2019 Exposure Draft, in which entities would be required, for the purposes of the retrospective assessment, to demonstrate the existence of an economic relationship between the hedged item and hedging instrument similar to the requirements in IFRS 9. However, the Board noted that the existence of an economic relationship between the hedged item and the hedging instrument, is only one of the requirements in IFRS 9 for a hedging relationship to be highly effective. The Board considered that the requirements in paragraph 6.4.1(c) of IFRS 9 are inherently linked and the application of the economic relationship in isolation might not

achieve the intended objective and could result in unintended consequences. The Board therefore rejected this approach.

BC250 The Board decided on an approach whereby an entity could continue to apply hedge accounting for hedging relationships directly affected by the reform, even if the actual results of the hedging relationship do not meet the requirements in paragraph AG105(b) of IAS 39, if the ineffectiveness arose from uncertainty arising from the reform or other sources, subject to satisfying the other conditions in paragraph 88 of IAS 39, including the prospective assessment (as amended by paragraph 102F of IAS 39).

BC251 The Board acknowledged that such an approach might provide less discipline compared to the approach described in paragraph BC248, which would introduce additional requirements to mitigate the risk of continuing hedge accounting for hedging relationships that failed the retrospective assessment for reasons other than the reform. However, the Board noted that its approach still maintains a level of discipline around the application of the IAS 39 hedge accounting model through the prospective assessment and neither imposes additional costs or burden for preparers nor introduces new requirements in IAS 39.

BC252 The Board noted that any exception to the retrospective assessment will apply only to a well-defined population of hedging relationships during the period of uncertainty on the hedged items and hedging instruments arising from the reform. Furthermore, the Board noted that the risk of allowing hedge accounting to be applied for hedging relationships that would not otherwise qualify for hedge accounting is mitigated by the required prospective assessment as only the uncertainty arising from the reform is excluded from that assessment. Any other sources of ineffectiveness would continue to be included in the assessment of whether the hedge is expected to be highly effective in future periods. The Board noted that any high level of ineffectiveness arising in a hedging relationship is expected to be captured by the prospective assessment. The Board also noted that all ineffectiveness would be recognised and measured and thus be transparent in financial reporting. The Board, therefore, decided to provide an exception from the requirement to discontinue hedge accounting as a result of paragraph 88(e) of IAS 39 because the actual results of the hedge do not meet the requirements in paragraph AG105(b) of IAS 39.

Measurement of ineffectiveness

BC253 The Board noted that the exceptions were not intended to change the requirement that entities measure and recognise hedge ineffectiveness. The Board considered that the actual results of the hedging relationships would provide useful information to users of financial statements during the period of uncertainty arising from the reform. Therefore, the Board decided that entities should continue to measure and recognise hedge ineffectiveness as required by IFRS Standards.

BC254 The Board also considered whether any exceptions should be made to the measurement of hedged items or hedging instruments because of the uncertainty arising from the reform. However, the Board noted that such an exception would be inconsistent with the decision not to change the requirements to measure and recognise hedge ineffectiveness in the financial statements. Therefore, the Board decided not to provide an exception from the measurement of hedging instruments and hedged items. This means that the fair value of a derivative designated as the hedging instrument should continue to be measured using the assumptions that market participants would use when pricing that derivative as required by IFRS 13 *Fair Value Measurement*.

BC255 For a hedged item designated in a fair value hedge, IAS 39 requires an entity to remeasure the hedged item for changes in fair value attributable to the hedged risk and recognise the gain or loss related to that fair value hedge adjustment in profit or loss. In doing so, the entity uses the assumptions that market participants would use when pricing the hedged item for changes in fair value attributable to the hedged risk. This would include a risk premium for uncertainty inherent in the hedged risk that market participants would consider. For example, to measure changes in fair value attributable to the hedged risk such as the IBOR component of a fixed-rate loan, an entity needs to reflect the uncertainty caused by the reform. When applying a present value technique to calculate the changes in fair value attributable to the designated risk component, such measurement should reflect market participants' assumptions about the uncertainty arising from the reform.

BC256 When an entity designates interest rate benchmark-based cash flows as the hedged item in a cash flow hedge, to calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, the entity may use a derivative that would have terms that match the critical terms of the designated cash flows and the hedged risk (this is commonly referred to as a 'hypothetical derivative'). As the Board decided that entities should continue to measure and recognise hedge ineffectiveness as required by IFRS Standards, entities should continue to apply assumptions that are consistent with those applied to the hedged risk of the hedged item. For example, if an entity designated interest rate benchmark-based cash flows as the hedged item in a cash flow hedge, the entity would not assume for the purpose of measuring hedge ineffectiveness that the expected replacement of the interest rate benchmark with an alternative

benchmark rate will result in zero cash flows after the replacement. The hedging gain or loss on the hedged item should be measured using the interest rate benchmark-based cash flows (that is, the cash flows on which the hypothetical derivative is based) when applying a present value technique, discounted at a market-based discount rate that reflects market participants' assumptions about the uncertainty arising from the reform. The Board concluded that reflecting market participants' assumptions when measuring hedge ineffectiveness provides useful information to users of financial statements about the effects of the uncertainty arising from the reform on an entity's hedging relationships. Therefore, the Board decided that no exceptions are needed for the measurement of actual ineffectiveness.

Hedges of designated portions

BC257 The Board noted that in accordance with IAS 39 an entity may designate an item in its entirety or only a portion thereof, as the hedged item in a hedging relationship. For example, an entity that issues a 5-year floating-rate debt instrument that bears interest at 3-month LIBOR + 1%, could designate as the hedged item either the entire debt instrument (that is, all of the cash flows) or only the 3-month LIBOR portion of the floating-rate debt instrument. Specifically, paragraphs 81 and AG99F of IAS 39 allow entities to designate only changes in the cash flows or fair value of an item attributable to a specific risk or risks (designated portion), provided that the designated portion is separately identifiable and reliably measurable.

BC258 The Board observed that an entity's ability to conclude that an interest rate benchmark is a separately identifiable designated portion in accordance with paragraph 81 of IAS 39 requires a continuous assessment over the duration of the hedging relationship and could be affected by the reform. For example, if the outcome of the reform affects the market structure of an interest rate benchmark, it could affect an entity's assessment of whether a non-contractually specified LIBOR portion is separately identifiable and, therefore, an eligible hedged item in a hedging relationship. The Board considered only those designated portions that are implicit in the fair value or the cash flows of an item of which they are a part (referred to as non-contractually specified) because the same issue does not arise for designated portions that are explicitly specified in the contract.

BC259 For the reasons outlined in paragraph BC227, the Board noted that discontinuing hedging relationships due to uncertainty arising from the reform would not provide useful information. Consequently, the Board decided to propose amending IAS 39 so that entities would not discontinue hedge accounting solely because the designated portion is no longer separately identifiable as a result of the reform. In the 2019 Exposure Draft, the Board proposed that the separately identifiable requirement for hedges of the benchmark portion of interest rate risk be applied only at the inception of those hedging relationships affected by the reform.

BC260 The Board proposed not to extend the relief to allow entities to designate the benchmark portion of interest rate risk as the hedged item in a new hedging relationship if the designated portion is not separately identifiable at the inception of the hedging relationship. In the Board's view, allowing hedge accounting for designated portions that are not separately identifiable at the inception would be inconsistent with the objective of the exception. The Board noted that such circumstances are different from allowing continued designation as the hedged item for designated portions that had met the requirement at the inception of the hedging relationship.

BC261 Furthermore, the Board did not propose any exception from the requirement that changes in the fair value or cash flows of the designated portion must be reliably measurable. As noted in paragraph BC243, in the Board's view, an offset between the hedged item and the hedging instrument is a fundamental principle of the hedge accounting model in IAS 39 and, therefore, the Board considered reliable measurement of the hedged item and the hedging instrument to be critical to maintain this principle.

BC262 Almost all respondents agreed with the exception proposed in the 2019 Exposure Draft to apply the separately identifiable requirement only at the inception of a hedging relationship. However, some respondents noted that the proposed exception did not provide equivalent relief to hedging relationships that frequently reset (ie discontinue and restart). In those hedging relationships both the hedging instrument and the hedged item frequently change (ie the entity uses a dynamic process in which both the hedged items and the hedging instruments used to manage that exposure do not remain the same for long). As hedging instruments and hedged items are being added or removed from a portfolio, entities are de-designating and redesignating hedging relationships regularly to adjust the exposure. If each redesignation of the hedging relationship is considered to be the inception of a new hedging relationship (even though it is still the same hedging strategy), then the separately identifiable requirement would need to be assessed for all hedged items at each redesignation even if they have been assessed previously. For the same reasons as those noted in paragraph BC258, this could affect an entity's ability to conclude that a non-contractually specified risk component remains separately identifiable and, therefore, an eligible hedged item for hedge accounting purposes.

BC263 The Board noted that the exception proposed in the 2019 Exposure Draft has the effect that if a non-contractually specified designated portion meets the separately identifiable requirement at the inception of a hedging relationship, then that requirement would not be reassessed subsequently. Hence, providing a similar exception for hedging relationships that frequently reset (ie discontinue and restart) would be consistent with the objective of the exception originally provided in the 2019 Exposure Draft.

BC264 Thus, the Board confirmed the proposal that a designated portion is only required to be separately identifiable at the inception of the hedging relationship. In addition, to respond to the feedback described in paragraph BC262, the Board added the exception in paragraph 102I of IAS 39 for hedging relationships that, consistent with an entity's hedge documentation, frequently reset (ie discontinue and restart) because both the hedging instrument and the hedged item frequently change. Applying that paragraph, an entity shall determine whether the designated portion is separately identifiable only when it initially designates an item as a hedged item in the hedging relationship. The hedged item is not reassessed at any subsequent redesignation in the same hedging relationship.

BC265 In reaching its decision for the exception in paragraph 102I of IAS 39 the Board considered an example when an entity applies hedge accounting for a portfolio hedge of interest rate risk under IAS 39 and designates the LIBOR portion of floating-rate loans as the hedged risk. At the inception of the relationship, the entity assesses whether LIBOR is a separately identifiable designated portion for all loans designated within the hedging relationship. As the entity updates the risk position with the origination of new loans and the maturity or repayment of existing loans, the hedging relationship is adjusted by de-designating the 'old' hedging relationship and redesignating a 'new' hedging relationship for the updated amount of the hedged items. Applying the exception in paragraph 102I of IAS 39 requires the entity to assess whether LIBOR is a separately identifiable designated portion only for the new loans added to the hedging relationship. The entity would not reassess the separately identifiable requirement for the loans that have been redesignated.

Mandatory application

BC266 The Board decided to require entities to apply the exceptions in paragraphs 102D–102N of IAS 39 to all hedging relationships to which the exceptions are applicable. In other words, the Board decided that an entity is required to apply the exceptions to all hedging relationships that are directly affected by the uncertainties arising from the reform and continue to apply the exceptions until required to cease their application as specified in paragraphs 102J–102N of IAS 39.

BC267 The Board considered but rejected alternatives that would have allowed entities to apply the exceptions voluntarily. In the Board's view, voluntary application of these exceptions could give rise to selective discontinuation of hedge accounting and selective reclassification of the amounts recorded in other comprehensive income related to previously discontinued hedging relationships. The Board does not expect that requiring entities to apply the exceptions would entail significant cost for preparers and other affected parties because the exceptions require entities to assume that the interest rate benchmark, on which the hedged risk and the hedged cash flows and cash flows of the hedging instrument are based, is not altered as a result of the reform.

BC268 In addition, the Board observed that in some circumstances the exceptions in paragraphs 102D–102N of IAS 39 may not be applicable. For example, for a particular interest rate benchmark not subject to the reform or replacement with an alternative benchmark rate, there is no uncertainty affecting the timing or the amount of the interest rate benchmark-based cash flows arising from a hedged item or a hedging instrument. The exceptions set out in paragraphs 102D–102N of IAS 39 would not be applicable to such a hedging relationship.

BC269 Furthermore, for a particular hedging relationship the exceptions may be applicable to some but not all aspects of the hedging relationship. For example, if an entity designates a hedged item that is based on LIBOR against a hedging instrument that is already referenced to an alternative benchmark rate (assuming the entity can demonstrate that hedging relationship meets the qualifying criteria for hedge accounting in IAS 39), the exceptions in paragraphs 102D and 102F of IAS 39 would apply for the hedged item because there is uncertainty related to its future cash flows. However, there is no uncertainty regarding how the reform would impact the cash flows of the hedging instrument and, therefore, the exception in paragraph 102F of IAS 39 is not applicable for the hedging instrument. Similarly, the exception applicable to non-contractually specified designated portions would not be relevant for hedging relationships that do not involve the designation of non-contractually specified portions.

End of application

BC270 As described in paragraph BC227, the Board decided to amend IAS 39 to address specific aspects of hedge accounting affected by uncertainties in relation to the hedged items and hedging instruments about when

the interest rate benchmarks will change to alternative benchmark rates, when any spread adjustment between the interest rate benchmark and the alternative benchmark rate will be determined (collectively, timing) and what the cash flows based on the alternative benchmark rate will be, including their frequency of reset, and any spread adjustment between the interest rate benchmark and the alternative benchmark rate (collectively, amount). Therefore, the Board intended the exceptions set out in paragraphs 102D–102N of IAS 39 to be available only while these uncertainties are present.

BC271 The Board considered whether to provide an explicit end date for the exceptions but decided not to do so. The reform is following different timelines in different markets and jurisdictions and contracts are being modified at different times and, therefore, at this stage, it is not possible to define a period of applicability for the exceptions.

BC272 The Board decided that an entity ceases applying the exceptions at the earlier of (a) when the uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows is no longer present as it relates to a hedged item and/or hedging instrument (depending on the particular exception) and (b) the discontinuation of the hedging relationship.[25] The exceptions require entities to apply specific hedge accounting requirements assuming the interest rate benchmark on which the hedged risk, hedged cash flows or the cash flows of the hedging instrument are based is not altered as a result of the reform. The end of applicability of the exceptions means that entities would from that date apply all hedge accounting requirements in IAS 39 without applying these exceptions.

BC273 In the Board's view, for uncertainty regarding the timing and the amount of cash flows arising from a change in an interest rate benchmark to be eliminated, the underlying contracts are generally required to be amended to specify the timing and the amount of cash flows based on the alternative benchmark rate (and any spread adjustment between the interest rate benchmark and the alternative benchmark rate). The Board noted that, in some cases, a contract may be amended to include reference to the alternative benchmark rate without actually altering the interest rate benchmark-based cash flows in the contract. Such an amendment may not eliminate the uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows in the contract. The Board considered the following scenarios to assess the robustness of the end of application requirements. However, these scenarios are not exhaustive and other scenarios may exist in which the uncertainties arising from the reform regarding the timing and the amount of cash flows would no longer be present.

BC274 Scenario A—a contract is amended to include a clause that specifies (a) the date the interest rate benchmark will be replaced by an alternative benchmark rate and (b) the alternative benchmark rate on which the cash flows will be based and the relevant spread adjustment between the interest rate benchmark and the alternative benchmark rate. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract is eliminated when the contract is amended to include this clause.

BC275 Scenario B—a contract is amended to include a clause that states modifications of contractual cash flows will occur due to the reform but that specifies neither the date that the interest rate benchmark will be replaced nor the alternative benchmark rate on which the amended cash flows will be based. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract has not been eliminated by amending the contract to include this clause.

BC276 Scenario C—a contract is amended to include a clause which states that conditions specifying the amount and timing of interest rate benchmark-based cash flows will be determined by a central authority at some point in the future. But the clause does not specify those conditions. In this case, the uncertainty regarding the timing and the amount of the interest rate benchmark-based cash flows for this contract has not been eliminated by including this clause in the contract. Uncertainty regarding both the timing and the amount of cash flows for this contract will be present 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.

BC277 Scenario D—a contract is amended to include a clause in anticipation of the reform that specifies the date the interest rate benchmark will be replaced and any spread adjustment between the interest rate benchmark and the alternative benchmark rate will be determined. However, the amendment does not specify the alternative benchmark rate or the spread adjustment between the interest rate benchmark and the alternative benchmark rate on which the cash flows will be based. In this scenario, by amending the contract to include this clause, uncertainty regarding the timing has been eliminated but uncertainty about the amount remains.

BC278 Scenario E—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

[25] For the purpose of applying the exception in paragraph 102E of IAS 39 to a discontinued hedging relationship, the amendments require an entity to cease applying the exception at the earlier of (a) as described above and (b) when the entire amount that had been recognised in other comprehensive income with respect to the hedging relationship has been reclassified to profit or loss. See paragraph 102K of IAS 39.

interest rate benchmark and the alternative benchmark rate but does not specify the date from which the amendment to the contract will become effective. In this scenario, by amending the contract to include this clause, uncertainty about the amount has been eliminated but uncertainty with respect to timing remains.

BC279 Scenario F—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 an interest rate benchmark with an alternative benchmark rate. The objective of the reform is to cease the publication of the current interest rate benchmark and replace it with an alternative benchmark rate. As part of the reform, 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 interest rate benchmark. Uncertainty about the timing or the amount of the alternative benchmark rate-based cash flows will not be eliminated during the interim period because the interim benchmark rate (including the fixed spread adjustment determined by the administrator) represent an interim measure in progressing towards the reform but it does not represent the alternative benchmark rate (or any related spread adjustment agreed between parties to the contract).

BC280 For reasons similar to those described in paragraph BC269, the Board noted that there could be situations in which the uncertainty for particular elements of a single hedging relationship could end at different times. For example, assume an entity is required to apply the relevant exceptions to both the hedged item and the hedging instrument. If the hedging instrument in that hedging relationship is subsequently amended through market protocols covering all derivatives in that market, and will be based on an alternative benchmark rate such that the uncertainty about the timing and the amount of interest rate benchmark-based cash flows of the hedging instrument is eliminated, the relevant exceptions would continue to apply to the hedged item but would no longer apply to the hedging instrument.[26]

BC281 The Board observed that continuing to apply the exception after the uncertainty was resolved would not faithfully represent the actual characteristics of the elements of the hedging relationship in which the uncertainty arising from the reform is eliminated. The Board considered whether it should extend the relief provided such that the exceptions would apply at the hedging relationship level for as long as any element of that hedging relationship was affected by the uncertainties arising from the reform. The Board agreed that doing so would be beyond the objective of addressing only those issues directly affected by the uncertainty arising from the reform. This is also because the exceptions in paragraphs 102D–102N of IAS 39 and the respective requirements in IAS 39 apply to the same elements of the hedging relationship. Therefore, applying each exception at the hedging relationship level would be inconsistent with how the underlying requirements are applied.

BC282 The Board decided that the end of application requirement would also apply to hedges of a forecast transaction. The Board noted that IAS 39 requires an entity to identify and document a forecast transaction with sufficient specificity so that, when the transaction occurs, the entity is able to determine whether the transaction is the hedged transaction. For example, if an entity designates a future issuance of a LIBOR-based debt instrument as the hedged item, although there may be no contract at the time of designation, the hedge documentation would refer specifically to LIBOR. Consequently, the Board concluded that entities should be able to identify when the uncertainty regarding the timing and the amount of the resulting cash flows of a forecast transaction is no longer present.

BC283 In addition, the Board decided not to require end of application with respect to the exception for the separately identifiable requirements set out in paragraphs 102H and 102I of IAS 39. Applying these exceptions, entities would continue applying hedge accounting when an interest rate benchmark meets the separately identifiable requirement at the inception of the hedging relationship (assuming all other hedge accounting requirements continue to be met). If the Board included an end date for these exceptions, an entity may be required to immediately discontinue hedge accounting because, at some point, as the reform progresses, the designated portion based on the interest rate benchmark may no longer be separately identifiable (for example, as the market for the alternative benchmark rate is established). Such immediate discontinuation of hedge accounting would be inconsistent with the objective of the exception. The Board noted that linking the end of application for these exceptions to contract amendments would not achieve the Board's intention either because, by definition, non-contractually specified designated portions are not explicitly stated in a contract and, therefore, these contracts may not be amended for the reform. This is particularly relevant for fair value hedges of a fixed-rate debt instrument. Therefore, the Board decided that an entity should cease applying the exceptions to a hedging relationship only when the hedging relationship is discontinued applying IAS 39.

BC284 Some respondents to the 2019 Exposure Draft noted that the Board had not addressed when an entity ceases applying the proposed exceptions to a group of items designated as the hedged item or a combination of financial instruments designated as the hedging instrument. Specifically, when assessing whether the

[26] In this scenario, the entity would first consider the accounting consequences of amending the contractual terms of the hedging instrument. The Board will consider the accounting consequences of the actual amendment of financial instruments as a result of interest rate benchmark reform in the next phase of this project (ie the replacement phase).

uncertainty arising from the reform is no longer present, these respondents asked whether that assessment should be performed on an individual basis (that is, for each individual item within the group or financial instrument within the combination) or on a group basis (that is, for all items in the group or all financial instruments in the combination until there is no uncertainty surrounding any of the items or financial instruments).

BC285 Consequently, the Board decided to add paragraph 102N of IAS 39 to clarify that, when designating a group of items as the hedged item or a combination of financial instruments as the hedging instrument, entities assess when the uncertainty arising from the reform with respect to the hedged risk and/or the timing and amount of the interest rate benchmark-based cash flows of that item or financial instrument is no longer present on an individual basis—that is, for each individual item in the group or financial instrument in the combination.

Effective date and transition

BC286 The Board decided that entities shall apply the amendments for annual periods beginning on or after 1 January 2020, with earlier application permitted.

BC287 The Board decided that the amendments apply retrospectively. The Board highlighted that retrospective application of the amendments would not allow reinstating hedge accounting that has already been discontinued. Nor would it allow designation in hindsight. If an entity had not designated a hedging relationship, the exceptions, even though applied retrospectively, would not allow the entity to apply hedge accounting in prior periods to items that were not designated for hedge accounting. Doing so would be inconsistent with the requirement that hedge accounting applies prospectively. Retrospective application of the exceptions would enable entities to continue hedge accounting for a hedging relationship that the entity had previously designated and that qualifies for hedge accounting applying IAS 39.

BC288 Many respondents to the 2019 Exposure Draft commented on the clarity of the proposed retrospective application and suggested that further explanation be provided in the Standard. Consequently, the Board amended the transition paragraph to specify that retrospective application applies only to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies these amendments or were designated thereafter, and to the gain or loss recognised in other comprehensive income that existed at the beginning of the reporting period in which an entity first applies these amendments. The Board used this wording to permit an entity to apply the amendments from the beginning of the reporting period in which an entity first applies these amendments even if the reporting period is not an annual period.

Amendments for *Interest Rate Benchmark Reform—Phase 2* (August 2020)

Background

BC289 In 2014, the Financial Stability Board recommended the reform of specified major interest rate benchmarks such as interbank offered rates (IBORs). Since then, public authorities in many jurisdictions have taken steps to implement interest rate benchmark reform and have increasingly encouraged market participants to ensure timely progress towards the reform of interest rate benchmarks, including the replacement of interest rate benchmarks with alternative, nearly risk-free interest rates that are based, to a greater extent, on transaction data (alternative benchmark rates). The progress towards interest rate benchmark reform follows the general expectation that some major interest rate benchmarks will cease to be published by the end of 2021. The term ‘interest rate benchmark reform’ refers to the market-wide reform of an interest rate benchmark as described in paragraph 102B of IAS 39 (the reform).

BC290 In September 2019, the Board amended IFRS 9, IAS 39 and IFRS 7, to address as a priority issues affecting financial reporting in the period before the reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate (Phase 1 amendments). The Phase 1 amendments provide temporary exceptions to specific hedge accounting requirements due to the uncertainty arising from the reform. Paragraphs BC223–BC288 discuss the background to the Phase 1 amendments.

BC291 After the issuance of the Phase 1 amendments, the Board commenced its Phase 2 deliberations. In Phase 2 of its project on the reform, the Board addressed issues that might affect financial reporting during the reform of an interest rate benchmark, including changes to contractual cash flows or hedging relationships arising from the replacement of an interest rate benchmark with an alternative benchmark rate (replacement issues).

BC292 The objective of Phase 2 is to assist entities in providing useful information to users of financial statements and to support preparers in applying IFRS Standards when changes are made to contractual cash flows or hedging relationships because of the transition to alternative benchmark rates. The Board observed that for information about the effects of the transition to alternative benchmark rates to be useful, the information has to be relevant to users of financial statements and faithfully represent the economic effects of that transition on the entity. This objective assisted the Board in assessing whether it should amend IFRS Standards or whether the requirements in IFRS Standards already provided an adequate basis to account for such effects.

BC293 In April 2020 the Board published the Exposure Draft *Interest Rate Benchmark Reform—Phase 2* (2020 Exposure Draft), which proposed amendments to specific requirements in IFRS 9, IAS 39, IFRS 7, IFRS 4 *Insurance Contracts* and IFRS 16 *Leases* to address replacement issues.

BC294 Almost all respondents to the 2020 Exposure Draft welcomed the Board's decision to address replacement issues and agreed that the proposed amendments would achieve the objective of Phase 2. Many respondents highlighted the urgency of these amendments, especially in some jurisdictions that have progressed towards the reform or the replacement of interest rate benchmarks with alternative benchmark rates.

BC295 In August 2020 the Board amended IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 by issuing *Interest Rate Benchmark Reform—Phase 2* (Phase 2 amendments). The Phase 2 amendments, which confirmed with modifications the proposals in the 2020 Exposure Draft added paragraphs 102O–102Z3 and 108H–108K of IAS 39. Paragraph 102M was amended.

Amendments to hedging relationships

BC296 The Phase 2 amendments relating to the hedge accounting requirements in IAS 39 apply to hedging relationships directly affected by the reform as and when the requirements in paragraphs 102D–102I of IAS 39 cease to apply to a hedging relationship (see paragraphs 102J–102O of IAS 39). Therefore, an entity is required to amend the hedging relationship to reflect the changes required by the reform as and when the uncertainty arising from the reform is no longer present with respect to the hedged risk or the timing and the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. The scope of the hedging relationships to which the Phase 2 amendments apply is therefore the same as the scope to which the Phase 1 amendments apply, except for the amendment to the separately identifiable requirement, which also applies to the designation of new hedging relationships (see paragraph 102Z3 of IAS 39).

BC297 As part of the Phase 1 amendments, the Board acknowledged that, in most cases, for uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows arising from the reform to be resolved, the underlying financial instruments designated in the hedging relationship would have to be changed to specify the timing and the amount of alternative benchmark rate-based cash flows.

BC298 The Board noted that, applying the hedge accounting requirements in IAS 39, changes to the basis for determining the contractual cash flows of a financial asset or a financial liability (see paragraphs 5.4.6–5.4.9 of IFRS 9) that are designated in a hedging relationship would affect the designation of such a hedging relationship in which an interest rate benchmark was designated as a hedged risk.

BC299 The Board observed that amending the formal designation of a hedging relationship to reflect the changes required by the reform would result in the discontinuation of the hedging relationship. This is because, as part of the qualifying criteria for hedge accounting to be applied, IAS 39 requires the formal designation of a hedging relationship to be documented at inception. The hedge documentation includes identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess hedge effectiveness.

BC300 The Board therefore concluded that, in general, the hedge accounting requirements in IAS 39 are sufficiently clear about how to account for hedging relationships directly affected by the reform after the Phase 1 exceptions set out in paragraphs 102D–102I of IAS 39 cease to apply. However, consistent with the Board's objective for Phase 2 (see paragraph BC292) and its objective for Phase 1 (see paragraph BC227), the Board considered that discontinuing hedge accounting solely due to the effects of the reform would not always reflect the economic effects of the changes required by the reform on a hedging relationship and therefore would not always provide useful information to users of financial statements.

BC301 Accordingly, the Board decided that if the reform requires a change to a financial asset or a financial liability designated in a hedging relationship (see paragraphs 5.4.6–5.4.8 of IFRS 9), it would be consistent with the Board's objective for Phase 2 to require the hedging relationship to be amended to reflect such a change without requiring discontinuation of that hedging relationship. For these reasons, in the 2020 Exposure Draft, the Board proposed that an entity would be required to amend the formal designation of the hedging relationship as previously documented to make one or more of these changes:

(a) designating the alternative benchmark rate (contractually or non-contractually specified) as a hedged risk;

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

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

(d) amending the description of how the entity will assess hedge effectiveness.

BC302 Respondents to the 2020 Exposure Draft agreed with the proposed amendments because those proposals would generally result in an entity continuing to apply hedge accounting to hedging relationships directly affected by the reform. Respondents also said that changes to the hedge designation necessary to reflect changes required by the reform are not expected to represent a change in an entity's risk management strategy or risk management objective for hedging their exposure to interest rate risk. Therefore, the Board concluded that continuing to apply hedge accounting to the affected hedging relationships when making changes required by the reform would correspond with the Board's objective for issuing the Phase 1 amendments in September 2019.

BC303 However, notwithstanding their general agreement with the proposed amendments, some respondents asked the Board to clarify the scope and timing of the required changes to the affected hedging relationships.

BC304 Regarding the scope of the required changes to the affected hedging relationships, the Board acknowledged it may be necessary to amend the designated hedged portion of the cash flows or fair value being hedged when the hedging relationship is amended to reflect the changes required by the reform. The Board also noted that the changes required by the reform described in paragraphs 5.4.6–5.4.8 of IFRS 9 were implicit in the required amendments to the hedging relationships as proposed in the 2020 Exposure Draft. In considering the timing of when entities are required to amend an affected hedging relationship, the Board sought to balance the operational effort needed to amend the hedging relationships with maintaining the required discipline in the amendments to hedging relationships. Specifically, it sought to address the challenges associated with specifying the timing of when entities have to amend hedging relationships as required in paragraph 102P of IAS 39—particularly in the context of the large volume of changes that entities may need to make in a relatively short time—while also ensuring that the amendments to hedging relationships are accounted for in the applicable reporting period.

BC305 In response to respondents' requests, the Board revised the proposed wording in paragraph 102P of IAS 39 so that:

(a) amending the description of the hedged item includes amending the description of the designated portion of the cash flows or fair value being hedged;

(b) the changes required by the reform described in paragraphs 5.4.6–5.4.8 of IFRS 9 are relevant when amending the formal designation of a hedging relationship; and

(c) amendments to hedging relationships are required to be made by the end of the reporting period during which the respective changes to the hedged item, hedged risk or hedging instrument are made.

BC306 The Board noted that the Phase 1 amendments may cease to apply at different times to directly affected hedging relationships and to the different elements within a hedging relationship. Therefore, an entity may be required to apply the applicable Phase 2 exceptions in paragraphs 102P–102Z2 of IAS 39 at different times, which may result in the designation of a particular hedging relationship being amended more than once. The Phase 2 amendments to the hedge accounting requirements in IAS 39 apply only to the requirements specified in these paragraphs. All other hedge accounting requirements in IAS 39, including the qualifying criteria in paragraph 88 of IAS 39, apply to hedging relationships directly affected by the reform. In addition, consistent with the Board's decision for the Phase 1 amendments (see paragraph BC254), the Phase 2 amendments also do not provide an exception from the measurement requirements for a hedging relationship. Therefore, entities apply the requirements in paragraphs 89 or 96 of IAS 39 to account for any changes in the fair value of the hedged items or hedging instruments (also see paragraphs BC315–BC320).

BC307 As set out in paragraph BC5.318 of the Basis for Conclusions on IFRS 9, the Board considered that changes might be made to a financial asset or a financial liability, or to the formal designation of a hedging relationship, in addition to those changes required by the reform. The effect of such additional changes to the formal hedge designation on the application of the hedge accounting requirements would depend on whether those changes result in the derecognition of the underlying financial instrument (see paragraph 5.4.9 of IFRS 9).

BC308 The Board therefore required an entity first to apply the applicable requirements in IAS 39 to determine if those additional changes result in discontinuation of hedge accounting, for example, if the financial asset or

financial liability designated as a hedged item no longer meets the qualifying criteria to be an eligible hedged item as a result of changes in addition to those required by the reform. Similarly, if an entity amends the hedge designation to make a change other than the changes described in paragraph 102P of IAS 39 (for example, if it extends the term of the hedging relationship), the entity would first determine if those additional changes to the hedge designation result in the discontinuation of hedge accounting. If the additional changes do not result in the discontinuation of hedge accounting, the designation of the hedging relationship would be amended as required by paragraph 102P of IAS 39.

BC309 Some respondents to the 2020 Exposure Draft said that entities may change a hedging relationship as a result of the reform, but such a change is not necessary as a direct consequence of the reform. This could include, for example, designating a basis swap as a new hedging instrument to mitigate ineffectiveness arising from the difference between the compounding of the alternative benchmark rates used for cash products and derivatives. These respondents asked the Board to permit such changes to be in the scope of the required changes to the hedging relationship set out in paragraph 102P of IAS 39. The Board however decided not to extend the scope of paragraph 102P of IAS 39 to other changes an entity makes as a result of the reform. The Board considered that its objective for the Phase 2 amendments is not only to support entities in applying the IFRS requirements during the transition to alternative benchmark rates, but also to provide users of financial statements with useful information about the effect of the reform on an entity's financial statements. To balance achieving this objective with maintaining the discipline that exists in the hedge accounting requirements in IAS 39, the Board limited the scope of the changes required to the designation of hedging relationships to only those changes that are necessary to reflect the changes required by the reform (as described in paragraphs 5.4.6–5.4.8 of IFRS 9).

Replacement of hedging instruments in hedging relationships

BC310 Respondents to the 2020 Exposure Draft said that, instead of changing the contractual terms of a derivative designated as a hedging instrument, counterparties may facilitate the transition to alternative benchmark rates using approaches that result in outcomes that are equivalent to changing the contractual terms of the derivative. These respondents asked whether using such an approach would be within the scope of the Phase 2 amendments—ie whether paragraph 102P(c) of IAS 39 would apply—if the approach results in an economic outcome that is similar to changing the basis for determining the contractual cash flows of the derivative.

BC311 The Board confirmed that, consistent with the rationale in paragraph BC5.298 of the Basis for Conclusions on IFRS 9, it is the substance of an arrangement, rather than its form, that determines the appropriate accounting treatment. The Board considered that the conditions in paragraph 5.4.7 of IFRS 9—ie the change is necessary as a direct consequence of the reform and is done on economically equivalent basis—are helpful in analysing the amendments to the contractual terms of derivatives described in paragraph BC310. In this context, the Board noted that if these other approaches result in derivatives with substantially different terms from those of the original derivative, the change may not have been made on an economically equivalent basis. The Board also noted that if a hedging instrument is derecognised, hedge accounting is required to be discontinued. Therefore, the Board decided that for hedge accounting to continue it is also necessary that the original hedging instrument would not be derecognised.

BC312 The Board considered these approaches described by respondents:

(a) *close-out and replace on the same terms (ie off-market terms)*—An entity applying this approach would enter into two new derivatives with the same counterparty. These two would be, a new derivative that is equal and offsetting to the original derivative (so both contracts are based on the interest rate benchmark to be replaced), and a new alternative benchmark-based derivative with the same terms as the original derivative so its fair value at initial recognition is equivalent to the fair value—on that date—of the original derivative (ie the new derivative is off-market). Under this approach the counterparty to the new derivatives is the same as to the original derivative, the original derivative has not been derecognised and the terms of the alternative benchmark rate derivative are not substantially different from that of the original derivative. The Board therefore concluded that such an approach could be regarded as consistent with the changes required by the reform as required in paragraph 102P of IAS 39.

(b) *close-out and replace on substantially different terms (eg on-market terms)*—An entity applying this approach would terminate (close-out) the existing interest rate benchmark-based derivative with a cash settlement. The entity then enters into a new on-market alternative benchmark rate derivative with substantially different terms, so that the new derivative has a fair value of zero at initial recognition. Some respondents to the 2020 Exposure Draft were of the view that since this approach does not result in any gain or loss recognised in profit or loss, it suggests the exchange was done on an economically equivalent basis. The Board disagreed with this view because the original derivative is extinguished and replaced with an alternative benchmark rate derivative

with substantially different contractual terms. Therefore, this approach is not considered consistent with the changes required by the reform as required in paragraph 102P of IAS 39.

(c) *add a new basis swap*—An entity applying this approach would retain the original interest rate benchmark-based derivative but enter into a basis swap that swaps the existing interest rate benchmark for the alternative benchmark rate. The combination of the two derivatives is equivalent to modifying the contractual terms of the original derivative to replace the interest rate benchmark with an alternative benchmark rate. The Board noted that, in principle, the combination of an interest rate benchmark-based derivative and an interest rate benchmark-alternative benchmark rate swap could achieve an outcome economically equivalent to amending the original interest rate benchmark-based derivative. However, the Board observed that, in practice, basis swaps are generally entered into on an aggregated basis to economically hedge an entity's net exposure to basis risk, rather than on an individual derivative basis. The Board therefore noted that for this approach to be consistent with the changes required by the reform as described in paragraph 102P of IAS 39, the basis swap must be coupled or linked with the original derivative, ie done on an individual derivative basis. This is because a change to the basis for determining the contractual cash flows of a hedging instrument is made to an individual instrument and, to achieve the same outcome, the basis swap would need to be coupled with an individual derivative.

(d) *novating to a new counterparty*—An entity applying this approach would novate the original interest rate benchmark-based derivative to a new counterparty and subsequently change the contractual cash flows on the novated derivative to replace the interest rate benchmark with an alternative benchmark rate. The Board noted that novation of a derivative would result in the derecognition of the original derivative and thus would require hedge accounting to be discontinued in accordance with paragraph 101 of IAS 39 (see further paragraphs BC220E–BC220G). Therefore, this approach is not consistent with the changes required by the reform as set out in paragraph 102P of IAS 39.

BC313 The Board therefore added paragraph 102Q of IAS 39 so that, an entity also applies paragraph 102P(c) of IAS 39 if these three conditions are met:

(a) the entity makes a change required by the reform using an approach other than changing the basis for determining the contractual cash flows of the hedging instrument (as described in paragraph 5.4.6 of IFRS 9);

(b) the original hedging instrument is not derecognised; and

(c) the chosen approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument (as described in paragraphs 5.4.7 and 5.4.8 of IFRS 9).

BC314 The Board decided not to add further amendments or provide application guidance because IAS 39 as amended provides an adequate basis for analysing the accounting requirements in context of the approaches described in paragraph BC312.

Remeasurement of the hedged item and hedging instrument

BC315 In paragraph BC254, the Board explained that no exceptions were made in Phase 1 to the measurement requirements for hedged items or hedging instruments. The Board concluded that the most useful information would be provided to users of financial statements if requirements for recognition and measurement of hedge ineffectiveness remain unchanged (see paragraph BC253). This is because recognising ineffectiveness in the financial statements based on the actual results of a hedging relationship faithfully represents the economic effects of the reform, thereby providing useful information to users of financial statements.

BC316 Applying the hedge accounting requirements in IAS 39, a gain or loss arising from the remeasurement of the hedged item attributable to the hedged risk or from remeasuring the hedging instrument is reflected in profit or loss when measuring and recognising hedge ineffectiveness.

BC317 When deliberating the Phase 2 amendments, the Board considered that changes in the fair value of the hedged item or hedging instrument could arise when the formal designation of a hedging relationship is amended.

BC318 The Board considered whether to provide an exception from the requirement to include in hedge ineffectiveness such fair value changes when they arise. The Board considered, but rejected, these approaches:

(a) *recognising the measurement adjustment in profit or loss over time*—An entity applying this approach would recognise the measurement adjustment in profit or loss over time (ie amortised) as the hedged item affects profit or loss. The Board rejected this approach because it would require an offsetting entry to be recognised either in the statement of financial position or as an adjustment to the carrying amount of the hedged item or hedging instrument. Such an offsetting entry would fail to meet the definition of an asset or a liability in the *Conceptual Framework*. Adjusting the carrying amount of the hedged item or hedging instrument would result in the recognition of a net measurement adjustment of zero and would be inconsistent with the Board's decision that no exceptions would be made to the measurement of hedged items or hedging instruments. The Board also noted that such an approach would likely result in increased operational complexity because an entity would need to track adjustments that occur at different times for the purpose of amortising the adjustments in the period(s) in which the hedged item affects profit or loss.

(b) *recognising the measurement adjustment as an adjustment to retained earnings*—An entity applying this approach would recognise the measurement adjustment as an adjustment to retained earnings during the period in which the measurement difference arises. However, the Board rejected this approach because the changes to the hedged risk might be driven by amendments to hedging relationships that may occur in different reporting periods. Therefore, recognising adjustments to retained earnings over time would be inconsistent with the Board's previous decisions (throughout IFRS Standards) that an adjustment to retained earnings only applies on transition to new requirements in IFRS Standards. Furthermore, the Board noted that the measurement adjustment would meet the definition of income or expense in the *Conceptual Framework* and therefore should be recognised in the statement of profit or loss. The Board also noted that recognising measurement adjustments directly in retained earnings would be inconsistent with the decision that no exceptions should be made to the measurement of hedged items or hedging instruments.

BC319 Some respondents to the 2020 Exposure Draft said they would not expect any significant changes in fair value to arise from the remeasurement of a hedged item or hedging instrument based on the alternative benchmark rate. That is because these amendments would apply only when the conditions in paragraph 5.4.7 of IFRS 9 are met, which require that changes are made on an economically equivalent basis. The Board acknowledged these comments noting that, applying paragraph 102P of IAS 39, a significant change in fair value arising from the remeasurement of the hedged item or the hedging instrument indicates that the changes were not made on an economically equivalent basis. Furthermore, the Board observed that the requirement in paragraph 102P(b) of IAS 39 which requires the description of the designated portion for the cash flows or fair value being hedged enables entities to amend a hedging relationship to minimise fair value changes on the remeasurement of the hedged item or the hedging instrument.

BC320 The Board therefore confirmed its previous decision not to provide an exception from the requirements in IAS 39 regarding the measurement and recognition of hedge ineffectiveness. Therefore, an entity would apply the requirements in paragraphs 89 (for a fair value hedge) and 96 (for a cash flow hedge) of IAS 39 for the measurement and recognition of hedge ineffectiveness. The Board considered that accounting for such fair value changes in any other way would be inconsistent with the decision to continue applying hedge accounting for such amended hedging relationships (see paragraph 102P of IAS 39). In the Board's view, applying the requirements in IAS 39 for the recognition and measurement of ineffectiveness reflects the economic effects of the amendments to the formal designation of a hedging relationship and therefore, provides useful information to users of financial statements.

Accounting for qualifying hedging relationships

Retrospective effectiveness assessment

BC321 Applying the Phase 1 exception in paragraph 102G of IAS 39, an entity is not required to discontinue a hedge accounting relationship because the actual results of the hedge do not meet the requirements in paragraph AG105(b) of IAS 39. Applying paragraph 102M of IAS 39, an entity is required to cease applying this exception when the uncertainty is no longer present with respect to the hedged risk and the timing and the amount of the interest rate benchmark-based cash flows of the hedged item and hedging instrument, unless the hedging relationship is discontinued before that date. As with the other Phase 1 amendments, at the date the exception in paragraph 102G of IAS 39 ceases to apply, an entity must apply the requirements in IAS 39 (as amended by the Phase 2 amendments). Therefore, at that time, an entity would apply paragraph AG105(b) of IAS 39 to assess whether the actual results of the hedge are within a range of 80–125 per cent and, if the results are outside that range, discontinue hedge accounting.

BC322 The Board considered that when paragraph 102G of IAS 39 ceases to apply and an entity first applies the requirement in paragraph AG105(b) of IAS 39 to assess the retrospective effectiveness of a hedging relationship, the hedging relationship could fail the retrospective assessment if the entity assesses hedge effectiveness on a cumulative basis. In the Board's view, this outcome would be inconsistent with the Board's objective for Phase 1. Specifically, it would be inconsistent with the objective of the exception to prevent the discontinuation of hedge accounting solely due to the effects of the uncertainties arising from the reform on the actual results of a hedge while recognising all ineffectiveness in the financial statements.

BC323 To address the issue described in paragraph BC322, the 2020 Exposure Draft proposed an amendment to IAS 39 that would require an entity, only for the purpose of applying the retrospective assessment, to reset to zero the cumulative fair value changes of the hedged item and the hedging instrument when the exception from the retrospective assessment ceases to apply. This proposed amendment would apply only when an entity assesses retrospective effectiveness on a cumulative basis (ie using the dollar offset method on a cumulative basis). As required by IAS 39, the entity would continue to measure and recognise hedge ineffectiveness by comparing the actual gains or losses on the hedged item to those on the hedging instrument.

BC324 Respondents to the 2020 Exposure Draft agreed with the objective of this proposed amendment but identified particular circumstances in which it could unintentionally cause some hedging relationships to fail the retrospective effectiveness assessment. For example, this could be the case when there is market volatility during the initial period following the transition to an alternative benchmark rate. Such volatility could cause the retrospective effectiveness assessment to breach the 80-125 per cent threshold because an entity would be precluded from assessing effectiveness based on data prior to the reset date even if that data would show that the hedging relationship actually is effective over a longer time horizon. The Board agreed with these comments and therefore, amended paragraph 102V of IAS 39 so that it permits, rather than requires, entities (ie entities may elect) to reset to zero the cumulative fair value changes for the purpose of assessing the retrospective effectiveness of a hedging relationship on a cumulative basis. Considering the nature of this amendment, the Board decided this election is made on an individual hedging relationship basis.

Prospective assessments

BC325 The Phase 1 exception in paragraph 102F of IAS 39 requires an entity to assume that, for the purpose of the prospective effectiveness assessment as required by paragraphs 88(b) and AG105(a) of IAS 39, the interest rate benchmark on which the hedged cash flows and/or the hedged risk (contractually or non-contractually specified) are based, is not altered as a result of the reform. As noted in paragraph 102L of IAS 39, this exception ceases to apply to the hedged item and the hedging instrument, respectively, at the earlier of, when there is no longer uncertainty about the hedged risk or the timing and the amount of the interest rate benchmark-based cash flows; and when the hedging relationship that the hedged item and the hedging instrument are a part of is discontinued.

BC326 Consistent with the Board's considerations on the highly probable requirement (see paragraphs BC327–BC328), the Board considered that, when the formal designation of a hedging relationship has been amended (see paragraph 102P of IAS 39), the prospective assessment should be performed based on the alternative benchmark rate on which the hedged cash flows and/or the hedged risk will be based. The Board therefore provided no exceptions from the prospective assessment for the period after the Phase 1 exception in paragraph 102F of IAS 39 ceases to apply.

Amounts accumulated in the cash flow hedge reserve

BC327 During the period in which a hedging relationship is affected by uncertainty arising from the reform, paragraph 102D of IAS 39 requires an entity to assume that the interest rate benchmark on which the hedged cash flows (contractually or non-contractually specified) are based is not altered for the purpose of determining whether a forecast transaction (or a component thereof) is highly probable. An entity is required to cease applying this exception at the earlier of the date the uncertainty arising from the reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and the date the hedging relationship of which the hedged item is a part of is discontinued.

BC328 The Board considered that uncertainty about the timing and the amount of the hedged cash flows would no longer be present when the interest rate benchmark on which the hedged cash flows are based is altered as required by the reform. In other words, uncertainty would no longer be present when an entity amends the description of the hedged item, including the description of the designated portion of the cash flows or fair value being hedged, applying paragraph 102P(b) of IAS 39. Thereafter, applying the requirement in paragraph 88(c) of IAS 39, the assessment of whether the hedged cash flows are still highly probable to

occur would be based on the contractual cash flows determined by reference to the alternative benchmark rate.

BC329 The Board noted that the amendment in paragraph 102P(b) of IAS 39 for amending the formal designation of a hedging relationship could lead to changes in the hedged item. Therefore, if an entity uses a hypothetical derivative—that is, a derivative that would have terms matching the critical terms of the designated cash flows and the hedged risk, commonly used in cash flow hedges to represent the forecast transaction—the entity may need to change the hypothetical derivative to calculate the change in the value of the hedged item to measure hedge ineffectiveness.

BC330 Consequently, as hedge accounting would not be discontinued when a hedging relationship is amended for changes required by the reform (see paragraph 102P of IAS 39), the Board decided that an entity would deem the amount accumulated in the cash flow hedge reserve at that point to be based on the alternative benchmark rate on which the hedged future cash flows are determined. Therefore, in applying paragraph 97 of IAS 39, the amount accumulated in the cash flow hedge reserve would be reclassified to profit or loss in the same period(s) during which the hedged cash flows based on the alternative benchmark rate affect profit or loss.

BC331 The approach described in paragraph BC330 is consistent with the Board's view that, when a hedging relationship is amended for changes required by the reform, more useful information is provided to users of financial statements if hedge accounting is not discontinued and amounts are not reclassified to profit or loss solely due to the changes required by the reform. This is because such an approach will more faithfully reflect the economic effects of changes required by the reform.

BC332 Consistent with the requirements in paragraphs 102E and 102K of IAS 39, the Board considered whether to provide similar relief for any discontinued hedging relationships in which the previously designated hedged item is subject to the reform. The Board observed that although a hedging relationship may have been discontinued, the amount accumulated in the cash flow hedge reserve arising from that hedging relationship remains in the reserve if the hedged future cash flows are still expected to occur. The Board noted that if the hedged future cash flows are still expected to occur, the previously designated hedged item will be subject to a change required by the reform, even if the hedging relationship has been discontinued.

BC333 The Board therefore decided that, for the purpose of applying paragraph 101(c) of IAS 39, an entity deems the cumulative gain or loss recognised in the other comprehensive income for a discontinued hedging relationship, to be based on the alternative benchmark rate on which the contractual cash flows will be based, which is similar to the amendment in paragraph 102W of IAS 39. That amount is reclassified to profit or loss in the same period(s) in which the hedged future cash flows based on the alternative benchmark rate affect profit or loss.

BC334 Some respondents to the 2020 Exposure Draft asked the Board to clarify whether the requirements in paragraphs 102W–102X of IAS 39 require the retrospective measurement of the hedged item based on the alternative benchmark rate-based cash flows—in other words, whether an entity would be required to recalculate what the cumulative gain or loss recognised in other comprehensive income would have been if the hedged item was based on the alternative benchmark rate since inception.

BC335 The Board considered that the cumulative gain or loss recognised in other comprehensive income is adjusted as required by paragraph 96 of IAS 39 (ie the cumulative gain or loss recognised in other comprehensive income is not subject to separate measurement requirements, but instead is derived from the cumulative changes in the fair value of the hedged item (present value) and hedging instrument). The Phase 2 amendments do not include an exception from the measurement requirements in IFRS 9. Accordingly, the fair value of the hedging instrument or of the hedged item (ie the present value of the cumulative changes in the hedged expected future cash flows) is determined at the measurement date based on the expected future cash flows and assumptions that market participants would use. In other words, the fair values are not determined retrospectively. The Board therefore considered that the cumulative gain or loss recognised in other comprehensive income is not remeasured as if it had been based on the alternative benchmark rate since inception of the hedging relationship.

BC336 The Board confirmed that the amendments in paragraphs 102W–102X of IAS 39 extend to cash flow hedges, regardless of whether the cash flow hedge is for an open or closed hedged portfolio. The general reference to cash flow hedges in these paragraphs reflects such scope, therefore, the Board considered that explicitly addressing open or closed hedged portfolios was unnecessary.

Groups of items

BC337 The Board considered that for groups of items designated as hedged items in a fair value or cash flow hedge, the hedged items could consist of items still referenced to the interest rate benchmark as well as items already referenced to the alternative benchmark rate. Therefore, an entity could not amend the

description of the hedged risk or the hedged item, including the designated portion of the cash flows or fair value being hedged with reference only to an alternative benchmark rate for the whole group. The Board also considered that it would be inconsistent with the objectives of the Phase 2 amendments to require the discontinuation of such a hedging relationship solely because of the effects of the reform. In the Board's view, the same requirements and relief that apply to other hedging relationships should apply to groups of items designated as hedged items, including dynamic hedging relationships.

BC338 Paragraphs 102Y–102Z of IAS 39 therefore require an entity to allocate the individual hedged items to subgroups based on the benchmark rate designated as the hedged risk for each subgroup and to apply the requirements in paragraphs 78 and 83 of IAS 39 to each subgroup separately. The Board acknowledged that this approach is an exception to the hedge accounting requirements in IAS 39 because other hedge accounting requirements, including the requirements in paragraphs 89 and 96 of IAS 39, are applied to the hedging relationship in its entirety. However, in the Board's view, the robustness of the hedge accounting requirements is maintained because if any subgroup fails to meet the requirements in paragraphs 78 and 83 of IAS 39, the entity is required to discontinue hedge accounting for that entire hedging relationship. The Board concluded this accounting outcome is appropriate because the basis for designating the hedged item on a group basis is that the entity is managing the designated hedge for the group as a whole.

BC339 The Board acknowledged that preparers may incur additional costs to assess each subgroup in a hedging relationship separately, and to track items moving from one subgroup to another. However, the Board concluded that an entity is likely to have such information available because IAS 39 already requires it to identify and document hedged items designated within a hedging relationship with sufficient specificity. Therefore, the Board concluded that the benefits of avoiding the discontinuation of hedge accounting and the resulting accounting impacts outweigh the associated costs of this exception.

BC340 Respondents to the 2020 Exposure Draft asked the Board whether the requirement for groups of items applies to dynamic hedges of interest rate benchmark-based items when the items mature and are replaced with alternative benchmark rate-based items. The Board considered that although the objective of the Phase 2 amendments is to provide relief when individual items transition to an alternative benchmark rate, the replacement of items that have expired with items that reference the alternative benchmark rate is a natural consequence of a dynamic hedging relationship. Therefore, the Board observed that new items designated as part of the group to replace interest rate benchmark-based items that have matured would be allocated to the relevant subgroup based on the benchmark rate being hedged.

BC341 Respondents also asked the Board to clarify how the requirements in paragraphs 102Y–102Z of IAS 39 apply to the hypothetical derivative in a cash flow hedge, specifically, whether the hypothetical derivative could be amended (and therefore measured) based on the alternative benchmark rate if the actual hedged item (such as a floating rate loan) has not yet transitioned to the alternative benchmark rate. The Board considered that IAS 39 does not include specific requirements for the hypothetical derivative because it is one possible way of calculating the change in the value of the hedged item to measure ineffectiveness. Therefore, the terms on which the hypothetical derivative is constructed replicate the hedged risk and the hedged cash flows of the hedged item an entity is hedging. The hypothetical derivative cannot include features in the value of the hedged item that exist only in the hedging instrument (but not in the hedged item). The Board therefore decided that the identification of an appropriate hypothetical derivative is based on the requirements to measure hedge ineffectiveness and it would not be appropriate to include specific amendments for applying the requirements in paragraphs 102Y–102Z to the hypothetical derivative.

Designating financial items as hedged items

End of application of the Phase 1 exception

BC342 An entity may designate an item in its entirety or a portion of an item as the hedged item in a hedging relationship. Paragraphs 81 and AG99F of IAS 39 allow entities to designate only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk portion).

BC343 When developing the Phase 1 amendments, the Board decided not to set an end date for applying the exception for the separately identifiable requirement (see paragraphs 102H–102I of IAS 39). The Board considered that including an end date for that exception could require an entity to immediately discontinue hedge accounting at a point in time because, as the reform progresses, a risk portion based on the interest rate benchmark may no longer be separately identifiable (for example, as the market for the alternative benchmark rate is established). As noted in paragraph BC283, in the Board's view, such an immediate discontinuation of hedge accounting would be inconsistent with the objective of this exception in Phase 1. Therefore, when issuing the Phase 1 amendments, the Board decided that an entity should cease applying the Phase 1 exception from the separately identifiable requirement to a hedging relationship only when that hedging relationship is discontinued applying the requirements in IAS 39.

BC344 Having considered the interaction between the Phase 1 exception from the separately identifiable requirement and the Phase 2 amendments to the hedge accounting requirements in IAS 39, the Board decided it is necessary to specify that an entity is required to cease applying the Phase 1 exception from the separately identifiable requirement when the uncertainty arising from the reform, which led to that exception, is no longer present.

BC345 The Board considered that continuing to apply the Phase 1 amendments after the uncertainty arising from the reform is no longer present would not faithfully represent the actual characteristics of the elements of the hedging relationship in which the uncertainty has been eliminated nor the economic effects of the reform. The Board therefore added paragraph 102O to IAS 39 so the Phase 1 exception from the separately identifiable requirement ceases to apply at the earlier of:

(a) when changes required by the reform are made to the non-contractually specified risk portion as set out in paragraph 102P of IAS 39; or

(b) when the hedging relationship in which the non-contractually specified risk portion was designated is discontinued.

Application of the 'separately identifiable' requirement to an alternative benchmark rate

BC346 In developing the Phase 2 amendments, the Board was aware that considerations similar to those discussed in paragraphs BC342–BC345 apply to designating an alternative benchmark rate as a non-contractually specified risk portion in either a cash flow hedge or a fair value hedge. This is because an entity's ability to conclude that the alternative benchmark rate meets the requirements in paragraphs 81 and AG99F of IAS 39 that a risk portion must be separately identifiable and reliably measurable could be affected in the early stages of the reform.

BC347 Specific requirements on the separately identifiable requirement are already set out in paragraph 81 of IAS 39. However, the Board considered that an entity might expect an alternative benchmark rate to meet the separately identifiable requirement in IAS 39 within a reasonable period of time even though the alternative benchmark rate does not meet the requirement when it is designated as a risk portion.

BC348 The amendment in paragraph 102Z1 of IAS 39 applies to different set of instruments from the Phase 1 exception. For items within the scope of paragraph 102Z1 of IAS 39, the separately identifiable requirement has never been satisfied. In contrast, the population of hedging relationships to which the Phase 1 relief applied had already satisfied the qualifying criteria for hedge accounting to be applied. The Board therefore considered that any relief from the separately identifiable requirement in Phase 2 should be temporary.

BC349 Consequently, in the 2020 Exposure Draft, the Board proposed that an alternative benchmark rate that does not meet the requirement to be separately identifiable at the date it is designated as a non-contractually specified risk portion would be deemed to have met the requirement at that date if, and only if, an entity reasonably expects that the alternative benchmark rate will be separately identifiable within 24 months from the date it is designated as a risk portion.

BC350 Respondents to the 2020 Exposure Draft agreed with this proposed amendment but asked the Board to clarify the date from which the 24-month period applies. The Board acknowledged respondents' concerns, and considered whether the 24-month period applies:

(a) on a hedge-by-hedge basis—that is, to each hedging relationship individually, beginning from the date an alternative benchmark rate is designated as a risk portion in that relationship; or

(b) on a rate-by-rate basis—that is to, each alternative benchmark rate separately, beginning from the date when an entity first designates an alternative benchmark rate as a hedged risk for the first time.

BC351 The Board acknowledged that applying the 24-month period to each hedging relationship individually (as proposed in the 2020 Exposure Draft)—that is, on a hedge-by-hedge basis—is consistent with the basis on which hedging relationships are designated. For each new hedge designation, an entity is required to assess whether the qualifying criteria to apply hedge accounting, including the separately identifiable requirement, have been met. However, the Board also considered that applying the 24-month period to different hedging relationships (with the same alternative benchmark rate designated as a risk portion) at different times, could add an unnecessary operational burden as the period would end at different times and thus would need to be monitored over different periods, for different hedging relationships. For example, if an entity designates the alternative benchmark rate as the risk portion in two hedging relationships—the first designated on 31 March 20X1 and the second on 30 June 20X1—the 24-month period for each hedge

would begin and end at different dates, although the designated risk is the same in both hedging relationships.

BC352 Therefore, the Board decided that the requirement in paragraph 102Z1 would apply on a rate-by-rate basis so the 24-month period applies to each alternative benchmark rate separately and hence, starts from the date that an entity designates an alternative benchmark rate as a non-contractually specified risk portion for the first time (but see also paragraph 108J of IAS 39). The Board considered that if an entity concludes for one hedging relationship that it no longer has a reasonable expectation that the alternative benchmark rate would meet the requirements within the 24-month period, it is likely that the entity would reach the same conclusion for all other hedging relationships in which that particular alternative benchmark rate has been designated. Applying this requirement to the example in paragraph BC351, the 24-month period will begin on 31 March 20X1 for that alternative benchmark rate.

BC353 Despite the requirement to apply the 24-month period to each alternative benchmark rate separately, the requirement to assess whether an alternative benchmark rate is separately identifiable continues to separately apply to each hedging relationship. In other words, an entity is required to assess, for each hedge designation, whether the qualifying criteria to apply hedge accounting, including the separately identifiable requirement, are met for the remainder of the 24-month period (ie until 31 March 20X3 following from the example in paragraph BC351).

BC354 Consistent with the requirement in IAS 39 to continuously assess the separately identifiable requirement, an entity's ability to conclude that an alternative benchmark rate is a separately identifiable component requires assessment over the life of the hedging relationship including during the 24-month period discussed in paragraph BC352. However, the Board decided that to avoid the complexity of detailed judgements during the 24-month period, an entity is required to cease applying the requirement during the 24-month period if, and only if, the entity reasonably expects that the alternative benchmark rate will not meet the separately identifiable requirement within that period. If an entity reasonably expects that an alternative benchmark rate will not be separately identifiable within 24 months from the date the entity designates it as a non-contractually specified risk portion for the first time, the entity is required to cease applying the requirement in paragraph 102Z1 of IAS 39 to that alternative benchmark rate and discontinue applying hedge accounting prospectively from the date of that reassessment to all hedging relationships in which the alternative benchmark rate was designated as a non-contractually specified risk portion.

BC355 The Board acknowledged that 24 months is an arbitrary period. However, in the Board's view, a clearly defined end point is necessary because of the temporary nature of the amendment. The exception described in paragraphs 102Z1–102Z3 of IAS 39 is a significant relief from one of the requirements that is a basis for the robustness of the hedge accounting requirements, therefore the relief is intentionally short-lived. The Board considered that a period of 24 months will assist entities in applying the hedge accounting requirements in IAS 39 particularly during the early stages of the transition to alternative benchmark rates. Therefore, the Board decided that a period of 24 months from the date an entity first designates an alternative benchmark rate as a non-contractually specified risk portion, is a reasonable period and would enable entities to implement the reform and comply with any regulatory requirements, while avoiding potential short-term disruption as the market for an alternative benchmark rate develops.

BC356 While developing the proposals in the 2020 Exposure Draft, the Board considered proposing alternative periods for the requirement in paragraph 102Z1 of IAS 39, including a period of 12 months or a period longer than 24 months. However, the Board acknowledged the diversity in the approaches to the reform or replacement of interest rate benchmarks and the timing of the expected completion across various jurisdictions. The Board was concerned that 12 months would not provide sufficient time across all jurisdictions. At the same time, the Board considered that entities may not be able to have a reasonable expectation that an alternative benchmark rate would satisfy the separately identifiable requirement over a period longer than 24 months.

BC357 The Board emphasised that the amendments apply only for the separately identifiable requirement and not the reliably measurable requirement. Therefore, if the risk portion is not reliably measurable, either when it is designated or thereafter, the alternative benchmark rate would not meet the qualifying criteria to be designated as a risk portion in a hedging relationship. Similarly, if the hedging relationship fails to meet any other qualifying criteria set out in IAS 39 to apply hedge accounting, either at the date the alternative benchmark rate is designated or during the 24-month period, the entity is required to discontinue hedge accounting prospectively from that date. The Board decided that providing relief only for the separately identifiable requirement would achieve the objective described in paragraph BC292.

Mandatory application

BC358 The Board decided to require application of the Phase 2 amendments. The Board considered that allowing voluntary application of these amendments (ie except for the amendment in paragraph 102V of IAS 39

which is permitted, but not required) could lead to selective application to achieve specific accounting results. The Board also noted that the amendments are, to a large extent, interlinked and need to be applied consistently. Voluntary application, even if only possible by area or type of financial instruments, would reduce comparability of information provided in the financial statements between entities. The Board also does not expect that mandatory application of these amendments would result in significant additional costs for preparers and other affected parties because these amendments are designed to ease the operational burden on preparers, while providing useful information to users of financial statements, and would not require significantly more effort by preparers in addition to what is already required to implement the changes required by the reform.

End of application

BC359 The Board did not add specific end of application requirements for the Phase 2 amendments because the application of these amendments is associated with the point at which changes to financial instruments or hedging relationships occur as a result of the reform. Therefore, by design, the application of these amendments has a natural end.

BC360 The Board noted that, in a simple scenario, the Phase 2 amendments will be applied only once to each financial instrument or element of a hedging relationship. However, the Board acknowledged that because of differences in the approach to the reform applied in different jurisdictions and differences in timing, implementing the reform could require more than one change to the basis for determining the contractual cash flows of a financial asset or a financial liability.

BC361 As noted in paragraph 102R of IAS 39, the Board considered that an entity may be required to amend the formal designation of its hedging relationships at different times, or to amend the formal designation of a hedging relationship more than once. For example, an entity may first make changes required by the reform to a derivative designated as a hedging instrument, while only making changes required by the reform to the financial instrument designated as the hedged item later. In applying the amendments, the entity would be required to amend the hedge documentation to amend the description of the hedging instrument. The hedge documentation of the hedging relationship would then have to be amended again to change the description of the hedged item and/or hedged risk as required in paragraph 102P of IAS 39.

BC362 The amendment for hedges of risk portions in paragraph 102Z1 of IAS 39 applies only at the date an entity first designates a particular alternative benchmark rate as a non-contractually specified risk portion for the first time if an entity's ability to conclude that an alternative benchmark rate is separately identifiable is directly affected by the reform. Thus, an entity could not apply this amendment in other circumstances in which the entity is not able to conclude that an alternative benchmark rate is a separately identifiable risk portion.

BC363 The Board developed the amendment in paragraph 102V of IAS 39 to address the potential effect in hedge accounting at the date the Phase 1 exception from the retrospective assessment in paragraph 102G of IAS 39 ceases to apply. Therefore, the amendment in paragraph 102V of IAS 39 only applies at that date ie the date that the exception from the retrospective assessment in paragraph 102G of IAS 39 ceases to apply.

Effective date and transition

BC364 Acknowledging the urgency of the amendments, the Board decided that entities must apply the Phase 2 amendments for annual periods beginning on or after 1 January 2021, with earlier application permitted.

BC365 The Board decided that the amendments apply retrospectively in accordance with IAS 8 (except as discussed in paragraphs BC367–BC370) because prospective application would have resulted in entities applying the amendments only if the transition to alternative benchmark rates occurred after the effective date of the amendments.

BC366 The Board acknowledged that there could be situations in which an entity amended a hedging relationship as specified in paragraph 102P of IAS 39 in the period before the entity first applied the Phase 2 amendments; and in the absence of the Phase 2 amendments, IAS 39 would require the entity to discontinue hedge accounting. The Board noted that the reasons for the amendment in paragraph 102P of IAS 39 (see paragraphs BC300–BC301), apply equally in such situations. The Board therefore considered that discontinuation of hedge accounting solely because of amendments an entity made in hedge documentation to reflect appropriately the changes required by the reform, regardless of when those changes occurred, would not provide useful information to users of financial statements.

BC367 The Board acknowledged that the reinstatement of discontinued hedging relationships is inconsistent with the Board's previous decisions about hedge accounting in IAS 39. This is because hedge accounting is applied prospectively and applying it retrospectively to discontinued hedging relationships usually requires the use of hindsight. However, the Board considered that in the specific circumstances of the reform, an

entity would typically be able to reinstate a discontinued hedging relationship without the use of hindsight. The Board noted that this reinstatement of discontinued hedging relationships would apply to a very targeted population for a short period—that is, for hedging relationships which would not have been discontinued if the Phase 2 amendments relating to hedge accounting had been applied at the point of discontinuation. The Board therefore proposed in the 2020 Exposure Draft that an entity would be required to reinstate hedging relationships that were discontinued solely due to changes required by the reform before an entity first applies the proposed amendments.

BC368 Respondents to the 2020 Exposure Draft generally supported and welcomed the transition proposals but asked the Board to reconsider a specific aspect of the proposal that would require entities to reinstate particular discontinued hedging relationships. Specifically, these respondents highlighted circumstances in which reinstating discontinued hedging relationships would be challenging or have limited benefit—for example, when:

(a) the hedging instruments or the hedged items in the discontinued hedging relationships have been subsequently designated into new hedging relationships;

(b) the hedging instruments in the discontinued hedging relationships no longer exist at the date of initial application of the amendments—eg they have been terminated or sold; or

(c) the hedging instruments in the discontinued hedging relationships are now being managed within a trading mandate with other trading positions and reported as trading instruments.

BC369 The Board noted that the transition requirements as proposed in the 2020 Exposure Draft to apply the amendments retrospectively in accordance with IAS 8—including the requirement to reinstate particular discontinued hedging relationships—would be subject to impracticability applying IAS 8. However, the Board agreed with respondents' concerns that there could be other circumstances in which it would not be impracticable to reinstate the hedging relationship, but such reinstatement would be challenging or would have limited benefit. For example, if the hedging instrument or hedged item has been designated in a new hedging relationship, it appears inappropriate to require entities to reinstate the 'old' (original) hedging relationship and discontinue or unwind the 'new' (valid) hedging relationship. Consequently, the Board added paragraph 108I(b) to IAS 39 to address these concerns.

BC370 In addition, the Board concluded that if an entity reinstates a discontinued hedging relationship applying paragraph 108I(b) of IAS 39, for the purpose of applying paragraphs 102Z1–102Z2 of IAS 39, the 24-month period for the alternative benchmark rate designated as a non-contractually specified risk portion begins from the date of initial application of the Phase 2 amendments (ie it does not begin from the date the entity designated the alternative benchmark rate as a non-contractually specified risk portion for the first time in the original hedging relationship).

BC371 Consistent with the transition requirements for Phase 1, the Board decided that an entity is not required to restate comparative information. However, an entity may choose to restate prior periods if, and only if, it is possible without the use of hindsight.

Dissenting opinions

Dissent of John T Smith from the issue in March 2004 of *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* (Amendments to IAS 39)

DO1 Mr Smith dissents from these Amendments to IAS 39 Financial Instruments: Recognition and Measurement—*Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*. He agrees with the objective of finding a macro hedging solution that would reduce systems demands without undermining the fundamental accounting principles related to derivative instruments and hedging activities. However, Mr Smith believes that some respondents' support for these Amendments and their willingness to accept IAS 39 is based more on the extent to which the Amendments reduce recognition of ineffectiveness, volatility of profit or loss, and volatility of equity than on whether the Amendments reduce systems demands without undermining the fundamental accounting principles.

DO2 Mr Smith believes some decisions made during the Board's deliberations result in an approach to hedge accounting for a portfolio hedge that does not capture what was originally intended, namely a result that is substantially equivalent to designating an individual asset or liability as the hedged item. He understands some respondents will not accept IAS 39 unless the Board provides still another alternative that will further reduce reported volatility. Mr Smith believes that the Amendments already go beyond their intended objective. In particular, he believes that features of these Amendments can be applied to smooth out ineffectiveness and achieve results substantially equivalent to the other methods of measuring ineffectiveness that the Board considered when developing the Exposure Draft. The Board rejected those methods because they did not require the immediate recognition of all ineffectiveness. He also believes those features could be used to manage earnings.

