ISDA Webcast on Benchmark Reform

Update on ISDA and Industry Initiatives

ISDA Safe, Efficient Markets

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Interest Rate Benchmark Reform: Impact on Accounting under IFRS

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Main Benchmarks by Jurisdiction:
Overview of alternative RFR

Working Groups in each jurisdiction have recommended robust, alternative RFRs to transition away from existing IBORs, the alternative RFR benchmarks are overnight, whereas current use of IBORs is largely in term rates.

Jurisdiction	Working Group	Alternative RFR	Rate administration	Status:	
				Secured vs. unsecured	Publication status
UK	Working Group on Sterling Risk-Free Reference Rates	Reformed Sterling Overnight Index Average (SONIA)	Bank of England	Unsecured	**Published**
US	Alternative Reference Rates Committee	Secured Overnight Financing Rate (SOFR)	Federal Reserve Bank of New York	Secured	**Published**
Europe	Working Group on Risk-Free Reference Rates for the Euro Area	European Short Term Rate (€STER)	European Central Bank	Unsecured	Published
Switzerland	The National Working Group on **CHF Reference Rates**	Swiss Average Rate Overnight (SARON)	SIX Swiss Exchange	Secured	Published
Japan	Study Group on Risk-Free Reference Rates	Tokyo Overnight Average Rate (TONA)	Bank of Japan	Unsecured	Published

IBOR Fallbacks: ISDA's Work

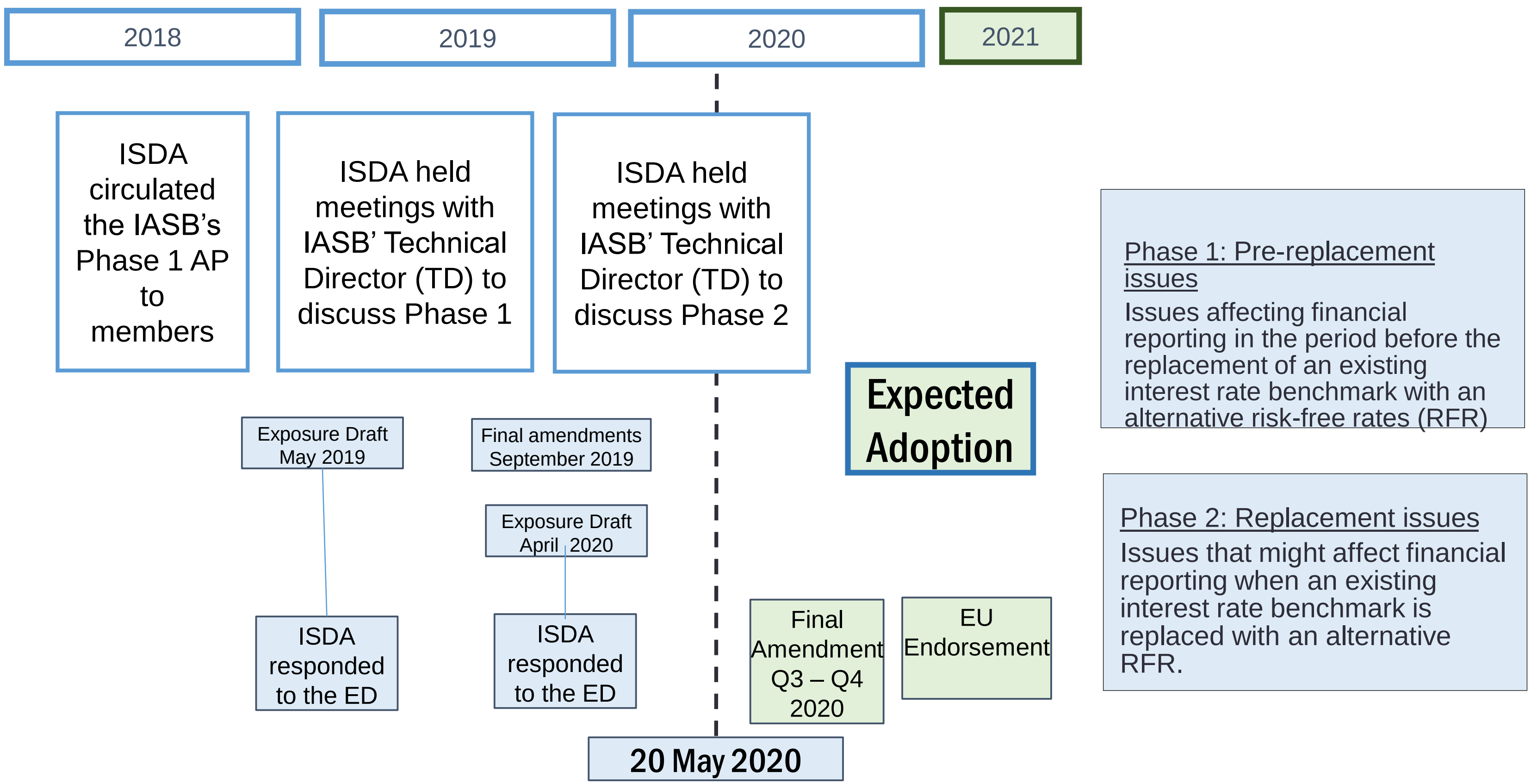
- ISDA is currently undertaking work to amend the **2006 ISDA Definitions** to implement **fallbacks for:**
  - **LIBOR in USD, GBP, JPY, CHF and EUR;**
  - **EURIBOR;**
  - **JPY TIBOR and Euroyen TIBOR;**
  - **BBSW;**
  - **HIBOR; and**
  - **CDOR (the 'IBORs').**

- The fallbacks will apply upon the ***permanent discontinuation*** of the relevant IBOR (based on pre-determined, objective triggers) and will be to the ***relevant alternative risk-free rate*** ('RFR'), subject to term and spread adjustments.

Benchmarks Update – Transition: Key 2020 Milestones

Milestone	Project	Target Date (all 2020)
Bloomberg publication of monthly test data in Excel files	ISDA IBOR Fallbacks	Roll outs on a currency-by-currency basis throughout **May-June**
Publication of ISDA templates for bilateral negotiation of CSA changes for non-cleared euro and US dollar derivatives	USD/EUR Collateral	'EONIA Amendment' published in **April** and amendment to US dollar to be published in **July**
Full connectivity (Bloomberg terminal, API, Bloomberg website) to indicating fallbacks	ISDA IBOR Fallbacks	**Mid-July**
Publication of IBOR Fallback Supplement and Protocol (and related bilateral templates)	ISDA IBOR Fallbacks	**End of July** (or later date after receive positive Business Review Letter from the US DoJ and similar comfort from other relevant competition law authorities)
PAI/discounting switch from EONIA to €STR for cleared euro derivatives	USD/EUR Collateral	**July**
PAI/discounting switch from EFFR to SOFR for cleared US dollar derivatives	USD/EUR Collateral	**October**
Effectiveness of IBOR Fallback Supplement and Protocol	ISDA IBOR Fallbacks	**End of November** (or four months after publication)

ISDA Involvement in the IFRS Project to Date and Next Steps…



The Phase 1 amendments took effect from 1 January 2020, with early adoption permitted

The Phase 2 exposure draft (ED) was published in April 2020. The amendments are expected to be finalised in Q3 or Q4, effective from 1 January 2021 with early adoption permitted, e.g. for 31 December 2020 year–end

Phase 1: Issues Prior to Modification

- It may be assumed that the referenced interest rate benchmark will not be altered:
  1. To determine whether a forecast transaction is **highly probable**
  2. To determine whether a forecast transaction is no longer **expected to occur** (and so the cumulative gain or loss in the cash flow hedge reserve is reclassified to profit or loss)
  3. **To assess hedge effectiveness**

- Relief from IAS 39 **80 to 125%** retrospective effectiveness test

- For a hedge of a non-contractually specified benchmark, the assessment of whether is it is **separately identifiable** is made only at the inception of the hedge relationship.

- Effective date 1 January 2020 with earlier application permitted

- New disclosures

Phase 2: Issues Subsequent to Modification - Agenda

The following slides go through the IASB phase 2 proposal & the expected changes to give relief to IFRS filers - after the recent redeliberations of the IASB's Board in June:

Modifications (i)

Summary of ED proposals:

- A financial instrument is ‘modified’ if the basis for determining the cash flows is changed, even if the contractual terms of the instrument are not amended
- Most modifications will not result in derecognition
- A practical expedient to treat changes directly required by IBOR reform as a change to a floating rate of interest, if the new basis is **economically equivalent**

Modifications (ii)

Our members agree with the proposals except:

- It is not necessary for the IASB at this time to define modifications to include situations where, although there has been no change in contractual terms, the method of determining the cash flows has changed
- The practical expedient will not apply where a fall back is not economically equivalent, even if it is only temporary
- The modification amendments need to be positioned outside of the hedging section of IFRS 9

Amendments to Hedging Arrangements (i)

Summary of ED proposals:

- ED proposed amendments to IFRS9 and IAS39 to permit changes to the formal hedging relationship when the uncertainty around interest benchmark reform is no longer present

- Permissible hedge designation changes outlined in paragraphs 6.9.7-6.9.10 in the ED cover:
  - Amending the description of the hedging instrument and/or hedged item so that it refers to an alternative benchmark rate
  - Designating an alternative benchmark rate as a hedged risk

Amendments to Hedging Arrangements (ii)

Main Concerns:

1) **Instruments transacted through clearing houses:**
   - ED proposals based on modifications to financial contracts as a result of benchmark reform
   - Does not cover where an existing IBOR referenced financial instrument is replaced by an instrument that references a new RFR benchmark
   - Potential route to transition derivatives transacted via clearing houses

2) **Amendments to hedging documentation:**
   - Further clarification through wording changes in the ED that hedge designation can be amended multiple times, if necessary, to cover:

   a. when the hedging instrument is modified,
   b. when the hedged item is modified
   c. when even though the hedged item has not been modified, it is highly probable that future cash flows will be, and
   d. when there is a change to the designated hedged risk.

Accounting for Qualifying Hedging Relationships (i)

Summary of ED proposals

ED proposed amendments to IFRS9

- Remeasurement of the hedging instrument and hedged item based on the alternative benchmark rate – any ineffectiveness recognised in P&L
- Amounts in cash flow hedge reserves – when hedged item is updated then future cashflows now considered to be based on alternative benchmark rate
- Groups of items – split into sub-groups within each hedging relationship linked to their benchmark rate – proportionality test applied to each sub-group
- Retrospective effectiveness testing – cumulative fair values of hedged items and hedging instruments reset to zero

Accounting for Qualifying Hedging Relationships (ii)

Main Concerns:

1) **Hedge effectiveness:**
   - though the reset to zero wording is helpful – this was considered that it should be optional

2) **Hedged risk:**
   - Paragraphs 6.9.7, 6.9.8, 102J and 102O not felt to be clear and should not be mis-read to preclude an entity from changing the hedge designation if uncertainty remains for the hedged item
   - Cash flow hedges – may want to amend the hypo to reflect the alternative benchmark rate even though the underlying hedged item such as a loan remains referenced to IBOR

3) **Remeasurement:**
   - Need to ensure paragraph 6.9.7 covers all examples included in 6.9.4

   - Remeasurement should reflect all changes to the instruments that form part of the hedging relationship permitted by paragraph 6.9.4 and not just the risk free rate.

4) **Redeliberations: further decisions expected at the July 2020 Board Meeting**

Designation of Risk Components and Portions

- Groups of items designated as hedged items are allocated to sub-groups based on the benchmark rate to which they refer
- An RFR may be designated as a non-contractually specified risk component if it is reliably measurable and is expected to be separately identifiable within 24 months
- Where an RFR is specified as the hedged risk, it needs to be possible to **add a fixed spread** to compensate for the basis difference between LIBOR and RFR
- References to zero coupon bonds to support the separately identifiable requirement
    - **IFRS 9 B6.3.14** describes the presence of a term structure of zero-coupon real interest rates is required to demonstrate the risk component as separately identifiable for the specific example of inflation linked bonds
    - A difference could arise in the development of a term structure for derivative instruments and cash instruments
    - An additional indicator that an RFR is separately identifiable could be if the local regulatory authority has deemed an RFR to be an eligible replacement of an IBOR
- **The 24-month window** for relief from separately identifiable requirement may not be long enough, especially if it is a requirement for a zero-coupon term structure to develop for cash instruments
- Differences exist between the description of the separately identifiable requirement in IAS 39 and IFRS 9. ***Current practice is established and well understood and should not be reinterpreted*** by the amendments.

Effective Date and Transition

- The amendments proposed that **hedges should be reinstated** if the hedging relationship was discontinued due to IBOR reform
- In some circumstances this may give rise to problems. For example, hedges may have been:
  - **Terminated or compressed** as part of the entity's ongoing activities
  - **Designated in a new hedging relationship**
- Therefore, it should not be mandatory to reinstate hedging relationships if hedging instruments have been subsequently **designated in new hedging relationships**
- Effective date 1 January 2021 with earlier application permitted
- New disclosures

Fair value Hedge Example

1. On 1 November 2020, a derivative is amended from pay fixed 3%, receive $ LIBOR, to pay fixed 2.7%, receive SOFR. It had been previously designated in a FV hedge of cash flows equivalent to a 3% coupon plus principal of a 4% fixed $ borrowing

2. The amendment of the derivative is not considered to be a substantial modification and so it is not derecognised

3. SOFR is expected to be a separately identifiable component within 24 months

4. The hedge documentation is amended to describe the modified derivative as the hedging instrument in a FV hedge of cash flows of 2.7% coupon plus principal, of the 4% liability.

5. Any net change of fair value on the modification of the derivative and amendment of the hedged item, is recorded in profit or loss.

Cash Flow Hedge Example (1)

1. On 1 November 2020, a derivative is amended from pay fixed 3%, receive $ LIBOR, to pay fixed 2.7%, receive SOFR. It had been previously designated in a cash flow hedge of LIBOR risk on a $ LIBOR plus 20bp borrowing

2. The amendment of the derivative is not considered to be a substantial modification and so it is not derecognised

3. SOFR is expected to be a separately identifiable component within 24 months

4. As described in January Staff Paper 14A, the hedge documentation is amended to describe the modified derivative as the hedging instrument in a cash flow hedge of the SOFR component of the $ LIBOR liability. The hypothetical derivative is amended to reflect this designation

Cash Flow Hedge Example (2)

1. The cash flow hedge reserve is remeasured to the lower of:
   - the cumulative gain or loss in FV of the modified derivative
   - the cumulative gain or loss in FV of the amended hypo

2. The original hedge designation continues and amounts in the CF hedge reserve are now deemed to based on SOFR

3. On 15 January 2021, the liability is amended to pay SOFR plus 50bp.

4. The amendment of the liability is not considered to be a substantial modification and so it is not derecognised

5. The hedge documentation is amended as a cash flow hedge of the SOFR component of the SOFR plus 50 bp liability.

Disclosures

Summary of ED proposals

Disclosure objective: information to users to understand:

- Nature and extent of risks arising from benchmark reform the entity is exposed to and how they are managing those risks
- Progress in the entity completing transition

Detailed requirements include:

- Quantitative disclosures for carrying amount of non-derivative financial assets and liabilities and nominal amount of derivatives, disaggregated by each significant alternative benchmark rate (para 24J (b))
- For each significant alternative benchmark rate, a description of how the entity determined the 'base rate and relevant adjustments' to be in scope of the reliefs (para 24J (c))

Disclosures

Main Concerns:

In relation to para 24J (b):

- Recommend clarification that disclosure of comparative information is not required
- Concerns regarding the extent of quantitative disclosure and availability of such information without significant system enhancements or manual adjustments

In relation to para 24J (c):

- Lack of clarity for the term ‘base rate’ and what is therefore required
- Lack of clarity on whether this disclosure is intended to be quantitative or qualitative

Wrap Up: What happens next?

- Re-deliberation of remaining issues in July
  - Principally relating to hedge accounting amendments
- Intention of staff to begin balloting process for amendments at the July board meeting
- Expected issuance of final Phase 2 Amendments late Q3 2020

Antonio Corbi

Antonio joined ISDA's Risk and Capital team (London) and is responsible for ISDA's international activities on accounting and European tax. He is also ISDA's representative at the EFRAG (Brussels) and EU's tax projects such as the Savings Directive an AEFI projects.

Antonio joined ISDA from Fitch Ratings (London) where he was responsible for rating a wide range of Asset Backed Securities in the European Structured Finance team.

Previously, he had different responsibilities in financial institutions managing international projects in more than twenty-five countries in a mixture of private and public sector work in capital markets and regulated banks, including the World Bank (Washington DC) publishing a Working Paper for the Economic Policy and Prospects Group, and the European Commission (Brussels) as consultant. Prior to that, he worked for the EBRD (London) in the Financial Institutions Department.

Mr. Corbi is a qualified chartered accountant fellow of the ACCA and a member of the Chartered Institute for Securities and Investment in London. He has degrees in Economics from the University of Valencia (Spain) and from the University College Cardiff (UK).

David Bradbery

David is a director at EY and a member of the team that provides technical accounting guidance to EY's financial services clients in the audit and advisory functions. He provides technical accounting support to the ISDA, European Accounting Committee.

Prior to joining EY in September 2018, David spent sixteen years in industry with spells at Morgan Stanley, UBS and Barclays where he held a variety of roles dealing primarily with technical accounting matters but also covering valuation and operational accounting issues.

Fiona Thomson

Fiona Thomson is the International Head of Accounting Policy at Goldman Sachs International, with responsibility for application of both IFRS and US GAAP across EMEA and Asia.

Fiona has worked in accounting policy roles for 12 years, having previously worked in technical accounting advisory for KPMG. Ms. Thomson is the co-lead for the Finance work-stream for Goldman Sachs' Global IBOR Implementation Programme.

Additionally, Fiona is the chairperson of the ISDA European Accounting Working Group.

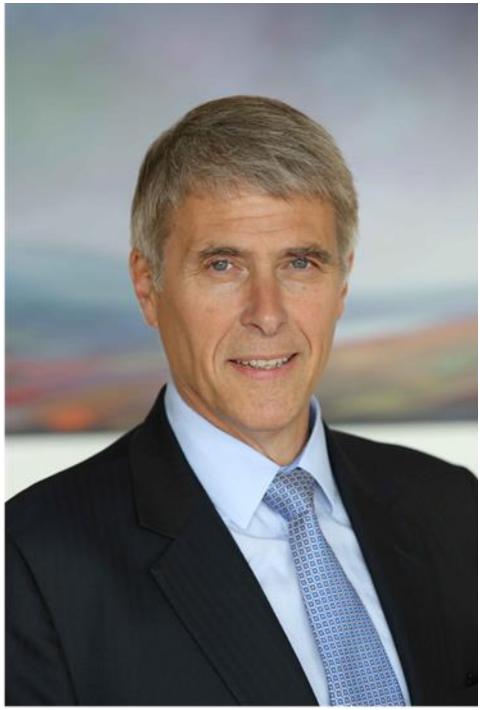
Steve Woolf

Steve joined Lloyds Banking Group's Group Corporate Treasury in 2010 where is the Head of Banking Volatility Management, and has responsibility for the Group's hedge accounting processes. His role covers the development and operation of hedge accounting solutions, working with other business areas within LBG to ensure accounting volatility is minimised, through to P&L reporting of accounting volatility and associated hedge accounting disclosures.

Steve joined LBG from EY's Financial Services division where his role was to support and assist both external clients and EY audit teams with the IFRS accounting for financial instruments and the application and implementation of hedge accounting.

Prior to this Steve has worked for various other organisations in product control, accounting & reporting roles.

Tony Clifford



Tony Clifford has recently retired as a partner at E&Y, but continues to work with the firm as a Senior Advisor, while also working independently.

Over the course of the 40 years he has been with EY, Tony has audited banks and trading entities and provided accounting-led consulting services for many banks, both in the UK and overseas. This has included a number of investigations of fraudulent futures trading activity and acting as an expert witness. He has, for the last ten years headed up the firm's accounting technical department and been a member of its Global IFRS Policy Committee.

He has also been co-chair of the EY global network of IFRS financial instrument experts for the last sixteen years, during which time he has also been the advisor to the ISDA European Accounting Committee. He has been heavily involved in the development and application of IFRS 9 and, more recently, the accounting amendments in respect of IBOR reform.