



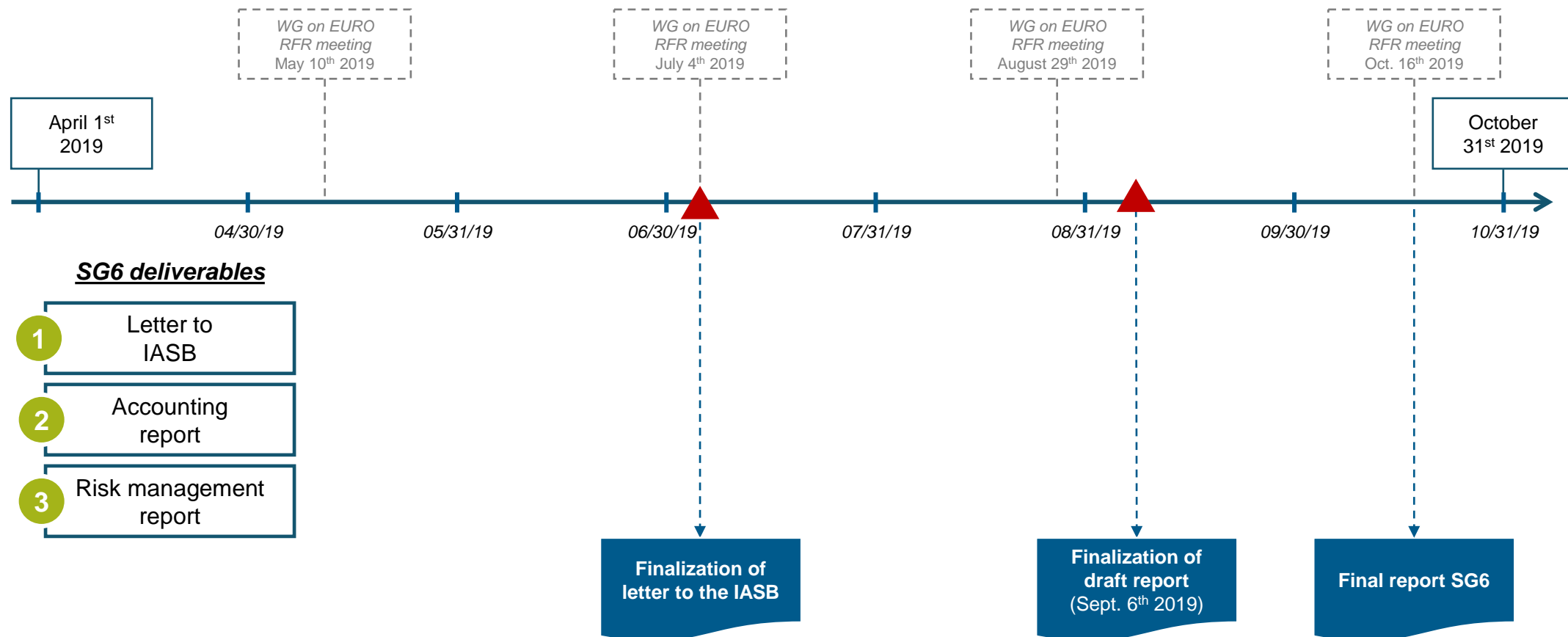
Working Group on Euro Risk-Free Rates
Subgroup 6 reporting

4 July 2019

»»» Agenda

1	Timeline
2	Status update: Risk management
3	Status update: Accounting
4	Letter to the IASB

>>> Intended timeline for subgroup 6



»»» Developments risk management

Risk management report

1

Impact analysis of EONIA to €STR transition

Content:

- **Checklist** of risks affected and respective impact assessment
 - Financial risk (e.g. valuation, market, counterparty, credit, liquidity risk)
 - Non-financial risk (e.g. operational, reputational, model, compliance risk)
- **Practical implications** on valuations and market risk management
 - Valuation and multi-curve environment
 - Market risk management for trading book
 - Market risk management for banking book
- **Technical implications**
 - For data (incl. regulatory requirements)
 - For IT systems (impact on entire front-to-back system landscape)

Status: is currently drafted

2

Impact analysis of €STR-based fallbacks to EURIBOR

Content:

- Fallback rate = replacement rate plus adjustment spread (to avoid value transfer)
- Fallback trigger: cessation vs. pre-cessation
- Potential inconsistencies (e.g. between different product classes or different jurisdictions)
→ Recommendation: avoid inconsistencies for timing and computation of fallbacks
- **Risk management implications**
 - Potential effect on valuation
 - Basis risks could arise (e.g. through fixed adjustment spread, different fallbacks)
 - Potential hedging mismatch (→ hedge acc.)
 - Liquidity of new hedging instruments
- **Data and IT implications**
 - Flexibility to incorporate fallback waterfalls
 - Adjust loan accounting systems/processes
 - Availability of historical data

Status: is currently drafted

3

Implications for insurance and asset management industry

Content:

- **Asset management** specific topics, e.g.
 - Potential impact on risk and performance benchmarks
 - Potential Impact on performance fees
 - NAV calculation and “t+1” issue
 - Outsourcing of middle/back office function requires communication to third parties
 - Client approval for adjustment of legacy business
- **Insurance industry** specific topics, e.g.
 - Regulatory aspects related to Solvency II (regulatory curve, credit risk adjustment)
 - Potential impact on coverage ratios
 - Impact of reformed EURIBOR and new fallbacks to EURIBOR

Status: is currently drafted



»»» Developments accounting

Accounting report

The accounting report will be composed of 3 main parts:

1 Impact analysis of EONIA - €STR-transition on hedge accounting

→ Drafted after finalization of the IASB letter

2 Impact analysis of €STR-based fallbacks to EURIBOR

- a. Overview on possible fallbacks (rates and trigger) for different product classes
- b. Impact of potential inconsistencies on hedge accounting

→ currently drafted

3 Implications on (non-hedge related) accounting standards

→ already under review by SG6

Potential (non-hedge related) accounting implications of IBOR reform

Version	Date	Author
1	21/05/2019	Kevin Williams (ING)

Summary

From an accounting perspective, the transition to Risk Free Rates (RFRs) has a significant impact on hedge accounting, and is the subject of the IASB's proposed reliefs in the recent Exposure Draft (ED) issued for comment. But the implications are wide reaching, beyond hedge accounting. The analysis that follows investigates other potential accounting and reporting implications that should be considered as part of the overall transition.

Most of these implications are relevant at the point of transition to each RFR. The IASB have made it clear that they consider these replacement issues to be in scope of their so-called Phase 2, but there may also be implications for the period leading up to transition. These pre-replacement issues are specifically identified below where relevant, and they are not addressed in the ED, which is focused solely on hedge accounting reliefs.

The main potential accounting implications for discussion purposes can broadly be categorized into four sub-groups. These are elaborated in the next section.

- i. **IFRS 13 Fair value measurement considerations** - in particular the potential need change the classification of certain financial instruments to level 3 for reporting and disclosure purposes;
- ii. **Where discount rates are used in other IFRS standards** - if the discount rate is based on an IBOR, there may be changes in measurement value and therefore P&L impacts on transition. In certain circumstances, this may extend to impacts ahead of transition;
- iii. **IFRS 9 considerations** - including the potential need for wide-ranging modifications that trigger derecognition and re-recognition, and impacts on the business model and SPPI testing; and
- iv. **Assorted other** - accounting, reporting and disclosure implications.

A number of resources have been referenced in the drafting of this paper, and these are included in Appendix 1.

Main potential accounting implications

(i) IFRS 13 - Fair value measurement

Fair value hierarchy IFRS 13 provides the requirements for accounting for assets classified and measured at



»»» Developments accounting

Ongoing IASB project and efforts by SG6

General objective

- Discontinuation of a hedge relationship could have impacts on releasing amounts previously recognized in OCI for cash flow hedges with potentially significant effects on profit or loss or amortization of hedge adjustments for fair value hedges.
- Discontinuation of a hedging relationship is appropriate when the original risk management objective has changed. However, the transition from EONIA to €STR does not substantially change an entities' original risk management objective but happens in response to the market-wide transition driven by the EU benchmark regulation.
- Thus, discontinuation that is solely caused by the transition to €STR would not provide useful information and should be avoided.

IASB – IBOR reform project

- Phase 1:** Issues affecting financial reporting before replacement of an existing interest rate benchmark
- Exposure Draft (ED/2019/1):
 - Proposed amendments for pre-replacement issues
 - Idea: Relief for the following hedge accounting requirements due to uncertainty during pre-replacement period
 - Highly probable requirement
 - Prospective assessments
 - Separately identifiable risk components
 - Effective date: 1 Jan. 2020 (earlier permitted)
- Phase 2:** Issues affecting financial reporting when an existing interest rate benchmark is replaced
- Especially relevant for EONIA to €STR transition
 - Standard amendments require a time-consuming endorsement process
 - WG on RFR needs to stress the urgency of phase 2 and of associated accounting issues

SG6 – Letter to the IASB

SG6 has prepared a letter to the IASB

Content:

- Description of Euro reform agenda
 - Stresses the urgency to start phase 2
 - Requests for clarification or relief for some issues related to modification of contracts and discontinuation of hedge accounting:
 - De-recognition of hedged item or hedging instrument
 - Replacement of hedging instrument
 - Documentation of hedging relationship
 - Ineffectiveness of hedging relationship
- Intention to finalize the letter at the WG meeting
- Subsequently send it to the IASB and publication on the ECB website



>>> Letter to the IASB (1/2)

Modification of contracts

Modification of contracts

- A critical issue triggered by the transition from EONIA to €STR is the resulting **change in the underlying contracts**. Such changes could require entities to assess whether the modifications made should be considered **substantial or non-substantial** modifications of the contractual terms with the **potential consequence of derecognition and re-recognition of contracts**.
- The large number of contracts impacted by the transition creates significant **operational challenges** due to the need to analyze each contract individually. If financial statement preparers could perform such **analyses on an aggregate rather than on an individual level**, this would reduce some of these challenges caused by the IBOR and Euro reform agenda. However, such a **relief** would require the IASB to make respective **changes to IAS 39 and IFRS 9**.
- **IASB** is asked to address the issue of modifications of contracts and the potential risk of derecognition due to the IBOR and Euro reform agenda and provide financial statement preparers with **specific guidance how to treat changes of contracts driven by the reforms** in light of the existing IASB guidance on modifications of floating-rate instruments.



>>> Letter to the IASB (2/2)

Discontinuation of hedging relationships

De-recognition of hedged item or hedging instrument	Replacement of hedging instrument	Documentation of the hedging relationship	Ineffectiveness of the hedging relationship
<ul style="list-style-type: none">- Discontinuation due to de-recognition of hedged item or the hedging instrument <p>→ Guidance needed similar to potential impacts due to the amendment of existing contracts.</p>	<ul style="list-style-type: none">- Replacement of EONIA-based with a €STR-based hedging instrument: No issue should arise if an entity has already provided for rollover of the hedging instrument in the hedge documentation.- However, many entities will have set up hedge documentations before the replacement of EONIA was announced.- Usually a replacement of a hedging instrument not foreseen under the hedge documentation would indicate that the original risk management objective has changed, this is not true if the replacement is made in response to BMR. <p>→ It appears reasonable to apply a similar treatment for replacements of hedging instruments made solely in response to the EONIA/€STR reform as for rollovers foreseen in the hedge documentation.</p>	<ul style="list-style-type: none">- Once EONIA is replaced by €STR, necessary updates to hedge documentations (to account for €STR) could be viewed as substantive amendment giving rise to discontinuation of the hedging relationship. <p>→ However, the update is made in response to the market-wide transition to €STR and is not to reflect a change in the underlying risk management objective.</p>	<ul style="list-style-type: none">- Under IAS 39 entities need to demonstrate to meet the 'highly effective' requirement by applying prospective and retrospective effectiveness tests (80%-125% test).- However, during the transition phase from EONIA to €STR hedging relationships might face (additional) prospective and/or retrospective ineffectiveness (e.g. if the modification of hedged item and hedging instrument do not take place simultaneously or when valuation is affected by the transition to €STR).- The discontinuation of hedging relationships which only temporarily fail the 'highly effective' requirement (80%-125% test) would contradict the IASB's effort taken in ED/2019/1 with the relief to prospective effectiveness testing.→ Therefore, similar relief is required with regards to the retrospective effectiveness test (80-125% test) under IAS 39.