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(EFRAG)
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Ref: EFRAG's Draft Comment Letter on IASB's Exposure Draft *Interest Rate Benchmark Reform – Proposed amendments to IFRS 9 and IAS 39*

Dear Mr Gauzès,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the EFRAG's draft comment letter on the IASB's Exposure Draft (ED) *Interest Rate Benchmark Reform* which proposes amendments to *IFRS 9 Financial Instruments and IAS 39 Financial Instruments: Recognition and Measurement*. We are pleased to provide you with the following comments with the aim of improving the enforceability and consistent application of IFRSs.

In light of its mandate, ESMA is committed to promote the consistent application and supervision of the Benchmark Regulation¹ in the European Union and, therefore, ESMA is also actively involved in the relevant Global and European initiatives addressing the reform of interest rate benchmarks which, due to the potentially significant impacts on a broad range of financial products, represents a challenge from a financial stability and consumer protection perspective.

In this context, we are aware that financial market participants have raised concerns with respect to the potential accounting implications for financial instruments that rely on existing interest rate benchmarks which may be subject to future changes. Therefore, like EFRAG, ESMA supports the IASB's initiative to provide in a staged approach a timely response to the increasing level of uncertainty about the possible financial reporting impacts of the long-term viability of some interest rate benchmarks.

Particularly, like EFRAG, ESMA agrees with the proposals set out in the ED to amend IFRS 9 and IAS 39 to address, first of all, the issues that affect the application of hedge accounting requirements in the period before the replacement of an existing interest rate benchmark with

¹ Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds

an alternative interest rate by setting out well-specified exceptions to the relevant requirements in IFRS 9 and IAS 39.

We agree that the IASB has identified the area that is the most urgent to address. However, we would recommend that the IASB considers providing some of the clarifications concerning the limitations on the application of the proposed exceptions that are currently included in the basis for conclusions of the ED, as amendments to the accompanying authoritative guidance of both IFRS 9 and IAS 39. We think that this would promote consistent application and facilitate both implementation and enforceability of the proposed changes.

ESMA urges the IASB to proceed rapidly towards the finalisation of the proposed amendments, so that they can be applicable for the preparation of the 2019 annual financial statements. In order to enable such application, ESMA also highlights the importance of an expeditious endorsement process in Europe and, in this respect, recommends that EFRAG stands ready to provide timely support to the European Commission so that, once finalised, the amendments can be endorsed in time for their application to the 2019 annual financial statements.

Finally, we also concur with the IASB that there are other issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative benchmark as part of a second phase. Like EFRAG, we would like to highlight that addressing these 'post-replacement' accounting issues is also urgent and therefore we encourage the IASB to address these aspects as soon as possible, taking into consideration the progress of the benchmark reforms.

In particular, in ESMA's view, the next phase of the proposed changes should consider and address issues that relate inter alia to the application guidance on derecognition and modification of financial instruments, implications for the determination of fair value, as well as addressing the implications on hedge accounting of changes in the contractual terms and in the contractual documentation.

Our detailed comments on the ED are set out in the Appendix to this letter. In case you have any questions or comments please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'S/M' with a flourish.

Steven Maijor

Appendix – ESMA’s detailed answers to the questions in the ED

Question 1

Highly probable requirement and prospective assessments

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

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

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

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

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

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

1. ESMA supports the IASB’s proposed exceptions to the hedge accounting requirements in both IFRS 9 and IAS 39 with respect to the highly probable requirement and prospective assessments to address the uncertainties arising from the interest rate benchmark reform.
2. In particular, as stated in paragraph BC12 of the ED, ESMA agrees that discontinuing all affected hedging relationships solely in light of these uncertainties would not provide useful information to users of financial statements.
3. However, ESMA would recommend that some of the clarifications provided in paragraphs BC14 and BC15 of the ED on the limitations of the exceptions are incorporated as application guidance instead of basis for conclusions as they explain how to apply the proposed requirements of the Standard.
4. With respect to prospective assessments, ESMA also agrees with the IASB’s proposed amendments. However, also in this area, ESMA believes that the clarifications on the limitations to the applications of the proposed exceptions that are included in paragraphs BC22 of the ED are incorporated as application guidance. In our view, this will promote consistent application and facilitate both implementation and enforceability of the proposed changes.
5. Finally, ESMA agrees with the IASB’s decision as explained in paragraph BC23 of the ED not to propose any exception on the retrospective assessments as these are based on the actual results of the hedging relationship and therefore they do not require any prospective assumption on the development of the reform of interest rate benchmarks.

Question 2

Designating a component of an item as the hedged item

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

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

6. ESMA agrees with the proposed amendments with respect to the designation of a component of an item as hedged item and particularly with respect to the separately identifiable requirement, but without any changes of the requirement on reliable measurement.
7. ESMA also agrees with the IASB's decision as explained in paragraph BC27 not to allow entities to designate the benchmark component of interest rate risk as the hedged item in a new hedging relationship if the risk component is not separately identifiable at the inception of the hedging relationship. In our view, such an exception would go beyond the objective of the proposed amendments.

Question 3

Mandatory application and end of application

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

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

(i) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows; and

(ii) when the hedging relationship is discontinued, or if paragraph 6.8.9 of IFRS 9 or paragraph 1021 of IAS 39 applies, when the entire amount accumulated in the cash flow hedge reserve with respect to that hedging relationship is reclassified to profit or loss.

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

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

8. ESMA agrees with the IASB's proposal to make the application of the proposed exception mandatory in order to avoid selective discontinuation of hedges as a result of the uncertainties arising from interest rate benchmark reforms.

9. ESMA agrees with not proposing an end of application of requirements related to exceptions with respect to the highly probable requirement and the prospective assessments as well as for the separately identifiable requirement.

Question 4

Disclosures

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

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

10. ESMA agrees with the ED proposals in relation to disclosures as we concur with the IASB's view that IFRS 7 *Financial Instruments: Disclosures* already provides for the necessary requirements in relation to outstanding hedge accounting relationships. Therefore, it is sufficient to further require the use of separately disclosed information for the hedges that are subject to the exceptions.
11. However, ESMA is of the view that the proposed disclosure requirements should be included directly as amendment to IFRS 7 together with other disclosure requirements rather than as amendments to IAS 39 or IFRS 9.

Question 5

Effective date and transition

For the reasons set out in paragraphs BC45–BC47, the Board proposes that the amendments would have an effective date of annual periods beginning on or after 1 January 2020. Earlier application would be permitted. The Board proposes that the amendments would be applied retrospectively. No specific transition provisions are proposed.

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

12. ESMA agrees with the ED proposal to require retrospective application while clarifying that this would allow neither reinstatement of previously discontinued hedge accounting nor designation with hindsight. However, we recommend to the IASB to assess whether structuring opportunities would not arise as a consequence of not requiring retrospective reinstatement of hedge accounting relationships. This is relevant for those hedge accounting relationships that were discontinued before the application date of the proposed relief, solely due to uncertainties arising from the IBOR reform.
13. ESMA recommends to the IASB to include the clarifications in relation to the use of the retrospective application of the proposed exception directly as application guidance instead of including them as part of the basis for conclusions.