



Report by the working group on euro risk-free rates

On the financial accounting implications of the transition
from EONIA to the €STR and the introduction of €STR-based fallbacks for EURIBOR

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1 Executive summary

This report by the working group on euro risk-free rates focuses on the implications for International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) of the transition from the current euro overnight index average (EONIA) to the European Central Bank's euro short-term rate (€STR) and the inclusion of fallback rates for EURIBOR based on a €STR-based term structure methodology. While the report primarily focuses on the EU Benchmarks Regulation (BMR) implications for hedge accounting related topics, it also touches upon challenges for non-hedge related topics. While the working group acknowledges that EONIA and EURIBOR contracts are held by reporting entities across the world and, therefore, considerations under other accounting frameworks may also be relevant, this report focuses on IFRS/IAS as the predominant reporting framework within Europe. Implications for national generally accepted accounting principles (GAAP) do not fall within the scope of the report.

Key recommendations

Working group recommendations regarding the impact of the transition from EONIA to the €STR on the modification of contracts and hedge accounting:

- 1) The working group recommends that preparers of financial statements qualitatively and quantitatively assess whether changes to contracts resulting from the transition from EONIA to the €STR are substantial or non-substantial modifications¹.
- 2) The working group recommends that the International Accounting Standards Board (IASB) address the issue of modifications of contracts and the potential risk of derecognition owing to the BMR and provide preparers of financial statements with specific guidance on how to treat changes of contracts driven by the reforms in the light of the existing IASB guidance on modifications of floating rate instruments² (see also the Annex).
- 3) The working group recommends that preparers of financial statements assess whether the EONIA component designated in hedge relationships is still reliably measurable throughout the transition.
- 4) The working group recommends that preparers of financial statements evaluate whether the change in hedged risk from the transition from EONIA to the €STR will lead to the discontinuation of existing hedging relationships.
- 5) The working group recommends that preparers of financial statements analyse the effect that a potential timing mismatch between the transition of the hedged item and the transition of the hedging instrument – as regards the switching of either the floating rate option or the discounting curve from EONIA to the €STR – would have on the effectiveness of the hedge relationship affected by the transition. In any case, preparers of financial statements should consider if the amendments introduced by the IASB to IFRS 9 and IAS 39 already cover this potential mismatch.

¹ The terms “substantial” and “non-substantial” refer to the accounting treatment of modified financial instruments under IFRS 9 and IAS 39. These terms should not be confused with the “material changes of a benchmark” referred to in the EU Benchmarks Regulation.

² IFRS 9.B5.4.5/ IAS 39.AG7

Recommendations of the working group regarding fallbacks for EURIBOR and hedge accounting:

- 6) From a financial accounting perspective, market participants should try to reduce variability in fallbacks between different product classes (including derivatives) to a minimum as this would reduce technical implementation challenges and accounting complexity. However, this is ultimately a matter for parties to resolve, taking account of their individual circumstances.
- 7) The working group recommends that preparers of financial statements take the following actions.
 - a) Analyse whether there might be fallback scenarios under which hedge relationships would need to be discontinued.
 - b) Consider incorporating a provision for replacing benchmark interest rates in their hedge documentations for new contracts. Consequently, the risk of hedge de-designations resulting from documentation adjustments could be reduced for new business.
 - c) Consider the risk of inconsistency when developing fallback provision triggers. This should be taken into account when amending existing contracts and setting up new contracts. The working group highlights the risk of hedge ineffectiveness and potential discontinuation of hedge relationships in the event of (i) having timing inconsistencies in fallback provision triggers, and (ii) incorporating different fallback trigger language for hedged items and hedging instruments.

Further recommendations of the working group regarding accounting and financial reporting:

- 8) Where EONIA or EURIBOR-based valuation curves are replaced by the €STR curve or a curve based on a €STR-based term structure methodology, the working group recommends that preparers of financial statements assess the potential impact of a change in value for financial instruments measured at fair value on the day of transition.
- 9) The working group recommends that preparers of financial statements closely monitor the IASB project on IBOR reforms and any amendments or clarifications to the standards resulting from it.

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The report discusses a variety of options to address the transition from EONIA to the €STR and the introduction of €STR-based fallback clauses for EURIBOR. Recipients of this report are responsible for making their own assessments as to the suitability of the various options discussed in the report. Recipients must continue to operate in an independent and competitive manner and they should not use the content of this report to coordinate their activities in breach of applicable law.

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2 Introduction

2.1 Background

EURIBOR and EONIA are the most widely used interest rate benchmarks for euro-denominated financial contracts. Both are administered by the European Money Markets Institute (EMMI). EURIBOR is the term reference rate for the euro, and is available for several tenors. EONIA is the overnight reference rate for the euro, computed on the basis of real transactions in the interbank market.

In 2018 the EU Benchmarks Regulation (BMR)³ came into effect. Owing to their systemic importance, the two aforementioned benchmarks were added by European Commission to the list of critical benchmarks pursuant to Article 20 of the BMR.⁴

2.2 The working group on euro risk-free rates

In September 2017 the European Central Bank (ECB), the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission announced the launch of the industry working group on euro risk-free rates. The working group was tasked with identifying and recommending risk-free rates that could serve as an alternative to the current benchmarks used in a variety of financial instruments and contracts in the euro area and with developing adoption plans.⁵

In September 2018 the working group recommended that the €STR become the successor to EONIA.⁶ In order to ensure smooth market adoption, there will be a two-year transition period. Key elements of the transition from EONIA to the €STR are:

- the existence of a transition period, which started on 2 October 2019 and will end on 31 December 2021, with the consequent cessation of publication of EONIA on 3 January 2022;
- the dependency of EONIA on the €STR during the transition period, as the EONIA methodology has been redefined as the €STR plus a fixed spread of 8.5 basis points.

By contrast, EURIBOR has been reformed to become BMR-compliant under a new hybrid methodology which will be fully implemented by the end of 2019. Authorisation was granted by the FSMA, EMMI's supervisor, on 2 July 2019.

³ Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (OJ L 171, 29.6.2016, p. 1)

⁴ See [Commission Implementing Regulation \(EU\) 2017/1147 of 28 June 2017 amending Implementing Regulation \(EU\) 2016/1368 establishing a list of critical benchmarks used in financial markets pursuant to Regulation \(EU\) 2016/1011 of the European Parliament and of the Council \(OJ L 166, 29.6.2017, p. 32\)](#).

⁵ See [Terms of reference for the Working Group on Euro Risk-Free Rates and Composition of the Working Group on Euro Risk-Free Rates](#).

⁶ See [ECB press release of 13 September 2018](#).

Because the overnight benchmark rate EONIA will cease to exist, the transition from EONIA to the €STR is currently the main focus of the work of the working group on euro risk-free rates. Although EURIBOR will continue to be provided under its reformed methodology, its use needs to comply with the requirements of the BMR. As a contingency measure to avoid future financial instability, the BMR requires EU supervised entities to produce and maintain robust written plans setting out the actions they will take in the event that a benchmark materially changes or ceases to be provided, including fallback provisions. This requires supervised entities to include a fallback for EURIBOR in their written plans and contracts where feasible and appropriate.

2.3 The sub-group on financial accounting and risk management

In order to ensure that its recommendations are adopted by all market participants, the working group has created a sub-group on financial accounting and risk management. The sub-group was tasked with analysing the impact on financial accounting and risk management of (i) the transition from EONIA to the €STR and (ii) the inclusion of fallbacks for EURIBOR based on a €STR-based term structure methodology and the possible fallback triggers. The results of the analysis are published across three documents:

- a letter from the working group on euro risk-free rates to the IASB⁷;
- a report analysing the impact on risk management⁸;
- this report analysing the impact on financial accounting.

The sub-group comprises representatives of European and international credit institutions, consulting and accounting firms, clearing houses, investment management firms and associations. The ECB, ESMA, the European Commission, and the FSMA act as observers in the sub-group.

2.4 Structure of the report

The present report focuses on IFRS accounting implications of the transition from EONIA to the €STR and the inclusion of fallbacks for EURIBOR based on a €STR-based term structure methodology. Notably, the purpose of the report is not to give regulatory recommendations on the accounting treatment of specific financial contracts and instruments but rather to provide information on the overall consequences for financial accounting and potential issues that may arise, especially concerning hedge accounting during the transition period. While the report primarily focuses on BMR implications for hedge accounting related topics, it will also touch upon challenges for non-hedge related topics.

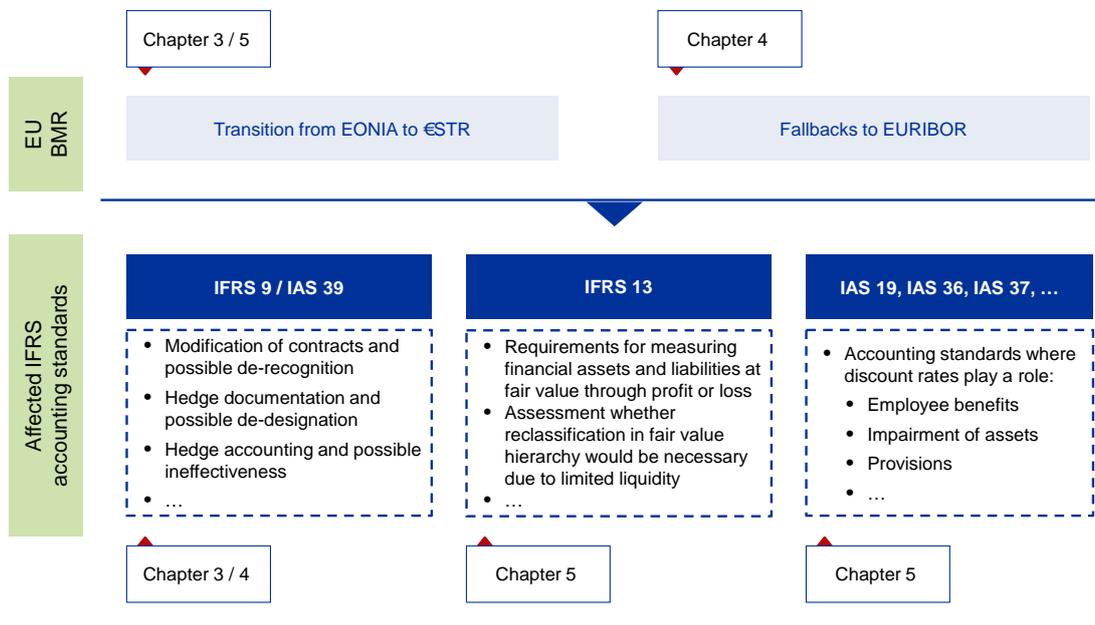
Furthermore, it should be noted that this report focuses on IFRS/IAS accounting issues that might arise as a result of the EU Benchmark Reform. Implications for national GAAP do not fall within the scope of this report.

⁷ See [letter of 15 July 2019 from the working group on euro risk-free rates to the IASB](#).

⁸ See [“Report by the working group on euro risk-free rates on the risk management implications of the transition from EONIA to the €STR and the introduction of €STR-based fallbacks for EURIBOR”](#).

Figure 1

Structure of the report and specific accounting standards affected by the Benchmarks Regulation



The report consists of five chapters. Following the executive summary and the introduction, Chapter 3 analyses the impact of the EONIA to €STR transition on hedge accounting. The analysis builds on the transition period as outlined in Chapter 3.1 and provides insights about the modification of contracts, changes in hedge documentation and the impact on hedge effectiveness.

Chapter 4 focuses on the possible accounting impacts of the implementation of €STR-based fallbacks for EURIBOR. In line with the structure of the previous chapter, assumptions about the realisation of fallback rates are outlined to subsequently discuss practical implications for accounting. Chapter 5 will complete the analysis by looking at potential (non-hedge related) accounting and financial reporting implications of the interbank offered rate (IBOR) reform.

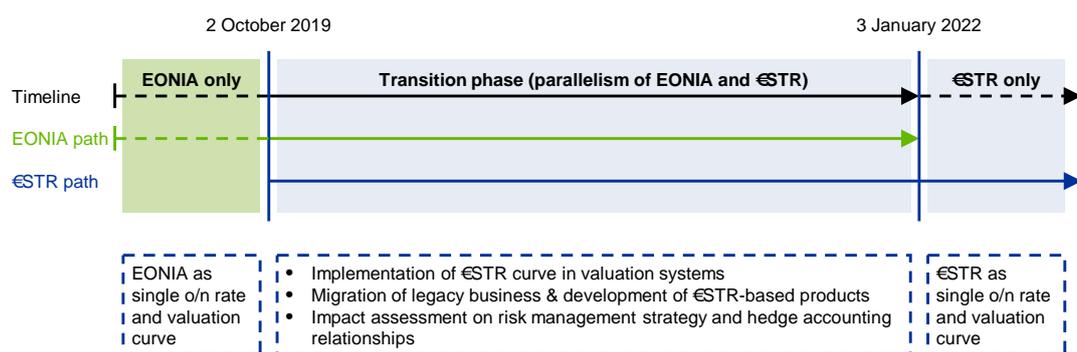
3 Impact analysis of EONIA to €STR transition on hedge accounting

3.1 The EONIA to €STR transition period

Before discussing the accounting implications, this section provides a summary of the EONIA to €STR transition period. In September 2018 the working group recommended that the €STR should become the successor to EONIA⁹. Publication of the €STR started on 2 October 2019 based on transaction data from 1 October. For a smooth transition from EONIA to the €STR, there will be a two-year transition period which serves to avoid market disruptions and provide market participants with the opportunity to migrate legacy business from EONIA to the €STR. During this period, EONIA will be calculated as the €STR plus a fixed spread of 8.5 basis points.¹⁰ Under this new methodology, EONIA will continue to be published by EMMI until 2 January 2022. The timeline for the transition period, as recommended by the working group,¹¹ is shown in Figure 2 below.

Figure 2

Timeline of transition phase



In order to ensure a smooth transition, financial institutions need to implement the €STR as the new reference rate in their valuation and accounting systems so that new business references the €STR instead of EONIA and legacy business referencing EONIA with maturities exceeding 3 January 2022 can be transitioned to the €STR.

The use of EONIA as a benchmark interest rate can be divided into two categories:

- EONIA used as a floating rate option, i.e. as a reference rate for the determination or projection of current and future cash flows;
- EONIA used as a discounting rate for valuation purposes.

⁹ See [ECB press release of 13 September 2018](#).

¹⁰ See [ECB Press release of 31 May 2019](#).

¹¹ See the [presentation detailing the discussions on the recommendations on the EONIA transition](#), 27 February 2019.

While the former category (i.e. floating rate option) affects cash flows of floating rate instruments and interest rate swaps, the latter category (i.e. a valuation change by virtue of a change in discounting regime) could even have an impact on a wider range of products and financial instruments.

3.2 Relevance for IFRS hedge accounting and current state of IASB activities

As explained in the previous section, until now the major focus of the work carried out by the working group on euro risk-free rates has been the replacement of EONIA with the €STR. For financial instruments and contracts that are migrated from EONIA to the €STR, the transition could have an impact on the cash flows of EONIA-based instruments, net present values and market liquidity. This is especially relevant for hedge accounting, which may have to be discontinued if the hedging instrument and/or the hedged item are considered to be substantially modified¹².

Discontinuation of a hedging relationship in response to the transition from EONIA to the €STR could ultimately have an impact on profits or losses. Discontinuation is clearly appropriate if the original risk management objective has changed. However, the transition from EONIA to the €STR does not substantially change an entity's original risk management objective but happens in response to the market-wide transition driven by the EU Benchmarks Regulation. Thus, the discontinuation of hedging relationships that is caused solely by the transition from EONIA to the €STR would not provide useful information to users of financial statements. The working group expressed this idea in a letter to the IASB, which can be found in the Annex to this report and on the ECB website¹³.

The IASB is following a phased response to the reform of interest rate benchmarks. During phase 1 the IASB addressed the pre-replacement issues related to the reform. As initially proposed by the IASB in its exposure draft of May 2019¹⁴, amendments to IFRS 9 and IAS 39 would provide relief, enabling entities to continue with hedging relationships during the pre-replacement phase of the IBOR reform (so-called phase 1). The working group also asked the IASB to provide further clarification and relief (including for replacement issues during phase 2), following the same logic. In September 2019 the IASB published amendments to its IFRS standards for the pre-replacement phase in order to "support the provision of useful financial information by companies during the period of uncertainty arising from the phasing out of interest-rate benchmarks such as interbank offered rates (IBORs)"¹⁵. This was the culmination of phase 1 of the IASB's IBOR reform project. In phase 2, which addresses replacement issues, the IASB is considering the potential consequences on financial reporting of replacing an existing benchmark with an alternative.

The following three sections highlight the IFRS 9 and hedge accounting issues that could arise as a result of the transition to the €STR. Figure 3 provides a simplified graphical overview of these

¹² The terms "substantial" and "non-substantial" refer to the accounting treatment of modified financial instruments under IFRS 9 and IAS 39. These terms should not be confused with the "material changes of a benchmark" referred to in the BMR.

¹³ See [letter of 15 July from the working group on euro risk-free rates to the IASB](#).

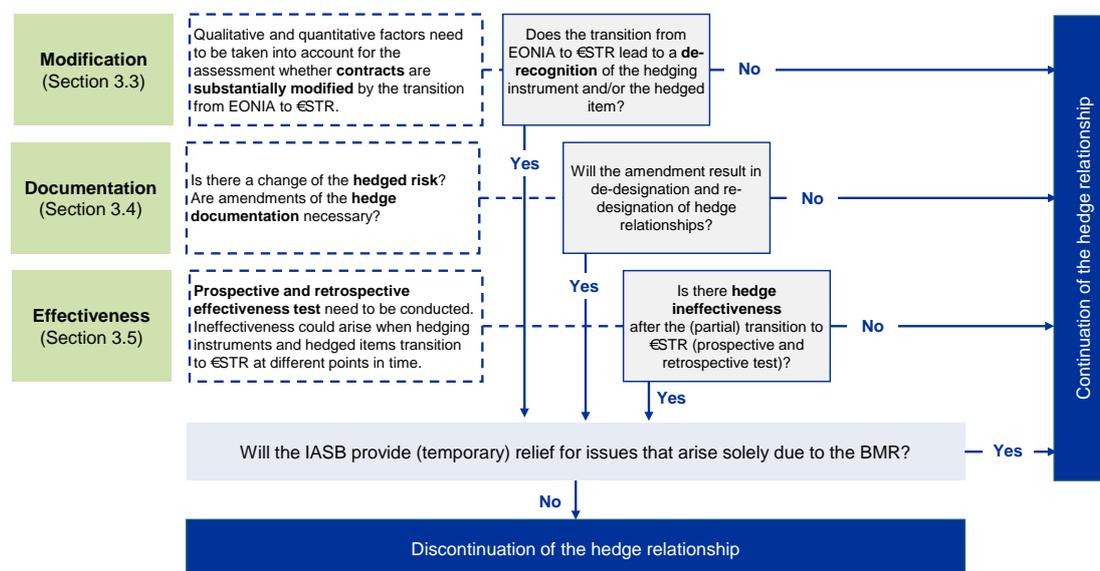
¹⁴ See the [Exposure Draft ED/2019/1 on interest rate benchmark reform](#), IASB, May 2019.

¹⁵ See the IFRS Foundation's press release entitled "[IASB amends IFRS Standards in response to the IBOR reform](#)", 26 September 2019.

sections and illustrates the three core considerations (modification, documentation and effectiveness) that should, as a minimum, form part of a BMR impact analysis on hedge accounting¹⁶.

Figure 3

Three core considerations in the analysis of the continuation of hedge relationships



3.3 Modification of contracts

According to IFRS 9, financial instruments have to be derecognised if the terms of the instrument are substantially modified¹⁷. In this case, the instrument has to be derecognised and the modified instrument is re-recognised. Derecognition can trigger further accounting implications, such as the discontinuation of an existing hedge accounting relationship.

In the context of the BMR, the following scenarios will require an assessment with regard to the relevant IFRS modification requirements:

- the existing EONIA benchmark rate in a financial instrument is replaced by the new €STR benchmark rate;
- an existing financial instrument is amended by introducing a fallback provision providing for an automatic change from EONIA to the €STR¹⁸.

¹⁶ Furthermore, when a forecast transaction is designated as the hedged item, the hedged cash flows are required to be “highly probable”. As the IASB has already indicated a potential relief for the highly probable requirement (see [Exposure Draft ED/2019/1 on interest rate benchmark reform](#)) and published the respective amendments, this criterion is not discussed in more detail in this report.

¹⁷ The terms “substantial” and “non-substantial” refer to the accounting treatment of modified financial instruments under IFRS9 and IAS 39. These terms should not to be mixed up with “material changes of a benchmark” to which the BMR is referring.

¹⁸ For a more detailed analysis of fallback provisions, see Chapter 4.

The triggering of an existing contractual fallback clause should not be considered a contractual modification, as the original contract already incorporated fallback provisions and therefore anticipated that such a replacement could occur.

For financial liabilities, IFRS 9 provides for a quantitative approach and a respective threshold to determine whether a financial liability has been substantially modified¹⁹. In certain circumstances preparers of financial statements may also have to take into account qualitative factors when assessing the magnitude of a modification. However, there is less guidance on how to assess whether a financial asset has been substantially modified. With this in mind, a critical issue generated by the transition from EONIA to €STR is the resulting change to contracts that reference EONIA.

If the contractual change is deemed substantial, derecognition of the old contract and re-recognition of a new contract will be required. This could result in significant volatility in the income statement.

It should be noted that preparers of IFRS financial statements could interpret a non-substantial modification as requiring a re-estimation of cash flows and a recalculation of amortised cost based on those new cash flows discounted on the basis of the original effective interest rate, with any differences between the old and new amortised cost being recognised immediately in the income statement. Therefore, if the transition to a new benchmark is treated as a non-substantial modification there could still be an impact on profit or loss depending on what the original effective interest rate is considered to be in the context of a change of benchmark.

In addition to the impact on the financial statement, the transition from EONIA to the €STR also has an operational impact. The large number of contracts affected by the transition is expected to create significant operational challenges owing to the need to analyse each contract individually. If preparers of financial statements could perform such analyses on an aggregate level rather than on an individual level, it would lessen some of the operational challenges. The working group has expressed this view in its letter to the IASB, as it would require changes to IAS 39 and IFRS 9 (see also the Annex).

Recommendation:

- 1) The working group recommends that preparers of financial statements qualitatively and quantitatively assess whether changes to contracts resulting from the transition from EONIA to the €STR are substantial or non-substantial modifications²⁰.

The working group emphasises that the IASB has already provided guidance on modifications of floating rate instruments such that re-estimations of cash flows to reflect movements in market rates of interest can also be reflected in the effective interest rate and, consequently, would not be expected to trigger a derecognition of the respective financial instrument (see also the Annex)²¹.

¹⁹ For financial liabilities, amendments are deemed substantial where there is a change of more than 10% in present value of expected future cash flows, discounted at the original effective interest rate (EIR) (IFRS 9 B3.3.6).

²⁰ The terms “substantial” and “non-substantial” refer to the accounting treatment of modified financial instruments under IFRS 9 and IAS 39. These terms should not be confused with the “material changes of a benchmark” referred to in the EU Benchmarks Regulation.

²¹ IFRS 9.B5.4.5/ IAS 39.AG7.

Although there has not been an official accounting pronouncement in this regard, the working group is of the opinion that if a benchmark rate is replaced by another benchmark rate because the previous rate no longer exists, this should similarly be considered a re-estimation of cash flows which can be reflected in the effective interest rate used for the 10% test and amortised cost calculations. The working group believes this argument to be particularly valid in the case of the BMR, which represents a regulatory induced change of a benchmark rate that affects all preparers of financial statements. If the derecognition of financial instruments owing to the BMR can be avoided, hedge relationships will also not need to be discontinued for this particular reason.

Recommendation:

- 2) The working group recommends that the IASB address the issue of modifications of contracts and the potential risk of derecognition owing to the BMR and provide preparers of financial statements with specific guidance on how to treat changes of contracts driven by the reforms in the light of the existing IASB guidance on modifications of floating rate instruments²² (see also the Annex).

Owing to the general goal of equivalence when shifting from a benchmark to its fallback rate (including the introduction of a fallback clause in an existing contract), the working group's view is that this change should be considered a substantial modification only when such equivalence is not fulfilled. The rationale with respect to equivalence is based on the objectives of the EU benchmark reform. The replacement of one benchmark rate by another is not intended to change the character of the instrument.²³ However, this view would have to be supported by the IASB.

3.4 Changes in hedge documentation

When an entity applies hedge accounting, an essential requirement under IAS 39 and IFRS 9 is to properly document the characteristics of the hedging relationship. This generally includes:

- the type of hedge (e.g. cash flow hedge, fair value hedge, portfolio hedge of interest rate risk);
- identification of the hedged item;
- identification of the hedging instrument;
- identification of the hedged risk.

Therefore, if an entity has set up hedging relationships where the documentation referred to EONIA, transitioning from EONIA to the €STR will likely have implications on the hedge documentation. The following subsections illustrate the implications of the EONIA to €STR transition for hedge documentation.

²² *ibid.*

²³ Rather, the purpose of this replacement is to increase confidence in the reliability and integrity of interest rate benchmarks by introducing new benchmark rates that are determined on the basis of a more robust and objective methodology.

3.4.1 Implications for the hedged item

Transitioning a floating rate loan previously based on EONIA to the €STR could give rise to a modification as described above. If the modification is substantial, the impact on the hedge documentation may be that the hedged item previously designated would have to be derecognised.

A fixed-rate loan may be part of a fair value hedge where only the EONIA component was designated as a hedged item, i.e. other changes in the fair value of the loan (e.g. credit risk) are not part of the hedging relationship. IFRS 9 requires that a component must be separately identifiable and reliably measurable to be eligible for designation. The transition from EONIA to the €STR could affect this assessment as the EONIA component may no longer be reliably measurable.

In both cases, the previous hedge relationship would cease. Depending on which type of hedge was designated, this could require amounts previously recognised in other comprehensive income (OCI) to be reclassified (“recycling”) or hedge adjustments to be amortised to the carrying amount of a hedged item. Nevertheless, new documentation could be drawn up for a new hedging relationship that reflects the new terms of the hedged item based on the €STR.

The IASB has already published relief (for phase 1) for the assessment of whether a component that is subject to a benchmark reform is separately identifiable. Under this amendment of IAS 39 and IFRS 9 an entity needs to assess whether the component is separately identifiable only at the inception of the hedging relationship²⁴.

However, no equivalent relief was proposed for the assessment of whether the component is reliably measurable. Nevertheless, the assessment with respect to the reliably measurable criterion is simplified by the fact that (i) the successor rate for EONIA, the €STR, has already been defined and has been published since 2 October 2019 on a daily basis, and (ii) a firm link between EONIA and the €STR of 8.5 basis points has been established.

Recommendation:

- 3) The working group recommends that preparers of financial statements assess whether the EONIA component designated in hedge relationships is still reliably measurable throughout the transition.

3.4.2 Implications for the hedging instrument

If an EONIA-based hedging instrument is amended to subsequently reference the €STR, an entity needs to assess whether this modification gives rise to derecognition of the hedging instrument, something which would consequently lead to discontinuation of the respective hedge relationship. Alternatively, an entity could close out the original hedging instrument and enter into a new one. However, unlike discontinuation of the hedge owing to derecognition of the hedged item, when the hedge relationship is discontinued because the hedging instrument had expired, was terminated or sold, no immediate recycling of amounts previously recognised in OCI takes place. Nevertheless, new

²⁴ See [Project summary: interest rate benchmark reform – amendments to IFRS 9, IAS 39 and IFRS 7](#), IASB, September 2019.

documentation could be drawn up for a new hedging relationship that reflects the new terms of the hedging instrument based on the €STR.

Some hedge documentation may have already foreseen a change in the hedging instrument to reflect the transition from EONIA to the €STR. Both IFRS 9 and IAS 39 foresee a so-called rollover of hedging instruments. This usually applies for derivatives with maturities shorter than the hedged item. When applying rollovers to allow designation of a hedging relationship throughout the period the hedged item is outstanding, some entities may have documented their intention to roll over existing EONIA-based derivatives into €STR-based derivatives once EONIA is replaced by the €STR. However, many entities will have drawn up hedge documentation before the replacement of EONIA was announced and did not foresee any need for a rollover at inception of such hedges.

While the replacement of a hedging instrument that was not foreseen under the hedge documentation would usually indicate that the original risk management objective has changed, the working group is of the opinion that this is not true if the replacement needs to be made in response to the market-wide replacement of EONIA with the €STR. On the contrary, it is the working group's view that the replacement is actually made in order to maintain the original risk management objective²⁵. However, this view would have to be supported by the IASB.

3.4.3 Implications for the hedged risk

An entity may have defined the hedged risk with reference to EONIA (e.g. by hedging interest cash flows against changes in EONIA). If EONIA is no longer present or if an entity changes its risk management objective so that the hedged risk is no longer EONIA but the €STR, this needs to be reflected in the hedge documentation. An entity needs to assess how such a change affects the current hedging relationship because a change in hedged risk usually requires changes to the hedge documentation. Depending on facts and circumstances, an entity may:

- have to discontinue the current hedging relationship if the change of the hedged risk is deemed to be a substantial amendment (with the possibility of setting up a new hedging relationship based on the €STR as the hedged risk);
- need to update the hedge documentation without discontinuing the current hedging relationship;
- be able to continue without any changes if the change in hedged risk was already foreseen in the original hedge documentation.

The working group observed that, with respect to the EONIA to €STR transition, an update of the hedged risk to the €STR is made in response to the market-wide transition to the €STR and not to reflect a change in the underlying risk management objective, which should remain the same.

²⁵ This point has also been stressed in the letter to the IASB (see the Annex).

Recommendation:

- 4) The working group recommends that preparers of financial statements evaluate whether the change in hedged risk from the transition from EONIA to the €STR will lead to the discontinuation of existing hedging relationships.

3.5 Impact on hedge effectiveness

A hedging relationship must be effective in order to apply hedge accounting to it. The transition from EONIA to the €STR could have an impact on the assessment of prospective effectiveness and retrospective effectiveness and the measurement of ineffectiveness. The potential effects are discussed in the following subsections.

3.5.1 Impact on prospective effectiveness

An entity needs to demonstrate its expectation that a hedging relationship will be effective, i.e. that the hedging instrument is expected to offset changes in the risk of the hedged item.

More specifically, if an entity applies IFRS 9 to its hedging relationships, there must be an economic relationship between the hedged item and the hedging instrument. This exists when there is an expectation that the value of the hedging instrument and the value of the hedged item will generally move in opposite directions because of changes of the hedged risk. Similarly, if an entity applies IAS 39, the hedge must be expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk. Therefore, financial statement preparers need to consider the extent to which the prospective effectiveness of the hedging relationship will be affected by the transition from EONIA to the €STR.

The IASB has already published relief (for phase 1) in relation to the prospective assessment of effectiveness. Under this amendment to IAS 39 and IFRS 9, an entity shall assume that the interest rate benchmark on which the cash flows for the hedged item or the hedging instrument are based are not altered, i.e. consider EONIA-based cash flows instead of €STR-based cash flows as long as there is uncertainty arising from the transition from EONIA to the €STR with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedged item or the hedging instrument²⁶.

3.5.2 Impact on retrospective effectiveness

Hedging relationships under IAS 39 are also required to be “highly effective” on a retrospective basis. To assess retrospective effectiveness, changes in the fair values of the hedged item and the hedging

²⁶ See [Project summary: interest rate benchmark reform – amendments to IFRS 9, IAS 39 and IFRS 7](#), IASB, September 2019.

instrument are determined based on actual market movements. These fair value changes must be in a range between 80% and 125% to qualify for hedge accounting. The hedged item and the hedging instrument can be affected by the EONIA to €STR transition in two ways: (i) by the transition of the floating rate option to the €STR²⁷, or (ii) by the transition of the discounting curve to the €STR. If the transition of the hedged item and the transition of the hedging instrument take place at different points in time or if the valuation is affected by the transition to the €STR, the fair values of the hedged item and the hedging instrument can differ as a result of the transition.

The working group noted in its letter to the IASB (see Annex) that the discontinuation of hedging relationships which only temporarily fail the “highly effective” requirement (80%-125% test) would cause the discontinuation of hedge relationships solely because of the BMR.

This matter was subsequently addressed by the IASB and respective amendments to the IFRS standards were published in September 2019²⁸. With the relief, an entity will not need to discontinue hedge accounting if the effectiveness of a hedge falls outside of the 80%-125% range during the period of uncertainty arising from the reform²⁹.

3.5.3 Impact on the measurement of ineffectiveness

Even if a hedging relationship meets the effectiveness requirements, the actual value changes of the hedged item or the hedging instruments may not completely offset each other. Therefore, measurement of the hedged item and the hedging instrument at fair value may give rise to ineffectiveness that is generally recognised in profit or loss. In the same way as for retrospective effectiveness testing, this may be the case when the modification of the hedged item and the modification of the hedging instrument take place at different points in time or when the valuation is affected by the transition to the €STR³⁰.

Recommendation:

- 5) The working group recommends that preparers of financial statements analyse the effect that a potential timing mismatch between the transition of the hedged item and the transition of the hedging instrument – as regards the switching of either the floating rate option or the discounting curve from EONIA to the €STR – would have on the effectiveness of the hedge relationship affected by the transition. In any case, preparers of financial statements should consider if the amendments introduced by the IASB to IFRS 9 and IAS 39 already cover this potential mismatch.

²⁷ I.e. when EONIA as reference rate for the determination or projection of current and future cash flows is replaced by €STR.

²⁸ See the IFRS Foundation’s press release entitled “IASB amends IFRS Standards in response to the IBOR reform”, 26 September 2019.

²⁹ See [Project summary: interest rate benchmark reform – amendments to IFRS 9, IAS 39 and IFRS 7](#), IASB, September 2019.

³⁰ The latter could occur in a fair value hedge relationship as it would affect the fair value changes of the hedging derivative but not necessarily those of the hedged component. Such a situation would give rise to ineffectiveness.

4 Hedge accounting impact analysis of €STR-based fallbacks for EURIBOR

A crucial difference between EURIBOR and EONIA is that EURIBOR will continue to be provided under the new methodology. The analysis of EURIBOR will therefore primarily focus on the implementation of new fallback rates for EURIBOR based on a €STR-based term structure methodology. This is important because the BMR requires EU supervised entities to produce and maintain robust written plans setting out the actions they will take in the event that a benchmark materially changes or ceases to be provided, including fallbacks provisions. This requires supervised entities to include a fallback for EURIBOR in their written plans and contracts where feasible and appropriate.

In the context of hedge accounting, new fallbacks to EURIBOR could have an impact for two main reasons.

- **Modification:** amending contracts to incorporate new fallback clauses could require derecognition of the instrument if it is deemed a substantial modification. This in turn could cause a discontinuation of the hedge relationship (see also Section 3.3 on modification of contracts).
- **Inconsistency:** if the hedged item and the hedging instrument contain inconsistent fallback language this could lead to ineffectiveness and cause a discontinuation of the hedge relationship.

While modification mainly affects legacy contracts, inconsistency could cause issues for both legacy contracts and new contracts. Before the hedge accounting impact analysis, this section provides a brief introduction to fallbacks, followed by an analysis on when and how potential inconsistencies could occur between different product classes that might use different fallback rates and/or triggers.

4.1 Introduction and scope

Incorporating fallback provisions in contracts that make use of reference rates is not only required under the BMR for certain entities and contracts, it should also be seen as sound practice for every user of these rates. Therefore, contracts containing references to market indices should contain suitable fallback arrangements that will apply in the event that the original reference index materially changes or ceases to be provided. These fallback rates will become effective if a fallback trigger event occurs. Such an event typically consists of official notice from the administrator or the competent regulatory authority that the index cannot be provided. The index fixing process itself often contains contingency safeguards and alternative procedures that are intended to provide index values if there are temporary disruptions to ordinary delivery, but these are not covered in this chapter.

Although EURIBOR was declared BMR-compliant by the FSMA on 2 July 2019 and will continue, a prudent approach should take the possibility of the non-availability of EURIBOR into account. This is also a requirement of the BMR and the International Organization of Securities Commissions. If EURIBOR materially changes or ceases to be provided, the corresponding fallback rates would become effective.

A €STR-based term structure to be used as a fallback for EURIBOR could be produced by applying either a backward-looking methodology (based on calculations using realised rates) or a forward-looking methodology (which includes expectations). The working group is analysing how to produce such €STR-based term structures³¹, analysing the possible coexistence of backward and forward-looking methodologies and which would be the most appropriate methodology for each financial product³². It is important to note that as of the time of writing, the working group is still undertaking evaluations and analyses with respect to fallback provisions and rates. Although this chapter focuses on fallbacks for EURIBOR, similar accounting implications apply for non-EURIBOR fallbacks.

4.2 Scenarios for fallback provisions and rates

Concrete fallback clauses contain a replacement rate together with an adjustment computation procedure and adjustment spread; the latter is in place to minimise the value transfer when shifting from the previous rate. When a fallback scenario is no longer seen as remote, the fallback arrangements will influence the affected instrument’s valuation in proportion to the perceived likelihood of transition.

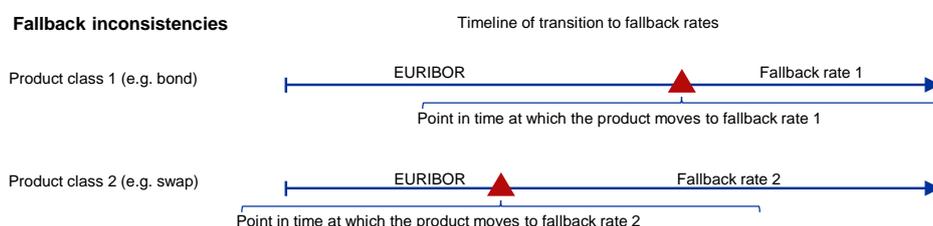
Different classes of instruments are normally subject to different contractual agreements. Therefore it could well be that, when introducing fallback agreements for EURIBOR-linked contracts, these agreements differ across product classes.

In addition, there may be inconsistencies in the timing of fallback trigger events. If explicit wording in contracts differs from the standard definition of potential trigger events, fallback provisions can in principle be triggered at different times for different products.

Figure 4 shows the two types of inconsistencies, in (i) fallback rate definition and (ii) timing of fallback transition. It is evident that a timing inconsistency can add to the discrepancy between different fallback rate definitions, increasing potential risks to hedging, hedge accounting and asset and liability management.

Figure 4

Potential main fallback inconsistencies between product classes



³¹ See [Terms of reference of subgroup on term rates of the working group on euro risk-free rates](#).

³² See [Terms of reference of subgroup 5 on cash and derivatives products of the working group on euro risk-free rates](#).

At present, working groups on risk-free rates in different jurisdictions are considering a multitude of possible fallback arrangements. In the United States, the Alternative Reference Rates Committee (ARRC) has published final recommendations for more robust LIBOR fallback language, differentiating between different product classes (namely bilateral business loans, floating rate notes, securitisations and syndicated loans, while adjustable rate mortgages are still in the consultation phase as of July 2019).³³ These recommendations try to strike a balance between flexibility in unforeseeable circumstances, appropriateness for the financial instruments in question and standardisation and alignment between underlying cash products and hedging derivatives.

Furthermore, on 20 December 2018 the International Swaps and Derivatives Association (ISDA) published an [Anonymized Narrative Summary of Responses to the ISDA Consultation on Term Fixings and Spread Adjustment Methodologies](#). The feedback from this consultation, covering some of the major currencies, supports a fallback for ISDA derivative contracts based on a “compounded in arrears” methodology. The ISDA is planning to launch a similar consultation covering EURIBOR fallbacks for ISDA derivative contracts.

The working group is considering a range of possible fallback approaches and their pros and cons, taking the Financial Stability Board (FSB) user guide³⁴ as a starting point as well as the experience and proposals of other working groups and industry bodies.

In view of the different work streams across major markets, it is possible that there could be different proposals for fallback arrangements applying across products and jurisdictions. This may lead to certain valuation differences, which could have implications for hedge accounting if the inconsistencies affect the items of a hedge relationship.

Recommendation:

- 6) From a financial accounting perspective, market participants should try to reduce variability in fallbacks between different product classes (including derivatives) to a minimum as this would reduce technical implementation challenges and accounting complexity. However this is ultimately a matter for parties to resolve, taking account of their individual circumstances.

An easy consideration in this recommendation is to reduce the details of fallback rate/computation diversity to the required minimum. For example, for the adjustment spread determination several different historical spread averaging mechanisms are being discussed. Establishing a common market practice is important as this would reduce technical implementation challenges and accounting complexity, but it is ultimately a matter for parties to resolve, taking account of their individual circumstances.

The possible effects of implementing a certain fallback can be quantified by estimating the effect on valuations of a concrete fallback provision. A key aspect here is the determination of the spread adjustment that will occur during the fallback transition. On the basis of such quantitative assessments, the possible valuation differences of different fallback rates can be compared to guide the selection of different fallback options.

³³ See “[Fallback Contract Language](#)”, ARRC.

³⁴ See “[Overnight Risk-Free Rates: A User’s Guide](#)”, FSB, June 2019.

4.3 Practical accounting implications of fallback provisions and rates

4.3.1 General accounting implications of fallback provisions and rates

The impact of €STR-based fallbacks for EURIBOR on accounting is twofold. First, inserting fallback clauses to existing contracts could affect the relevant IFRS modification requirements. Second, triggering existing fallbacks could cause valuation shifts that have a potentially greater impact on hedge accounting. While the former mainly affects legacy contracts, the latter could cause issues for both legacy contracts and new contracts. These two impacts are discussed below.

As outlined at the beginning of this chapter, amending a contract to incorporate new fallback clauses represents a modification of the contract. If this modification is considered substantial, it will probably result in derecognition and re-recognition of the modified financial instrument (see also Section 3.3). In the context of hedge accounting, this concerns both hedged items and hedging instruments. If either needs to be derecognised, there will be an impact on the hedge relationship, which would have to be de-designated and re-designated.

The same applies if an entity amends a derivative contract to avoid basis risk. For example, if the hedged item has already been triggered to its fallback rate and the entity amends the hedging instrument accordingly, this could imply a discontinuation of the hedge relationship.

By contrast, the triggering of an existing contractual fallback clause should not be considered a contractual modification, as the original contract already anticipated that a replacement could occur³⁵. Nevertheless, in some situations, applying such a contractual clause could imply a change in the instrument's value as a result of the shift from the old benchmark to the new one (e.g. if the contractual clause does not require equivalence of the two rates). However, this modification of the parameters (and of the expected cash flows) was already a contract provision and therefore should not lead to derecognition of the old and re-recognition of a new financial instrument with corresponding profit and loss catch-up effects³⁶. Potential effects of such value shifts on hedge effectiveness are discussed in the next subsection.

Once again, the working group emphasises its belief that, owing to the general goal of equivalence when (i) introducing a fallback rate in an existing contract, or (ii) shifting from a benchmark rate to its fallback rate, this change should be considered a substantial modification only when such equivalence is not fulfilled (for a more detailed discussion see Section 3.3 on modification of contracts). The rationale with respect to equivalence is based on the objectives of the EU benchmark reform. The replacement of one benchmark rate by another is not intended to change the character of the instrument³⁷. However, this view would have to be supported by the IASB.

If counterparties agreed to apply a fallback prior to the contractual trigger event (e.g. owing to liquidity concerns), this could give rise to modification accounting (see Section 3.3), which could

³⁵ For a detailed discussion on modification of contracts, please refer to Section 3.3.

³⁶ Profit and loss effects owing to value shifts would thus be limited to situations in which fallbacks of financial instruments measured at fair value through profit and loss are triggered.

³⁷ Rather, the purpose of this replacement is to increase confidence in the reliability and integrity of interest rate benchmarks by introducing new benchmark rates that are determined on the basis of a more robust and objective methodology.

trigger the discontinuation of existing hedge relationships. To avoid such modification issues, counterparties should assess the need for pre-cessation triggers before entering into a contract.

4.3.2 Hedge accounting implications of fallbacks and fallback inconsistency

As illustrated in Figure 3, hedge accounting could be affected by the BMR in three main ways³⁸:

- modification of contracts;
- changes in hedge documentation;
- hedge ineffectiveness (owing to inconsistent fallback language of hedged item and hedging instrument).

The question of whether contracts should be considered as substantially modified following the insertion of new fallbacks or the triggering of existing fallbacks has been discussed above. If a modification is deemed substantial, the hedging instrument and/or hedged item would have to be derecognised, which would imply discontinuation of the corresponding hedge relationship.

In addition to contract modification, it also needs to be assessed whether an adjustment of the hedge documentation to account for €STR-based fallbacks is necessary. If adjustments are required, this could result in de-designation and re-designation of respective hedge relationships.

A shift from EURIBOR to a contractual fallback rate could also be considered a change of the originally documented hedged risk. If the risk changed and the documentation needed to be amended accordingly, hedge de-designation and re-designation would typically require profit and loss recycling of amounts recorded in OCI because there are no longer probable cash flows based on EURIBOR^{39,40}.

Notably, even if the hedged risk remained unchanged (i.e. interest rate risk⁴¹), hedge accounting could still be affected by inconsistencies in fallbacks, something which can lead to hedge ineffectiveness. If hedged items and hedging instruments shift at different points in time due to inconsistent fallback triggers, this probably gives rise to (temporary) ineffectiveness. In addition to inconsistent fallback triggers within a hedge relationship, hedged items and hedging instruments could have different €STR-based fallback rates. Such mismatching could also cause ineffectiveness that might have to be analysed. As ineffectiveness could require the discontinuation of hedge relationships, entities should try to avoid mismatches in the future whenever possible.

Besides fallback inconsistency, ineffectiveness might also result from de-designation and subsequent re-designation of hedge relationships. If a hedge relationship needs to be de-designated (e.g. owing

³⁸ Furthermore, when a forecast transaction is designated as the hedged item, the hedged cash flows are required to be “highly probable”. As the IASB has already indicated a potential relief for the highly probable requirement (see [Exposure Draft ED/2019/1 on interest rate benchmark reform](#)) and published the respective amendments, this criterion is not discussed in more detail in this report.

³⁹ Alternatively, even if the hedge is discontinued, it could be argued that the OCI could still be reversed as far as new cash flows will impact profit and loss in the future.

⁴⁰ Although EURIBOR was declared BMR-compliant by the FSMA on 2 July 2019 and will continue, a prudent approach should take the possibility of the non-availability of EURIBOR into account.

⁴¹ The answer ultimately depends on how the hedged risk is defined in the hedge documentation and needs to be assessed by each entity individually.

to substantial contractual modification as a result of a new fallback clause), the subsequent re-designation will typically involve a hedging instrument with a non-zero fair value. Consequently, the effectiveness of the new hedge relationship deviates from 100% at inception, making hedge ineffectiveness more likely in the future.

According to the published amendments of IFRS 9 and IAS 39 (for phase 1), temporary relief is granted for prospective and retrospective effectiveness. In this way, entities are expected to be able to continue hedge relationships even if they are temporarily ineffective owing to uncertainty from the BMR (for details please refer to Section 3.5). Although the IASB published relief for effectiveness testing, profit and loss effects from hedge ineffectiveness could still occur.

The above deliberations have implicitly focused on pure euro hedge relationships, for example, a euro-denominated loan and a euro-denominated interest rate swap. However, similar considerations have to be made for other jurisdictions where IBOR reforms are taking place and to which entities have an exposure (e.g. via cross currency swaps).

Recommendation:

- 7) The working group recommends that preparers of financial statements take the following actions.
 - a) Analyse whether there might be fallback scenarios under which hedge relationships would need to be discontinued.
 - b) Consider incorporating a provision for replacing benchmark interest rates in their hedge documentations for new contracts. Consequently, the risk of hedge de-designations resulting from documentation adjustments could be reduced for new business.
 - c) Consider the risk of inconsistency when developing fallback provision triggers. This should be taken into account when amending existing contracts and setting up new contracts. The working group highlights the risk of hedge ineffectiveness and potential discontinuation of hedge relationships in the event of (i) having timing inconsistencies in fallback provision triggers, and (ii) incorporating different fallback trigger language for hedged items and hedging instruments.

The working group stresses the importance of the general goal of equivalence that should be fulfilled when more robust benchmark rate fallbacks are incorporated in contracts or when the new benchmark risk is accounted for in the adjusted documentation. Thus, it is the working group's view that for changes solely induced by the BMR, the replacement is actually made in order to maintain the original risk management objective and practice. However, this view would have to be supported by the IASB.

5 Potential (non-hedge related) accounting and financial reporting implications of the IBOR reform

The implications of the transition to new benchmark rates are wide reaching and extend beyond hedge accounting. These potential non-hedge related accounting and financial reporting implications that should be considered as part of the overall IBOR transition can be categorised into three areas (i) fair value measurement hierarchy; (ii) compensation mechanism considerations; and (iii) indirect dependency on reference rates in question.

Most of these implications are relevant at the point of transition to each new benchmark rate. The IASB has indicated that these replacement issues are being considered in phase 2 of its project on IBOR reforms, but there may also be implications for the period leading up to each transition. These pre-transition issues are specifically highlighted below where relevant. None of the items – pre-replacement or otherwise – are addressed in the recent IFRS amendments, which focus solely on providing relief for hedge accounting.

5.1 Fair value measurement hierarchy

IFRS 13 sets out the requirements for measuring financial assets and liabilities classified and measured at fair value. For the purposes of consistency and comparability in the measurement of fair value, the standard has established a fair value hierarchy that categorises the inputs to valuation techniques used to measure fair value into three levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical instruments that an entity can assess at measurement; level 2 inputs are inputs other than quoted prices included within level 1 that are directly or indirectly observable for the instrument; and level 3 inputs are unobservable.

The use of reference rates before or during the respective transition periods may have an impact on the level and valuation of financial instruments, for example when a reference rate forward curve can no longer be generated for the life of an instrument. Similarly, beyond respective transition periods, where there is a dependence on quotations of legacy reference rates when pricing legacy instruments, the liquidity of such rates may fall, in particular if the quotations are not in an active market. In each of these scenarios, IFRS 13 may deem these as unobservable inputs for valuation purposes and, as such, judgement will be required as to whether the resulting valuations should be classified as level 2 or 3.

While re-categorisation is a potential issue for other transitioning reference rates, this will probably not be the case for the EONIA to €STR transition. EONIA has been firmly linked to the €STR by a fixed spread of 8.5 basis points since October 2019, and this link is expected to be established along the term structure⁴². This means that during the transitional phase, the €STR curve can be derived from

⁴² See the annex to the working group's [report on the risk management implications of the transition from EONIA to the €STR and the introduction of €STR-based fallbacks for EURIBOR](#).

the EONIA curve (and vice versa). As such, liquidity is expected to be shared between both markets. It could therefore be argued that this shared liquidity pool effectively ensures the forward curves derived from either rate will remain sufficiently observable to continue to meet the requirements of a level 2 input for IFRS 13 purposes, assuming that there are no other interfering factors. But this judgement is ultimately comes down to an entity's accounting policy.

Recommendation:

- 8) Where EONIA or EURIBOR-based valuation curves are replaced by the €STR curve or a curve based on a €STR-based term structure methodology, the working group recommends that preparers of financial statements assess the potential impact of a change in value for financial instruments measured at fair value on the day of transition.

5.2 Compensation mechanism considerations

Derivatives represent financial instruments classified and measured at fair value through profit or loss and their value is determined by their mark-to-market (MTM). This value may change when IBORs transition.

For the transition from EONIA to the €STR, the working group has recommended changing the collateral remuneration rate in credit support annexes. This repapering from EONIA to the €STR will result in a change in the discounting curve used for the valuation of derivatives. This change will give rise to an immediate impact on profit or loss for the parties to the derivative. To avoid an inadvertent value transfer between parties, the working group recommends introducing a compensation mechanism to offset the economic gain or loss caused by the transition. One potential mechanism involves the payment of cash by the benefiting party, at an amount equal to the valuation change, to the party suffering an economic loss from the transition.⁴³ The offsetting impact of the change in value and the payment of cash compensation ensure that there is no economic value transfer for either party (i.e. the net profit and loss effect should be zero).

If preparers of financial statements use cash compensation to offset the gain or loss in MTM movement attributable to the €STR transition, it is the opinion of the working group that such payments should be recognised in the statement of profit or loss. While there is no explicit guidance in IFRS standards, cash payments or receipts of this nature meet the definition of expenses and income, respectively, in the IFRS Conceptual Framework⁴⁴. But this judgement is ultimately a matter of an entity's accounting policy.

⁴³ See the [Report by the working group on euro risk-free rates on the impact of the transition from EONIA to the €STR on cash and derivatives products](#).

⁴⁴ In the Framework, the definition of "expenses" encompasses losses (F 4.33), and these losses represent other items that may, or may not, arise in the course of ordinary activities of an entity (F 4.34). The definition of income encompasses both revenue and gains (F 4.29), and these gains may, or may not, arise in the course of ordinary activities of an (F 4.30).

5.3 Indirect dependency on reference rates in question

As well as analysing exposures with a direct dependency on the reference rates in question, market participants should also assess indirect dependencies to these rates. Indirect dependency occurs when products are not explicitly linked to reference rates, but rather rely on the reference rate for fair value measurement or for discounting purposes.

There are a number of potential areas where reference rates are used for fair value measurement and where discount rates are used in IFRS. Accordingly, changes in the measurement of assets and liabilities could have an impact on profit and loss. The appropriate treatment of such measurement changes is governed by IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors. The standard states that a change in accounting policy is applicable only where the change is explicitly required by an IFRS Standard, or where it results in the financial statements providing more reliable and relevant information about the effects of transactions, other events or conditions on the entity's financial position, performance or cash flows (IAS 8.14(a) and (b)). Alternatively, a change to an estimate may be needed if changes occur in the circumstances on which the estimate was based, or as a result of new information or more experience (IAS 8.34). Changes owing to IBOR reform arise as a direct consequence of a market-wide recommendation to reform major interest rate benchmarks, and can reasonably be considered as changes in the circumstances on which the estimates were based.

Impacts that are deemed to relate to changes in an estimate do not require retrospective application. During the reporting period in which the change in an estimate occurs, the carrying amount of the relevant asset or liability should be adjusted and the gain or loss recognised in profit or loss. Any material changes in an accounting estimate that have an impact on the current period or are expected to have an impact on future periods should be disclosed (IFRS 9, IAS 8, IAS 39).

The below represents a non-exhaustive list of areas where reference rates may be used for fair value measurement or discounting purposes in IFRS standards.

- IAS 19 – Employee Benefits: defined benefit obligations are measured on the basis of present value of estimated ultimate cost. This valuation should be updated for any material transactions or changes in circumstances (interest rates are specifically referenced).
- IAS 36 – Impairment of Assets: the “value in use” measurement basis is used for the impairment assessment of non-financial assets when the recoverable amount is value in use. Market interest rates are identified in IAS 36.12(c) as one of several external sources of information an entity should consider when assessing whether there are any indicators of impairment.
- IAS 37 – Provisions, Contingent Liabilities and Contingent Assets: provisions are measured at the best estimate of the amount to settle or transfer the item. Where the effect of the time value of money is material (paragraph 45), the amount of a provision should be the present value of expected expenditure required to settle the obligation. If one reference rate is used to discount expected cash outflows in a future period, the transition to another reference rate may have an impact.
- IFRS 15 – Revenue from Contracts with Customers: significant financing components in contracts with customers that arise when an entity receives consideration more than a year before or after it transfers goods or services to the customer must be adjusted at the reporting date using the interest

rate implicit in the contract. If this interest rate is anchored to one reference rate transitioning to another reference rate, there may be a profit and loss impact to account for.

- IFRS 4/ 17 – Insurance Contracts: the measurement of insurance guarantees in insurance contracts may rely indirectly on one reference rate, so the transition to another reference rate may have a profit and loss impact on the transition.
- IFRS 9 – Financial Instruments: if the discount factor used in the expected credit loss (ECL) collective-assessment modelling process references one reference rate, this may have an impact on the transition to another reference rate, with an impact on both the P&L charge and the amount of ECL reported on the balance sheet.
- IFRS 16 – Leases: a lease modification could occur under IFRS 16 if there are variable lease payments linked to a reference rate. Depending on whether operating or finance leases are affected by the BMR, an assessment of substantial modification is required, which could result in derecognition and re-recognition of the lease (IFRS 9, IFRS 16, IFRS 87).
- IAS 12 – Taxation (in conjunction with interpretations by the IFRS Interpretations Committee): each jurisdiction needs to consider the taxation implications associated with triggers arising from the transition to new benchmark rates. These include the potential deductibility for taxation purposes of profit and loss losses arising from the transition, as well as material amendments to a contract that may constitute a disposal of an existing contract and entering into a new one for corporation tax purposes.

6 Annex: Working group letter to the IASB

The [letter sent from the WG to the IASB](#) is available on the webpage of the working group on risk-free rates (please find it below).

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Standard setting agenda – Euro overnight interest rate reform

15 July 2019

Dear Mr Hoogervorst,

In September 2017 the European Central Bank (ECB), the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission announced the launch of the industry Working Group on Euro Risk-Free Rates (WG Euro RFR). The working group was tasked with identifying and recommending risk-free rates that could serve as an alternative to EONIA and EURIBOR used in a variety of financial instruments and contracts in the European Union¹, and developing adoption plans. Within the WG Euro RFR, a subgroup analyses risk management and accounting issues in relation to the adoption of alternative risk-free rates. I am writing to you in my capacity as chair of the WG Euro RFR.

The purpose of this letter is to inform the International Accounting Standards Board (IASB) of the objective and status of the reform agenda regarding interest rates in the euro area (Euro reform agenda) and to express some concerns in relation to potential accounting issues triggered by the reform based on the analysis of the potential IFRS accounting issues, as detailed in Appendix 1 to this letter.

The Euro reform agenda focuses on the replacement of EONIA by the recommended euro risk-free rate €STR, which will be published by the ECB starting on 2 October 2019. The rationale for the replacement is that the underlying transaction base of EONIA, in its current form, is thin, and therefore EONIA's compliance with the EU Benchmarks Regulation cannot be guaranteed².

To support the market-wide transition from EONIA to the €STR, and to ensure an orderly and time-limited process, the WG Euro RFR has recommended a transition path that has been widely adopted by the relevant stakeholders.

Key elements of the transition from EONIA to the €STR are: (a) the existence of a transition period, which will start on 2 October 2019 and end on 31 December 2021, with the consequent cessation of

¹ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html

² Please refer to Appendix 2 for further information on the €STR, the relationship between EONIA and the €STR, and the transition period.

publication of EONIA on 3 January 2022; and (b) the dependency of EONIA on the €STR during the transition period, as EONIA will become the €STR plus a fixed spread of 8.5 basis points; the spread is necessary to avoid any basis risk between the two rates.

During the transition period, market participants must migrate their relevant business activities and relevant valuation infrastructure from EONIA to the €STR for those financial instruments and contracts that mature after this period. For financial instruments and contracts that mature during this period, migration is possible. This could have an impact on cash flows of EONIA-based instruments and net present values, since EONIA plays a pivotal role in the valuation of financial assets and liabilities for many market participants.

The transition may have a further impact on the financial accounting of the relevant market participants and could lead to undesirable accounting volatility and not provide useful and relevant information on the performance of the institutions. Consequently, the market-wide implementation of the €STR as the new reference rate could be impeded.

The working group has identified critical accounting issues with respect to the following:

- Modification of contracts
- Derecognition of hedged items or hedging instruments
- Replacement of hedging instruments
- Documentation of hedging relationships
- Ineffectiveness of hedging relationships

The WG Euro RFR asks the IASB to consider further clarifications and relief in respect of the above accounting issues, which arise solely on account of the replacement of EONIA with the €STR. The issues are described in more detail in Appendix 1 to this letter.

The working group highly appreciates the IASB's standard-setting process in support of the reforms to the interbank offered rate and the current exposure draft (phase 1), and stresses the urgency to start phase 2, especially since the transition of EONIA to the €STR will become effective on 2 October 2019³.

Please do not hesitate to contact us should you have questions or if the IASB requires further information for the upcoming deliberations on phase 2 of the standard-setting process.

Yours sincerely,



Steven van Rijswijk
Chair of the Working Group on Euro Risk-Free Rates

³ Please refer to Appendix 2 for more background on the transition period from EONIA to the €STR.

Appendix 1: Accounting issues arising from EONIA-€STR reform

The WG Euro RFR appreciates the IASB's view that the discontinuation of hedge accounting solely due to uncertainties before the reform's economic effects are known would not provide useful information to users of financial statements. As proposed in ED/2019/1, relief would enable entities to continue with the hedging relationships during phase 1. However, the Exposure Draft proposes that relief related to the highly probable and prospective assessment requirements will cease to apply when the interest rate benchmark reform uncertainty is no longer present. Since uncertainty on the transition from EONIA to the €STR could somehow be considered to have dissipated, a clarification on this specific situation would be needed.

The transition from EONIA to the €STR is fast approaching, affecting hedging relationships impacted by the benchmark interest rate reform that were continued under the relief from phase 1. More specifically, once entities have amended existing contracts so that they refer to the €STR instead of EONIA, we understand that entities are faced with "replacement issues", which the IASB seeks to address in phase 2. Since the transition from EONIA to the €STR will start in October 2019 with a fixed spread, which has already been defined, we would like to highlight the urgency of starting phase 2 in parallel with the finalisation of the amendments proposed in the Exposure Draft.

Modification of Contracts

As discussed above, a critical issue triggered by the transition from EONIA to the €STR is the resulting change in contracts that reference EONIA. Such changes could require entities to assess whether the modifications made should be considered substantial or non-substantial modifications to the contractual terms, potentially leading to derecognition and re-recognition of contracts and resulting in significant volatility on the income statement.

The large number of contracts impacted by the transition creates significant operational challenges owing to the need to analyse each contract individually. If preparers of financial statements could perform such analyses on an aggregate rather than an individual level, it would lessen some of the challenges caused by the interbank offered rate and Euro reform agenda. However, such relief would require the IASB to make related changes to IAS 39 and IFRS 9.

More generally speaking, we recommend the IASB address the issue of modifications of contracts and the potential risk of derecognition owing to the interbank offered rate and the Euro reform agenda, and provide financial statement preparers with specific guidance on how to treat changes to contracts driven by the reforms in the light of the existing IASB guidance on modifications of floating-rate instruments.

This guidance could also consider the following:

- there is a general goal of equivalence when shifting from a benchmark to its fallback rate (including the introduction of a fallback rate for an existing contract) and therefore the change should be considered a modification only when such equivalence is not fulfilled;
- whether applying the existing guidance on changes in cash flows (IFRS 9.B5.4.5/IAS 39.AG7) to a change from one overnight rate to its successor overnight rate (i.e. market-wide transition from EONIA to the €STR) would provide more useful information to the readers of the financial statements.

Discontinuation of hedging relationships

There are several circumstances under which a hedging relationship might need to be discontinued. This applies to both cash flow hedges and fair value hedges (including portfolio hedges). In the context of the transition from EONIA to the €STR, issues that require further consideration include:

- Derecognition of a hedged item or hedging instrument

If either the hedged item or the hedging instrument were to be derecognised, hedge accounting would have to be discontinued. We refer to the above regarding the potential impact owing to the amendment of existing contracts.

- Replacement of a hedging instrument

If an entity replaces an existing EONIA-based hedging instrument with a €STR-based hedging instrument, no issue should arise if the entity has already provided for the rollover of the hedging instrument in the hedge documentation. However, many entities will have drawn up hedge documentation before the replacement of EONIA was announced and did not foresee any need for a rollover at inception of the hedge. While the replacement of a hedging instrument that was not foreseen under the hedge documentation would usually indicate that the original risk management objective has changed, this is not true if the replacement has to be made in response to the market-wide replacement of EONIA with the €STR. On the contrary, the replacement is actually made in order to maintain the original risk management objective. Against this background, it appears reasonable to treat replacements of hedging instruments made solely in response to the EONIA/€STR reform in a similar way to rollovers foreseen in the hedge documentation.

- Documentation of the hedging relationship

Once EONIA is replaced by the €STR in legacy contracts maturing after 31 December 2021, in addition to the rollover of hedging instruments, there will likely be further effects on hedge documentation that did not foresee the replacement of EONIA and accordingly made no reference to the €STR. An update to the hedge documentation regarding the €STR could be viewed by some as a substantive amendment, giving rise to the discontinuation of the hedging relationship. However, as with the reasoning above, the update is made in response to the market-wide transition to the €STR and is not being made to reflect a change in the underlying risk management objective, which is still the same.

- Ineffectiveness of the hedging relationship

Under IAS 39, hedging relationships are required to be “highly effective”. Entities need to demonstrate they meet this requirement by conducting frequent prospective and retrospective effectiveness tests (80%-125% test).

However during the period of transition from EONIA to the €STR (from 2 October 2019 to 31 December 2021), hedging relationships might face (additional) prospective and/or retrospective ineffectiveness. This might be the case, in particular, in situations where the modification of the hedged item and the hedging instrument take place at different points in time or where the valuation is affected by the transition to the €STR (see Appendix 2 on valuation).

The discontinuation of hedging relationships that only temporarily fail the “highly effective” requirement (80%-125% test) would contradict the IASB’s effort relating to the relief for prospective effectiveness testing made in ED/2019/1. In order to be consistent with the objective in the Exposure Draft, similar relief is required as regards the retrospective effectiveness test (80%-125% test) under IAS 39.

In all cases, discontinuation of a hedging relationship in response to the transition from EONIA to the €STR could have an impact on releasing amounts previously recognised in other comprehensive income for cash flow hedges, with potentially significant effects on profits or losses, or the amortisation of hedge adjustments for fair value hedges, as the case may be. Discontinuation of a hedging relationship is clearly appropriate if the original risk management objective has changed. However, the transition from EONIA to the €STR does not substantially change an entity's original risk management objective but happens in response to the market-wide transition driven by the EU Benchmarks Regulation. Thus, the discontinuation of hedging relationships that is caused solely by the transition from EONIA to the €STR would not provide useful information to users of financial statements. We therefore request the IASB provide further clarification and relief, in the same manner as proposed in ED/2019/1, that the replacement from EONIA to the €STR should not trigger a discontinuation of a hedge relationship that is not otherwise amended.

Appendix 2: The transition from EONIA to the €STR

1. The Euro reform agenda

The most widely used interest rate benchmarks for euro-denominated financial contracts are the euro interbank offered rate (EURIBOR) and the euro overnight index average (EONIA). Both are based on the unsecured interbank market and administered by the European Money Markets Institute (EMMI). EURIBOR is a quote-based interest rate benchmark, available for several tenors. EONIA is the overnight reference rate for the euro computed on the basis of real transactions in the interbank market. Furthermore, the two benchmarks have also been designated as critical by the European Commission, which makes them subject to specific provisions, notably regarding the modalities for their supervision⁴.

Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts was published in 2016 and became effective in 2018. EONIA and EURIBOR have been undergoing in-depth reform led by EMMI, aimed at bringing both benchmarks into compliance with the new EU Benchmarks Regulation:

- (1) EURIBOR has been reformed to become EU Benchmarks Regulation-compliant under a new “hybrid” methodology, which will be fully implemented by the end of 2019. Authorisation by the FSMA, EMMI’s supervisor, was granted on 2 July 2019.
- (2) In contrast, EONIA will be discontinued at the end of 2021 and replaced by the new euro short-term rate (the €STR) as recommended by the WG Euro RFR in September 2018.

2. The focus of the Euro reform agenda is the replacement of EONIA

In September 2018, the WG Euro RFR recommended that the €STR becomes the successor of EONIA⁵. Both the €STR and EONIA rely on transactions from the euro-denominated overnight unsecured money market segment. However, they differ in several ways:

- (1) EONIA is administered by the EMMI, while the €STR will be administered by the ECB.
- (2) EONIA relies on voluntary data input by panel banks⁶, whereas the ECB’s new rate will be built on the daily data submissions of the banks reporting in accordance with the money market statistical reporting (MMSR) Regulation⁷.
- (3) EONIA is a weighted average rate of the submitted contributions; the €STR relies on individual transactions rather than on a single contribution per bank.
- (4) The €STR is based on unsecured overnight borrowing deposit transactions, while EONIA is calculated using unsecured overnight lending transactions⁸.

Table 1 provides a comparison of the two overnight rates and their underlying characteristics. As can be inferred from Table 1, the €STR relies on a larger volume of transaction data and is less volatile. This makes the €STR less vulnerable to outliers⁹ and thereby a more robust overnight interest rate.

⁴ For the Terms of reference of the Euro RFR Group (2018), see:
https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk_free_rates/shared/pdf/2017_11_29_terms_of_reference.pdf

⁵ <https://www.ecb.europa.eu/press/pr/date/2018/html/ecb.pr180913.en.html>

⁶ <https://www.emmi-benchmarks.eu/euribor-eonia-org/about-eonia.html>

⁷ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/html/index.en.html

⁸ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/euro_short-term_rate/html/ester_qa.en.html

⁹ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk_free_rates/shared/pdf/20180711/2018_07_11_WG_on_euro_RFR_meeting_Item_3.2_ECB_Presentation_on_EST_ER.pdf

Table 1: Characteristics of EONIA and €STR

	EONIA	€STR
Economic interest of index	The rate reflects overnight unsecured lending in the interbank market in the European Union and the European Free Trade Association (EFTA)	The rate reflects the unsecured wholesale euro overnight borrowing cost of euro area banks
Methodology	Volume-weighted average rate of lending transactions reported by EONIA panel banks	Volume-weighted average rate of transactions reported to the ECB in accordance with money market statistical reporting (MMSR) requirements
Representativeness of index	Panel-based bank lending	Non-panel-based bank borrowing
Average daily volume (15 Mar 2017 to 16 Apr 2019)	€4.8 billion	€32.9 billion
Lowest daily volume (15 Mar 2017 to 16 Apr 2019)	€0.5 billion	€16.4 billion
Number of reporting agents (€STR) or trading participants	28	52
Average number of banks reporting daily volume	10	32
Average number of countries represented	5	9
Performance during periods of market stress	Known to market participants	Not yet known to market participants
Standard deviation of day-to-day changes (15 Mar 2017 to 16 Apr 2019)	0.7 basis points	0.4 basis points
Publication day and time	Same day by 19:00 CET	Next day by 09:00 CET
Nature of administrator	Non-profit-making association; non-panel bank fees apply as per EMMI data subscription service package	Central bank; data to be freely available
Availability of historical data	Since January 1999	Since August 2016

3. Transition phase: fixed spread between EONIA and the €STR

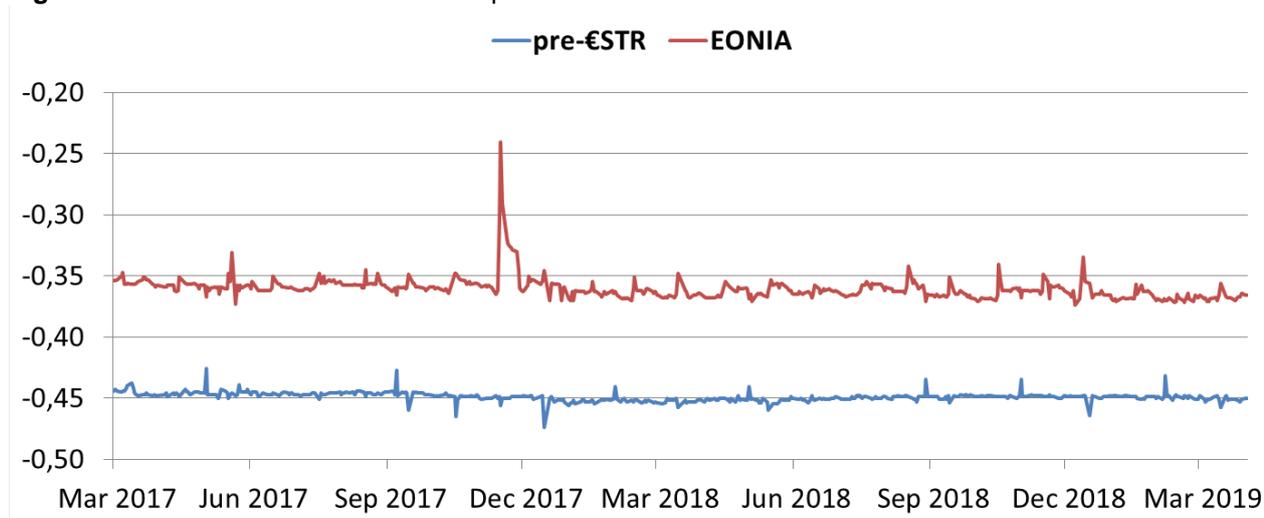
Publication of the €STR by the ECB will start on 2 October 2019 with transaction data from 1 October. For a smooth transition from EONIA to the €STR, there will be a transition period until 31 December 2021. During this period EONIA will be calculated as the €STR plus a fixed spread of 8.5 basis points. Under this new methodology, the reformed EONIA will probably become EU Benchmarks Regulation-compliant and will continue to be published by EMMI until 31 December 2021.

The ECB has provided a one-off computation of the spread between the €STR and EONIA at 8.5 basis points, based on the methodology recommended by the WG Euro RFR¹⁰:

- (1) Calculation of the daily spread between EONIA and the pre-€STR for the most recent year of publicly available pre-€STR data (from 17 April 2018 until 16 April 2019);
- (2) Ordering of the spread series from the lowest to the highest spread;
- (3) Removing exactly 15% of observations from the top and from the bottom of the sorted series (with a partially weighted inclusion of the observations at the border, if relevant);
- (4) Calculation of the arithmetic average of the remaining 70% of observations.

Figure 1 shows the two time series of EONIA and the pre-€STR and gives an indication of their relative stability over time¹¹:

Figure 1: Time series of EONIA and the pre-€STR¹²



4. Potential accounting implications during the transition period

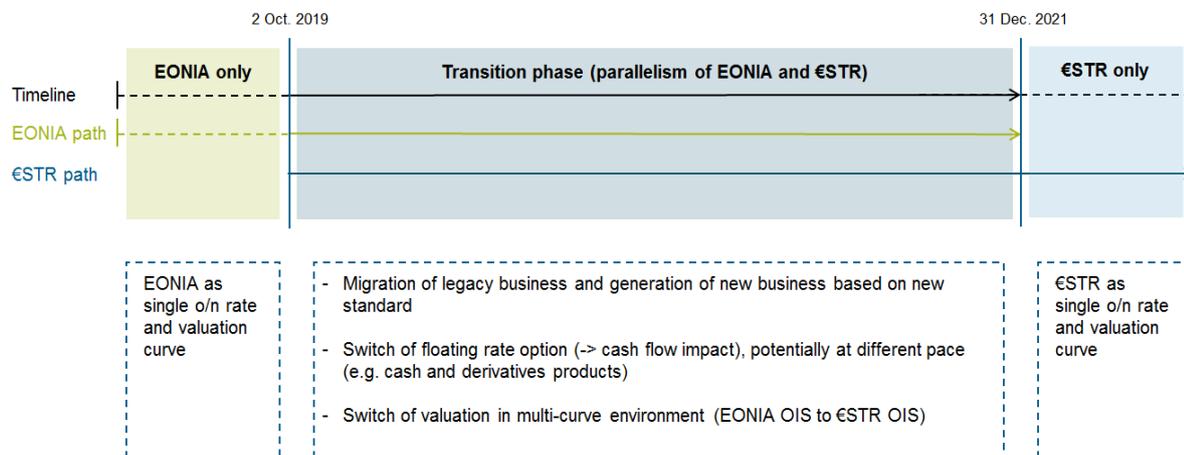
The two-year transition period serves to avoid market disruptions and provide market participants with the opportunity to migrate legacy business from EONIA to the €STR. The following figure illustrates the transition phase:

¹⁰ <https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190314~28790a71ef.en.html>

¹¹ The pre-€STR is calculated using the same methods as defined for the €STR (https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/html/index.en.html)

¹² Data source: Bloomberg.

Figure 2: Illustration of the transition period from EONIA to the €STR:



The switch from EONIA to the €STR could affect financial accounting in two main ways:

- (1) Cash flow impact: financial contracts maturing after 2021 and containing a reference to EONIA (e.g. EONIA as the relevant interest rate or underlying of derivatives) need to be adjusted. EONIA will be replaced by the €STR in these contracts.
- (2) Valuation impact: the calculations of the fair value of financial assets and liabilities using an EONIA-based valuation curve to discount future cash flows need to be adjusted. For fair value calculations, an EONIA-based discount curve will be replaced by an €STR-based discount curve (i.e. switch of valuation curve).

While the cash flow impact would affect only those institutions that have EONIA-linked contracts in their portfolios, the valuation impact would affect all institutions that use an EONIA-based discount curve for valuing their euro-denominated financial products, even those without EONIA-linked legacy business.

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Postal address 60640 Frankfurt am Main, Germany

Telephone +49 69 1344 0

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For most of the specific terminology, please refer to the [ECB glossary](#).