Disclaimer

This document has been discussed at the 22nd meeting of the National Working Group on CHF Reference Rates (NWG). The NWG is the key forum to foster the transition to SARON and to discuss the latest international developments. The NWG will cease to exist once the transition to SARON is materially completed. The NWG is co-chaired by a representative of the private sector and a representative of the Swiss National Bank (SNB). The SNB supports the NWG by co-chairing the working group alongside a representative from the private sector. The NWG publishes recommendations based on consensus. Recommendations are not legally binding. The SNB acts as a moderator. Furthermore, the SNB runs the NWG's technical secretariat and facilitates the organisation of the meetings. In this capacity, the SNB also publishes on its webpage documents discussed by the NWG such as this document. The items published do not necessarily reflect the views of the SNB.

This document provides an assessment of the open issues with respect to the effects on financial reporting.

IBOR TO RFR TRANSITION: EFFECTS ON FINANCIAL REPORTING[1]

Key Facts

- The IBOR transition is affecting financial reporting. US GAAP and IFRS are influenced more by the transition from IBOR to RFR compared to SWISS GAAP FER.
- Most directly affected is hedge accounting, which aims to avoid artificial earnings volatility. This might occur if value changes in the hedging instrument and hedged item are recognized in different reporting periods.
- A transition from IBOR to RFR without an amendment to existing accounting rules might lead to an increase in earnings volatility due to de-designation of hedge accounting relations.
- Related to IFRS: In May 2019, the IASB issued an exposure draft that reliefs these earnings volatility concerns. Entities can assume existing IBOR-based contractual terms for assessing the hedge accounting requirements.
- Related to US GAAP: A change in a contract's reference rate as a result of the IBOR transition would not create a new contract but would be accounted for as a continuation of that contract. Specifics on hedge accounting will be addressed in a future board meeting.
- Cash flow hedge accounting allows some flexibility in payment dates of the hedging instrument and the hedged item. This will be an important feature with alternative RFRs.

Abbreviations

ASC: Accounting Standards Codification
FASB: Financial Accounting Standards Board
IAS: International Accounting Standards
IASB: International Accounting Standards Board
IBOR: Interbank Offered Rate
IFRS: International Financial Reporting Standards
LIBOR: London Interbank Offered Rate
RFR: Risk-free rate
SARON: Swiss Average Rate Overnight
SWISS GAAP FER: Swiss Accounting and Reporting Recommendations
US GAAP: United States Generally Accepted Accounting Principles

Executive Summary

The IBOR transition is affecting financial reporting mainly in relation to the accounting choice ‘hedge accounting’. Hedge accounting aims to avoid artificial earnings volatility, which might occur if value changes in the hedging instrument and the hedged item are recognized in different reporting periods.

US GAAP and IFRS are influenced more severely by the transition from LIBOR to new reference rates than SWISS GAP FER, given that the latter is a very principle-based set of standards. Regarding IFRS and US GAAP, the main concern is an increase in earnings volatility before (phase 1) and after (phase 2) transition from IBOR to new reference rates. Increased earnings volatility could occur as a result of de-designation of hedge accounting relations where fair value hedge adjustments are amortized and the cash flow hedge reserve is reclassified to profit and loss (P&L). De-designation could happen if the

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requirements of the prospective assessment & 'highly probable' (under IFRS) and 'highly effective' assessment (under US GAAP) are no longer met with the new benchmark. Subsequent use of IBOR-derivatives might increase earnings volatility due to measurement at fair value through P&L absent hedge accounting, or by hedge accounting re-designation with non-zero fair values. Basis risk, i.e., when the timing of the transition of the hedging instrument does not match the timing of the transition of the hedged item, is perceived as a further issue.

In response to these concerns, the IASB issued the exposure draft ED/2019/1 in May 2019[2]. It gives concrete guidance on the proposed relief for concerns that may arise leading up to the IBOR transition. When assessing the likelihood that a forecast transaction will occur, an entity can assume that the IBOR-based contractual terms will remain unchanged. Further, an entity can base the hedge effectiveness assessment on existing contractual cash flows from the hedging instrument and the hedged item. An entity will be allowed to continue hedge accounting where an IBOR risk component met the separately identifiable requirement at the inception of the hedging relationship. An entity should cease to apply the proposed relief when the nature and timing of the designated future cash flows are certain and should apply the proposed amendments retrospectively. The proposed effective date of the amendment is 1 January 2020 with earlier application permitted. Specific disclosures about the extent to which the proposed relief is applied will be required. The FASB tentatively decided in June 2019 that a change in a contract's reference rate as a result of the IBOR transition would not create a new contract but would be accounted for as a continuation of that contract. Hedge accounting will be addressed in a future meeting.

1 Institutional Background: Three Accounting Regimes

In Switzerland, the National Working Group (NWG) recommended in 2017 the Swiss Average Rate Overnight (SARON) as the alternative to the Swiss franc Libor. SARON is a secured overnight rate based on the most liquid segment of the Swiss franc money market.[3] With the change from LIBOR to SARON, many different business areas are affected. Financial reporting of financial instruments is one of them. Given the business environment in Switzerland[4], three accounting regimes with specific hedge accounting rules are of interest regarding the IBOR transition: IFRS (relevant standard: IAS 39 and IFRS 9), US GAAP (relevant standard: ASC 815), and Swiss GAAP FER (relevant standard: FER 27).

Under IFRS and US GAAP, there are two general ways to account for hedging relationships. For fair value hedges, value changes of the hedged item are recognized in P&L symmetrically with those of the hedging instrument. For cash flow hedges (and hedges of a net/foreign investment), effective value changes of the hedging instrument are parked in equity and recycled to P&L when the value changes of the hedged item affect earnings. Both regimes require comprehensive qualification criteria to designate hedge accounting. Requirements are for example related to the prospective assessment of hedge effectiveness, a 'highly probable' hedging relationship, and the related documentation. Some differences remain between IFRS 9 and ASC 815, e.g., whether a benchmark has to be recognized, in the quantitative limits of qualification criteria, and in the accounting for ineffectiveness of hedge accounting relationships.

[2] The exposure draft published on 3 May 2019 is available here: https://www.ifrs.org/-/media/project/ibor-reform/ed-ibor-reform-may-19.pdf?la=en (15 May 19).
[3] 111th Annual Report, Swiss National Bank, 2018, p.52., see https://www.snb.ch/en/mmr/reference/annrep_2018_komplett/source/annrep_2018_komplett.en.pdf (9 Apr 19).
[4] See https://www.iasplus.com/en/jurisdictions/europe/switzerland (17 May 19): Most Swiss companies whose equity shares are listed on the main board of the Swiss Exchange are required to use IFRS or US GAAP. However, listed Swiss companies that operate primarily in Switzerland may also choose Swiss GAAP FER.

Swiss GAAP FER is a principle-based standard with few detailed rules. FER 27 does not include a definition of what constitutes a hedging relationship. The interpretation and application of FER is discussed and evaluated in expert rounds and consequently closely aligned with industry practice standards.

In the following, a more detailed institutional background on hedge accounting per regime is provided.

1.1 IFRS

Under IFRS, two standards are of interest related to hedge accounting, IAS 39 and IFRS 9. IFRS 9 *Financial Instruments* is the new set of rules for hedge accounting issued on 24 July 2014 and effective since 1 January 2018. Macro hedge accounting, which is particularly important to banks, was decoupled from IFRS 9. Therefore, when an entity first applies IFRS 9, it may choose to continue the application of the hedge accounting requirements of IAS 39 instead of the requirements of IFRS 9. The IASB currently is undertaking a project on macro hedge accounting[5] (so-called: Dynamic Risk Management), which is expected to eventually replace these sections of IAS 39.

To qualify for hedge accounting, IAS 39 requires three main criteria (IAS 39.88):

1. Relationship needs to be designated and documented as hedging at the inception of the hedge
2. Hedging relationship needs to pass a test for prospective hedge effectiveness
3. "Highly probable" that the hedge takes place

The hedge accounting rules under IAS 39 and IFRS 9 aim to provide the link between an entity's risk management strategy, the rationale for hedging, and the impact of hedging on the financial statement. Main differences of hedge accounting under IAS 39 and IFRS 9 are the following:

	IAS 39	**IFRS 9**
Hedged items	• Designation of non-financial items in its entirety for all risks or for foreign currency risks • No designation of derivatives	• Hedging of a risk component of financial and non-financial items • Designation of aggregated exposure (combination of derivative and non-derivative financial instruments)
Hedging instruments	• More restrictions regarding designation of hedging instruments for a hedge relationship	• Less restrictions: all financial instruments measured at fair value through P&L can be designated
Effectiveness testing	• Two stage procedure: prospective and retrospective testing • Effectiveness range: 80% - 125% • De-designation if out of effectiveness range	• Solely prospective testing • Omission of quantitative limits • Rebalancing if hedge relationship ceases to meet hedge effectiveness relating hedge ratio

Most important to the benchmark transition is the change in effectiveness testing. In practice, many companies have regularly complained that the two-stage procedure to test for effectiveness including both a prospective and a retrospective test plus fulfilling the effectiveness range of 80%-125% is a huge

[5] See https://www.iasplus.com/en/standards/ias/ias39 (9 April 19).

impediment to apply hedge accounting. Under IFRS 9, the effectiveness test solely contains a prospective and qualitative test with the quantitative thresholds completely being eliminated.

Hedge Accounting further requires a comprehensive set of disclosures following IFRS 7 §§ 22-24, (§ 33). In general, two types of disclosures are required: (1) significance of financial instruments (other disclosure), (2) nature and extent of risk arising. Given the high discretion in the application of the standard, transparency on a firm's hedging activities differs substantially.

1.2 US GAAP

Under US GAAP, ASC 815 (last amendment: 2017-12) the basic accounting is the same to IFRS. However, contrasting IFRS 9[6], US GAAP ASC 815 holds on to quantitative limits as criteria to qualify for hedge accounting. Hedging relationships are required to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk. The term "highly effective" has been interpreted in practice as the change in fair value or cash flows of the designated component of the hedging instrument is within 80% to 125% of the change in fair value or cash flows of the designated proportion of the hedged item attributable to the risk being hedged.

Under US GAAP, ineffectiveness is no longer reported separately from the effective portion of the change in the value of the hedging instrument. Hedge accounting ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item. In contrast, IFRS requires measurement and recognition of ineffectiveness in a hedging relationship even though the hedge meets the effectiveness criteria. [7] US GAAP no longer has a concept of ineffectiveness that is separately measured and disclosed.[8]

Regarding eligible hedged items, US GAAP requires the interest rate to be specified contractually for variable-rate financial assets and liabilities. Both US GAAP and IFRS permit designation of the contractually specified interest rate as the hedged risk in a cash flow hedge of interest rate risk of a variable-rate financial instrument. Under IFRS 9, the interest rate does not need to be contractually specified; it only needs to be separately identifiable and reliably measurable.

1.3 SWISS GAP FER

Swiss GAAP FER is a principle-based standard with only about 250 pages of regulations, applied mainly by small and mid-size companies. Detailed rules are rather rare. Regarding interest rates for valuation purposes, Swiss GAAP FER only requires that those rates reflect market conditions ("marktgerecht"), and risk ("risikogerecht"). The impact of the transition from IBOR to RFR is expected to be non-significant.

Swiss GAAP FER has no definition of what constitutes a hedging relationship. FER 27 only uses the term "Absicherungsgeschäft" (meaning "hedging instrument") without explaining any further. It belongs

[6] For a comparison of IFRS and US GAAP on hedge accounting see https://www.pwc.com/hu/hu/szolgaltatasok/konyvvizsgalat/treasury_tanacsadas/kiadvanyok/hedge_accounting_contrasting_us_gaap_and_ifrs.pdf (9 Apr 19).

[7] An example for cash flow hedges: the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (i.e., the portion that is offset by the change in the cash flow hedge reserve) is recognized in other comprehensive income. Any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve) is hedge ineffectiveness and is recognized in profit or loss (see IFRS 9, 6.5.11 (b, c)).

[8] See comments of https://www.journalofaccountancy.com/news/2017/aug/new-fasb-standard-hedge-accounting-201717342.html and https://bakertilly.com/insights/fasb-updates-hedge-accounting-rules/ (9 Apr 19).

to professional judgement of the accountant and auditor to determine whether a sufficiently strong hedging relationship exists. The interpretation and application of FER is discussed and evaluated in expert rounds and consequently closely aligned with industry practice standards. This approach is common under principle-based accounting standards. FER 27 offers some basic guidance for cash flow hedges in FER 27.18.[9] Entities can choose between accounting (similar to IFRS) in equity resulting in neither profit nor loss. Alternatively, hedging instruments are only disclosed in the notes. Two methods are common: (1) the hedging instrument is accounted for with the hedged item (“Durchbuchungsmethode”), or (2) the hedged item is recognized with the hedged value and the hedging instrument is not accounted (“Einfrierungsmethode”).

2 Impact assessment

The change from LIBOR to RFR effects the three accounting regimes differently. US GAAP and IFRS are influenced more by the transition from IBOR to RFR compared to SWISS GAAP FER.

2.1 Impact for the existing set of rules (without relief)

The following figure summarizes the assessed impact of the transition from IBOR to RFR for financial reporting leading up to (phase 1) and after (phase 2) the IBOR to RFR transition for the three accounting regimes under the existing set of rules.[10]

	US GAAP: ASC 815 *[FASB]*	**IFRS:** IAS 39 & IFRS 9 *[IASB]*	**Swiss GAAP FER:** FER 27 *[Fachkommission]*
Benchmark recognition	ASC amendment needed (SOFR OIS included with Update 2018-16 to ASC 815)	No amendment but rate has to be proven ‘separately identifiable and reliably measurable’	No amendment needed, rate has to reflect market conditions and riskiness (marktgerecht) and riskiness (risikogerecht)
Phase 1: Leading up to IBOR reform	**‘Highly effective’** in achieving offsetting changes in fair value or cash flow requirements of hedged item and the hedging instrument	**> Prospective assessment** and the **‘highly probable’** requirements of hedged item & hedging instrument **> Discontinuation** – Either (1) keeping hedging relationships with RFR instead of IBOR, (2) discontinuation of hedge accounting, (3) de-/re-designation, or (4) modification of contractual terms → What will provide most useful information to users of financial statements?	No official documentation or hedging requirements but **‘common best practice’**: > **Economic hedging:** Hedging instrument related to a specific hedged item > **Prospective assessment** adequately documented > Future transaction ‘**highly probable**’
	Increased P&L volatility at de-designation when fair value hedge adjustments are amortized to P&L and the cash flow hedge reserve is reclassified to P&L		
Phase 2: After transition to RFR	**ASC 815.BC19-21.** Relief is needed from the requirement to **de-/re-designate** as a result of a change in any of the critical terms (= change in fallback-provisions or the contractual variable rate of LIBOR-based contracts) –‘Relief provision’ project added (Ineffectiveness reporting removed in ASC 815 amendment 2017-12)	> Amendments necessary to both **IAS 39 and IFRS 9** to relief **discontinuation** **> Increased P&L volatility** when continuing to use IBOR-hedge-accounting derivatives (1) either measured at fair value through P&L absent hedge accounting, or (2) re-designated with non-zero fair values (increase in hedge accounting ineffectiveness due to different mismatches in value changes of the hedged item and the hedging instrument) **> Uncertain about conditions of replacement,** e.g., hedge accounting documentation, risk objective on contract-by-contract basis, IBOR as a non-contractual specific risk component	> Due to **no P&L effect** in the FER hedge accounting model, no volatility increase expected > Only **equity effect** and/or changes in disclosures in the notes depending on chosen accounting option > **No problem with discontinuation**, if any
	> **Coexistence** of more benchmarks approved > Application on a **prospective basis** for qualifying new or re-designated relations	> **Novation** hedge accounting with eased rules (compare e.g., with the 2013 hedge accounting amendment) > **Coexistence** of more benchmarks unclear yet	**> Coexistence** of more benchmarks no problem

Regarding IFRS and US GAAP, the main concern is an increase in earnings volatility before (phase 1) and after (phase 2) transition from IBOR to RFR. Increased earnings volatility could occur as a result of de-designation of hedge accounting relations where fair value hedge adjustments are amortized and the cash flow hedge reserve is reclassified to profit and loss (P&L). De-designation could happen if the requirements of the prospective assessment & ‘highly probable’ (under IFRS) and ‘highly effective’

[9] See Loser, Sieber, ‘Abbildung von Cash Flow Hedges unter Swiss GAAP FER (mit Verweisen auf IFRS sowie Obligationenrecht/HGB)’. IRZ, Heft 10, Oktober 2018.

[10] See the latest FASB update ASC 815 (No. 2018-16 October 2018) and new project developments under https://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdateExpandPage&cid=1176171426463. See the IASB exposure draft, staff papers on ‘IBOR Reform and the Effects on Financial Reporting’, and new project developments under https://www.ifrs.org/projects/work-plan/ibor-reform-and-the-effects-on-financial-reporting/ (both 27 May 19).

assessment (under US GAAP) are no longer met with the new benchmark. Subsequent use of IBOR-derivatives might increase earnings volatility due to measurement at fair value through P&L absent hedge accounting, or by hedge accounting re-designation with non-zero fair values. Basis risk, i.e., when the timing of the transition of the hedging instrument does not match the timing of the transition of the hedged item, is perceived as a further issue.

Furthermore, IFRS reporting entities report hedge accounting ineffectiveness, while it is not reported under US GAAP. This ineffectiveness might increase in the IBOR transition due to different mismatches in value changes of the hedged item and the hedging instrument.

Regarding SWISS GAAP FER, it is reasonable to expect the influence of the benchmark transition to be non-significant. When Swiss franc LIBOR ceases to exist, SARON instruments will follow to essentially work the same. Hedging could therefore (materially) continue under the new interest rate.

2.2 Relief from standard setter bodies

International Accounting Standards Board (IASB). To address these concerns, the IASB issued an exposure draft (ED/2019/1) in May 2019. ED/2019/1 addresses concerns that may arise leading up to the IBOR transition. Issues affecting financial reporting when the IBOR transition is enacted (i.e., when contracts are amended) will be discussed during the second phase of the project. The Exposure Draft proposes amendments to IFRS 9 and IAS 39, to enable hedge accounting to continue for certain hedges that might otherwise need to be discontinued due to uncertainties arising from the IBOR transition. More specifically, the Exposure Draft proposes that:

- the 'highly probable' requirement should be amended such that, when assessing the likelihood that a forecast transaction will occur, an entity would assume that IBOR-based contractual terms are not altered;
- the prospective hedge effectiveness assessment should be amended such that an entity would assume that the IBOR-based contractual cash flows from the hedging instrument and the hedged item are not altered; and
- an entity would continue hedge accounting where a non-contractually specified IBOR risk component met the separately identifiable requirement at the inception of the hedging relationship, although identification may be affected by the IBOR transition in the future.

To address potential discretionary discontinuation of hedge accounting and to be consistent with the IFRS 9's prohibition on voluntary discontinuation of hedge accounting, it is proposed that the reliefs are mandatory. They would apply to both existing and new hedges. An entity further needs to provide specific disclosures about the extent to which it applies the proposed relief. All jurisdictions facing an IBOR transition and applying IFRS are affected by this amendment. Companies across all industries (banks, insurances and corporates) that have applied hedge accounting for IBOR-related hedges, will be affected. Impact is expected to matter most for products such as hedges of loans, bonds and borrowings with instruments such as interest rate swaps, interest rate options, FRAs and cross-currency swaps. Without the reliefs, some hedges might fail to qualify for hedge accounting in the near future. The IASB therefore proposed as effective date the accounting period beginning on or after 1 January 2020, with earlier as well as retrospective application permitted. The application of the relief shall end when the uncertainty regarding the timing and amount of cash flows is no longer present, or the hedge relationship is discontinued.

Financial Accounting Standards Board (FASB). In the amendment to ASC 815 (No. 2018-16 October 2018) SOFR OIS has been recognized as an interest rate for US GAAP. The IBOR project is added to the FASB agenda (as mentioned in ASC 815.BC20) as "Facilitation of the Effects of the London

Interbank Offered Rate (LIBOR) to the Secured Overnight Financing Rate (SOFR) Transition on Financial Reporting". This project broadly considers changes to GAAP necessitated by the market-wide transition away from LIBOR, which includes but is not limited to the transition of existing hedging relationships referencing LIBOR. The IBOR project thus seems to combine phase 1 and 2 of the IASB within one project. On June 19[11], the FASB gave first advisory that a change in a contract's reference rate as a result of the IBOR transition would not create a new contract but would be accounted for as a continuation of that contract. The decision is applicable to loans, debt, leases, embedded derivatives and other arrangements and provides relief from companies having to perform a costly and complex accounting analysis. Hedge accounting will be addressed in a future meeting.

In addition, payment date conventions are of special interest under the new RFR environment. Payment date conventions might differ between cash products and derivatives by a few days, e.g., when the cash flows of an interest rate swap do not match the payment dates of a bond exactly to the very day. It might be a potential problem as "perfect hedges" (exact same payment dates) are eliminated. However, it should be possible to apply cash flow hedge accounting under both IFRS and US GAAP as both regimes allow some flexibility in payment dates applying critical term matching. Under IFRS, the critical terms match under IFRS 9 (effectiveness test grouped in monthly buckets) allows for much more flexibility than the effectiveness testing under IAS 39. Further, IFRS reporting entities should consider the impact on ineffectiveness (especially banks with large volumes). The more time lies between payment dates, the higher will the reported ineffectiveness be.

[11] See details on this first MEDIA ADVISORY 06-19-19 under https://fasb.org/cs/Satellite?c=FASBContent_C&cid=1176172859120&pagename=FASB%2FFASBContent_C%2FNewsPage (25 June 2019).