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ISCA Financial Reporting Bulletin 9

FRB 9:
Accounting Implications of the Interest Rate Benchmark Reform in Singapore

Global Mindset, Asian Insights

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The terms of reference are executed through FRC with the support of two Sub-Committees, namely the Core Sub-Committee and the Valuation Sub-Committee. The FRC Core Sub-Committee is the technical accounting arm of FRC and comprises various technical accounting subject matter experts mainly from accounting firms. The Core Sub-Committee engages in technical deliberations on emerging accounting issues in Singapore and new or revised accounting developments proposed by the international accounting standards setter.

Note:

- Although this FRB makes references to SFRS(I) 9 *Financial Instruments* and SFRS(I) 1-39 *Financial Instruments: Recognition and Measurement*, the guidance in this FRB is also applicable to entities applying FRS 109 *Financial Instruments* and FRS 39 *Financial Instruments: Recognition and Measurement*.

- This FRB is based on publicly available information as at 30 September 2021. References made to the Association of Banks in Singapore (ABS) and IASB website are accurate as at the date of issuance of this FRB. Members are strongly advised to refer to the respective ABS' webpages relating to the transition to SORA for the latest updates on the transition.

Table of Abbreviations

The following abbreviations are used often in this publication:

Abbreviations	Description
ABS	Association of Banks in Singapore
ASC	Accounting Standards Council Singapore
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IBOR	Interbank Offered Rate
LIBOR	London Interbank Offered Rate
MAS	Monetary Authority of Singapore
SC-STS	Steering Committee for SOR and SIBOR transition to SORA
SFEMC	Singapore Foreign Exchange Market Committee
SFRS(I)	Singapore Financial Reporting Standards (International)
SIBOR	Singapore Interbank Offered Rate
SOR	Swap Offer Rate
SORA	Singapore Overnight Rate Average

Contents

1. Background

Globally, there has been a shift away from interbank offered rates and a move towards the adoption of alternative, nearly risk-free benchmark rates. This is commonly known as the interbank offered rate (IBOR) benchmark reform. Due to the upcoming discontinuation of USD London Interbank Offered Rate (LIBOR) by end of June 2023, the Steering Committee for SOR and SIBOR transition to SORA[1] (SC-STS) together with the Association of Banks in Singapore (ABS) and Singapore Foreign Exchange Market Committee (SFEMC), has recommended the discontinuation of Swap Offer Rate (SOR) and Singapore Interbank Offered Rate (SIBOR) and a shift towards the use of Singapore Overnight Rate Average (SORA) as the alternative interest rate benchmark in Singapore. The timeline for SORA to replace SOR and SIBOR is by the end of June 2023 and December 2024 respectively.

In order to address the financial reporting implications of the IBOR reform, the International Accounting Standards Board (IASB) undertook their "Interest Rate Benchmark (IBOR) Reform and its Effects on Financial Reporting" project in two phases.

In September 2019, IASB amended IFRS 9 *Financial Instruments*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures* under its Phase 1 amendments to provide temporary reliefs from the potential effects of the uncertainty caused by the reform and allow entities to continue their hedge accounting relationships during the period of uncertainty, with an effective date for annual periods beginning on or after 1 January 2020. Shortly after that, the Accounting Standards Council (ASC) issued equivalent Phase 1 amendments to SFRS(I) 9 *Financial Instruments*, SFRS(I) 1-39 *Financial Instruments: Recognition and Measurement* and SFRS(I) 7 *Financial Instruments: Disclosures* with the same effective date.

In August 2020, IASB amended IFRS 9, IAS 39, IFRS 7, IFRS 4 *Insurance Contracts* and IFRS 16 *Leases* under its Phase 2 amendments to assist entities in applying the Standards when changes are made to contractual cash flows or hedging relationships because of the reform, with an effective date for annual periods beginning on or after 1 January 2021. Shortly after, ASC issued equivalent Phase 2 amendments to SFRS(I) 9, SFRS(I) 1-39, SFRS(I) 7, *SFRS(I) 4 Insurance Contracts and SFRS(I) 16 Leases* with the same effective date.

The above developments have given rise to questions over how entities in Singapore that hold financial instruments affected by the IBOR reform and/or engage in hedge accounting should account for them during the IBOR reform before and when the benchmark interest rates in the financial contracts are replaced by alternative benchmark rates.

In Singapore, ABS' SC-STS formed a technical subgroup, Subgroup 7 (SG 7) to consider the accounting implications of the transition of SOR and SIBOR to SORA. SG 7 requested ISCA to publish guidance concerning IBOR reform in relation to accounting matters. In response, the ISCA Financial Reporting Committee (FRC) set up a dedicated working group (IBOR Working Group[2]) which comprises representatives from SG 7 and ISCA Banking and Finance Committee, together with FRC Core Sub-Committee members.

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[1] SC-STS was established by the Monetary Authority of Singapore (MAS) to oversee the industry-wide interest rate benchmark transition from SOR & SIBOR to SORA.

[2] ISCA gratefully acknowledge and thank the following members of the IBOR Working Group for their contributions towards the development of this publication:

- Mr Chen Voon Hoe (IBOR WG Chairman)
- Ms Chan Yen San
- Mr Chua Kim Chiu
- Mr Andrew Goh (representative from SC-STS SG 7)
- Mr Aylwin How
- Mr Lian Wee Cheow
- Ms Ong Suat Ling
- Mr Jonathan Phua (representative from SC-STS SG 3)
- Ms Wong Tien Chi

ISCA, through its FRC and IBOR Working Group, is issuing this Financial Reporting Bulletin (FRB) to guide entities reporting under International Financial Reporting Standards (IFRSs) issued by the IASB, or Singapore Financial Reporting Standards (International) (SFRS(I)s) and Financial Reporting Standards (FRSs) issued by the ASC, in addressing some of the accounting implications arising from the IBOR reform in Singapore.

2. Scope of this FRB

This FRB addresses accounting implications arising from the IBOR reform.

The accounting matters addressed in this FRB were brought to the attention of the IBOR Working Group by the SG 7. This FRB is intended to assist entities holding financial contracts that reference benchmark interest rates that will be replaced by alternative benchmark rates during the IBOR reform to understand the accounting implications.

This FRB addresses five accounting matters that were considered by the IBOR Working Group. This FRB will be revised accordingly as and when there are updates/changes to existing matters or new accounting matters to be addressed.

The accounting matters addressed within this FRB are not exhaustive. Preparers are strongly advised to consult their auditors/advisors if necessary.

3. Overview of the Interest Rate Benchmark Reform (or Interbank Offered Rate ("IBOR") Reform)

3.1 International Developments in IBOR Reform

In 2014, the Financial Stability Board[3] recommended the reform of specified major interest rate benchmarks such as interbank offered rates. Since then, public authorities in many jurisdictions have taken steps to implement interest rate benchmark reform and increasingly encouraged market participants to ensure timely progress towards the reform of interest rate benchmarks, including the replacement of interest rate benchmarks with alternative nearly risk-free interest rates that are based, to a greater extent, on transaction data (alternative benchmark rates).

On 5 March 2021, the Financial Conduct Authority[4] confirmed the dates on which all London Interbank Offered Rate (LIBOR) settings will either cease to be provided, or will no longer be representative, as follows:

(a) Overnight and 1, 3, 6 and 12 month USD LIBOR settings − Immediately after 30 June 2023; and

(b) All other LIBOR settings − Immediately after 31 December 2021.

[3] The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system. FSB's report on reforming major interest rate benchmarks can be found here (https://www.fsb.org/wp-content/uploads/r_140722.pdf)

[4] The Financial Conduct Authority (FCA) is a financial regulatory body for financial firms providing services to consumers and seeks to maintain the integrity of the financial markets in the United Kingdom. FCA made an announcement on the end of LIBOR on 5 March 2021 (https://www.fca.org.uk/news/press-releases/announcements-end-libor).

3.2 Regulatory landscape of the Financial Services industry and Interest Rate Benchmarks in Singapore

3.2.1 Regulatory Landscape

The Monetary Authority of Singapore (MAS) is the sole regulator in Singapore having regulatory oversight of the financial services industry across various sectors. The MAS is also the central bank of Singapore.

The following organisation and committees were commissioned by MAS to undertake the groundwork relating to the interest rate benchmark reform in Singapore:

(a) Association of Banks in Singapore (ABS):

ABS is a non-profit organisation that represents the interests of the commercial and investment banking community.

(b) Steering Committee for SOR and SIBOR transition to SORA (SC-STS):

SC-STS was set up by ABS and MAS in August 2019 to oversee the industry-wide interest rate benchmark transition from SOR to SORA. In 2020 the scope was extended to include the transition of SIBOR to SORA.

(c) Singapore Foreign Exchange Market Committee (SFEMC)[5]:

The SFEMC, comprising industry representatives and MAS, aims to foster the growth and development of Singapore as a leading global financial centre in Asia, with specific focus on foreign exchange, money markets, fixed income and derivatives markets.

3.2.2 Interest Rate Benchmarks

In Singapore there are currently three published Singapore Dollar (SGD) interest rate benchmarks, namely SOR, SIBOR and SORA. SOR and SIBOR are administered by the ABS Benchmarks Administration Co Pte Ltd and published on ABS' website. SOR and SIBOR are widely used as interest rate benchmarks in financial contracts. SORA is administered and published by MAS.

(a) Singapore Overnight Rate Average (SORA)[6]

SORA is a volume-weighted average rate of borrowing transactions in the unsecured overnight interbank SGD cash market in Singapore between 8am and 6.15pm.

MAS, as the administrator of SORA, reviews SORA's methodology and governance processes periodically to ensure that it continues to capture the underlying interest adequately and is aligned with the International Organization of Securities Commissions (IOSCO) Principles.

SORA is computed based on actual transactions and generally viewed as being nearly free of credit risk ("near risk-free" rates). The short tenor (overnight) lending has minimal credit risk and therefore minimal credit spread.

[5] SFMEC Terms of Reference: https://www.sfemc.org/sfemc-terms-of-reference.html

[6] MAS website on SORA https://www.mas.gov.sg/monetary-policy/sora

On 14 May 2020, DBS Bank issued the first floating-rate notes in Singapore referencing SORA. On 16 June 2020, OCBC Bank made its first SORA-pegged loan to CapitaLand, followed shortly by the launch of home loans referencing SORA in July 2020. Since then, more banks in Singapore have jumped on the bandwagon for the issuance of SORA-pegged banking products.

(b) Swap Offer Rate (SOR)[7]

SOR is defined by ABS as the synthetic rate for deposits in SGD. SOR represents the effective cost of borrowing SGD synthetically by borrowing USD funds for the same maturity and swapping out the USD funds in return for SGD funds.

SOR is used mainly in bonds and loans by large institutions with hedging requirements[8] and in certain housing loans. SOR relies on USD LIBOR in its computation methodology. The shift away from SOR is necessary given that SOR will discontinue together with the cessation of USD LIBOR on 30 June 2023.

(c) Singapore Interbank Offered Rate (SIBOR)[7]

SIBOR is computed based on the contributions from a panel of banks of the interest rates at which they could borrow funds from one another. It is commonly used as a reference interest rate for banking products such as housing loans and loans to corporate customers. ABS has confirmed its plan to cease 6-month SIBOR on 31 March 2022, followed by 1-month SIBOR and 3-months SIBOR by end 2024.

3.3 Singapore's Transition from SOR and SIBOR to SORA

As mentioned in Section 3.1, USD LIBOR is expected to cease after 30 June 2023. Hence, SOR is also expected to cease at the same date, given it has USD LIBOR as an input. All financial contracts using SOR as the reference benchmark rate that mature after this date will have to be addressed (e.g. updated or terminated). It was confirmed in March 2021 that SOR and SIBOR will not be available as benchmark rates after 30 June 2023 and 31 December 2024 respectively.

On 30 August 2019, ABS and SFEMC identified SORA as an alternative interest rate benchmark for SOR. On 11 December 2020, SC-STS, together with ABS and SFEMC, also recommended[9] the discontinuation of SIBOR and adoption of a SORA-centred approach. A SORA-centred approach means that SORA will be the only interest benchmark to be used in Singapore after the cessation of SOR and SIBOR. It was also mentioned in the same paper that this shift is expected to support a deepening of SORA markets, resulting in more transparent loan market pricing for borrowers, and more efficient risk management for lenders.

[7] ABS website on published SOR & SIBOR rates: https://abs.org.sg/benchmark-rates/rates-sibor

[8] Extracted from page 5 of ABS publication on SORA: A Guide for Corporates and SMEs https://abs.org.sg/docs/library/sora-a-guide-for-corporates-and-smes.pdf

[9] ABS-SFMEC & SC-STS' response paper to feedback received on SIBOR Reform and the Future Landscape for SGD Interest Rate Benchmarks: https://abs.org.sg/docs/library/response-to-feedback-sibor-reform-and-the-future-landscape-for-sgd-interest-rate-benchmarks.pdf

3.3.1 Fallback Provisions[10]

Benchmark fallbacks or fallback reference rates (fallbacks) are replacement rates that may apply to financial instruments referencing a particular benchmark. Fallbacks take effect if the relevant benchmark (e.g. USD LIBOR, SGD SOR) becomes unavailable while market participants continue to have exposure to that rate.

One such fallback is "Fallback Rate (SOR)" which is the primary fallback for SOR derivatives. This is a backward-looking rate and follows the same calculation formula as SOR, except that the USD LIBOR component used in the SOR calculation is replaced by Fallback Rate (USD Secured Overnight Financing Rate - SOFR), the contractual fallback rate for USD LIBOR.

For existing financial contracts using SOR as the interest rate benchmark, Fallback Rate (SOR) is an option as an interim measure for entities which do not wish to transition from SOR to SORA directly. Fallback Rate (SOR) is available from July 2021 to December 2024, but as SOR will be available until 30 June 2023 the use of Fallback Rate (SOR) is only expected to commence from 1 July 2023 in practice.

4. IBOR Reform and its Effects on Financial Reporting

The International Accounting Standards Board (IASB) undertook a two-phase approach to address accounting issues arising from the IBOR reform. The amendments issued by IASB in both phases were then also issued in Singapore by ASC.

4.1 Interest Rate Benchmark Reform - Phase 1 Amendments

Phase 1 amended SFRS(I) 9 *Financial Instruments*, SFRS(I) 1-39 *Financial Instruments: Recognition and Measurement* and SFRS(I) 7 *Financial Instruments: Disclosures*.

These amendments mainly provide temporary exceptions from the potential effects of the uncertainty caused by the reform and allow entities to continue their hedge accounting relationships during the period of uncertainty. They are effective for annual periods beginning on or after 1 January 2020 and will cease to be applied at the earlier of when the uncertainty from IBOR reform is no longer present and when the hedging relationship is discontinued. In addition, the amendments added specific disclosures about the extent to which hedging relationships are affected by the amendments.

In relation to these temporary exceptions from applying specific hedge accounting requirements, paragraphs 6.8.1 to 6.8.12 were added to SFRS(I) 9 and paragraphs 102A to 102N were added to SFRS(I) 1-39. As for disclosures, paragraph 24H was added to SFRS(I) 7.

[10] ISDA-ABS Fallback Rate (SOR) Factsheet: https://abs.org.sg/docs/library/abs-co-amp-isda-fallback-rate-(sor)-factsheet.pdf

4.2 Interest Rate Benchmark Reform - Phase 2 Amendments

Phase 2 amended SFRS(I) 9 *Financial Instruments*, SFRS(I) 1-39 *Financial Instruments: Recognition and Measurement*, SFRS(I) 7 *Financial Instruments: Disclosures*, SFRS(I) 4 *Insurance Contracts* and SFRS(I) 16 *Leases*.

The objective of the Phase 2 amendments[11] was to address issues that might affect financial reporting during the IBOR reform, including the effects of changes to contractual cash flows or hedging relationships arising from the replacement of an interest rate benchmark with an alternative benchmark rate. These amendments are effective for annual periods beginning on or after 1 January 2021 with earlier application permitted.

The following are the key reliefs provided under the Phase 2 amendments to SFRS(I) 9[12] and SFRS(I) 1-39[12] for changes arising from the IBOR reform:

4.2.1 Practical Expedient for Changes to Contractual Cash Flows Required by the Reform

Scope and effect of practical expedient

Paragraphs 5.4.5 to 5.4.9 were added to SFRS(I) 9 under the section “Changes in the basis for determining the contractual cash flows as a result of interest rate benchmark reform”. This is applicable to financial assets and financial liabilities accounted for under the amortised cost method.

The practical expedient provided in SFRS(I) 9 paragraph 5.4.7 requires entities to apply B5.4.5 to account for a change in the basis for determining the contractual cash flows of a financial asset or financial liability that is required by interest rate reform.

SFRS(I) 9 paragraph B5.4.5 explains that the periodic re-estimation of the future interest payments for floating-rate financial assets or floating-rate financial liabilities normally has no significant effect on their carrying amounts.

IFRS 9 Basis For Conclusions paragraph BC5.308 *“Applying the practical expedient in paragraph 5.4.7 of IFRS 9, an entity would account for a change in the basis for determining the contractual cash flows of a financial asset or a financial liability required by the reform as being akin to a ‘movement in the market rates of interest’ applying paragraph B5.4.5 of IFRS 9. As a result, an entity applying the practical expedient to account for a change in the basis for determining the contractual cash flows of a financial asset or a financial liability that is required by the reform would not apply the derecognition requirements to that financial instrument, and would not apply paragraphs 5.4.3 or B5.4.6 of IFRS 9 to account for the change in contractual cash flows. In other words, changes in the basis for determining the contractual cash flows of a financial asset or a financial liability that are required by the reform would not result in an adjustment to the carrying amount of the financial instrument or immediate recognition of a gain or loss. The IASB concluded that the application of the practical expedient would provide useful information about the effect of the reform on an entity’s financial instruments in the circumstances in which it applies.”*

[11] IASB IBOR Reform and its Effects on Financial Reporting—Phase 2 https://www.ifrs.org/projects/completed-projects/2020/ibor-reform-and-its-effects-on-financial-reporting-phase-2/#about

[12] SFRS(I) 9 and SFRS(I) 1-39 are equivalent to FRS 109 and FRS 39 respectively.

As explained in paragraph BC5.308 above, the entity is not required to apply the derecognition requirements to the financial instrument or apply paragraphs 5.4.3 or B5.4.6 of SFRS(I) 9 to account for the change in contractual cashflows.

The practical expedient is applied if the following conditions are met:

(a) The contractual changes are a direct consequence of interest rate benchmark reform; and

(b) The new basis for determining the contractual cash flows as a result of the interest rate benchmark reform is economically equivalent to the previous basis.

Without the practical expedient, SFRS(I) 9 would require an entity to first consider whether changes to contractual cash flows of financial instrument would result in the derecognition of the financial asset or financial liability. If these changes do not result in derecognition, an entity would have to apply modification accounting in either SFRS(I) 9 paragraph 5.4.3 or B5.4.6 accordingly. This would mean recalculating the gross carrying amount and recognising a gain or loss immediately in profit or loss. The gross carrying amount of the financial asset would be recalculated as the present value of the modified contractual cash flows that are discounted at the financial instrument's original effective interest rate.

Contractual changes not in scope of practical expedient
SFRS(I) 9 paragraph 5.4.9 states that if there are any changes to the contractual terms of the financial instruments other than those required by IBOR reform, an entity will first apply the practical expedient to those changes. The entity will then apply the other applicable requirements in SFRS(I) 9 to the additional changes to which the practical expedient does not apply. If the other changes do not result in the financial instrument being derecognised, the entity accounts for the changes as a modification of the financial instrument using the revised effective interest rate which references the new, alternative benchmark rate.

4.2.2 Reliefs for Hedge Accounting

ASC added paragraphs 6.9.1 to 6.9.13 to SFRS(I) 9 under the section "Additional temporary exceptions arising from interest rate benchmark reform". ASC added equivalent paragraphs 102P to 102Z3 to SFRS(I) 1-39.

In addition to the temporary exceptions for specific hedge accounting requirements under the Phase 1 amendments, the Phase 2 amendments provide additional temporary exceptions from certain hedge accounting requirements so that, subject to meeting the applicable criteria, changes to hedge designations and hedge documentation required by the IBOR reform would not result in discontinuation of hedge accounting.

Changes to the hedge documentation to preserve hedge accounting
When an entity ceases to apply the IBOR Phase 1 amendments to a hedging relationship, the entity is required to amend the formal designation of a hedging relationship as previously documented to reflect the changes that are required by the IBOR reform in accordance with paragraph 6.9.1 of SFRS(I) 9. Otherwise, this would result in the discontinuation of hedge accounting. If hedge accounting is to be continued this would require designation of a new hedging relationship.

Changes to hedge documentation required by the IBOR reform include:

(a) Designating an alternative benchmark rate as the hedged risk (e.g. from SOR interest rate risk to SORA interest rate risk)

(b) Changing the description of the hedged item (e.g. from a SOR based borrowing to a SORA based borrowing), including the designated portion of the hedging instrument.

(c) For those applying SFRS(I) 1-39, amending the description of how the entity will assess hedge effectiveness (see SFRS(I) 1-39.102P(d)).

Changes to hedge documentation required by the IBOR reform include:

(a) Designating an alternative benchmark rate as the hedged risk (e.g. from SOR interest rate risk to SORA interest rate risk).

(b) Changing the description of the hedged item (e.g. from a SOR based borrowing to a SORA based borrowing), including the designated portion of the hedging instrument.

(c) For those applying SFRS(I) 1-39, amending the description of how the entity will assess hedge effectiveness (see SFRS(I) 1-39.102P(d)).

To amend the hedge designation, the entity needs to ensure that the following two conditions in paragraph 5.4.7 are met:

(a) The change is necessary as a direct consequence of interest rate benchmark reform; and

(b) The new basis for determining the contractual cash flows as a result of the interest rate benchmark reform is economically equivalent to the previous basis.

Changes to the hedge documentation are required to be made by the end of the reporting period during which the change required by the interest rate reform is made to the hedged risk, hedged item or hedging instrument.

Hedge accounting can also be preserved by entering into new hedging instruments when certain conditions are met. Apart from a direct amendment of the contractual terms of the hedging instrument, the changes to hedge documentation can also apply when entities enter into new derivatives provided that the following three conditions under paragraph 6.9.2 of SFRS(I) 9 or 102Q of SFRS(I) 1-39 are met.

(a) The entity makes a change required by the reform using an approach other than changing the basis for determining the contractual cash flows of the hedging instrument;

(b) The original hedging instrument is not derecognised; and

(c) The chosen approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument.

Other reliefs for hedge accounting

The following are other reliefs provided for specific hedge accounting requirements under the Phase 2 amendments:

(a) Amounts accumulated in the cash flow hedge reserve

When a hedged item in a cash flow hedge is amended to reflect the changes that are required by the reform, the amount accumulated in the cash flow hedge reserve will be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined. Therefore, the entity reclassifies the cash flow hedge reserve to profit or loss only when the cash flows of the amended hedged item affect profit or loss. The same relief is also provided for a discontinued cash flow hedging relationship.

(b) Groups of items designated as hedged items

When a group of items is designated as a hedged item and an item in the group is amended to reflect the changes that are required by the reform, an entity will allocate the hedged items to sub-groups based on the benchmark rate being hedged, and designate the benchmark rate for each sub-group as the hedged risk. An entity will assess each sub-group separately to determine whether the sub-group is eligible to be a hedged item.

(c) Separately identifiable requirement

If an entity reasonably expects that an alternative benchmark rate will be separately identifiable within a period of 24 months from the date that benchmark rate is first designated, it can designate the rate as a non-contractually specified risk component even if it is not separately identifiable at the designation date. This is applied on a rate-by-rate basis and is also applicable to new hedge accounting relationships.

(d) Retrospective effectiveness assessment (SFRS(I) 1-39 only)

When performing a retrospective hedge effectiveness assessment under SFRS(I) 1-39, an entity may choose to reset the cumulative fair value changes of the hedged item and hedging instrument to zero immediately after ceasing to apply the Phase 1 relief on a hedge-by-hedge basis.

4.2.3 Disclosures

ASC added paragraphs 24I and 24J to SFRS(I) 7 to require additional disclosures relating to the interest rate benchmark reform.

5. Accounting Considerations

5.1 What does "necessary as a direct consequence" of interest rate benchmark reform mean?

Interest rate benchmark reform refers to the market-wide reform of interbank offered rates (IBOR) including their replacement with alternative benchmark rates, such as those resulting from the Financial Stability Board's recommendations set out in its July 2014 report *Reforming Major Interest Rate Benchmarks*.[13]

The scope of the Phase 2 reliefs is limited to changes in contractual cash flows that are "necessary as a direct consequence" of the reform. This condition was designed to capture only changes in the basis for determining the contractual cash flows that are required to implement the reform.[14]

SFRS(I) 9 does not give specific examples of changes that are a direct consequence of interest rate benchmark reform. Therefore, entities may be required to exercise judgement to determine if the changes are direct consequences of the reform. The necessary changes might also vary depending on the type of contract (for example, a loan, or a derivative). However, the following are some examples of changes that would generally be a direct consequence of interest rate benchmark reform:

(a) Replacement of the existing interest rate benchmark affected by IBOR reform with an alternative benchmark rate;

(b) Addition of a fixed spread made to reflect the basis difference between the existing interest rate benchmark affected by the IBOR reform as compared to the new alternative benchmark rate;

(c) Amendments in the computation method used to derive the applicable interest rate (for example, where the new methodology calculates the interest rate as a daily compounded average of an overnight benchmark rate instead of a quoted rate); and

(d) Addition of a fallback clause to address any of the above changes.

The following changes are some examples which would generally not be a direct consequence of interest rate benchmark reform:

(a) Amendments to the original contracted amount or due date;

(b) Amendments to the arrangement (type/nature) or repayment methods (for example, changing a revolving loan facility to a term loan);

(c) Changes in credit spread to reflect changes in the credit quality of the borrower;

(d) Changes in terms that are unrelated to the interest rate benchmark such as changing payments to be indexed to the price of a commodity;

(e) Changes in the contracting parties who are not related to the original contracting parties; and

(f) Amendments to the type of currency used in the contract.

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[13] Paragraph BC6.546 in the Basis For Conclusion of IFRS 9

[14] Paragraph BC5.310 in the Basis For Conclusion of IFRS 9

Where there are changes to contractual terms that are not a direct consequence of the IBOR reform, an entity would have to apply the requirements in paragraph 5.4.9 of SFRS(I) 9 to account for these changes.

5.2 What does "economically equivalent" mean?

IASB requires "economic equivalence" as the second condition for applying the Phase 2 reliefs, because the objective of the reform is limited to the transition to alternative benchmark rates – i.e. it does not encompass other changes that would lead to value transfer between the parties to a financial instrument.[15]

Examples of changes that are economically equivalent to the previous basis (that is, the basis immediately preceding the change) are provided in paragraph 5.4.8 of SFRS(I) 9 as follows:

(a) The replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an alternative benchmark rate − or the implementation of such a reform of an interest rate benchmark by altering the method used to calculate the interest rate benchmark − with the addition of a fixed spread necessary to compensate for the basis difference between the existing interest rate benchmark and the alternative benchmark rate. Paragraph BC5.316 in the Basis For Conclusion of IFRS 9 adds that in such circumstances, no additional analysis is required to determine that the economic equivalence condition has been satisfied;

(b) Changes to the reset period, reset dates or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and

(c) The addition of a fallback provision to the contractual terms of a financial asset or financial liability to enable any change described in (a) and (b) above to be implemented.

IASB intends "economic equivalence" to be principle-based and has therefore provided no detailed application guidance. Acknowledging that different entities in different jurisdictions would implement the reform differently, the IASB does not require a particular approach for assessing this condition. As IASB has set no "bright line", an entity is required to apply judgement to assess whether its circumstances meet the economic equivalence condition. For example, assuming that the entity determines that replacing an interest rate benchmark with an alternative benchmark rate is necessary for the affected financial instrument as a direct consequence of the reform, the entity determines[16]:

(a) What alternative benchmark rate will replace the interest rate benchmark and whether a fixed spread adjustment is necessary to compensate for a basis difference between the alternative benchmark rate and the interest rate benchmark preceding replacement. The entity would assess the overall resulting cash flows, including amounts relating to interest (i.e. alternative benchmark rate plus any fixed spread adjustment), to determine whether the economic equivalence condition is met. In other words, in this example, the entity would assess whether the interest rate has remained substantially similar before and after the replacement – specifically, whether the interest rate after replacement (i.e. the alternative benchmark rate plus the fixed

[15] Paragraph BC5.311 in the Basis For Conclusion of IFRS 9

[16] Paragraph BC5.315 in the Basis For Conclusion of IFRS 9

spread) is substantially similar to the interest rate benchmark immediately preceding the replacement; and

(b) Whether the alternative benchmark rate (plus the necessary fixed spread described in (a)) is applied to the relevant affected financial instruments.

There is no requirement in SFRS(I) 9 for economic equivalence to be demonstrated or assessed by comparing the fair value or discounted present value of the cash flows of an instrument immediately before and after the change. If the entity can demonstrate that economically, the basis for determining the contractual terms will remain substantially the same immediately before and after the transition, it would not normally be necessary to make a quantitative evaluation for each financial instrument transition. However, a comparison of fair values or discounted present value of the cash flows before and after the transition are examples of quantitative assessments. Conversely, an example of a qualitative assessment is the use of SORA plus an adjustment spread based on market SOR-SORA basis swap rate as recommended by the SC-STS under the purview of MAS. This basis is considered as economically equivalent because the SORA rate plus an adjustment spread based on SOR-SORA basis swap rate is deemed to be economically equivalent to the SOR rate.

5.3 Does changing the contractual benchmark rate of a SOR/SIBOR-based loan/borrowing to SORA qualify for the Phase 2 relief for amortised cost measurement?

Pursuant to paragraph 5.4.7 of SFRS(I) 9, an entity applies the Phase 2 relief for amortised cost measurement if, and only if, both conditions are met:

(a) The change is “necessary as a direct consequence” of interest rate benchmark reform; and

(b) The new basis for determining the contractual cash flows is “economically equivalent” to the previous basis (i.e. the basis immediately preceding the change).

The change of the contractual benchmark rate from SOR/SIBOR to SORA is deemed “necessary as a direct consequence” of the IBOR reform in Singapore due to the following:

(a) Both SOR and SIBOR are subject to the interest rate benchmark reform in Singapore and will discontinue after 30 June 2023 and end of 2024 respectively;

(b) SORA has been recommended to be the main benchmark for SGD financial markets, replacing both SOR and SIBOR;

(c) Therefore, for a loan referencing SOR/SIBOR and maturing after the index cessation date, it is necessary to consider making changes to the loan terms prior to the cessation of SOR/SIBOR (if the loan is not repaid prior). A change to the referenced interest rate to SORA instead of SOR/SIBOR can be considered as a direct consequence of the reform.

For SOR/SIBOR-based loans/borrowings that transition to SORA, entities will also need to make a determination of whether the “economic equivalence” condition is also met (See Section 5.2 on the accounting considerations for this assessment).

When the two conditions in paragraph 5.4.7 of SFRS(I) 9 are met, entities apply the practical expedient in paragraph B5.4.5 to adjust the effective interest rate for the changes required by interest rate benchmark reform. The effect is such that there should be no change to the carrying amount of a financial asset or a financial liability that is measured at amortised cost on the date of contract modification.

Illustrative Example 1

Entity X has an existing S$100m borrowing at 3-month SOR + 1%[a], maturing on 31 December 2025. Assuming no transaction costs, the original effective interest rate of the borrowing is based on 3-month SOR + 1%[a]. Interest is payable in arrears every 3 months.

Due to the interest rate benchmark reform, the borrowing is modified on 31 December 2021 on the following basis:

- The contractual benchmark rate of 3-month SOR is replaced by SORA* plus an adjustment spread.
- Assume that the published SOR-SORA basis swap rate is 0.5%. The new basis (SORA* + 0.5%) for determining the contractual cash flows is substantially similar to the preceding basis (3-month SOR).
- Accordingly, the original contractual interest rate of 3-month SOR + 1%[a] is amended to SORA* + 1.5%[b].
- There is no change to the other terms of the borrowing.

Entity X has assessed that:

(a) The change of benchmark interest rate from 3-month SOR to SORA plus an adjustment spread is necessary as a result of the IBOR reform and hence, is a direct consequence of IBOR reform in Singapore; and

(b) The new basis of SORA* + 0.5% for determining the contractual cash flows is economically equivalent to the original basis of 3-month SOR.

Therefore, on 31 December 2021, Entity X will apply the Phase 2 practical expedient to adjust the effective interest rate of the borrowing to reflect SORA* + 1.5%[b]. As a result, there will be no change to the carrying amount of the borrowing as at the date of contract modification.

[a] *This refers to Entity X's credit spread of 1%.*
[b] *The revised spread of 1.5% includes Entity X's credit spread of 1%.*
* *SORA in this example refers to SORA daily compounded in arrears (explained in Section 5.5 and Appendix A) over each 3-month interest period.*

5.4 What are the considerations to transit existing cash flow hedges in order to qualify for Phase 2 reliefs for hedge accounting?

For the purpose of applying the Phase 2 reliefs for hedge accounting where entities would be able to continue their existing hedge accounting assuming risk management objective remains unchanged, the following conditions have to be met:

(a) Changes in the basis for determining the contractual cash flows of the hedged item and hedging derivative are "necessary as a direct consequence" of interest rate benchmark reform[17];

(b) The new basis for determining the contractual cash flows is "economically equivalent" to the previous basis[18];

(c) The original hedging derivative is not derecognised[19]; and

(d) The formal hedge designation and hedge documentation should be amended by the end of the reporting period (including interim reporting period if applicable) during which the change required by interest rate benchmark reform is made to the hedged item or hedging derivative[20].

When the above conditions are met, the following Phase 2 reliefs for hedge accounting are applied:

(a) The amendment of hedge designation and the hedge documentation constitutes neither the discontinuation of the hedging relationship nor the designation of a new hedging relationship[21]; and

(b) The amount accumulated in the cash flow hedge reserve is deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.[22]

Notwithstanding the above, if the transition results in mismatch in the critical terms of the hedged item (or hypothetical derivative) and the hedging derivative, any hedge ineffectiveness should be recognised immediately in profit or loss.

Illustrative Example 2
Entity X has an existing S$100m borrowing that pays 3-month SOR + 1%[a], maturing on 31 December 2025. The borrowing is hedged by an interest rate swap ("IRS") that receives 3-month SOR and pays 0.8%, maturing on 31 December 2025. All critical terms of the borrowing and the IRS match. Entity X has designated the IRS since inception as a cash flow hedge of the borrowing's exposure to cash flow variability attributable to SOR.

[17] Paragraph 5.4.7(a) and paragraph 6.9.1 of SFRS(I) 9

[18] Paragraph 5.4.7(b) and paragraph 6.9.1 of SFRS(I) 9

[19] Paragraph 6.9.2 of SFRS(I) 9

[20] Paragraph 6.9.4 of SFRS(I) 9

[21] Paragraph 6.9.4 of SFRS(I) 9

[22] Paragraph 6.9.7 of SFRS(I) 9

Illustrative Example 2 (Cont'd)

Due to the interest rate benchmark reform, both the borrowing and the IRS are modified on 31 December 2021 on the same basis:

- The contractual benchmark rate of 3-month SOR is replaced by SORA* plus an adjustment spread.
- The adjustment spread is determined based on the SOR-SORA basis swap rate of 0.5%, as the new basis of SORA* + 0.5% for determining the contractual cash flows is substantially similar to the old basis of 3-month SOR.
- There is no change to the other terms of the borrowing.

The table below shows the contractual cash flows before and after the modification of both the hedged borrowing and the IRS.

	Hedged Borrowing	Hedging IRS		Total Interest Rate Payable[c] by Entity X
	Pay Float	Receive Float	Pay Fix	
Before	3-month SOR + 1%[a]	3-month SOR	0.8%	1.8%
After	SORA* + 1.5%[b]	SORA*	0.3%	1.8%

[a] *This refers to Entity X's credit spread of 1%.*
[b] *The revised spread of 1.5% includes Entity X's credit spread of 1%.*
[c] *While the hedged risk is the 3-month SORA, we have included the Entity X's credit spread of 1% to show the total interest rate payable.*

Entity X's year end is on 30 June, but it prepares and announces its half-year interim results for 31 December 2021. On 31 December 2021, Entity X will amend its hedge documentation to reflect the changes in the hedged item and the hedging instrument – specifically, it will designate the SORA-based IRS to hedge the SORA cash flows of the borrowing.

Entity X has assessed that the changes to the hedged borrowing and the hedging IRS qualify for Phase 2 reliefs for hedge accounting, because:

(a) The change of benchmark interest rate from 3-month SOR to SORA plus fixed adjustment spread is necessary as a direct consequence of IBOR reform in Singapore;
(b) The replacement of 3-month SOR with SORA* + 0.5% is on an economically equivalent basis;
(c) The transition approach does not result in the derecognition of the IRS; and
(d) The hedge designation and hedge documentation have been amended in the same reporting period ending 31 December 2021 when the hedged borrowing and the IRS are modified.

Hence, the hedge accounting relationship would be preserved.

The amount accumulated in the cash flow hedge reserve as at 31 December 2021 is deemed to relate to the hedged cash flows based on SORA*, and there is no reclassification to profit or loss arising from the SOR-SORA transition. Notwithstanding so, the test for hedge effectiveness is required to be applied prospectively using the revised hedge designation from the date of change. Any hedge ineffectiveness is to be recognised immediately in profit or loss.

Additional considerations:

- In this example, we have assumed a simple scenario whereby both the hedged item and hedging instrument transit to the alternative benchmark rate on the same day using the same adjustment spread. Differences including transition timing or mismatch in critical terms may give rise to hedge ineffectiveness.
- If the hedged item and/or the hedging derivative are/is amended in a reporting period that begins before 1 January 2021, the reporting entity has to early adopt Phase 2 amendments to SFRS(I) 9 in order to apply the Phase 2 reliefs.

** SORA in this example refers to SORA daily compounded in arrears (explained in Section 5.5 and Appendix A) over each 3-month interest period.*

For discontinued hedging relationships, the following Phase 2 relief can be applied:

Paragraph 6.9.8 of SFRS(I) 9 provides relief for cash flow hedges in a discontinued hedging relationship. An entity is required to apply paragraph 6.5.12 of SFRS(I) 9 in order to determine whether the hedged future cash flows are expected to occur and the amount accumulated in the cash flow hedge reserve for that hedging relationship shall be deemed to be based on the alternative benchmark.

For example, an entity discontinues hedge accounting for a cash flow hedge but re-enters into another interest rate swap to hedge its SORA-based cashflows. If the new hedged item (borrowing) is measured at amortised cost, the accumulated cash flow hedge reserve would be amortised to profit or loss over the remaining term of the borrowing if the hedged future cash flows (SORA-based cash flows) are still expected to occur.

5.5 From a borrower's perspective, does a SORA compounded in advance interest rate give rise to an embedded derivative that is not closely related to the host debt?

Singapore Overnight Rate is the interest rate for unsecured SGD borrowings between banks for a period of one day. SORA is a volume-weighted **average** of the overnight rates on actual transactions for a given business day and is published by 9.00am on the next business day.

A debt instrument referencing SORA is effectively a floating-rate note (FRN) with daily interest rate reset to SORA. However, instead of paying interest on a daily basis, the borrower will pay interest at the end of the interest period of either 1 month, 3 months or 6 months. Also, instead of calculating the interest daily, the interest amount for the entire period (1 month, 3 months or 6 months) is calculated at a compounded SORA of 1-month, 3-month or 6-month tenor.

If the compounded SORA is calculated based on the actual daily SORA readings (published the next business day) over the **same** period, the resulting interest rate is called "SORA compounded in arrears". An FRN referencing SORA compounded in arrears is consistent with a basic debt instrument, without an embedded interest rate derivative.

If the compounded SORA is calculated based on the actual daily SORA readings over an agreed **preceding** observation period, the resulting interest rate is called "SORA compounded in advance". For example, if the contractual basis is to reset interest rate for the month of February 2021 to the historical SORA for the month of January 2021, the resulting interest rate is called "SORA compounded in advance". Under SFRS(I) 9 this would result in a host debt instrument which contains an embedded interest rate derivative.

When considering whether such an embedded derivative should be separately accounted for at Fair Value through Profit or Loss (FVTPL), the borrower should assess whether that embedded derivative is closely related to the host contract.

Paragraph B4.3.8(a) of SFRS(I) 9 states that an embedded interest rate derivative is closely related to the host debt, unless (i) the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment or (ii) the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host debt.

An example would be a term borrowing at a variable interest rate referencing SORA compounded in advance, reset every 3 months, with the interest amount being settled at the end of 3 months. The interest rate in this example is said to be SORA compounded in advance as it is based on actual daily SORA reading over a preceding observation period of 3 months. Hence, there is an embedded derivative in this borrowing. The embedded derivative is “closely related” to the host contract (i.e. borrowing) if the following conditions are met:

(a) The hybrid contract (compound instrument, i.e. borrowing plus embedded derivative) can be settled in such a way that the holder (lender) would recover substantially all of its recognised investment; or

(b) The embedded derivative could not have doubled the holder’s initial rate of return on the host contract and could not result in a rate of return that is at least twice what the market rate would be for a contract with the same terms as the host contract.

In this example, the conditions are likely to be met because the SORA compounded in advance is expected to be not materially different from SORA compounded in arrears. If the embedded derivative is closely related to the host contract, it is not required to be separated and the borrower can continue to account for this borrowing using amortised cost.

In addition, due consideration should be given to the materiality concept in assessing whether the derivative is closely related to the host contract.

Appendix A: Embedded Derivatives and SORA-based Interest Rate

Embedded Derivatives

SFRS (I) 9 Appendix A Defined Terms defines a derivative as a financial instrument or other contract with all the following characteristics:

- Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- It is settled at a future date.

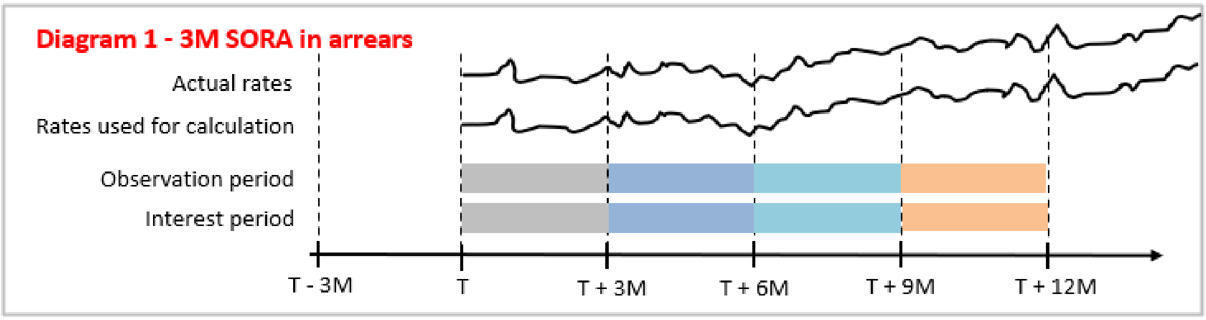
Examples of derivatives include interest rate swaps and foreign exchange forwards.

SFRS(I) 9 paragraph 4.3.1 states that "An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract."

Debt instruments may contain embedded interest rate terms that can change the amount of interest that would otherwise be paid or received. For example, if the interest rate on the loan would increase exponentially as SOR decreases (i.e. a leveraged inverse floater), the embedded derivative would not be closely related to the host contract and thus would be accounted for on a FVPL basis.

Comparison of SORA compounded in arrears and SORA compounded in advance

SORA compounded in arrears



Singapore Overnight Rate is the interest rate for unsecured SGD borrowings between banks for a period of one day. SORA is a volume-weighted **average** of the overnight rates on actual transactions for a given business day and is published by 9.00am on the next business day.

A debt instrument referencing SORA is effectively a floating-rate note (FRN) with daily interest rate reset to SORA. However, instead of paying interest on a daily basis, the borrower will pay interest at the end of an interest period of either 1 month, 3 months or 6 months. The interest amount for the entire period (1 month, 3 months or 6 months) is calculated at a compounded SORA of 1-month, 3-month or 6-month tenor.

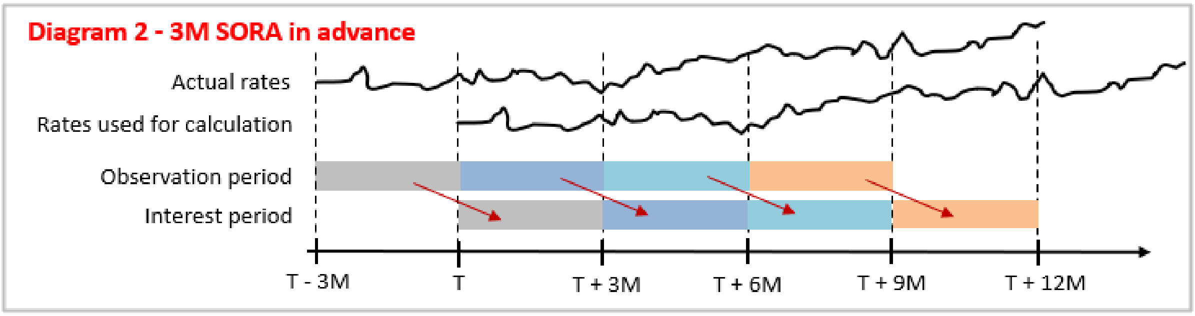
If the compounded SORA is calculated based on the actual daily SORA readings (published the next business day) over the relevant period, the resulting interest rate is called "SORA compounded in arrears".

As illustrated in Diagram 1 above, the compounded SORA for T + 3 months is calculated based on the actual daily SORA readings over the same period and the resulting interest rate is called "SORA compounded in arrears".

An FRN referencing SORA compounded in arrears is consistent with a basic debt instrument, without an embedded interest rate derivative.

SORA compounded in advance

While SORA compounded in advance products offer the advantage of increased payment certainty, the time lag in the interest rate as explained below might result in some of the cash flows of the combined instrument varying in a way similar to the effect of a stand-alone derivative.



As illustrated in Diagram 2 above, the compounded SORA for T + 3 months is calculated based on the actual daily SORA readings over an agreed **preceding** observation period and the resulting interest rate is called "SORA compounded in advance".

SFRS(I) 9 would regard the host debt instrument to contain an embedded interest rate derivative causing the cash flows of the hybrid instrument (host plus embedded derivative) to vary from those determined based on SORA compounded in arrears.

For reference: ISCA Financial Reporting Codification Framework

In November 2019, ISCA issued the ISCA Financial Reporting Codification Framework (Framework). The Framework establishes a formalised categorisation, degrees of authority and a due process for future issuance of ISCA's technical documents. It provides credence to ISCA's technical content, promulgates ISCA's views on the application of accounting standards as well as promotes quality, consistency and best practices in financial reporting.

The Framework is summarised in the table below.

Category	Nature	Degree of authority	Due Process	Highest level of approval
1. Financial Reporting Practice (**FRP**)	Recommended best practices for financial reporting for specific industries, sectors or transactions	Expected to apply	Public consultation required	ISCA Council
2. Financial Reporting Guidance (**FRG**)	Technical guidance, views and insights on specific financial reporting issues for specific industries, sectors or transactions	Expected to follow or explain departures	Public consultation required	ISCA Financial Reporting Committee (FRC), with authority delegated by the ISCA Council
3. Financial Reporting Bulletin (**FRB**)	Technical bulletin containing discussions and highlight of emerging topical financial reporting issues	For information and educational purposes	Public consultation not required	ISCA FRC

For more details on the Framework and the guidance issued under the Framework, please refer to the following:

- Framework https://isca.org.sg/standards-guidance/financial-reporting/due-process/codification-framework
- FRG https://isca.org.sg/standards-guidance/financial-reporting/technical-guidance-issued-by-isca-professional-standards-division/technical-guidance-issued-under-codification-framework/financial-reporting-guidances
- FRB https://isca.org.sg/standards-guidance/financial-reporting/technical-guidance-issued-by-isca-professional-standards-division/technical-guidance-issued-under-codification-framework/financial-reporting-bulletins