Financial Reporting Council

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Dear Jean-Paul

EFRAG DCL on the IASB Exposure Draft ED/2019/1 *Interest Rate Benchmark Reform*

This letter sets out the comments of the UK Financial Reporting Council (FRC) on EFRAG's draft comment letter (DCL) to the IASB Exposure Draft ED/2019/1 *Interest Rate Benchmark Reform* (ED). Our detailed comments on EFRAG's DCL are set out in the Appendix to this letter and we have included our response to the IASB for your information.

We support the IASB's efforts to find solutions that avoid the discontinuance of hedge accounting solely for the effects of the uncertainties of the benchmark rate reforms. We welcome the IASB acting swiftly to introduce reliefs that could be applied for the 2019 year-ends. However, this requires timely endorsement in Europe prior to the 2019 financial statements being signed. We therefore urge EFRAG to expedite its assessment of the final amendments and press the European institutions to do the same to enable timely application of the reliefs.

We would urge the IASB to assess whether issues relating to the valuation and measurement requirements that are part of the hedge effectiveness assessment should also be addressed as part of Phase I.

We also agree with retrospective application of the amendments, but believe it should be made available to discontinued hedges, when hedge accounting ceased because the proposed amendments were not yet available.

We would recommend that EFRAG highlights to the IASB that the scope of the proposals is not clear. The ED defines benchmark reform as a market-wide <u>replacement</u> of an existing benchmark. We are unsure whether this would include the reform of EURIBOR for example, because this benchmark will not be replaced.

Our detailed responses to the questions are included in the Appendix to this letter.

If you would like to discuss these comments, please contact me or Susanne Pust Shah on s.pustshah@frc.org.uk.

Yours sincerely

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Appendix 1
Appendix: Questions

Question 1— [paragraphs 6.8.4–6.8.6 of IFRS 9 and paragraphs 102D–102F of IAS 39]
Highly probable requirement and prospective assessments For hedges of interest rate risk that are affected by interest rate benchmark reform, the Board proposes amendments to IFRS 9 and IAS 39 as described below. (a) For the reasons set out in paragraphs BC8–BC15, the Board proposes exceptions for determining whether a forecast transaction is highly probable or whether it is no longer expected to occur. Specifically, the Exposure Draft proposes that an entity would apply those requirements assuming that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of interest rate benchmark reform. (b) For the reasons set out in paragraphs BC16–BC23, the Board proposes exceptions to the hedge accounting requirements in IFRS 9 and IAS 39 so that an entity would assume that the interest rate benchmark on which the hedged cash flows are based, and/or the interest rate benchmark on which the cash flows of the hedging instrument are based, are not altered as a result of interest rate benchmark reform when the entity determines whether: (i) there is an economic relationship between the hedged item and the hedging instrument applying IFRS 9; or (ii) the hedge is expected to be highly effective in achieving offsetting applying IAS 39. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

A1 We agree with the IASB and EFRAG that discontinuation of hedge accounting solely due to the effects of the uncertainties of the benchmark rate reforms would not provide useful information.

A2 Although the ED addresses some of the pre-replacement hedge accounting issues, we also believe that there are unresolved problems around measurement. When the measurements of the hedged items and hedging instruments include the effects of the uncertainties through market inputs, it may be that either or both the prospective and retrospective tests are failed. We believe the IASB should explore measurement issues to decide whether they require urgent attention as part of Phase I to avoid immediate hedge accounting failures. Measurement poses particular problems for hedge accounting, because the effects of the uncertainties of the benchmark rate reforms may not be separable from other factors that affect the valuation of an instrument.

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A3 We also believe that any hedge accounting solution should be designed to avoid any arbitrage or difference in outcome between IAS 39 and IFRS 9 in respect of whether hedge accounting can be continued.

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Question 2— [paragraph 6.8.7 of IFRS 9 and paragraph 102G of IAS 39]
Designating a component of an item as the hedged item For the reasons set out in paragraphs BC24–BC27, the Board proposes amendments to the hedge accounting requirements in IFRS 9 and IAS 39 for hedges of the benchmark component of interest rate risk that is not contractually specified and that is affected by interest rate benchmark reform. Specifically, for such hedges, the Exposure Draft proposes that an entity applies the requirement—that the designated risk component or designated portion is separately identifiable—only at the inception of the hedging relationship. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you propose instead and why.

A4 We agree with the IASB's proposal to provide relief for the separately identifiable condition, but not for the reliable measurement condition. Providing relief for reliable measurement is not conducive to reliable and relevant financial reporting. However, because the two conditions are linked, we accept that these types of hedging relationships could fail hedge accounting as a consequence of the benchmark rate reforms when measurements are no longer reliable.

A5 Our understanding of the IASB proposal is that it would not be possible to designate non-contractual components in new hedging relationships as hedged items when the component is not identifiable. We do not agree that it is necessary to exclude new hedging relationships from the relief. We believe the second condition of reliable measurement is sufficiently robust to prevent any misuse of hedge accounting.

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Question 3 — [paragraphs 6.8.8–6.8.10 of IFRS 9 and paragraphs 102H–102J of IAS 39]
Mandatory application and end of application (a) For the reasons set out in paragraphs BC28–BC31, the Board proposes that the exceptions are mandatory. As a result, entities would be required to apply the proposed exceptions to all hedging relationships that are affected by interest rate benchmark reform. (b) For the reasons set out in paragraphs BC32–BC42, the Board proposes that the exceptions would apply for a limited period. Specifically, an entity would prospectively cease applying the proposed amendments at the earlier of: (i) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows; and (ii) when the hedging relationship is discontinued, or if paragraph 6.8.9 of IFRS 9 or paragraph 102I of IAS 39 applies, when the entire amount accumulated in the cash flow hedge reserve with respect to that hedging relationship is reclassified to profit or loss. (c) For the reasons set out in paragraph BC43, the Board is not proposing an end of application in relation to the separate identification requirement. Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.

Additional EFRAG questions to constituents
42 The Amendments require entities to cease applying the relief when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and amount of the interest rate benchmark-based cash flows. The assessment of when uncertainty ceases to exist requires the exercise of judgement. 43 Do constituents believe that the level of judgement involved in this assessment would deserve additional discipline? For example, should the IASB add a clarification that this assessment has to be done by management using all the available information applicable to the specific facts and circumstances?

A6 We concur with the IASB and EFRAG that the reliefs should be mandatory. We do not believe this will introduce greater cost compared to voluntary application and has the benefit of consistency.

A7 We also concur that IAS 39 and IFRS 9 should specify when the reliefs will end, except as proposed for the relief concerning hedges of components.

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A8 We understand from BC41 that the IASB permits partial application of the relief, ie if the hedged item has been switched to a new risk-free rate, but not the hedging instruments or vice versa, the parts of the relief that relate to the instrument that has not been switched will remain applicable. We agree with the IASB on that point.

A9 Partially switched hedging relationships may remain in place for a number of years, as it may not be uncommon that the hedging instrument is switched but the hedged item is not. We therefore recommend that the IASB should consider the impact on prospective and retrospective hedge effectiveness testing where there is only partial switching in a hedging relationship. Further relief for hedge accounting conditions that are based on fair value measurements may be needed to avoid failure of hedge accounting in partially switched hedging relationships.

A10 We suggest that the IASB explores whether the drafting of the cessation requirements could be simplified. A new paragraph 6.8.4 in IFRS 9 and new paragraph 102D in IAS 39 could require that when the uncertainties specified in paragraph 6.8.2 of IFRS 9 and paragraph 102B of IAS 39, respectively are resolved, the relief ceases to apply prospectively. Proposed paragraphs 6.8.8 to 6.8.10 in IFRS 9 and paragraphs 102H to 102J in IAS 39 could be deleted. It seems superfluous to specify that the reliefs end when for example the hedging relationship ends. This is already dealt with in IAS 39 and IFRS 9.

A11 EFRAG has suggested additional requirements to determine when the relief should end. BC33 to BC40 of the ED provide useful guidance. We do not believe that including the proposed additional requirements would remove any of the judgements involved in the decision making, nor would it enhance consistency of application.

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Question 4 — [paragraph 6.8.11 of IFRS 9 and paragraph 102K of IAS 39]
Disclosures For the reasons set out in paragraph BC44, the Board proposes that entities provide specific disclosures about the extent to which their hedging relationships are affected by the proposed amendments. Do you agree with these proposed disclosures? Why or why not? If not, what disclosures would you propose instead and why?

A12 The amendments proposed in the ED are narrow mandatory exceptions from the hedge accounting requirements. The disclosures related to the amendments should therefore also be narrow and designed to explain the consequences of these exceptions. We do not believe that the disclosures required as part of this amendment can address wider reporting or disclosure needs related to the uncertainties of the benchmark rate reforms. Exploring whether additional disclosures are needed should be part of Phase II of this project. We believe the IASB should consider the need for additional disclosures as soon as possible to address users' needs appropriately and timely.

A13 We believe there may be some benefit in the proposed disclosures because they could allow users to get a sense of the impact on the financial statements should the reliefs cease and the hedging relationships would be discontinued. However, the objective of the reliefs is to enable continuation of hedge accounting. We are therefore less convinced than EFRAG that the disclosures are useful, because they do not seem to support the objective of the reliefs.

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Question 5 — [paragraphs 7.1.9 and 7.2.26(d) of IFRS 9 and paragraph 108G of IAS 39]
Effective date and transition For the reasons set out in paragraphs BC45–BC47, the Board proposes that the amendments would have an effective date of annual periods beginning on or after 1 January 2020. Earlier application would be permitted. The Board proposes that the amendments would be applied retrospectively. No specific transition provisions are proposed. Do you agree with these proposals? Why or why not? If you disagree with the proposals, please explain what you propose instead and why.

A14 We agree with EFRAG that the reliefs should be effective as soon as possible as the bench mark rate reforms are progressing. Providing early application as a choice is the best option to make the reliefs available for financial years beginning prior to 1 January 2020.

A15 We support retrospective application of the amendments, except for component hedges. However, we would urge the IASB to reconsider whether the prohibition to reinstate discontinued hedges (BC46) should be lifted. For relationships where hedge accounting ceased because the proposed reliefs were not yet available, retrospective reinstatement of hedge accounting should be possible.

A16 In regard of component hedging (Question 2 above), the relief seems prospective in nature and we are unsure how it would be applied retrospectively.

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Appendix II of EFRAG DCL

Question to Constituents
25 In addition to the fact patterns above, are there different patterns of IBOR transition that the IASB should consider when dealing with the replacement issues? Please describe.

A17 We understand that the UK Financial Conduct Authority and contributor banks have worked to secure voluntary panel bank support to sustain LIBOR until the end of 2021. In the UK the Working Group on Sterling Risk-Free Reference Rates recommended SONIA, as its preferred risk-free rate. However, we do not believe that issuers of contracts referenced to LIBOR are compelled to transition to SONIA, they would have the option in negotiation with the counterparty to select another new risk-free rate.

Question to Constituents: Retrospective assessment: hedge accounting ineffectiveness
31 EFRAG has been informed that, during the period while the relief is ongoing, it will be necessary to have clarity on the outcome of not only the prospective assessment of a cash flow hedge relationship under IAS 39, but also of the retrospective assessment. This in order to determine, at the end of each reporting period, how much of the value difference between the hedged item and the hedging instrument is assigned to other comprehensive income and which amount is assigned to profit or loss. As such, the retrospective assessment at the beginning of the cash flow hedge relationship should be able to be carried forward during the period of the relief solely for the purpose of determining the cash flow hedge reserve.
32 In your view, are there particular circumstances in which a relief of the retrospective test is needed applying IAS 39? If so, please describe the reasons why as well as the specific fact patterns it would apply to

A18 We concur that the IASB should reassess its decision that there should be no relief for the retrospective test. We believe finalising the proposals in the ED is urgent, however, the IASB should as part of Phase I explore whether it is necessary to provide immediate relief also in respect of the measurement of the hedged item and hedging instrument, in order to avoid failure of the prospective and/or retrospective test.

A19 We concur with the IASB that ineffectiveness needs to be recorded in profit and loss. Measurement poses particular problems because the effects of the uncertainties may not be identifiable separately in the valuations. Therefore at this stage we would not preclude that the IASB may be unable to find an appropriate solution that would allow the continuation of hedge accounting in all circumstances. We believe it should be the aim of the IASB to provide clarification as soon as possible.

A20 We also believe that the aim of the IASB should be to provide reliefs in IAS 39 and IFRS 9 that would result in the same outcome for hedging relationships accounted for under IAS 39 or IFRS 9, ie continuation or discontinuation of hedge accounting.

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Question to Constituents

48 In your view which of the above topics should be addressed by the IASB when dealing with the replacement issues? Please explain the reasons why and your suggested accounting treatment.

49 In addition to the topics listed above, do you have any other matters that the IASB should consider when dealing with the replacement issues? Please describe.

A21 We believe if these are issues raised by stakeholders, EFRAG should inform the IASB. However, as we have emphasised in our response before, we believe it is important that the IASB finalises the amendments proposed in this ED swiftly and is not unnecessarily held up by issues that are not of immediate concern. It may be helpful for the IASB, if EFRAG were able to prioritise the listed issues by urgency. In regard of Phase II there will also be issues that will need to be prioritised.

A22 We also highlighted in our response that disclosures and other narrative reporting may be areas for investigation by the IASB.

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