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Submitted electronically

13 June 2019

Dear Sirs

Exposure Draft ED/2019/1 *Interest Rate Benchmark Reform*

I am writing on behalf of the UK Financial Reporting Council (FRC) to comment on the Exposure Draft ED/2019/1 *Interest Rate Benchmark Reform* (ED).

We welcome the IASB's decision to add this topic to its standard setting agenda. 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.

Stakeholders need clarity in terms of the application of the forward-looking hedge accounting requirements in IFRS 9 and IAS 39. In that regard we believe the IASB should finalise the proposals swiftly. However, as we explain in more detail in our response to Question 1 below, there are unresolved hedge accounting issues that require urgent attention. We suggest that the IASB analyses the impact of the reforms on the measurement of hedged items and hedging instruments and the effects that can have on prospective and retrospective assessment. The IASB should decide whether these issues should be addressed as part of Phase I and whether there are possible solutions to the measurement issues posed by the benchmark rate reforms.

We ask the IASB to clarify the objective of the proposed disclosures and propose in our response to Question 3 a simplification of the cessation requirements. We agree with the retrospective application of the amendments, but ask the IASB to reconsider whether retrospective application should be available for some discontinued hedges.

We would also recommend that the IASB reviews the drafting in the ED as it defines benchmark reform as a market-wide replacement of an existing benchmark. We note that not all benchmarks that are reformed will be replaced, eg EURIBOR and the IASB should clarify whether reforms other than by replacement would be in scope of the reliefs.

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 (s.pustshah@frc.org.uk) on 020 7492 2495.

Yours sincerely

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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 proposals to provide relief for the forward-looking hedge accounting conditions under IAS 39 and IFRS 9. However, the intentions of the Board regarding the relief for the prospective test are not entirely clear. Proposed paragraphs 6.8.6 of IFRS 9 and 102F of IAS 39 require that when the economic relationship/hedge effectiveness are assessed prospectively, the possible alteration of the interest rate benchmark is ignored. BC22, however, suggests that an entity cannot ignore the effects of the benchmark rate reform when measuring hedge effectiveness as part of the prospective assessment. We note therefore that hedges could fail the prospective test when the uncertainties of the benchmark rate reforms affect the valuations.

A2 The effect of the uncertainties of the benchmark rate reforms on the measurement of the hedged item and the hedging instrument is even more pertinent for the retrospective assessment under IAS 39. We note the Board decided not to propose an exception for the retrospective test under paragraph 88(e) and AG105(b) of IAS 39 as part of the proposals in this ED. Hedge accounting failure because the retrospective test is no longer met does not appear to be a remote possibility, because the valuations of the hedged item and the hedging instrument would be affected in the same way and there is no natural off-set.

A3 We believe the IASB should explore further the implications of the benchmark rate reforms on the prospective and retrospective assessment. We concur with the IASB that any relief should be limited to the effects of the uncertainties of the benchmark rate reform. Measurements, however, are affected by multiple factors and it may not be possible to reliably separate the effects of the benchmark rate reforms. Nevertheless, we urge the IASB to assess whether an adequate solution can be found to address the effects on measurement and allow continuation of hedge accounting.

A4 We expect that the effects on measurement may become apparent pre-replacement of the benchmark rates and the IASB should assess whether these issues require attention as part of Phase I or can be deferred until Phase II.

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.

A5 We believe the requirements in IAS 39 and IFRS 9 for the component to be separately identifiable and changes in the fair value to be reliably measurable are linked. We expect over time it could be difficult to measure reliably the fair value changes for a component that is no longer separately identifiable. However, we agree with the proposal to provide relief for the separately identifiable condition and no relief for the reliably measurement condition. Relief from the reliably measurable condition could impair relevance and reliability of financial information. We accept that these types of hedging relationships could fail hedge accounting as a consequence of the benchmark rate reforms.

A6 We understand from the proposals that the relief applies to existing hedging relationships when due to the uncertainties of the benchmark rate reforms it is no longer possible to separately identify the previously designated component. However, in respect of any new hedging relationships IFRS 9 and IAS 39 would require that at inception the component is separately identifiable and changes in fair value are reliably measurable. We do not believe that it is necessary for new hedging relationships that are affected by the uncertainties of the benchmark rate reforms to be excluded from hedge accounting because it is determined that the component can no longer be separately identified. We believe the second condition of reliable measurement is sufficiently robust to prevent any misuse of hedge accounting. We would therefore suggest that the separately identifiable condition is also lifted for new hedging relationships. By making this change the relief is consistently applied to existing and new hedging relationships. It would also preempt questions around the duration over which a component must be expected to be separately identifiable at inception.

A7 We also have a comment in respect of the retrospective application of this relief, which we address under Question 5 below.

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.

A8 We concur that the reliefs should be mandatory. In practice we expect that preparers would want to apply the relief to avoid hedge accounting failures. We therefore do not believe that mandatory application introduces any greater effort or cost than optional application of the relief, but it has the benefit of consistency.

A9 We also concur that IAS 39 and IFRS 9 should specify when the relief should end, except as proposed for the relief applicable to hedges of components.

A10 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. However, we have highlighted under Question 1 our concerns about the impact of the uncertainties on measurement. We believe the IASB should further explore the impact on measurement where there is only partial switching in a hedging relationship and whether further relief should be granted to avoid failure of hedge accounting due to measurement. We note that 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 not the hedged item.

A11 We suggest that the drafting of the cessation requirements could be simplified without changing the outcome, because they contain superfluous requirements. Proposed paragraph 6.8.2 of IFRS 9 and paragraph 102B of IAS 39 state that the relief only applies to hedging relationships affected by the uncertainties of the benchmark reform. It follows that when the uncertainties described in these paragraphs are resolved the exceptions will come to an end.

A12 IFRS 9 and IAS 39 deal with the accounting consequences of discontinuation of hedging relationships. We do not believe there is a need for new requirements specifying that the reliefs come to an end when the hedging relationships which apply the reliefs are discontinued.

A13 To simplify the drafting we suggest inserting new paragraph 6.8.4 in IFRS 9 and new paragraph 102D in IAS 39 to 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.

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?

A14 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. We believe the IASB should assess that need in collaboration with users as part of Phase II of this project. We believe the IASB should commence these debates as soon as possible to address users' needs appropriately and timely.

A15 The benefits of the proposed disclosures to users are not clear to us. In essence under the proposal information for hedges that apply the "standard" hedge accounting conditions is separately disclosed from information that relate to hedges accounted for applying the proposed exceptions. We suggest the IASB could clarify whether the intent of this separation is to enable users to get a sense of the impact on the financial statements should the reliefs cease and the hedging relationships are discontinued. If this is not the case then it is difficult to see a reason for the separate disclosures.

A16 The IASB may also consider hedging relationships where only the hedging instrument or hedged item qualify for the relief and the impact this may have on the proposed disclosures.

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.

A17 We agree that the relief should be effective as soon as possible as the benchmark rate reforms are progressing. Providing a choice of early application is the best option to make the reliefs available for financial years beginning prior to 1 January 2020.

A18 We support retrospective application of the exceptions as proposed in the ED. However, we disagree with the Board that retrospective application of the amendments should always be prohibited for hedges that were discontinued in a prior period (BC46). We support that retrospective reinstatement should be permitted for previously discontinued hedges that failed the hedge accounting requirements because, and only because, the proposed reliefs in the ED were not (yet) available.

A19 Although we support retrospective application, its use is not clear for component hedging (Question 2 above). This relief seems prospective in nature and we are unsure how the IASB believes it should be applied retrospectively.