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For the attention of Jenny Carter

20 September 2019

Dear Ms Carter

FRED 72: Draft amendments to FRS 102 – Interest rate benchmark reform

We appreciate the opportunity to comment on FRED 72.

We support the FRC's efforts to respond to accounting challenges resulting from the planned market-wide replacements of existing interest rate benchmarks with alternative near risk-free rates ("RFRs").

As noted in KPMG IFRG Limited's response to the related ISAB exposure draft, we believe the primary challenge for the project on interest rate benchmark reform is developing accounting guidance that supports the transition from existing interest rate benchmarks to alternative RFRs in a manner that prevents disruption to existing hedge relationships and eliminates financial statement volatility where that is not reflective of the economics of the transition. In our view, effectively addressing this challenge would best be achieved by developing and communicating overarching principles that are durable and can accommodate market-wide reforms of varying natures and timelines as well as differing specific hedge designations.

Identifying overarching principles has a number of benefits, as we set out in our detailed response in Appendix 1. Our preferred approach to standard setting in this area would be a principles-based approach in line with these suggestions. However, we appreciate that both the FRC and IASB has limited resources and a tight timetable against which to deliver solutions for accounting for the effects of interest rate benchmark reform. Given these constraints, we would understand if the FRC decided to persevere with further developing the approach it has proposed. As although we believe the FRC's proposed approach is subject to certain problems, we consider that it is preferable to taking no action.

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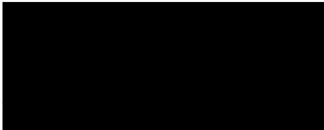
Please contact Colin Martin on 020 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely



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Enclosures:

Appendix 1: Detailed comments in relation to FRED 72

Appendix 1: KPMG's responses to the specific questions in the invitation to comment

Question 1
Do you agree with the proposed amendments to FRS 102? If not why not?

No, we believe a principles-based approach to be preferable as explained below.

<u>*A principles-based approach*</u>

KPMG IFRG Limited's response to the related ISAB exposure draft outlined a principles- based approach, which we believe would still be relevant under FRS 102. A principles based approach would:

- Apply to hedge relationships that include exposure to interest rates impacted by the market-wide replacement of an existing interest rate benchmark with an alternative RFR for the hedging instrument and/or hedged item (e.g. this would extend to hedges of foreign currency risk that use a cross-currency interest rate swap as a hedging instrument).
- Assume that where existing hedge documentation refers to the current benchmark rate, such a designation implicitly encompasses the alternative RFR that will replace the existing interest rate benchmark.
- Require that the measurement of ineffectiveness captures the economics of the hedge relationship by applying the principles of the fair value measuremnt guidance in the appendix of section 2 of FRS 102, including the impact of expected changes in cash flows caused by transition to a new RFR.
- Grant temporary relief from discontinuing hedge accounting if, as a result of uncertainties related to interest rate benchmark reform, effectiveness assessments no longer evidence that economic relationship (as defined in FRS 102:12.18A) exists between the hedged item and hedging insrument (notwithstanding that all ineffectiveness must continue to be recognised).

We believe that the transition to alternative RFRs should generally be seen as an evolution in affected hedging relationships rather than a discontinuity. Further, we are of the view that the aforementioned principles would meet this objective of providing continuity to hedge accounting and address qualitative and quantitative concerns related to interest rate benchmark reform.
From a qualitative perspective, hedged forecast benchmark cash flows should generally be considered to continue to be highly probable of occurring (or still expected to occur) to the extent that they will be replaced by alternative RFR cash flows. An entity that applies a qualitative methodology to demonstrate an economic relationship under FRS 102 would consider cash flows of the existing interest rate benchmark or alternative RFR to be similar in nature. These principles acknowledge that anticipated changes to interest rate benchmarks will generally impact both the hedged item and hedging instrument, and therefore the hedging instrument and hedged item will respond to these same risks.

From a quantitative perspective, derivative valuations will reflect market assumptions about alternative RFRs and changes to cash flows as the market moves towards the use of the new benchmarks and depending on whether and how the contract or laws and regulations require or permit the cash flows of the instrument to change. Interest rate benchmark reform does not alter the requirement for an entity to recognise derivatives at fair value even if their cash flows are subject to higher uncertainty. The principles above would require an entity to derive estimates and assumptions about market interest rates in projecting and valuing the future cash flows in a cash flow hedge. If forecast changes in derivative cash flows and hedged item cash flows are not anticipated to occur at the same time or otherwise have an exactly offsetting effect, then the effect of that expected mismatch should be reflected in ineffectiveness calculations and, as appropriate, profit or loss.

Although these principles may preserve the continuity of hedge accounting, we believe that it is important that any hedge ineffectiveness resulting from transition is reported in profit or loss as it arises. There should be a clear differentiation between the impacts of interest rate benchmark reform on the assessment of an economic relationship versus the measurement of ineffectiveness. We believe that while the Board should clarify that hedge disqualifications should not be caused by uncertainties related to interest rate benchmark reform nor by treating cash flows or values based on the new benchmark as of a fundamentally different type from those based on the old benchmark, it should also clarify that the requirements related to the measurement of ineffectiveness are not affected and continue to apply to the effects of such changes.
We believe that these principles-based proposals should permit retrospective application of the targeted relief, including reinstatement of hedges that were previously discontinued only because those principles were not previously applied.

When considered together, our proposals would mitigate the opportunity for abuse, maintain the discipline of hedge accounting, and reduce the risk for unwarranted financial reporting disruption during the transition to alternative RFRs. Such an approach would not seek to change the accounting standards or principles themselves, but rather it would provide clarity on how those existing principles should be interpreted. We believe such an approach may allow quicker adoption in practice.

The approach we recommend is succinct, and we think there is merit in providing concise guidance rather than complex detailed rules. Further, we think a principles-based approach is better placed to deal with new developments and unforeseen problems. Importantly, we believe that the adoption of a principles-based approach under FRS 102 would still be desirable even if the ISAB persevres with its current proposals. This is because a principles-based approach would be more intuitive to apply, especially for small and medium sized entities and would also have the benefit of addressing any uncertainty in respect of hedge relationships in financial statements signed in 2019 (before the proposed effective date of this FRED).