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Ref: AC/FRC

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Dear Madam

FRED 72, Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland,* Interest rate benchmark reform

Ernst & Young LLP welcomes the opportunity to comment on FRED 72 issued by the Financial Reporting Council ('the FRC').

We support the FRC's efforts to address the issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark (or an 'IBOR') with an alternative interest rate (referred to as 'Risk Free Rate' or 'RFR'). We note that the FRC's proposals are similar to the IASB's plans to amend IFRS 9, albeit appropriately simplified to reflect the FRS 102 approach. We agree with the vast majority of FRED 72 but request that some additional points are addressed, similar to those which the IASB discussed in their August 2019 meeting. The IASB's final amendments will form a good starting point to amend the proposals in FRED 72. We also ask that the FRC start to consider how to address those financial reporting challenges that will arise once financial instruments begin to be amended, again building on the work of the IASB.

Our responses to the specific questions in the FRED 72 are provided in the Appendix.

Should you wish to discuss the contents of this letter with us, please contact Tony Clifford at the above address or on +44 (0)20 7951 2250.

Yours faithfully

A.R.E. Clifford, for and on behalf of
Ernst & Young LLP
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Appendix – Responses to Exposure Draft Questions

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

We agree with the proposals, except as set out below. In each case the issue is equivalent to one of those discussed by the IASB in August 2019 and we recommend that the IASB's final wording is used as a basis for the amendment to FRS 102.

1. Scope of the amendments

Paragraph 12.25B states that the reliefs "…apply to hedging relationships of interest rate risk that are affected by benchmark reform." We are concerned that this has the effect of excluding other hedging relationships where interest rate risk is not the only designated risk. An example would be if a cross currency swap is designated as a hedge of both interest rate risk and foreign exchange risk.

Clarification should be provided that the reliefs apply when both interest rate risk and another risk (or risks), such as foreign currency risk, are jointly designated as hedged risks. The reliefs should apply to all hedging relationships directly affected by uncertainties due to IBOR reform that relate to the timing or amount of interest rate benchmark-based cash flows of the hedged item or hedging instrument.

2. End of relief for groups of hedging instruments and hedged items

Paragraph 12.25G(a) states that the relief shall cease 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. For hedges of groups of items, it is not clear whether this assessment should be performed on an individual instrument basis, or on a group basis (i.e. the uncertainty would not end for any item in the group until the last item in the group has been amended to the new benchmark rate). To clarify this point, we suggest the amendment states that when an entity designates a group of items as the hedged item, the end of application requirement applies separately to each individual item within the designated group of items.

3. Initial application

It would be potentially onerous for entities to provide the disclosures required by paragraph 10.13 of FRS 102 upon initial application of the amendments, and so we ask for reliefs similar to those discussed by the IASB in August 2019.

4. Challenges once IBOR has undergone reform

We encourage the FRC to progress its work to address the challenges which will arise once IBOR has undergone reform. The items we note as a priority are described below. Consideration of these matters should not delay finalisation of FRED 72 and we recommend that the FRC again builds on the work of the IASB.

i Discontinuance of hedge accounting upon transition

Once a hedging relationship is amended to refer to an RFR rather than an IBOR, the existing hedge may need to be de-designated and for there to be a re-designation as a new hedge. This is equally applicable to fair value and cash flow hedges (CFH). However, for CFHs, de and re-designation could affect subsequent hedge effectiveness because at re-designation the hedging instrument would have a non-zero fair value.

FRS 102 should be amended to clarify that where it is necessary for a hedge designation to change from referencing IBOR to an RFR due to IBOR reform, the change would not in itself require the discontinuance of the hedging relationship. The relief could be narrowly defined and limited only to re-designations as a direct result of IBOR reform and not from broader re-designations of risk.

ii Amounts deferred in CFH reserve following transition

Paragraph 12.25A requires that cash flows and forecast transactions identified in the hedge designation must still be expected to occur, for amounts to remain deferred in the CFH reserve. Following transition from IBOR, since IBOR cash flows will no longer occur, hence if IBOR cash flows have been specifically referenced in the hedge designation, the amount deferred in the CFH reserve may need to be released.

We recommend that the continued deferral of amounts recognised in the CFH reserve upon transition from IBOR to RFR should be permitted, even though IBOR cash flows will not occur, provided they have been replaced by RFR cash flows.

iii Timing of release of amounts deferred in the CFH reserve

Assuming amounts may continue to be deferred in line with point ii above, yet the originally forecast IBOR cash flows will no longer occur, the timing of the release needs to be considered.

We suggest paragraph 12.23 is amended to permit amounts deferred in the CFH reserve as a hedge of forecast IBOR variability, to be released to mitigate variability in the replacement RFR designated hedged risk as and when it affects profit and loss.

iv Interest rate adjustment for floating rate instruments at amortised cost

As a consequence of IBOR reform, the expected cash flows of affected instruments will change on transition to an RFR. Assuming no derecognition, it is unclear whether paragraph 11.19 or 11.20 applies. If paragraph 11.19 applies, the EIR would be amended prospectively and the carrying amount of the financial instrument would not change. If paragraph 11.20 applies, the gross carrying amount of the financial instrument would be adjusted with a modification gain or loss recognised in P&L and interest continuing to be recognised at the original EIR.

We consider the change in base rate from transitioning from IBOR to an RFR is most appropriately recognised under paragraph 11.19. It would also be both impracticable and not provide useful information, to require continued use of an EIR based on IBOR. We therefore suggest clarification is provided that a change in interest rate as a result of the transition from IBOR to RFR should be reflected as a movement in the market rate of interest, as set out in paragraph 11.19.

Question 2
In relation to the Consultation stage impact assessment, do you have any comments on the costs and benefits identified? Please provide evidence to support your views.

We consider the approach being proposed by the FRC will have a positive effect on financial reporting.