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Submitted electronically via email (ukfrs@frc.org.uk)

FRED 72 Interest rate benchmark reform

Grant Thornton UK LLP (Grant Thornton) is pleased to comment on the Financial Reporting Council's (FRC) consultation "FRED 72 Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland - Interest rate benchmark reform".

We welcome the FRC's proposals to provide relief from the effects of interest rate benchmark reform on hedge accounting. Reporting entities need clarity on the impact on hedge accounting urgently, and we therefore urge the FRC to finalise the proposal as quickly as possible.

We strongly support the overall objective and approach of FRED 72 as set out in our response to questions 1 and 2. We do however have some concerns relating to the impact of the proposals on the measurement of hedge effectiveness in general and also relating to the proposed end date of the relief in respect of previously discontinued hedges.

Our detailed responses to FRED 72's Invitation to comment questions are set out in the Appendix.

If you have any questions on our response, or wish us to amplify our comments, please contact me by email (alan.chapman@uk.gt.com) or telephone (+44 131 659 8509).

Yours sincerely

Alan Chapman

Director

Grant Thornton UK LLP

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Appendices

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

We agree with the proposals to provide relief for the effects of interest rate benchmark reform under FRS 102. Without the proposed amendments, the uncertainty surrounding the replacement of IBORs and the form this will take, could result in entities having to discontinue hedge accounting solely because of the reform's effect on their ability to make forward-looking assessments. This would not provide useful information. Making the assumption that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of interest rate benchmark reform is a practical solution to the problem and we therefore support it.

We also agree with the proposal that the hedged risk component or designated portion should only be separately identifiable at the inception of the hedging relationship. Making this assessment only once at inception is a practical relief which will allow entities to continue hedge accounting where the interest rate benchmark is not contractually specified.

The proposed changes to FRS 102 appear to be conceptually consistent with the changes proposed by the International Accounting Standards Board (IASB) to IFRS 9 and IAS 39 as set out in the IFRS 9 / IAS 39 exposure draft. The proposed changes to FRS 102 section 12 broadly mirror the proposed changes to IFRS 9 which is conceptually similar to the FRS 102 hedge accounting model. We observe that some issues were raised with the IASB in response to the IFRS 9 / IAS 39 exposure draft, and the resolution of those matters has not been finalised in IFRS at the time of writing. We consider that it is important that the FRS 102 changes mirror the IFRS related changes in order to avoid confusion.

We attach as an Appendix a copy of the Grant Thornton response to the IASB on the IAS 39 / IFRS 9 exposure draft. Within that letter we raised challenges in respect of the IAS 39 retrospective test and also effectiveness measurement. The effectiveness measurement aspects were relevant to both IAS 39 and IFRS 9 - see section titled "Retrospective assessments and effectiveness measurement". The measurement challenge would equally apply to FRS 102.12.23, in terms of the assumptions that a user should make when defining a hypothetical derivative.

In respect of the proposed end date for the relief, FRED 72 has proposed in FRS 102.25.25G for this date to be when"

(a) The uncertainty arising from the interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows; or

(b) The hedging relationship is discontinued; or

(c) When the entire amount accumulated in the cash flow hedge reserve with respect to that hedging relationship is reclassified to profit and loss"

The proposals do not make it entirely clear, but we would read this as implying that the relief ceases when any of events (a) to (c) occur.

This criterion is less specific than that set out in IFRS 9 and IAS 39. However, we raised a concern in relation to the IFRS 9 / IAS 39 proposals relating to discontinued hedges. This is set out in our response to question 3 in the Grant Thornton letter to the IASB. A similar concern would apply to the FRED 72 proposals. This means that where a LIBOR hedge has been discontinued, the end date proposed by FRS 102.12.25G would mean the relief in FRS 102.12.25D could be read to end once the loan which was the hedged item is changed to a risk free rate. This could in turn imply immediate reclassification at that point, which may not be the desired outcome.

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.

The amendments are in line with the FRC's objective to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information even more so as they are consistent with the amendments proposed in the International Financial Reporting Standards (IFRS).

Appendices

The relief provided by the amendment will allow entities to continue hedge accounting for relationships that may have otherwise been discontinued. The discontinuance would have introduced more complexity which would in turn have increased cost.

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Appendices

Grant Thornton response to the IASB on the IAS 39 / IFRS 9 exposure draft.

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ED/2019/1 Interest Rate Benchmark Reform - Proposed amendments to IFRS 9 and IAS 39

Grant Thornton International Ltd is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft ED/2019/1 'Interest Rate Benchmark Reform - Proposed amendments to IFRS 9 and IAS 39' ('the ED'). We have considered the ED, as well as the accompanying draft Basis for Conclusions.

We welcome the IASB's proposals to provide relief from the effects of interest rate benchmark reform on hedge accounting and its decision to split its overall project into two phases. Reporting entities need clarity on the impact on hedge accounting urgently, and we therefore urge the Board to finalise the first phase of this project as quickly as possible.

We are generally supportive of the specific proposals set out in the ED although as set out in our response to questions 1 and 3, we do have some concerns relating to the impact of the proposals on the:

- retrospective assessment of hedge effectiveness
- measurement of hedge effectiveness in general.

Finally, in addition to completing the first phase of this project we would encourage the Board to prioritise the second phase of the project as interest rate benchmark reform is progressing rapidly and will present live issues for preparers in coming months.

Our detailed responses to the ED's Invitation to Comment questions are set out in the Appendix.

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If you have any questions on our response, or wish us to amplify our comments, please contact me by email (edward.haygarth@gti.gt.com) or telephone (+ 44 207 391 9556).

Yours sincerely,

Edward Haygarth
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Appendices

Responses to Invitation to Comment 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.

We agree with the proposals to provide relief for the effects of interest rate benchmark reform on prospective hedge accounting testing under IAS 39 and IFRS 9. Without the proposed amendments, the uncertainty surrounding the replacement of IBORs and the form this will take, could result in entities having to discontinue hedge accounting solely because of the reform's effect on their ability to make forward-looking assessments. This would not provide useful information. Making the assumption that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of interest rate benchmark reform is a practical solution to the problem and we therefore support it.

We do however have some concerns relating to the impact of the proposals on the retrospective assessment of hedge effectiveness and the measurement of hedge effectiveness in general. We also have some comments on the discussion of discontinued hedges that is set out in the ED's Basis for Conclusions. We set these out below.

Retrospective assessments and effectiveness measurement

In relation to IAS 39 and IFRS 9's assessments of prospective hedge accounting, paragraph BC18 in the ED comments that these require estimation of future cash flows. BC21 then comments that in applying the proposed exceptions to the prospective assessment, an entity should assume that the interest rate benchmark is not altered as a result of benchmark reform. However, BC22 states that the ED is not intended to change the measurement of hedge effectiveness. BC23 further comments that no relief is proposed for IAS 39's assessment of retrospective effectiveness.

We consider that the proposals do not consider the inherent interaction between the assessment of forward-looking cash flows in the hedged item and the impact on both retrospective assessments and effectiveness measurement.

In the context of cash flow hedges, the accounting entries including the effectiveness measurement is based on the 'lesser of' calculation in IFRS 9.6.5.11 / IAS 39.96. In this calculation, the cumulative gain or loss on the hedged item is normally based on a hypothetical derivative. The hypothetical derivative is based on an assessment of future cash flows. Similarly, in performing the retrospective test in IAS 39, a common method is the dollar offset method which, in the context of a cash flow hedge, will typically use a hypothetical derivative to assess the fair value change of the hedged item. Therefore both the measurement of hedge effectiveness and the assessment of retrospective effectiveness involve the estimation of future cash flows. We believe that as currently written, the proposals could result in significant confusion in those areas.

To illustrate, consider where an entity has a cash flow hedge, where the hedging instrument is an IBOR based interest rate swap maturing in 2030 and where the hedged item relates to IBOR based debt together with replacement debt. Say for example it is anticipated that in 2021, the hedged item loan will change to a risk-free rate. In the effectiveness measurement, fair value principles would be used for the measurement of the hedging instrument, which would feed through to the accounting entries and assessment of retrospective effectiveness. However, we are unclear as to how to assess the hedged item for the purposes of effectiveness measurement and the retrospective assessment. For instance, BC8 might imply that without relief, the cash flows after 2021 would be nil for the hedged item/hypothetical derivative as there would be no further highly probable IBOR based cash flows after this date. If this were the case, current ineffectiveness would be substantial. This is because the fair value of the hedging instrument would reflect its contractual terms of cash flows up to 2030, while the hedged item/hypothetical derivative would only reflect those cash flows impacted by IBOR, being to 2021. If this were the case, the retrospective test would likely fail, and the 'lesser of' calculation would indicate a substantial mismatch between the hedged item and hedging instrument. If this were the case, then the objectives of the proposals might not be met. We consider this to be a 'phase 1' issue because of the inherent link to future cash flows in assessing the hedged item as part effectiveness measurement and retrospective assessment.

Conversely, it may be the intention of the Board for the hedged item/hypothetical derivative to reflect the full extent of future variable interest related cash flows, whether those are IBOR or risk-free rate related, while drawing out the inherent ineffectiveness. Using the illustrated example, if the hypothetical derivative were intended to reflect IBOR cash flows to 2021 but risk-free rate cash flows from 2021 to 2030, then there would be some complexity in measurement although this may be consistent with the overall objectives.

In summary we consider that the proposals should clarify the Board's intention relating to the assumptions that an entity should make for the purposes of the 'lesser of' calculation and retrospective assessment, when defining the hedged item relating to the future cash flows which are anticipated to be impacted by benchmark reform.

Discontinued hedges

The ED proposes in IFRS 9.6.8.5, for the purpose of IFRS 9.6.5.12(b), that when determining whether the hedged cash flows are no longer expected to occur, an entity shall assume that the interest rate benchmark on which the cash flows are based is not altered as a result of interest rate benchmark reform. A similar amendment is proposed in the context of

IAS 39.102E. This is in the context of discontinued cash flow hedges. Where the hedged item continues to exist, IFRS 9 and IAS 39 require the amount in the cash flow hedge reserve to be reclassified when the future cash flows occur, but immediate reclassification occurs when the hedged future cash flows are no longer expected.

BC10 comments on the Board's view of the existing application of IFRS 9 and IAS 39. The last two sentences indicate that in light of benchmark reform, an entity may conclude that the hedged item cash flows are no longer expected to occur, leading to immediate reclassification.

We agree with the underlying principle behind the proposals relating to discontinued hedges of cash flow hedges over interest rate risk. That is, the reclassification period of discontinued hedges should not be impacted by interest benchmark reform. We do not however necessarily see the existing requirements of IAS 39/IFRS 9 as clear in this area, in terms of the impact of IBOR reform on such discontinued hedges. While BC10 comments that interest rate benchmark reform may have led to a conclusion that cash flows are no longer expected to occur leading to immediate reclassification, we do not consider that such a conclusive outcome would have been reached in all cases under the existing requirements. The key principle in IFRS 9.6.5.12 relates to whether the hedged cash flows are expected to occur. The role of the original hedge designation documentation is important in this regard along with the risk management objectives of the discontinued hedge.

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.

We agree with the proposal that the hedged risk component or designated portion should only be separately identifiable at the inception of the hedging relationship. Making this assessment only once at inception is a practical relief which will allow entities to continue hedge accounting where the interest rate benchmark is not contractually specified.

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.

We agree that the exceptions should be mandatory. An important feature of hedge accounting is to allow entities to reflect accounting consistent with risk management objectives, while avoiding the potential for earnings management. If the exceptions were not mandatory, they would run the risk of abuse as entities would be able to choose which hedging relationships to discontinue and so manage their earnings.

We also agree with not proposing an end date to the application of the relief for hedges of the benchmark component of interest rate risk that is not contractually specified. We believe that this is consistent with the aim of the relief being given here.

With regard to paragraph (b) in the question, we do however have concerns about some aspects of the proposed date of cessation of the exceptions.

The ED proposes in IFRS 9.6.8.9 to cease the application of IFRS 9.6.8.5 at the earlier of when the uncertainty arising from the interest rate benchmark is no longer present in respect of the hedged item cash flows and when the entire amount accumulated in the cash flow hedge reserve has been reclassified. IFRS 9.6.8.5 relates to discontinued hedges. Similar proposals are included for IAS 39.

As noted in our response to question 1, we do not consider that the existing requirements in IAS 39 and IFRS 9 are clear in relation to the impact of IBOR reform when applied to discontinued hedges. If it is considered that immediate reclassification may arise in IFRS 9 and IAS 39 (without the relief from the exceptions) then the proposed cessation date in IFRS 9.6.8.9 could give rise to outcomes which are not helpful to a user of the financial statements. In particular, say a hedge is discontinued in 2020 through settlement of an IBOR based swap which had a maturity date of 2030, but where the IBOR based hedged item continues. However, say in 2021, the loan is then amended to a risk-free rate. The proposal in IFRS 9.6.8.9 would appear to give rise to full reclassification in 2021 which may not be the desired outcome.

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?

We agree with the proposed disclosures. Without these specific disclosures, information about the extent to which hedging relationships are affected by the proposed amendments, could be obscured through aggregation with other hedge relationships.

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.

We agree with the proposed effective date of the amendments. Given the rate at which interest rate benchmark reform is progressing in some markets, we believe it is important that relief from the possible effects on hedge accounting is available as soon as possible. Making the amendments effective for annual periods beginning on or after 1 January 2020 with the option of early application is a suitable means of achieving this objective.

We also broadly agree with retrospective application of the amendments. However, we disagree with the proposal that retrospective application of the amendments should always be prohibited for hedges discontinued in a prior period as inferred by paragraph BC46 in the ED. We believe retrospective application should be permitted for hedging relationships in situations where hedge accounting has previously been discontinued solely as the result of interest rate benchmark reform but would not have been had the proposed reliefs in the ED been available at the time of discontinuance.

We do not believe that specific additional transition provisions are necessary for the reasons set out in the ED.