Financial Reporting Council

IFRS Foundation
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Submitted electronically

Xx May 2020

Dear Board members

Exposure Draft ED/2020/1 *Interest Rate Benchmark Reform—Phase 2 Proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16*

I am writing on behalf of the UK Financial Reporting Council (FRC) to provide comments on the above Exposure Draft (ED).

We heard overwhelmingly positive comments from constituents on the proposals in this ED. They commended the IASB's efforts to produce proposals timely and reiterated that the expeditious completion of the amendments remains important, since the deadlines for completion of the reform have not shifted.

We share the views expressed by constituents and continue to support the IASB's efforts to make necessary amendments to IFRSs that facilitate a smooth transition to new benchmark rates. We welcome the proposed Phase II amendments, because they are designed to provide useful information about the real economic consequences of the reform. That said, we have identified a few areas where some clarification is needed either in the text of the standard itself or within the Basis for Conclusions.

I also wish to emphasise that although we generally agree with the proposals on modifications, our agreement is ringfenced to these specific proposals. Based on feedback we heard from constituents it will be necessary to have a wider debate about the merits of extending the definition of modifications used for the purpose of the proposals in this ED to changes outside of benchmark reform.

We also support the IASB's decision not to make amendments to IFRS 17 or IFRS 13 for consequences of the benchmark reform.

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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).

Yours sincerely

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Appendix: Questions

Question 1— Modifications of financial assets and financial liabilities (paragraphs 6.9.1–6.9.6 of the [Draft] amendments to IFRS 9, paragraphs 20R–20S and 50–51 of the [Draft] amendments to IFRS 4 and paragraphs 104–106 and C1A–C1B of the [Draft] amendments to IFRS 16)
Paragraphs 6.9.2–6.9.6 of the draft amendments to IFRS 9 propose that: (a) a financial asset or financial liability would be modified if the basis for determining the contractual cash flows is changed after the initial recognition of the financial instrument. In this context, a modification can arise even if the contractual terms of the financial instrument are not amended. (b) an entity would apply paragraph B5.4.5 of IFRS 9 as a practical expedient to account for a modification of a financial asset or financial liability that is required by interest rate benchmark reform. (c) a modification is required by interest rate benchmark reform if and only if (i) it is required as a direct consequence of interest rate benchmark reform; and (ii) the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the modification). (d) an entity would also apply the practical expedient proposed in paragraph 6.9.3 if an existing contractual term is activated that results in a change in the basis for determining the contractual cash flows of a financial asset or a financial liability, and particular other conditions are met. Paragraphs BC10–BC36 of the Basis for Conclusions describe the Board's reasons for these proposals. (e) The Exposure Draft proposes to make corresponding amendments to IFRS 4 that would require insurers applying the temporary exemption from IFRS 9 to apply the same practical expedient as described above. (f) The Exposure Draft proposes amendments to IFRS 16 that would require entities to apply paragraph 42 of IFRS 16 to account for a lease modification that is required by interest rate benchmark reform. Paragraphs BC39–BC41 and paragraphs BC118–BC125 of the Basis for Conclusions describe the Board's reasons for these proposals. 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 that the relief should equally apply to financial instruments that are modified and those that have existing contractual terms activated, as proposed in paragraphs 6.9.1, 6.9.2 and 6.9.5 of the ED. We also generally support the proposed practical expedient to apply paragraph B5.4.5 of IFRS 9 to these changes.

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A2 Paragraph B5.4.5 specifies the application of the effective interest rate method to floating rate financial instruments measured at amortised cost. However, the proposed practical expedient applies to all financial instruments regardless of their classification and the ED does not provide guidance on how this relief should be applied to financial instruments not measured at amortised cost.

A3 We believe it is not obvious how the requirements would be applied to financial instruments measured at fair value through other comprehensive income (FVOCI) or financial instruments measured at fair value through profit or loss (FVp&l), especially derivatives. We would therefore welcome some clarification in the Basis for Conclusion, or alternatively for the IASB to review the scope of this relief.

A4 We concur with the proposed conditions applicable to modifications and activations in paragraph 6.9.3 and 6.9.5 of the ED, respectively. We would suggest a couple of drafting changes. Firstly, paragraph 6.9.3(a) should be amended to "the modification is necessary", and paragraph 6.9.5(b) should refer to the activation being "triggered as a direct consequence of interest benchmark reform", instead of stating that such changes are required. We believe although the reform of benchmark indices is a requirement, a modification or activation in contracts to affect the new benchmarks, may not always be required under law, regulation or existing contractual terms.

A5 Paragraph 6.9.6 of the ED sets out the proposed order of accounting for changes to financial instruments made as a direct consequence of the reform and other additional changes. We generally concur with the proposals, although there appears to be an inconsistency with the related explanations in BC35 of the ED, as far as derecognition is concerned. BC35 seems to suggest that the financial instrument is assessed for derecognition first, if there are changes other than those required as a direct consequence of the reform. Paragraph 6.9.6, however, requires this step to be performed last. We do not necessarily believe the sequence would result in a different accounting outcome, but for ease of application, we suggest the IASB redrafts BC35 so it is clearly consistent with paragraph 6.9.6.

A6 As set out above we are supportive of the proposed amendments, including the proposal around what constitutes a modification. However, our agreement is ringfenced to these narrow amendments for benchmark reform. We acknowledge the IASB's intent to explore if there is diversity in practice on the application of the modification requirements in IFRS 9 in situations where the bases for calculating reference rates and other variables have been changed, and its desire to clarify or extend the scope of "modifications". However, we urge the IASB for any such work to be part of a project which allows more time for a wider debate and stakeholder input and not to assume that agreement with these proposals is tacit support from stakeholders for broader amendments.

A7 We concur with the proposed amendments to IFRS 4 and IFRS 16.

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Question 2 — Amendments to hedging relationships (paragraphs 6.9.7–6.9.10 of the [Draft] amendments to IFRS 9 and paragraphs 102O–102R of the [Draft] amendments to IAS 39)
Paragraphs 6.9.7–6.9.10 of the draft amendments to IFRS 9 and paragraphs 102O–102R of the draft amendment to IAS 39 propose that an entity would amend the formal designation of the hedging relationship only to make one or more of the changes specified in paragraph 6.9.7 and paragraph 102O as and when uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and/or the timing and the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. Paragraphs BC42–BC50 of the Basis for Conclusions describe the Board's reasons for these proposals. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you propose instead and why.

A8 We generally agree with the proposals in these paragraphs. Nevertheless, we heard some concern from constituents that the only change that can be made to the hedged item and hedging instrument is the reference to a new benchmark rate. We suggest for the IASB to consider whether more flexibility could be granted, for example to include adjustments to proportions being hedged, provided these changes are made as a direct consequence of referencing to a new benchmark rate.

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Question 3 — Accounting for qualifying hedging relationships and groups of items (paragraphs 6.9.11–6.9.15 of the [Draft] amendments to IFRS 9 and paragraphs 102S–102X of the [Draft] amendments to IAS 39)

Paragraphs 6.9.11–6.9.15 of the draft amendments to IFRS 9 and paragraphs 102S–102X of the draft amendments to IAS 39 propose that:

(a) the requirements in IFRS 9 and IAS 39 would be applied when the designation of a hedging relationship is amended to remeasure the hedging instrument and the hedged item based on the alternative benchmark rate and recognise any resulting ineffectiveness in profit or loss.

(b) the amount accumulated in the cash flow hedge reserve at the date the entity amends the description of the hedged item would be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

(c) when there is a change in the basis for determining the contractual cash flows of a financial asset or a financial liability previously designated as a hedged item in a hedging relationship that has been discontinued, the amount accumulated in the cash flow hedge reserve for the discontinued hedging relationship would be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

(d) when applying paragraph 6.9.7 or paragraph 102O to groups of items designated as hedged items, the hedged items would be allocated to sub-groups within the same hedging relationship based on the benchmark rate to which they are referenced and that the proportionality test would be applied to each sub-group separately.

(e) for the purpose of assessing retrospective effectiveness as required by IAS 39, the cumulative fair value changes of the hedged item and hedging instrument would be reset to zero when paragraph 102G of IAS 39 ceases to apply.

Paragraphs BC51–BC79 of the Basis for Conclusions describe the Board's reasons for these proposals.

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.

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A10 There has been some debate how the requirements in paragraphs 6.911 and 6.9.12 and paragraphs 102T and 102U of the ED should be read. We believe that these paragraphs require remeasurement of the hedging instrument when the designation of the hedging instrument has been changed and remeasurement of the hedged item when the designation of the hedged item and the hedged risk has been changed. This is consistent with the Board's intention that hedge ineffectiveness is recorded in profit or loss.

A11 Nevertheless, paragraph BC63 of the ED may be interpreted as requiring that both the hedged item and the hedging instrument are remeasured at the same time, based on the new benchmark rate on an "as if" basis. Such an interpretation would imply both the hedging instrument <u>and</u> the hedged item are remeasured on that new basis, regardless of whether the designation for both the hedging instrument <u>and</u> hedged item has been changed.

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A12 We concur with the Board that ineffectiveness should be recorded in profit or loss and therefore recommend that the final requirements and Basis of Conclusion are clarified to ensure alignment with our understanding of the proposed requirements.

A13 Such a clarification might focus, in part, on the wording in paragraph 6.9.10 of this ED and in particular, the following clause from the second sentence: "an entity shall apply paragraphs 6.9.11 to 6.9.17 to the extent relevant" [underlining added]. We interpret this as stating that each leg of, for example, a fair value hedge is only remeasured using an alternative benchmark rate when that leg has been modified. If this is correct, then clarification could be provided by, for example, inserting explanatory parentheses such as, "to the extent relevant (i.e. to the extent hedged items and hedging instruments have been individually modified)."

A14 We concur that relief should be provided for hedges of groups of items-hedges but acknowledge that finding an adequate solution poses challenges. The proposed solution in paragraph 6.9.15 of the ED could be operationally demanding but, in the absence of an alternative solution that is simpler to apply and maintains the robustness of the hedge accounting requirements, we agree with the proposal.

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Question 4 — Designation of risk components and portions (paragraphs 6.9.16–6.9.18 of the [Draft] amendments to IFRS 9 and paragraphs 102Y–102Z1 of the [Draft] amendments to IAS 39)
Paragraphs 6.9.16–6.9.18 of the draft amendments to IFRS 9 and paragraphs 102Y–102Z1 of the draft amendments to IAS 39 propose that: (a) an alternative benchmark rate designated as a non-contractually specified risk component that is not separately identifiable at the date it is designated, would be deemed to have met that requirement at that date, if and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within a period of 24 months from the date the alternative benchmark rate is designated as a risk component. (b) if subsequently, an entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months from the date it was designated as a risk component, an entity would cease applying the requirement in paragraph 6.9.16 and paragraph 102Y and discontinue hedge accounting prospectively from the date of that reassessment. Paragraphs BC87–BC97 of the Basis for Conclusions describe the Board's reasons for these proposals. 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 and why.

A15 We believe the proposals provide a pragmatic solution for existing and new hedging relationships.

A16 Constituents expressed some concern around explanations in the Basis for Conclusions. For example paragraph BC88 of the ED states that the concepts and principles in regard of separately identifiable in IFRS 9 and IAS 39 are very similar. Paragraphs BC87, BC89 and BC94 of the ED, make reference to market liquidity and volume of trades. These explanations are seen by some as inadvertently setting new de minimis criteria for all assessments of separate identifiability under IAS 39. We recommend the IASB reviews the wording in the Basis for Conclusion to avoid implying requirements beyond the words in the standard and clarify the limits of the discussions in these paragraphs.

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Question 5 — Effective date and transition (paragraphs 7.1.9 and 7.2.36–7.2.38 of the [Draft] amendments to IFRS 9 and paragraphs 108H–108J of the [Draft] amendments to IAS 39)
(a) The Exposure Draft proposes that the amendments would have an effective date of annual periods beginning on or after 1 January 2021. Earlier application would be permitted. (b) The Exposure Draft proposes that the amendments would be applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, except as specified in (ii) below. An entity would: (i) reinstate a discontinued hedging relationship if and only if the entity discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and, therefore, the entity would not have been required to discontinue that hedging relationship if the amendments had been applied at that time. (ii) not be required to restate prior periods to reflect the application of these amendments. However, the entity may restate prior periods if, and only if, it is possible without the use of hindsight. Paragraphs BC110–BC115 of the Basis for Conclusions describe the Board's reasons for these proposals. 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 and why.

A17 We generally agree with the proposals.

A18 We heard some concerns around the requirements for reinstatement of discontinued hedges, as proposed in paragraphs 7.2.37 and 108I of the ED. In practice, once a hedge is discontinued the derivatives may have been closed out or designated in an alternative hedging relationship. In this situation an entity would have to restate the hedge, but immediately discontinue again. We suggest the IASB consider whether the relief could be amended to avoid this situation.

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Question 5 — Disclosures (paragraphs 24I–24J and paragraphs 44HH–44II of [Draft] amendments to IFRS 7)
The Exposure Draft proposes that entities provide specific disclosures in order to provide information about: (a) the nature and extent of risks arising from interest rate benchmark reform to which the entity is exposed, and how it manages those risks; and (b) the entity's progress in completing the transition from interest rate benchmarks to alternative benchmark rates, and how the entity is managing that transition. Paragraphs BC105–BC109 of the Basis for Conclusions describe the Board's reasons for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you propose and why

A19 We agree with the proposals.

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