Accounting Task Force of the Working Group
on Sterling Risk Free Reference Rates

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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

We are responding to your invitation to comment on FRED 72 *Interest Rate Benchmark Reform* Proposed amendments to FRS 102 on behalf of the Accounting Task Force of the Working Group on Sterling Risk Free Reference Rates ('RFRs')[1].

We welcome the FRC's timely response to this important issue and support the FRC's efforts to provide relief for entities whose hedging relationships could be adversely affected by interest rate benchmark reform. We agree that some hedging relationships might fail to qualify for hedge accounting under FRS 102 because of uncertainties arising from interest rate benchmark reform. In our view this would not provide useful information to users of financial statements and hence reliefs should be provided.

We set out below our major comments on FRED 72. Our detailed responses to the questions in FRED 72 are included in Appendix I to this letter.

Pre-replacement/replacement issues

We note that the FRC in FRED 72 has followed the IASB's ED/2019/1 which only addresses those issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark (pre-replacement issues, also referred to as 'Phase 1'). There will be issues when an interest rate benchmark is replaced with an alternative interest rate (replacement issues, or 'Phase 2') that also need consideration.

We recognise that Phase 1 issues will - by definition - arise earlier than Phase 2 issues, and hence understand the rationale for addressing only Phase 1 at the moment. Nevertheless, we understand that some market participants are already seeking to transition to alternative rates rather than wait until the 'cliff edge' of 2021, and that uncertainty around accounting may be creating an impediment to an orderly market transition.

Solutions to the replacement issues that have been deferred to Phase 2 will therefore soon become critical to ensuring that financial reporting continues to meet the needs of users of financial statements. We therefore urge the FRC to expedite its own Phase 2 efforts and not necessarily wait for the IASB to issue a FRED on Phase 2. We have included in Appendix II our thoughts on the most important Phase 2 issues to be addressed by the FRC consistent with what we have communicated to the IASB.

[1] Please note the views expressed in this letter are the views of the individual members of the accounting task force and are not necessarily endorsed by the Bank of England or FCA nor the firms they represent.

If you have any questions in relation to this etter please do not hesitate to contact Frances Hinden (+ 44 7894838020) or Jessica Taurae (+ 44 7740166459) co-chairs of the accounting task force.

Yours faithfully,

Appendix I

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

We agree with the proposed exceptions for determining whether a forecast transaction is highly probable or whether it is no longer expected to occur by assuming that the interest rate benchmark is not altered as a result of interest rate benchmark reform. We believe this will provide relevant information to users of financial statements in circumstances where the relief is appropriate.

We agree with the proposed amendment to require entities to assess whether the designated risk component or designated portion is separately identifiable only at the inception of the hedging relationship. We believe there may be circumstances where a component might no longer meet the separately identifiable criterion, for example because debt instruments in a particular market are no longer compared by their spreads to an illiquid IBOR-based benchmark, and agree that the relationship should still be eligible for hedge accounting providing that the other FRS102 requirements are met.

However, there may be scenarios where the relief does not go far enough, in particular in macro hedge accounting relationships which rely on (eg) monthly dedesignations and redesignations such as those set out in paragraph 12. 15A. This is in effect a continuation of the same hedge and therefore the requirement that the designated risk component or designated portion is separately identifiable only at the inception of the hedging relationship may technically preclude this widely used strategy. We raised this point also in our letter to the IASB's ED2019/1 and based on the August 2019 IASB Update, the IASB are going to address this by assessing whether a non-contractually specified risk component is separately identifiable only at the time the hedged item is initially designated in the 'macro hedge'. We request the FRC to consider something similar.

We agree with the proposed principles based disclosures when an entity has taken advantage of the temporary amendments to the specific hedge accounting requirements rather than requiring anything prescriptively quantitative.

We agree that the amendments should be effective for annual periods beginning on or after 1 January 2020, with earlier application allowed even if the amendments to FRS 102 are not finalised until early 2020.

FRED 72 proposals are to be applied retrospectively. However, unlike the IASB's ED 2019/1 which precludes entities from reinstating hedge accounting that has been discontinued in prior periods it seems to be permitted by FRED 72. For example, if an entity discontinued a hedging relationship in a prior period solely due to the impact of interest rate benchmark reform, and would not have discontinued that hedging relationship had it applied the guidance in FRED 72, then retrospective application would normally require the restatement of prior periods to treat the hedge as being a continuing hedging relationship.

Nevertheless, we believe that an entity should not be required to reinstate hedges that were discontinued in previous periods, as this could otherwise result in undue cost or effort spent redesignating hedges that the entity may in any event have redesignated into new relationships. The FRC should consider providing a similar exemption from reinstating hedges as the IASB is proposing. That is, to make the amendments effective for all hedges that exist at the date of first application and not to those that have been dedesignated or discontinued in the prior periods.

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 agree with the FRC's conclusion that the draft amendments to FRS 102 in FRED 72 will have a positive impact on financial reporting, because discontinuing hedge accounting solely due to the uncertainties about interest rate benchmark reform before its economic effects are known would not provide useful information to users of the financial statements.

Appendix II - Items for consideration in Phase 2

We appreciate that the FRC will take into consideration what the IASB does on its Phase 2 issues however as noted in the cover letter we think the FRC should expedite its own Phase 2 process and not necessarily wait for the IASB to publish its next exposure draft before the FRC publishes a FRED. Set out below are the two areas we believe it is most important that the FRC considers in Phase 2.

<u>Hedge accounting</u>

In order to ensure that useful information is continued to be provided to users of the financial statements, and that no time is wasted by preparers in transitioning their financial assets and liabilities to the new RFRs, it would be helpful if the FRC developed an overall principle for ensuring hedge accounting is not discontinued solely because of changes due to IBOR reform.

For example, when the documented hedge risk/hedged item is specified in terms of IBOR and is updated to reflect the new RFR, this should not be a hedge discontinuance. Similarly a change in the terms of a hedging instrument that is necessitated by/a direct consequence of IBOR reform should be accounted for as a continuation of the same hedging instrument and hence should not result in hedge discontinuance. Amounts recognised in OCI in relation to cash flow hedges should also not be required to be recycled to P&L when the hedged risk/hedged item/hedging instruments are updated to reflect the new RFR.

<u>Modification of contract terms</u>

It would be helpful if the FRC developed a principle such that changes to terms of financial instruments due to IBOR reform do not lead to derecognition of the instrument. In addition the FRC should consider ensuring that changes to terms of financial instruments not measured at FVTPL that are due to IBOR reform are accounted for by applying FRS 102 11.19 and not 11.20 as that will provide the most relevant information to users of the financial statements.