Deloitte.

Deloitte LLP
Hill House
1 Little New Street
London
EC4A 3TR

Phone: +44 (0)20 7936 3000
Fax: +44 (0)20 7583 1198
www.deloitte.co.uk

Direct phone: +44 20 7007 0884
vepoole@deloitte.co.uk

September 2019

Jenny Carter
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

By email: ukfrs@frc.org.uk

Dear Ms Carter

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

Deloitte LLP welcomes the opportunity to comment on FRED 72 *Draft amendments to FRS 102 – Interest rate benchmark reform (FRED 72).*

We are supportive of the overall approach to reflect the International Accounting Standards Board's (IASB) proposals in *ED/2019/1 Interest Rate Benchmark Reform – Proposed Amendments to IFRS 9 and IAS 39* in FRS 102 to the extent relevant in order to ensure the amendments are available to all entities on a timely basis and that no significant deviations occur between the International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Practice (UK GAAP).

Our responses to the specific questions raised in FRED 72 are in the Appendix to this letter. Some of the issues identified in the appendix we have also raised with IASB in response to their proposals that we believe should also be considered by the FRC. However, we believe an additional practical expedient in relation to the measurement of hedge ineffectiveness should be made available to preparers applying Sections 11 and 12 of FRS 102 in full, which we have detailed in our response to Question 1 in the Appendix.

Given the speed at which market participants are choosing, or being required, to switch to new benchmark interest rates, we encourage the FRC to act swiftly in both finalising the amendments arising from this FRED and developing further amendments in response to the second phase of the IASB's interest rate benchmark reform project.

If you have any questions, please contact Veronica Poole on 020 7007 0884 or Helen Shaw on 020 7303 4658.

Yours sincerely

Veronica Poole

Veronica Poole
UK National Head of Accounting and Corporate Reporting
Deloitte LLP

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London, EC4A 3BZ, United Kingdom.

Deloitte LLP is the United Kingdom affiliate of Deloitte NWE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NWE LLP do not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.

© 2019 Deloitte LLP. All rights reserved.

Appendix – Responses to specific questions

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

Overall, we support the proposals in FRED 72 and the approach followed in respect of the IASB amendments to ensure that relief is available to all entities on a timely basis.

For entities applying Sections 11 and 12 in full we agree with the proposals that deal with the immediate need of addressing the effect of the uncertainty arising from changes in benchmark interest rates on the "highly probable" requirement for cash flow hedges and when assessing the economic relationship and the designated risk for cash flow and fair value hedges. However, as set out below, we believe the scope of the amendments should be widened and an additional practical expedient in relation to the measurement of hedge ineffectiveness should be made available. We also agree with the proposed conditions to cease applying the temporary amendments but have concerns in relation to amounts previously deferred in the cash flow hedge reserve which we have also outlined below.

We agree with the proposal to maintain consistency between the hedge accounting requirements of *IAS 39 Financial Instruments: Recognition and Measurement* for entities continuing to apply those requirements under IFRS and entities applying the recognition and measurement provisions of IAS 39 under FRS 102.

We agree with the disclosures proposed in FRED 72. However, we believe limited relief from the disclosures required by Section 10 on adoption of an amended FRS should also be provided as set out below. We agree with the proposed effective date and the ability to adopt the amendments early.

Scope

FRED 72 is explicit that it only applies to interest rate risk hedges. We believe it should not be restricted to hedges of interest rate risk only but should apply to any hedges that designate interest cash flows that are subject to the reform. For example, hedges of floating rate foreign currency loans for foreign currency risk that are swapped into floating rates in the functional currency should be in scope of the amendments. We note that the IASB has acknowledged this as part of their deliberations of their exposure draft in August 2019 and plan to reflect this broader scope in their forthcoming amendment to IFRS 9 and IAS 39.

Measurement

FRED 72 does not address the measurement of hedge ineffectiveness. It is assumed that consistent with paragraph 12.25E, whilst the proposed amendment is applied, the change in value of the hedged cash flows is determined based on the designated hedged cash flows unaltered by the interest rate benchmark reform. As outlined in our response to the IASB this is necessary to achieve the objective of the proposed amendment. However, we believe an additional practical expedient in this area for entities applying Sections 11 and 12 of FRS 102 in full is appropriate, given the less sophisticated systems in place in many such reporters.

We believe that a practical expedient is necessary to limit the circumstances in which ineffectiveness would be introduced into a cash flow hedge solely as a result of the uncertainty of benchmark interest rate reform. Consider the example of a cash flow hedge of variability in cash flows due to changes in LIBOR of floating rate debt with an interest rate swap, where the critical terms of the instruments match and the provisions for the replacement of LIBOR are identical (i.e. the timing and amount of the variable cash flows will always be identical). In this example ineffectiveness could arise if the hedged item and hedging instrument are measured differently in respect of the uncertainties associated with the benchmark interest rate reform.

Under FRS 102 the hedging instrument will be measured in accordance with the Appendix to Section 2, and therefore cannot ignore the impact of interest rate benchmark reform if market participants would factor that into their fair valuation. However, the valuation of the hedged item in a cash flow hedge does not ordinarily reflect any uncertainties in relation to the hedged cash flows. We propose the following additional paragraph is included to clarify the measurement requirements for the hedged item, and to provide an additional practical expedient under the temporary amendments:

“When identifying the hedged item for the purpose of applying the measurement requirements in paragraphs 12.20(b) and 12.23(a) an entity should assume that the interest rate benchmark on which the hedged risk or hedged cash flows are based is not altered as a result of interest rate benchmark reform. However, as a practical expedient, in a cash flow hedge an entity may measure those cash flows once identified to include assumptions on interest rate benchmark replacement should those assumptions apply to the hedging instrument so as to ensure that that uncertainty associated with interest rate benchmark replacement is not a source of hedge ineffectiveness.”

The practical expedient would allow an entity to incorporate any clauses governing how LIBOR will be replaced (i.e. fall back provisions) for the hedged item in the same manner as for an actual LIBOR linked derivative. Using consistent assumptions to value the hedged item and hedging instrument will reduce the possible additional costs of applying hedge accounting resulting from benchmark interest rate reform and avoid unwarranted hedge ineffectiveness, which might otherwise be recognised.

Cessation of the amendments on cash flow hedge reserve

We agree with the proposed conditions in FRED 72 to cease applying the temporary amendments in 12.25C to 12.25G. However we have concerns when applying the proposed approach to the end of the relief provided by the temporary amendments with respect to amounts previously deferred in the cash flow hedge reserve. We do not believe FRED 72 is clear with respect to how the cumulative amount in the cash flow hedge reserve is accounted for at the date when the relief ends. For example, if an entity chose to amend both its debt and interest rate swap so they both move from LIBOR to a new risk free rate (RFR), the proposal would require the relief to end as the uncertainty of the interest rate benchmark reform, for that hedge relationship, has ended. Given the amendment is no longer applied, FRED 72 appears to require immediate reclassification to profit or loss of the related amounts in the cash flow hedge reserve. We do not support this accounting treatment given that the designated risk, in this case LIBOR, is still expected to occur via its replacement as a new RFR. We do not believe this would be meaningful given that the amendments are intended to avoid cessation of hedge accounting due to benchmark reform.

Disclosures

We agree with the disclosures proposed in FRED 72 in relation to the application of the amendments. However, we believe that in addition relief should be provided from the requirement of 10.13(b) to disclose, to the extent practicable, the amount of the adjustment to each financial line item affected by the amendments in the current period. To disclose the effect had the amendment not been applied, and so likely illustrate the impact of not applying hedge accounting appears onerous and not meaningful to users of financial statements, given the amendments allow an entity to continue to apply hedge accounting to previously designated hedge relationships. We note that the IASB has acknowledged the need for relief from disclosing the effect of the amendment on each financial line item as part of their deliberations of their exposure draft in August 2019 and plan to provide relief from the equivalent disclosure in IAS 8 in their forthcoming amendment to IFRS 9 and IAS 39.

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 that the amendments to FRS 102 proposed in FRED 72 will have a positive impact on financial reporting. We believe that the benefit of avoiding disruption to hedge accounting resulting from the uncertainty of benchmark interest rate reform and the associated costs of mass discontinuation exceeds the cost of compliance with the proposed amendments.