Need to know

FRC issues Amendments to FRS 102 – Interest Rate Benchmark Reform (Phase 2)

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This *Need to know* addresses the amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* that were published by the Financial Reporting Council (FRC) in December 2020.

- The amendments are intended to adapt and simplify accounting requirements in the context of interest rate benchmark reform.
- The amendments affect many entities, in particular those with financial assets, financial liabilities or lease liabilities that are subject to interest rate benchmark reform and those that apply the hedge accounting requirements in Section 12 *Other Financial Instrument Issues* of FRS 102 to hedging relationships that are affected by the reform.
- The amendments are mandatory for all entities.
- The amendments are effective for annual periods beginning on or after 1 January 2021 with early application permitted.
- The amendments are applied retrospectively and include reinstatement of hedge relationships that were discontinued solely due to changes directly required by the reform. Restatement of prior periods is permitted but not required.
- Entities applying FRS 102 that have made an accounting policy choice to follow the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* and/or IFRS 9 *Financial Instruments* will apply the corresponding amendments made by the International Accounting Standards Board (IASB). However, such entities will make the disclosures required by the amendments to FRS 102, rather than those required by IFRS 7 *Financial Instruments: Disclosures.*

These amendments are referred to as Phase 2 of the Interest Rate Benchmark Reform related amendments to FRS 102. In December 2019, the FRC published the first set of amendments (Phase 1), see details in our previous ***Need to know***.

Background

Interest rate benchmarks such as interbank offered rates (IBORs) play a key role in global financial markets and index the equivalent of trillions of pounds in financial products. Work is underway in many jurisdictions to transition to alternative benchmark interest rates in response to systemic risk concerns. The Financial Stability Board (FSB) undertook a fundamental review of major interest rate benchmarks and published its recommendations for reform. As a result, public authorities have selected new benchmark interest rates in key currencies with the objective that such rates will be based on liquid underlying market transactions, and not be dependent on submissions based on expert judgement. The aim is that these new rates are more reliable and provide a robust alternative interest rate for products and transactions that do not need to incorporate the credit risk premium embedded in existing benchmark interest rates. In the UK the London Interbank Offered Rate (LIBOR) is due to be replaced with the Sterling Overnight Index Average (SONIA) by the end of 2021.

Observation

The amendments address issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative benchmark interest rate, i.e. replacement issues.

The accounting issues arising before an existing interest rate benchmark is replaced with an alternative risk free rate, i.e. pre-replacement issues, have been considered previously by the FRC and were addressed in the first set of amendments titled 'Interest Rate Benchmark Reform', published in December 2019. The Phase 2 amendments complement, not supersede, the Phase 1 amendments. Please refer to the ***Need to know*** for details on the Phase 1 amendments.

The amendments

The objective of the amendments is to provide relief and reduce disruption to the accounting for financial instruments, leases and hedge accounting as a result of the transition to an alternative benchmark interest rate.

The amendments to FRS 102 are based on the IASB's ***Interest Rate Benchmark Reform – Phase 2 Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16***. However, there are some differences either because the underlying requirements of FRS 102 are different (or less prescriptive e.g. in relation to the treatment of modifications to leases), or because the FRC wished to provide simpler requirements (e.g. disclosures) for entities reporting under FRS 102.

The amendments are designed to provide equivalent reliefs to all entities applying FRS 102 regardless of their accounting policy choice in relation to financial instruments. However, entities applying FRS 102 that have chosen to follow the recognition and measurement requirements of IAS 39 and/or IFRS 9 rather than those of Section 11 *Basic Financial Instruments* and *Section 12 Other Financial Instrument Issues*, will apply the corresponding amendments to those standards. The amendments added to IFRS 4 *Insurance Contracts* are also relevant to entities applying the recognition and measurement requirements of IAS 39. This has been addressed by copying the necessary requirements of IFRS 4 into the accounting policy choice paragraphs of Sections 11 and 12.

The amendments affect the following key areas: changes in the basis for determining the contractual cash flows, hedge accounting and disclosures.

Changes in the basis for determining the contractual cash flows – financial instruments

The amendments include specific requirements for financial assets and financial liabilities measured at amortised cost where the basis for determining the contractual cash flows changes as a result of interest rate benchmark reform. This can include cases where the contractual terms are amended, cases where the contractual terms are not amended but for example where the method for calculating the interest rate benchmark is altered, and cases where an existing contractual term is activated such as when an existing fallback clause is triggered.

When the cash flows of a financial asset measured at amortised cost change, an entity should assess whether it is required to apply either FRS 102.11.19 or FRS 102.11.20. Under FRS 102.11.19 the change in cash flows alters the effective interest rate and normally has no significant effect on the carrying amount of the financial instrument. Under FRS 102.11.20 the effective interest rate is not altered and a revised carrying amount is calculated by discounting the updated cash flows at the original effective interest rate. This adjustment to the carrying amount results in the recognition of a gain or loss. In general FRS 102.11.19 only applies to changes in market rates of interest or an index of general price inflation for variable rate financial assets and liabilities.

As a mandatory practical expedient, the amendments require an entity to apply FRS 102.11.19, such that the change in the basis for determining the contractual cash flows is applied by revising the effective interest rate. As a result, where the practical expedient is applied, such changes would not result in an adjustment to the carrying amount of the financial instrument or the immediate recognition of a gain or loss. This practical expedient only applies when the change in the basis for determining the contractual cash flows is necessary as a direct consequence of interest rate benchmark reform and the new basis for determining the contractual cash flows is economically equivalent to the previous basis (i.e. the basis immediately preceding the change).

The amendments provide a list of examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis:

a. the replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an alternative benchmark rate or the implementation of a reform of an interest rate benchmark by changing the method used to calculate the interest rate benchmark, with the addition of a fixed spread necessary to compensate for the basis difference between the existing interest rate benchmark and the alternative benchmark rate;

b. changes to the reset period, reset dates or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and

c. the addition of a fallback provision to the contractual terms of a financial asset or a financial liability to enable any of the changes described in a. and b. above to be implemented.

Observation

The list of examples of changes that are economically equivalent given in the amendments is not exhaustive. Other changes to contractual terms may be agreed as part of renegotiating bilateral contracts with the counterparty. Care is required to determine whether those changes are a direct consequence of interest rate benchmark reform and whether the new basis for determining the contractual cash flows is economically equivalent.

When multiple changes are made to a financial asset or a financial liability, the entity first applies the practical expedient to the changes required by interest rate benchmark reform. The applicable requirements of Section 11 are then applied to the other changes. For example, in the case of a financial liability if, having applied the practical expedient to changes required by interest rate benchmark reform, an entity makes additional changes, it would then be required to establish whether those additional changes constitute a substantial modification. A substantial modification would result in extinguishment of the original financial liability and the recognition of a new financial liability. If the additional changes did not constitute a substantial modification, the entity would apply FRS 102.11.20, and recognise any gain or loss immediately in the statement of profit or loss.

Changes in the basis for determining the contractual cash flows – finance lease liabilities

Section 20 *Leases* requires entities to apply the effective interest rate method to apportion the minimum lease payments on a finance lease liability between finance charge and reduction of the outstanding liability. As a result the requirements of FRS 102.11.19 and FRS 102.11.20 are applicable when the cash flows of a finance lease liability change. Section 20 has therefore been amended to extend the practical expedient for financial assets and liabilities set out above to finance lease liabilities.

Hedge accounting – designation and documentation

The amendments to Section 12 introduce an exception to the existing requirements so that certain changes in the designation and formal documentation of a hedge accounting relationship do not result in the discontinuation of hedge accounting nor the commencement of a new hedging relationship. The exception applies where there has been a change to the basis of determining the contractual cash flows of the hedged item or hedging instrument as a result of interest rate benchmark reform, and is limited to the following changes:

a. specifying an alternative benchmark rate (contractually or non-contractually specified) as a hedged risk;

b. amending the description of the hedged item, including the description of the portion of the cash flows or fair value being hedged; or

c. amending the description of the hedging instrument.

However, entities may transition their hedging instruments to an alternative benchmark interest rate using different approaches, for example by replacing the original hedging instrument with a new contract rather than amending the terms of the original hedging instrument. Where the original hedging instrument is legally cancelled and a new hedging instrument is entered into, an assessment would be required to determine whether this would lead to derecognition for accounting purposes. The above exception for hedging instruments is applied to a change to the hedging instrument required by benchmark interest reform if the original hedging instrument is not derecognised and the chosen approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument.

If changes are made in addition to those changes required by interest rate benchmark reform to the financial asset or financial liability in a hedging relationship or to the documentation of the hedging relationship, an entity first applies the requirements in Section 12 to determine if those additional changes result in the discontinuation of hedge accounting. If the additional changes do not result in the discontinuation of hedge accounting, the entity applies the exception introduced by the amendments.

Hedge documentation must be updated by the end of the reporting period during which a change required by interest rate benchmark reform occurs (i.e. the amendment to the documentation does not need to be made immediately). For first-time application of these amendments, this period is extended to the date the financial statements are authorised for issue. As the uncertainty arising from interest rate benchmark reform may cease to affect different items at different times, an entity may be required to amend the documentation of its hedging relationships at different times or may be required to amend the documentation for a hedging relationship more than once.

Hedge accounting – groups of items

Where an entity hedges a group of items, the uncertainty arising from interest rate benchmark reform may cease to affect different items within that group at different times, for example because negotiations with one counterparty conclude more quickly than those with another. This could result in a period where items within the group reference different benchmarks, for example some items continue to have LIBOR cash flows whilst others have already transitioned to SONIA. When an entity hedges a group of items and applies the exception discussed in the previous section, the entity allocates the hedged items to subgroups based on the benchmark rate being hedged and documents that rate as the hedged risk for each subgroup. Each subgroup is assessed separately to determine whether it meets the requirement to be an eligible hedged item. If any subgroup fails to be an eligible hedged item, the entity discontinues hedge accounting prospectively for the hedging relationship in its entirety (i.e. it is discontinued for all subgroups). The entity should also account for hedge ineffectiveness relating to the hedging relationship in its entirety.

Hedge accounting – components of an item

It is common for entities to fair value hedge the change in fair value of all, or a portion of, cash flows of a fixed rate debt instrument for changes in a benchmark rate, such as the LIBOR component. This can be described as a fair value hedge of the benchmark interest rate risk component. A risk component is only an eligible hedged item if it is separately identifiable and reliably measurable.

When an entity changes the hedged risk for an existing hedging relationship to an alternative benchmark rate under the amendments, that rate may not be separately identifiable. If the alternative benchmark rate is not a separately identifiable component at the date of the change, the separately identifiable requirement is deemed to be met at that date if the entity reasonably expects the rate will be separately identifiable within a period of 24 months from the date of identification. The 24-month period applies to each alternative benchmark interest rate separately (i.e. on a rate-by-rate basis) and starts from the date the entity identifies the alternative benchmark interest rate as a non-contractually specified risk component for the first time.

If, subsequently, it is no longer reasonable to expect the alternative benchmark interest rate to be separately identifiable within 24 months from the date it was identified as a risk component, hedge accounting is discontinued prospectively from the date of that reassessment for all hedging relationships in which the alternative benchmark interest rate was identified as a non-contractually specified risk component.

The 24-month provision also applies to new hedging relationships in which an alternative benchmark interest rate is documented as a non-contractually specified risk component when, because of interest rate benchmark reform, that risk component is not separately identifiable at the date it is documented as a hedged item.

Hedge accounting – cash flow hedges

The amendments to Section 12 introduce an exception to the existing requirements to avoid the immediate reclassification of amounts from the cash flow hedge reserve as a result of the transition to alternative benchmark rates. The exception requires that the amount accumulated in the cash flow hedge reserve at the date that the entity amends the hedged item is deemed to be based on the alternative benchmark interest rate on which the hedged future cash flows are determined.

For hedge relationships that have been discontinued, when the interest rate benchmark on which the hedged future cash flows were based is changed as required by interest rate benchmark reform, the amount accumulated in the cash flow hedge reserve is deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

Observation

The provisions for cash flow hedges ensure that amounts previously recognised in the cash flow hedge reserve are not immediately reclassified to profit or loss simply because of interest rate benchmark reform.

For example, an entity may have entered into a forward starting swap to receive fixed, pay LIBOR as a cash flow hedge of a highly probable forecast debt issuance. The entity derecognised the swap in a prior period and so ceased hedge accounting. Amounts accumulated in the cash flow hedge reserve were not reclassified to the profit or loss when hedge accounting ceased because the entity still expected to issue the debt and therefore continues to be exposed to LIBOR interest rates on the future issued debt. If the entity now considers that its exposure to LIBOR is no longer expected to occur only because LIBOR is replaced with an alternative benchmark interest rate as a result of interest rate benchmark reform, the entity does not reclassify amounts from the cash flow hedge reserve to profit or loss. However, if instead the entity assesses that the hedged risk is not expected to occur because it is not expecting to issue debt at all, the amounts in the cash flow reserve are reclassified to profit or loss.

Disclosures

The disclosures required in relation to the amendments are the same whether entities apply Sections 11 and 12 in full or apply the recognition and measurement requirements of IAS 39 and/or IFRS 9.

The amendments require that an entity provide disclosures that enable a user to understand the nature and extent of risks rising from financial instruments subject to interest rate benchmark reform, how the entity is managing those risks and its progress in completing the transition from interest rate benchmarks to alternative benchmark rates. An entity should also disclose if it has applied the practical expedient provided in the amendments to Section 11.

Qualifying entities that are not financial institutions are exempt from the disclosures in Section 11 included in the amendments provided equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated.

As the amendments are intended to minimise the disruption resulting from interest rate benchmark reform, entities are not required to make the disclosures in relation to the impact on the financial statements that are usually required for changes in accounting policy.

Where an entity chooses to adopt the amendments early, it should disclose that fact (unless it is a small entity as defined in the glossary to FRS 102 in which case it is encouraged to disclose that fact).

End of application

The amendments do not include a fixed date when the requirements introduced cease to apply as the amendments are associated with the point at which changes to financial instruments or hedging relationships occur as a result of interest rate benchmark reform. Therefore, by design, the application of the amendments has a natural end.

Transitional provisions and effective date

The amendments to FRS 102 apply for accounting periods beginning on or after 1 January 2021, with earlier application permitted. The amendments apply mandatorily to all entities. Restatement of prior periods is permitted but not required.

The amendments are applied retrospectively in accordance with Section 10 *Accounting Policies, Estimates and Errors*. Hedge relationships that were discontinued are reinstated if, and only if, the discontinuation arose solely due to changes directly required by interest rate benchmark reform and if at the beginning of the reporting period in which an entity first applies these amendments, the hedging relationship meets the qualifying criteria for hedge accounting.

Further information

If you have any questions about the Interest Rate Benchmark Reform amendments to FRS 102, please speak to your usual Deloitte contact.

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