Need to Know

FRC issues Amendments to FRS 102 – Interest Rate Benchmark Reform

Contents

This Need to Know addresses the recent amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* that have been published by the Financial Reporting Council (FRC). These amendments are titled *Interest Rate Benchmark Reform*.

- The amendments will affect entities reporting under FRS 102 that apply hedge accounting to relationships directly affected by the interest rate benchmark reform.
- The amendments modify specific hedge accounting requirements so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark is not altered as a result of the interest rate benchmark reform.
- If a hedging relationship no longer meets the requirements for hedge accounting for reasons other than those specified by the amended requirements, then discontinuation of hedge accounting is still required.
- The amendments are effective for annual periods beginning on or after 1 January 2020, with earlier application permitted.
- 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 to those standards 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.*

Background

Interest rate benchmarks such as interbank offered rates (IBORs) play a key role in global financial markets and index trillions of dollars in financial products. However, work is underway in multiple jurisdictions to transition to alternative risk free rates following 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, alternative risk free rates have been selected in key currency jurisdictions by working groups, with the objective that such rates will be based on liquid underlying market transactions, and not dependent on submissions based on expert judgement. This is designed to lead to rates that are more reliable and to provide a robust alternative for products and transactions that do not need to incorporate the credit risk premium embedded in the IBORs. In the UK the most common IBOR is the London Interbank Offered Rate (LIBOR) which is due to be replaced with the Sterling Overnight Index Average (SONIA) before the end of 2021.

Observation

The amendments address only the hedge accounting issues arising before an existing interest rate benchmark is replaced with an alternative risk free rate, i.e. the pre-replacement issues. The amendments consider the implications for specific hedge accounting requirements, which require a forward-looking analysis and provide a relief during this period of uncertainty.

Issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative interest rate, i.e. post-replacement issues, will be considered by the FRC in due course. The FRC's proposals to address these post-replacement issues are expected to be based on the corresponding proposals for International Financial Reporting Standards. The IASB is due to issue an exposure draft addressing these post-replacement issues in the first half of 2020. Entities may wish to delay amending contracts until the accounting implications of doing so are clear, and appropriate reliefs have been put in place.

Amendments

The amendments modify specific hedge accounting requirements so that entities would apply those hedge accounting requirements assuming that the interest rate benchmark relevant to the hedge accounting is not altered as a result of the uncertainties of the interest rate benchmark reform. The amendments apply to hedging relationships that are directly affected by the interest rate benchmark reform. Interest rate benchmark reform refers to the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations set out in the FSB's July 2014 report *Reforming Major Interest Rate Benchmarks*.

The specific modifications to the hedge accounting requirements depend on whether or not an entity applies the requirements of Sections 11 *Basic Financial Instruments* and 12 *Other Financial Instrument Issues* of FRS 102 in full, or has taken the accounting policy choice to apply the recognition and measurement requirements of IAS 39 and/or IFRS 9. However, the disclosures required in relation to the amendments are the same regardless of the recognition and measurement requirements followed.

Modifications to the hedge accounting requirements for entities applying Sections 11 and 12 in full

The amendments for entities applying Sections 11 and 12 in full affect the following areas:

1. *Highly probable requirement for cash flow hedges:* A forecast transaction is only an eligible hedged item if it is highly probable. If the hedged item is a forecast transaction, the amendments require an entity to determine whether the forecast transaction is highly probable assuming that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of the interest rate benchmark reform. .

2. *Reclassification of the amount in the cash flow hedge reserve to profit or loss:* Amounts relating to the effective portion of a cash flow hedge may only remain in the cash flow hedge reserve if the hedged cash flows are still expected to occur. To determine whether the hedged future cash flows are expected to occur for this purpose, the amendments require an entity to assume that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of the interest rate benchmark reform.

3. *Assessment of the economic relationship between the hedged item and the hedging instrument:* Hedge accounting may only be applied if there is an economic relationship between the hedged item and hedging instrument. The amendments require an entity to assume for the purposes of assessing the economic relationship that the interest rate benchmark on which the hedged cash flows and/or the hedged risk are based, or the interest rate benchmark on which the cash flows of the hedging instrument are based, is not altered as a result of the interest rate benchmark reform.

4. *Designation of a component of an item as a hedged item:* A risk component is only an eligible hedged item if it is separately identifiable and reliably measurable. For a hedge of a benchmark component of interest rate risk that is affected by the interest rate benchmark reform, the amendments require an entity to determine whether the risk component of the hedged item is separately identifiable and reliably measurable, only at the inception of the hedging relationship.

The amendments are intended to provide relief only during the period of uncertainty prior to the replacement of an existing benchmark. Therefore, an entity shall prospectively cease applying each of the amendments set out in points 1 to 3 above at the earlier of:

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

- when the entire amount accumulated in the cash flow hedge reserve with respect to that hedging relationship is reclassified to profit or loss.

In addition the relief set out in point 3 ceases to apply if the hedge relationship is discontinued.

Observation

The amendments aim to avoid disruption to existing cash flow and fair value hedge accounting relationships directly impacted by the reform that in the absence of the relief would result in hedge ineffectiveness and potential hedge accounting failures as result of IBORs (such as LIBOR) being replaced by alternative risk free rates. Such failures could have led to widespread reclassification of amounts in cash flow hedge reserves to profit or loss and cessation of fair value hedge accounting of fixed rate debt.

The amendments avoid this disruption for cash flow hedges by requiring that an entity continues to assume, for the purposes of the hedged item, that IBOR-based cash flows will continue beyond the period when the reference rate could potentially be replaced by an alternative risk free rate. This applies irrespective of whether the IBOR-based variability in cash flows arises from a non-contractual exposure, for example, a forecast debt issuance, or a contractual exposure, such as a recognised IBOR-based lending or borrowing. Even if an entity has a contractual exposure, there will often be uncertainty about the likelihood that the entity will be exposed to those IBOR-based cash flows given the reforms may result in an expectation that the debt will be modified or fall-back provisions within the terms of the debt would take effect when the IBOR benchmark ceases to exist.

Similarly, for fair value hedges, the amendments require that for the hedged item the IBOR designated risk continues even though it could potentially be replaced by an alternative risk free rate. This relief ensures continuity of fair value hedge accounting during a time when fixed rate debt may be increasingly priced using alternative risk free rates as opposed to IBORs.

Modifications to the hedge accounting requirements for entities applying the recognition and measurement requirements of IAS 39 and/or IFRS 9 as permitted by FRS 102

Entities that apply the recognition and measurement requirements of IAS 39 and/or IFRS 9 will apply the corresponding IFRS amendments to those standards. These amendments are similar to those to Section 12 of FRS 102 set out above. However, there are some differences either because the underlying requirements to apply hedge accounting are different or because the FRC wished to provide simpler requirements for entities applying Sections 11 and 12 in full. Please refer to the *Need to Know* for a summary of the amendments published by the IASB.

Disclosures applicable to all entities reporting under FRS 102

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.

Section 12 requires entities to disclose the fact they have taken advantage of these amendments and the significant interest rate benchmarks to which the entity's hedging relationships are exposed. Entities should also consider whether any further disclosure is necessary under the existing requirements of FRS 102, for example, whether disclosures in relation to critical judgements or key sources of estimation uncertainty would be required in relation to the application of the amendments.

Qualifying entities that are not financial institutions are exempt from the disclosures in Section 12 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 disruption, and allow the continuation of a previous accounting treatment, entities are not required to make the disclosures in relation to the impact on the financial statements that are usually required for a change in accounting policy.

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

Observation

The disclosures associated with the equivalent amendments to IFRS are extensive, which is not the case for an FRS 102 reporter. Therefore, all FRS 102 reporters will benefit from reduced disclosures irrespective of whether they are following the requirements of Sections 11 and 12 in full or chose to apply the recognition and measurement requirements of IFRS 9 and/or IAS 39.

Effective date

The amendments to FRS 102 are effective for annual periods beginning on or after 1 January 2020, with early application permitted. The amendments are applied retrospectively to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies the amendments or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies the amendments.

Observation

Early adoption of these amendments avoids risk of disruption to hedge accounting, and so the only visible difference in financial statements when compared to prior periods is likely to be the associated disclosures. Appropriate disclosure of the application of the amendment is therefore important in explaining to users of financial statements why hedge accounting continues given the uncertainty that currently arises from the reforms to benchmark interest rates.

Further information

For further information about this topic, please see the Deloitte website: LIBOR transition and IBOR reform. If you have any questions about the Interest Rate Benchmark Reform amendments to FRS 102, please speak to the following contacts.

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