

The Working Group on Sterling Risk-Free Reference Rates

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Mr Hoogervorst,

Standard setting agenda - IBOR Reform and the Effects on Financial Reporting

We are writing to you on behalf of the market-led Working Group¹ on Sterling Risk-Free Reference Rates².

The Working Group welcomes the “IBOR Reform and the Effects on Financial Reporting” Standard Setting project and the proposals to provide relief to allow hedge accounting in the lead up to IBOR reform. The purpose of this letter is to initiate engagement with the IASB on the progress made on RFR transition. We wish to reiterate your assessment of the importance of the topic and offer support to the IASB from the Working Group. Whilst the Working Group focuses on Sterling, the issues raised in this letter affect markets around the world. We welcome that the IASB has also framed their papers in the context of IBOR reforms in general.

How the Working Groups could support the IASB

The Working Group can support the IASB by:

- Discussing further with the IASB any of the topics raised in this letter or in the research paper in further depth. For example, the IASB staff observe that, at present, it is not clear how market participants will approach some key issues related to amendment of legacy positions. The Working Group can provide information on how this area of the transition is progressing.
- Providing comments on the Exposure Draft once it is published
- Assisting in any outreach to non-financial corporates, financial institutions and trade associations for research purposes.
- Assisting in communication to non-financial corporates, financial institutions and trade associations of any changes the IASB makes to IFRS due to IBOR reform.
- The Working Group is also in regular communication with working groups for other currencies (including USD, EUR, CHF and JPY). We will work with our colleagues to ensure coordination across the different jurisdictions on communications and consultation with their accounting standards boards and regulators such as the FASB and SEC.

¹ Please refer to Appendix A for further background on the Working Group.

² Please note that the views expressed in this letter are those of the Working Group and are not necessarily endorsed by the Bank of England and the FCA.

Implications of LIBOR transition on financial reporting

The Working Group, through discussions with financial institutions, non-financial corporates, accountancy firms and trade associations, has identified potential future accounting issues which could lead to financial instability and undesirable accounting volatility without the provision of guidance from the IASB. We are concerned that the accounting outcomes as currently provided for in IFRS may not provide the users of accounts useful and relevant financial information about the performance of the company. This is particularly pertinent as the volatile accounting outcomes would be due to a market-driven change in response to broader regulatory and market objective.

We are not only concerned as to potential income statement volatility but also other consequences such as impacts to distributable reserves or resulting financial covenant breaches.

Two key immediate issues have been identified which would drive accounting volatility: asset/debt modification and hedge accounting (refer to Appendix B for a technical analysis).

IASB's project

We welcome the IASB's decision on 12 December 2018, to add the IBOR Reform and the Effects on Financial Reporting project to its Standard Setting agenda. Additionally, we welcome the IASB's decision to prioritise the analysis of the accounting issues affecting financial reporting leading up to IBOR reform and the tentative decision on 8 February 2018 to provide relief to allow hedge accounting to continue in the lead up to IBOR reform. We support the IASB in considering solutions to respond to the potential financial reporting effects outlined and we broadly agree with the phasing of the issues as outlined in the IASB's project paper, however we request the IASB to accelerate its work on "phase 2", so as to be ready as soon as possible for when IBOR reform begins to take effect. Appendix B lays out the key issues that we see, not all of which have yet been addressed by the recent IASB publications. Amending IAS 39 and IFRS 9 for IBOR reform could help to avoid widespread hedge accounting discontinuation, asset/debt modifications and the resulting financial statement volatility which we consider as a possible risk to the ongoing of markets through the LIBOR transition period.

We believe the issues outlined in this letter and appendices are relevant in all markets where IBOR reform is underway and are not specific to Sterling. Given their potential impact we also see the IASB reform project as a high priority and would support completion of the project as soon as possible, with, if possible, an earlier indication of the direction of the IASB's project. The timing is particularly relevant for cash flow hedges with the requirement to ensure the designated cash flows derived from the benchmark interest rates remain highly probable.

Sincerely,



Tushar Morzaria

Chair of the Working Group on Sterling Risk-Free Reference Rates

Appendix A – Background on the Working Group and current progress of LIBOR transition

The Sterling Risk-Free Reference Rate Working Group was convened by the Bank of England and Financial Conduct Authority (FCA) in 2015. The Working Group's overall objective is to catalyse a broad-based transition to Sterling Overnight Interest Average (SONIA) by end-2021, to reduce the financial stability risks arising from the widespread reliance of financial markets on LIBOR.

Within the UK, the FCA has indicated that it will not compel banks to submit IBOR rates beyond 2021. The Working Group announced SONIA as its preferred alternative benchmark to Sterling LIBOR on 28 April 2017. On 23 April 2018 the Bank of England implemented reforms to SONIA, including methodological changes and taking over calculation and publication responsibility. Across differing instrument markets, the awareness of the transition to SONIA is strong with SONIA-linked debt instruments being issued and futures volumes rising.

Appendix B – Technical issues identified by the Working Group

1. Hedge accounting

The Working Group's concern is the potential for the transition to alternative RFRs could trigger widespread hedge relationship discontinuance, thus resulting in financial statement volatility.

a. Hedged Risk

Designation of the hedged risk is required within the hedge documentation. Many hedge relationships in both non-financial corporates and financial institutions specify LIBOR, as the relevant benchmark, as the designated risk. We are concerned that the replacement of LIBOR might represent a change in the hedged risk, even in cases where the hedge documentation has not already allowed for an alternative benchmark in the event that LIBOR was no longer quoted. In many cases hedge documentation would have been prepared well ahead of any knowledge of LIBOR reform. We believe that even if the hedge documentation does refer to LIBOR specifically as the hedged risk, without an allowance for its replacement, the entity has clearly demonstrated the intention to hedge benchmark risk. The replacement of LIBOR with an "equivalent" rate as the hedged risk due to the wholesale market change should, therefore, be treated as a continuation of the hedge relationship, and amending any hedge documentation in these circumstances should therefore not be seen as a de-designation event.

We agree with IASB's comments in the February Board meeting that the risk components might not be easily identifiable in the run-up to IBOR reform. We believe it would be necessary to allow for some flexibility in continuing with IBOR as a risk component until the alternative RFR is clearly identifiable. The transition to the alternative RFR should be allowed to be treated as a continuation of the hedge relationship in recognition that the risk component continues to be the benchmark risk.

b. Highly probable forecast transaction

From a cash flow hedge perspective, it is possible that as the market moves away from LIBOR, LIBOR based cash flows beyond 2021 may no longer be deemed highly probable. The assessment of highly probable LIBOR based cash flows is a forward looking assessment including current balances and future issuances of assets and liabilities, often over an extended period, so this is an increasingly important judgement as we move towards transition. We believe the hedge relationship should continue where the cashflows designated are based on LIBOR or an equivalent benchmark, as the change of the basis of the cashflow beyond 2021 has already been provided for, therefore cashflows for the entire designated hedge relationship should continue to be considered highly probable. We welcome that the IASB has agreed to amend IFRS 9 and IAS 39 to provide relief regarding the 'highly probable' requirement. However, in cases where hedge documentation does not reference LIBOR replacement we are concerned that the hedge relationship would have to be discontinued at some point before 2021; as mentioned above we believe that changes to hedge documentation should not be seen as a discontinuation event.

c. Rollover of hedging instrument

Where a specific derivative has been designated as a hedging instrument we are concerned that either a modification of the designated instrument or replacement of the existing hedging instrument only for the purposes of allowing for LIBOR reform would likewise cause discontinuance of the hedge relationships. Where an entity has already provided for rollover of the hedging instrument in the documented risk management objective the hedge relationship should be treated as continuing. This treatment should hold whether the existing designated instrument was modified or replaced with a (nearly) identical instrument only amended for LIBOR reform. However, once again many hedge documents will have been prepared before there was any knowledge of LIBOR reform and thus such allowances were not included, and therefore we believe that where hedge documentation does not provide for roll-over strategies, such changes to hedging instruments should not be considered a discontinuation of hedge accounting.

d. Hedge effectiveness

Decisions made on the designation of the hedged item and hedged risk may have consequential impacts on the methods of testing and measurement of hedge effectiveness, which is specified in hedge documentation. It would be important to consider methods of determining hedge effectiveness, and the identification and reporting of ineffectiveness, in determining an appropriate approach to hedge accounting for the transition. We welcome the relief provided for prospective effectiveness testing. We do, however, remain concerned that without relief being provided by the IASB, hedge accounting relationships tested retrospectively for effectiveness under IAS 39 will become ineffective either during the run-up to IBOR reform or once reform is in progress. We therefore ask that the IASB consider giving relief so that hedges do not fail hedge accounting simply because it is temporarily outside the 80% to 125% range purely as a result on IBOR reform.

e. Hedge documentation

At present a substantive amendment to hedge documentation, for example to allow for LIBOR reform, could be viewed by some as a discontinuance of the existing hedge relationship without specific transition relief from the IASB. As discussed above we believe this would not be appropriate in the context of a market-wide transition. In order to support an orderly transition for hedge accounting under these circumstances it would be necessary to consider ways in which hedge documentation could be updated to reflect appropriately the benchmark transition without discontinuance of the hedge accounting relationship.

f. Transition period

As there is no single date of transition to alternative RFRs there may be a period when hedged items and hedging instruments designated in a hedge relationship have not both transitioned away from LIBOR, resulting in a mismatch period. This could cause ineffectiveness to such an extent that, without specific transition relief, it may cause the hedge to fail retrospective testing under IAS 39. We believe there should be relief to permit continuation of the hedge relationship

in instances where the hedge effectiveness testing has failed due to LIBOR reform transitional impacts.

2. Modification of Contract Terms

Any modification of contract terms requires a review to determine if the modification is considered substantial for accounting purposes. If a substantial modification is identified, the existing asset/debt on the balance sheet is derecognised and the modified asset/debt is recognised with the difference between the carrying values to be immediately recognised in the income statement. For contracts where a provision has already been made for the permanent replacement of LIBOR with an alternative we consider that there is no change to the terms of the contract and thus no review for whether the instrument is substantially modified is required. However, in contracts with no such provision we are concerned that the replacement of LIBOR with an alternative RFR will result in a substantial modification of a large volume and value of asset/debt. This will lead to significant volatility on the income statement at the time of contract modification without any further guidance from the IASB to the contrary.

Furthermore, in the case of a non-substantial modification, the carrying amount of the asset/debt is required to be recalculated by discounting the modified cashflows using the original effective interest rate (EIR) with the difference between the original carrying value and the revised carrying value to be immediately recognised in the income statement. In the case where LIBOR no longer exists, the original EIR also no longer exists. Given the practical challenges this requirement would pose, relief would also be required from the IASB.