



**KPMG IFRG Limited**  
15 Canada Square  
London E14 5GL  
United Kingdom

Tel +44 (0) 20 7694 8871  
Chris.spall@kpmgifrg.com

Mr. Hans Hoogervorst  
International Accounting Standards Board  
7 Westferry Circus  
Canary Wharf  
London E14 4HD  
United Kingdom

Our ref CS/288

13 June 2019

Dear Mr. Hoogervorst,

**Comment letter on Exposure Draft ED/2019/1 Interest Rate Benchmark Reform (“the ED”)**

We appreciate the opportunity to comment on the ED. We have consulted with, and this letter represents the views of, the KPMG network.

We support the IASB’s swift efforts to respond to accounting challenges resulting from the planned market-wide replacements of existing interest rate benchmarks with alternative near risk-free rates (“RFRs”). Consistent with the Board’s view, we believe hedge accounting requires a robust framework that is applied consistently.

We believe the primary challenge for the Board’s project on interest rate benchmark reform is developing accounting guidance that supports the transition from existing interest rate benchmarks to alternative RFRs in a manner that prevents disruption to existing hedge relationships and eliminates financial statement volatility where that is not reflective of the economics of the transition. In our view, effectively addressing this challenge would best be achieved by developing and communicating overarching principles that are durable and can accommodate market-wide reforms of varying natures and timelines as well as differing specific hedge designations.

Identifying overarching principles has a number of benefits, as we set out below. Our preferred approach to standard setting in this area would be a principles-based approach in line with these suggestions. However, we appreciate that the IASB has limited resources and a tight timetable against which to deliver solutions for accounting for the effects of interest rate benchmark reform. Given these constraints, we would understand if the Board decided to persevere with further developing the approach it has proposed. We provide in Appendix A detailed comments on the specific proposals in the ED and have highlighted key issues related to the ED below. Although we do not believe the approach proposed in the ED is optimal and we believe it is subject to

certain problems, we consider that it is preferable to taking no action and, subject to the matters we highlight, could provide an adequate base for Phase 1 of the IASB's project.

### **A principles-based approach**

In developing our proposed principles-based approach below, we have considered the remarks provided by the staff of the United States Securities and Exchange Commission<sup>1</sup> in response to a stakeholder's concerns about the impact of interest rate benchmark reform on existing cash flow hedge accounting relationships. A principles-based approach for IFRS preparers would:

- Apply to hedge relationships that include exposure to interest rates impacted by the market-wide replacement of an existing interest rate benchmark with an alternative RFR for the hedging instrument and/or hedged item (e.g. this would extend to hedges of foreign currency risk that use a cross-currency interest rate swap as a hedging instrument).
- Assume that where existing hedge documentation refers to the current benchmark rate, such a designation implicitly encompasses the alternative RFR that will replace the existing interest rate benchmark.
- Require that the measurement of ineffectiveness captures the economics of the hedge relationship by applying the principles of IFRS 13, including the impact of expected changes in cash flows caused by transition to a new RFR.
- Grant temporary relief from discontinuing hedge accounting as a result of effectiveness assessments that breach the 80–125% threshold in IAS 39.AG105 if caused by uncertainties related to interest rate benchmark reform (notwithstanding that all ineffectiveness must continue to be recognised).

We believe that the transition to alternative RFRs should generally be seen as an evolution in affected hedging relationships rather than a discontinuity. Further, we are of the view that the aforementioned principles would meet this objective of providing continuity to hedge accounting and address qualitative and quantitative concerns related to interest rate benchmark reform.

From a qualitative perspective, hedged forecast benchmark cash flows should generally be considered to continue to be highly probable of occurring (or still expected to occur) to the extent that they will be replaced by alternative RFR cash flows. An entity that applies a qualitative methodology for its prospective assessment under IAS

---

<sup>1</sup> Refer to Rahim M. Ismail, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities and Exchange Commission, Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments (10 December 2018), available at: <https://www.sec.gov/news/speech/speech-ismail-121018>

39 or demonstration of an economic relationship under IFRS 9 would consider cash flows of the existing interest rate benchmark or alternative RFR to be similar in nature. These principles acknowledge that anticipated changes to interest rate benchmarks will generally impact both the hedged item and hedging instrument, and therefore the hedging instrument and hedged item will respond to these same risks.

From a quantitative perspective, derivative valuations will reflect market assumptions about alternative RFRs and changes to cash flows as the market moves towards the use of the new benchmarks and depending on whether and how the contract or laws and regulations require or permit the cash flows of the instrument to change. Interest rate benchmark reform does not alter the requirement for an entity to recognise derivatives at fair value even if their cash flows are subject to higher uncertainty. The principles above would require an entity to derive estimates and assumptions about market interest rates in projecting and valuing the future cash flows in a cash flow hedge. If forecast changes in derivative cash flows and hedged item cash flows are not anticipated to occur at the same time or otherwise have an exactly offsetting effect, then the effect of that expected mismatch should be reflected in ineffectiveness calculations and, as appropriate, profit or loss.

Although these principles may preserve the continuity of hedge accounting, we believe that it is important that any hedge ineffectiveness resulting from transition is reported in profit or loss as it arises. There should be a clear differentiation between the impacts of interest rate benchmark reform on the prospective and retrospective effectiveness assessments versus the measurement of ineffectiveness. We believe that while the Board should clarify that hedge disqualifications should not be caused by uncertainties related to interest rate benchmark reform nor by treating cash flows or values based on the new benchmark as of a fundamentally different type from those based on the old benchmark, it should also clarify that the requirements related to the measurement of ineffectiveness are not affected and continue to apply to the effects of such changes.

We believe that these principles-based proposals should permit retrospective application of the targeted relief, including reinstatement of hedges that were previously discontinued only because those principles were not previously applied.

When considered together, our proposals would mitigate the opportunity for abuse, maintain the discipline of hedge accounting, and reduce the risk for unwarranted financial reporting disruption during the transition to alternative RFRs. Such an approach would not seek to change the accounting standards or principles themselves, but rather it would provide clarity on how those existing principles should be interpreted. Such an approach may allow quicker adoption in practice and be particularly attractive for jurisdictions, such as the European Union, where any amendments to IFRS must be endorsed.

The approach we recommend is succinct, and we think there is merit in providing concise guidance rather than complex detailed rules. Further, we think a principles-based approach is better placed to deal with new developments and unforeseen problems that have not yet been thought of and would better provide a bridge to Phase 2, including allowing entities to deal immediately with certain Phase 2 issues if needed.

**High-level comments on the current draft text**

We would first like to clarify what we understand to be the approach generally adopted today by preparers in assessing whether cash flows based on existing benchmarks are “highly probable”. IAS 39 and IFRS 9 provide a helpful framework for evaluating the current market structure. Specifically, IAS 39.81, IG F.5.5, IG F.6.2(k), IG F.6.2(l) and IFRS 9.B6.3.10(d) indicate that a portion of a financial asset’s or financial liability’s cash flows or fair value may be designated as the hedged item provided that effectiveness can be measured. We believe that entities concluding that existing benchmark cash flows are highly probable beyond the expected replacement date are doing so by applying this guidance on market structure. Similar to our proposed principles-based approach, this effectively views the alternative RFR as a continuation of the existing benchmark. In many cases, it may be considered that market participants’ current best estimate of the alternative RFR cash flows from an instrument will track the existing benchmark cash flows, given the objective of risk neutralisation during transition. We do not believe that market participants are asserting that the existing interest rate benchmark cash flows will actually continue to be indexed to the existing benchmark for the duration of the hedge relationship. As currently drafted, parts of the ED could be interpreted to undermine these market approaches because it suggests that under current IFRS requirements it must be highly probable that hedged cash flows continue to be indexed to the existing benchmark even beyond the planned replacement date to continue hedge accounting for relationships that extend beyond that date. If that were the case, then it would appear that hedge accounting should have already ceased for such hedges today. Alternatively, parts of the ED could be read to mean that the standard must be amended for this opinion to continue rather than clarifying that continuing hedge accounting based on these market approaches is considered acceptable by the IASB. Hedge discontinuation is not an outcome that we believe the IASB intends. However, as market reform progresses, we agree that standard setting relief may become necessary for pre-replacement issues once the market structure begins to shift (for example, when the liquidity of the alternative RFR is much greater than the liquidity of the existing interest rate benchmark).

We are concerned that the Board does not have defined objectives for its project on interest rate benchmark reform, particularly given the comments in BC3 of the ED about “whether” the Board will address financial reporting issues once the existing interest rate benchmark is replaced with an alternative RFR. The introduction to the ED provides helpful background on the market forces that influenced the Board’s decision to publish an ED; however, it does not provide a conceptual rationale for why standard

setting is necessary. Establishing *why* this project is being undertaken would root the Board's intentions and objectives and would drive the proposed requirements that emerge for Phase 1 and Phase 2. Without overarching objectives, the possibility of there being no Phase 2 remains real and unsettling for market participants. We have outlined above our vision of the objectives with respect to hedge accounting and the Board should be formulating a similar perspective that encompasses the overall project. Alongside the publication of the final amendments, we believe the Board should commit to and communicate its intentions for Phase 2. Replacing existing interest rate benchmarks with alternative interest rates is under way in many jurisdictions. The Board should leverage its understanding of these efforts to inform its objectives for Phase 2. We are concerned that if the Board merely "monitors developments" and waits for replacement efforts to occur before progressing with Phase 2, as suggested in BC3, standard setting for Phase 2 would be too little too late.

Our detailed views on the proposals in the ED and other observations are described in *Appendix A - KPMG's responses to specific questions posed by the Board*. These responses directly address the IASB questions and do not assume that a principles-based approach is applied, such as we have recommended.

Please contact Reinhard Dotzlaw, Chris Spall or Colin Martin on +44 (0) 20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely,

*KPMG IFRG Limited*

KPMG IFRG Limited

## Appendix A

### KPMG's responses to specific questions posed by the Board

#### **Question 1: Highly probable requirement and prospective assessments**

*Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.*

Absent a principles-based approach (as discussed in our covering letter), we agree with the Board's proposals for the highly probable requirement and prospective assessments. The proposals are clear and targeted and sufficiently address some of the issues facing the forward-looking requirements of hedge accounting to allow hedge accounting to continue in many cases. We expect these proposals to be relatively easy to implement.

As expressed in our covering letter, we do not believe the highly probable requirement for existing cash flow hedges today is necessarily invalidated as a consequence of planned interest rate benchmark reform. We believe IAS 39<sup>2</sup> and IFRS 9<sup>3</sup> provide guidance that can be interpreted for both cash flow hedges and fair value hedges such that the existing interest rate benchmark is a component within the current market structure and that there is a specific risk inherent in the hedged item that can be designated. We extend the logic in IFRS 9.B6.3.10(d) to support an assertion that the existing interest rate benchmark is an implicit risk component of the market structure because the cash flows that an entity expects to receive for long-dated contracts are currently indistinguishable from post-replacement alternative interest rate benchmark cash flows. We observe that financial instruments generally continue to be priced or compared to existing interest rate benchmarks. Considered together, the market structure and behaviour of market participants indicate that uncertainties over the timing and amount of existing interest rate benchmark cash flows are in general not *currently* impacting the ability of entities to meet forward-looking hedge accounting requirements.

The proposed amendments to IAS 39 and IFRS 9 would need to undergo endorsement in various jurisdictions worldwide. The Board's tentative characterisation of an expected change in benchmark rates as negating an assertion that hedged benchmark cash flows are highly probable or still expected to occur may create problems in supporting the continuation of existing hedge relationships and preventing reclassification of existing cash flow hedge reserves if the amendments are not finalised quickly or if endorsement of the amendments for use by preparers under applicable local laws does not occur very shortly after the amendments are issued. This risk is intensified by the

---

<sup>2</sup> IAS 39.81, IG F.6.2(k), IG F.6.2(l)

<sup>3</sup> IFRS 9.B6.3.10(d)

Board's assertion that retrospective application would not permit reinstatement of already discontinued hedge relationships.

We find the Board's analysis in BC22 unclear and disagree with the decision reported in BC23 not to propose relief for retrospective assessments required by IAS 39. We believe that BC22–23 confuse the concepts of assessing effectiveness and measuring ineffectiveness by using the term “measurement of hedge effectiveness”. We believe that market rates and prices implicitly incorporate market participants' views as to the impact of interest rate benchmark reform. These market movements may be evident in the market yield and discount rate of the hedged item and hedging instrument. Consequently, market movements will be reflected in the retrospective assessment as they are based on actual fair value movements. The same relief for prospective assessments should be applicable to retrospective assessments to prevent hedge relationships from being disqualified solely due to uncertainties associated with benchmark reform. We believe the principles of IFRS 13 apply to an entity's measurement of ineffectiveness and that the financial statements should reflect the actual economics of the hedge relationship. Given the difference between our analysis above and that in BC23, we believe the Board should address whether – in measuring the cumulative change in fair value (present value) of the hedged item in a cash flow hedge for the purpose of recognising hedge ineffectiveness under IFRS 9.6.5.11(a) and IAS 39.96 – the entity should assume the current benchmark rate will apply or reflect expectations as to the nature and timing of transition to a new benchmark rate.

We also believe BC22–23 pose practical challenges that the Board should address. We are aware that many entities use their retrospective assessment as their prospective assessment. We believe this is an acceptable methodology. The proposed relief would be significantly less useful if retrospective assessments are not addressed (notwithstanding that ineffectiveness measurement should be unaffected).

**Question 2: Designating a component of an item as the hedged item**

*Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you propose instead and why.*

Absent a principles-based approach (as discussed in our covering letter), we agree with this proposal for the reasons set forth in the Basis for Conclusions.

**Question 3: Mandatory application and end of application**

*Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose instead and why.*



We agree with the proposal for mandatory application for the reasons stated in BC28–31.

Absent a principles-based approach (as discussed in our covering letter), we agree with most of the proposals about end of application relief for the reasons stated in BC32. However, there are certain elements we disagree with and there are elements of the supporting discussion in the Basis for Conclusions that, if appropriately amended, we believe should be more clearly reflected in the authoritative text of the amendments.

We believe the Board has explained in BC35 what it means by uncertainty as to the “amount” of hedged cash flows or fair value but we think that it would be better to explain this meaning as part of the proposed amendments rather than only in the Basis for Conclusions. We interpret the “amount” to be the “alternative interest rate on which cash flows will be based” and not the numerical value for any particular period. For the avoidance of doubt and to mitigate the opportunity for abuse, we encourage the Board to clarify that the “amount” does not refer to numerical fixing of the alternative interest rate for particular periods.

Although the scenarios described in BC35–39 are helpful, it appears that they address a single contract (e.g. only a hedging instrument or a hedged item) even though hedge relationships generally comprise two or more contracts or one or more hedging instrument(s) and uncontracted forecast transaction(s). We believe it is the Board’s intention that Scenarios A–E could be read to apply to either a hedged item or hedging instrument. Furthermore, Scenarios A–E read like authoritative application or implementation guidance as opposed to a basis for the Board’s conclusions. We encourage the Board to consider including Scenarios A–E as part of the application or implementation guidance of IFRS 9 and IAS 39, respectively.

We disagree with the Board’s assumption in BC40 that it is unlikely that there will be significant divergence between hedged items and hedging instruments for an extended period of time “because entities must agree to amend both contracts before this divergence can arise”. Many hedging instruments are governed by master agreements of the International Swaps and Derivatives Association (ISDA). We understand ISDA has published a timeline to amend all derivative contracts for the implementation of fallback interest rates. By contrast, it is likely that amendments to contracts that relate to the hedged item will proceed in a more piecemeal and less synchronised fashion. Such a divergence should be considered in the Board’s proposals.

In particular, as noted in BC41, it is possible that particular elements of the exceptions could end at different times for a single hedge relationship. BC41 suggests that a temporary mismatch between the interest rate basis of the hedging instrument and the hedged item (i.e. because one has been amended to the new benchmark but the other has not yet been) would be assumed to be a permanent mismatch when assessing effectiveness, presumably leading to an increased risk of failing the applicable



effectiveness assessment(s). We believe that the proposed reliefs should be extended to mitigate the risk of hedge disqualification in these circumstances given that the new benchmark rate should be seen as a replacement of the old benchmark rate (see our covering letter) and considering whether and how the item that is still indexed to the old benchmark may be amended; however, in this case the cash flows incorporated in the entity's measurement of ineffectiveness should as ever use market participant inputs and assumptions.

**Question 4: Disclosures**

*Do you agree with these proposed disclosures? Why or why not? If not, what disclosures would you propose instead and why?*

We agree that paragraphs 24A(a), 24A(c)–(d), 24B(a)(i)–(ii), 24B(a)(iv) and 24B(b) of IFRS 7 *Financial Instruments: Disclosures* are appropriate for hedging relationships to which the entity applies any of the requirements in IFRS 9.6.8.4–6.8.10 of IFRS 9 or paragraphs IAS 39.102D–102J.

Separate disclosures would highlight how interest rate benchmark reform does and may impact the entity's hedging and provide meaningful quantitative information. Absent separate disclosures, this information may be obscured by aggregation with other hedge relationships that are not impacted by interest rate benchmark reform.

In addition to the Board's proposals, we believe entities should be required additionally to disclose the names of the jurisdiction(s)/currency(ies) for which the entity is applying the targeted relief, together with qualitative information about the uncertainties as to the timing or amount of benchmark cash flows that affect hedging relationships. This will provide relevant information to allow financial statement users to assess more fully the nature of the relevant uncertainties and the assumptions the entity has made in applying the reliefs.

IAS 8.28 provides disclosure requirements for initial application of an IFRS, and we do not think it would be useful to financial statement users for entities to comply with this requirement upon adoption of the proposed amendments. We also do not think it would be practical for entities to comply in some cases and that the effort involved would significantly outweigh any benefits.

**Question 5: Effective date and transition**

*Do you agree with these proposals? Why or why not? If you disagree with the proposals, please explain what you propose instead and why.*

We agree with the Board's proposals on the effective date and transition. Given the varying timelines for and uncertainties related to interest rate benchmark reform, we

believe it is appropriate for the relief to have no fixed end date. We do not believe that specific additional transition provisions are necessary for the proposed amendments.

The Board states in BC46 that retrospective application would not allow an entity to reinstate hedge accounting that has already been discontinued. We believe that retrospective application to reinstate hedge accounting is appropriate if hedge accounting was discontinued solely due to the impact of interest rate benchmark reform and application of the relief at the time would have prevented discontinuation. It should also be made clearer that retrospective application would be required where relevant to reverse reclassification of amounts from the cash flow hedging reserve into the statement of profit or loss for previously discontinued cash flow hedges. The details of retrospective application may be particularly relevant in jurisdictions, such as the European Union, where the amendments must be legally endorsed and endorsement may follow some time after the IASB amendments are published, especially if final amendments are issued by the IASB in late 2019 but are not endorsed until early 2020. We agree with the Board that an entity cannot designate a new hedge relationship in hindsight for the reasons stated in BC46.

#### **Additional observations**

If the Board retains the proposed approach, we believe that further clarification should be made for the following.

- It appears that the reliefs in the ED would apply to hedges of interest rate risk only. We believe hedges of foreign currency risk, and hedges of both foreign currency risk and interest rate risk, may be impacted by interest rate benchmark reform. For example, an entity may use a floating-to-floating cross-currency interest rate swap as a hedge of its net investment in a foreign subsidiary where the floating rate is indexed to an interest rate impacted by interest rate benchmark reform. We recommend that the ED addresses these types of hedge relationships.
- It is unclear how the proposals would address the requirement for all exposures to share the risk being hedged (portfolio hedges of interest rate risk) or similar risk characteristics (groups of assets, liabilities, firm commitments, highly probable forecast transactions) in IAS 39.78 if the timing for replacement of the hedged interest rate varies within the designated group or portfolio.