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Dear Susanne

FRED 54 Basic Financial Instruments

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the Financial Reporting Council's (FRC) consultation 'FRED 54 Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland Basic Financial Instruments'.

We support strongly the overall objectives and approach of FRED 54. In particular we support the proposal to amend the conditions of paragraph 11.9 and make the requirements for debt instruments to be classified as basic less restrictive. We appreciate that there is a balance that needs to be achieved between making the standard excessively complex to apply and achieving an accounting treatment that is sensible for different types of debt instruments. We believe that the complexity that has been added by the proposal is manageable and worthwhile.

Overall, in our view the changes to paragraph 11.9 will distinguish basic from non-basic debt instruments more appropriately. This will help businesses by alleviating the onerous requirements under the existing wording to fair value debt instruments that are relatively simplistic in nature, and permit more meaningful information to be provided to users by allowing the profit and loss account to more fairly reflect underlying profitability. This will free up small and medium sized businesses from an unnecessary administrative burden, so they can invest precious time in unlocking their potential for growth.

However, we believe there are still some debt instruments where the proposals will not result in the most appropriate classification. These debt instruments include:

- debt instruments that permit the issuer to switch the interest rate basis between a fixed or variable rate and an inflation linked rate.
- debt instruments that include a mandatory cost adjustment.
- debt instruments which include a significant penalty, but where the early repayment option is at the issuer's discretion only.

These features are common in many debt instruments and we believe that amortised cost in the most appropriate measurement basis for such instruments.

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We expand on these debt instruments and set out our detailed responses to each of the questions raised in the attached Appendix.

If you have any questions on our response, or wish us to amplify our comments, please contact Alan Chapman (telephone: 0131 6598509, email alan.chapman@uk.gt.com), Joyce Grant (telephone: 020 77282073, email joyce.grant@uk.gt.com) or David Rice (telephone: 020 77282591, email david.f.rice@uk.gt.com).

Yours sincerely

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Response to specific questions

Question 1 - Do you support the proposal to amend the conditions of paragraph 11.9 and make the requirements less restrictive?

Yes, as set out in our letter above, we support the proposal to amend the conditions of paragraph 11.9 and make the requirements for debt instruments to be classified as basic less restrictive.

Question 2 - In your view, under the amended conditions will debt instruments be classified appropriately, ie will the proposal have the effect that debt instruments that are basic in nature are measured at amortised cost and debt instruments that are non-basic in nature are measured at fair value? If you have reservations, please specify the financial instruments that you believe would not be measured appropriately under the proposed requirements.

In general we agree with the proposed amendments. However there are some specific instruments which we believe should be considered further. These instruments contain features that we see arising commonly in practice particularly in those sectors where long term debt funding is in place, such as housing associations. The features outlined below are cases when we believe that amortised cost is a more useful measurement basis for these types of debt instruments. If these instruments are measured at fair value, this could lead to substantial volatility, particularly in fixed rate loans. This volatility would typically be much higher as compared to IAS 39 or IFRS 9, particularly from the perspective of a borrower. Such users could apply IAS 39 or IFRS 9 under the accounting policy choice in FRS 102 paragraph 11.2. However, we recommend these amendments are brought into FRED 54 in order to make sections 11 and 12 more widely accessible.

Debt instruments that permit the issuer to switch the interest rate basis to an inflation linked interest rate

We are aware that debt instruments that permit the issuer to switch the interest rate basis between a fixed, variable, or inflation linked interest are common in the housing association sector. As currently drafted, these debt instruments would fail the conditions to be classified as basic instruments. This is because the proposals in paragraph 11.9(c) only allow for a variation of the return if the new rate satisfies the condition in paragraph 11.9(a). Paragraph 11.9(c) does not allow for the new rate to be a paragraph 11.9(b) inflation linked rate.

For example, an entity takes out a 25 year £20M loan that requires the entity to initially pay a variable interest rate based on LIBOR. However, the loan agreement includes a provision that allows the entity to switch the interest rate basis to a RPI linked interest rate. Under the proposed wording the loan will fail the conditions to be classified as basic as the variation of the return does not result in a new rate that satisfies condition 11.9(a).

In our view, such debt instruments are still basic in nature, with amortised cost being the most appropriate measurement basis. If such debt instruments fail the conditions to be classified as basic, accounting for these long lived loans at fair through profit or loss will introduce significant volatility into profit or loss. We believe that if the FRED is not amended, entities, especially in the housing association sector that have such loans, may elect to apply IFRS 9 for financial instruments as opposed to applying section 11 & 12.

Paragraph 11.9(c) could be easily expanded to permit such debt instruments to be classified as basic, as follows:

> "(c) The contract may provide for a variation of the return to the holder during the life of the instrument, provided that:
>
> (i) the new rate satisfies condition (a) or (b) and the variation is not contingent on future events other than:
>
> (1) a change of a contractual variable rate; or
>
> (2) to protect the holder against credit deterioration of the issuer; or
>
> (ii) the new rate is a market rate of interest and satisfies condition (a) or (b)."

Mandatory cost adjustments

We have seen many examples of long term loans in both corporate entities and housing associations that include mandatory cost adjustment clauses. These are loans that vary the interest rate to compensate the bank for the cost of compliance with requirements of the Bank of England.

In the examples we have seen, the mandatory cost is calculated using a formula, where inputs to the formula include various bank capital restriction ratios, the interest rate that the Bank of England pays the bank on interest bearing special deposits, and fees payable to the banking regulators.

For a variable rate loan there may be no issue. This is because 11.9(c)(ii) allows for a variation of return, provided that the new rate is a market rate of interest and satisfies condition (a). The bank's capital requirements alter their costs of borrowing and this is being passed on to the borrower, the new rate would therefore appear to be a market rate.

Our concern is for fixed rate loans where the new rate, after the variation of a mandatory cost, would not equate to market rate. This is because the current fixed market rate will be different to the fixed rate when the loan was taken out. Such loans are in our view basic in nature and would be most appropriately measured at amortised cost.

This could be rectified by including a variation due to a mandatory cost adjustment as a contingent event in paragraph 11.9(c)(i), as the new rate would not in this case be required to be a market rate.

> "(c) The contract may provide for a variation of the return to the holder during the life of the instrument, provided that:
>
> (i) the new rate satisfies condition (a) and the variation is not contingent on future events other than:
>
> (1) a change of a contractual variable rate; or
>
> (2) to protect the holder against credit deterioration of the issuer; or
>
> (3) a **mandatory cost adjustment**; or
>
> (ii) the new rate is a market rate of interest and satisfies condition (a)."

Glossary

"Mandatory cost adjustment – contractual features which vary the interest rate to compensate the lending bank for the cost of compliance with banking regulatory requirements, such as levies due to regulatory authorities."

Early repayment options

We have seen many loans where the issuer (borrower) has the option to early repay, but where the penalty payable goes beyond compensating the holder for loss of interest. For example, where the penalty payable is based on a comparison between the loan's contractual rate and the government gilt rate. Such loans would fail the conditions to be classified as basic under the proposed wording as paragraph 11.9(e) only permits terms that require the issuer to compensate the holder for loss of interest.

Such features are common in long term fixed rate loans. In this case, the option to early repay is only exercisable by the borrower, but the break penalty is penal in size. The borrower typically has no intention to early repay. However the early repayment option is necessary in case the borrower has a future major change in their business.

Under IFRS 9 and IAS 39 the early repayment option would be treated as an embedded derivative, which would most likely be separately accounted for at fair value through profit or loss. However, in most cases the fair value of the embedded derivative and the resultant volatility through profit or loss would not be material. This is because the early repayment option typically does not allow the borrower to exit the loan for less than its fair value. In other words the early repayment option will usually never be 'in the money'. The underlying host loan would be accounted for at amortised cost. Hence the IAS 39/ IFRS 9 position result in considerably less volatility compared to a similar FRS 102 loan that must be measured at fair value.

In our view, loans that have early repayment options that are only at the discretion of the issuer are basic in nature with the most appropriate measurement basis being amortised cost, even if the penalty for early termination goes beyond compensation for loss of interest.

However, different principles should apply to early repayment provisions which are at the holder's discretion or are mandatory, based on contingent future events. In our view, if the break penalty, payable over and above amortised cost, exceeds reasonable compensation for lost interest, then such loans should fail the conditions to be classified as basic.

In summary, we therefore believe further analysis is required to differentiate between early repayment options that are only at the discretion of the issuer and those that are either at the holder's discretion or are mandatory based on contingent future events. In particular, if early repayment is only at the discretion of the issuer, then we do not consider that there should be any limit on the penalty payable by the issuer for exercising their option.

We also believe that loans where the issuer has an early repayment option that can only be exercised after a certain period of time, should be treated as if it were unconditional and classified as basic. This is however, not entirely clear from the proposed wording. It would be helpful if this issue was clarified in the final wording of the standard or illustrated in an early repayment option example.

Minor improvements and clarifications

Derivatives

It not clear why the term "derivative" is not used rather than the list of financial instruments in paragraph 11.6(b). If the term derivative was used this would also make paragraph 11.8(b) clearer, as it could end with "...and is not a derivative.". We note that the term derivative is defined in the glossary.

Date of change

The words "at the date of change" should be inserted in paragraph 11.9(c)(ii) to clarify that the new rate cannot be based on what the market rate was at the date that debt instrument originated, as follows:

> "(ii) the new rate is a market rate of interest <u>at the date of change</u> and satisfies condition (a)."

Change in interest rate due to taxation or law

A variation of the interest rate that is triggered by a change in relevant taxation or law should also be included as a contingent event in paragraph 11.9(c)(i), as has been done in paragraph 11.9(e). For example, if a loan's terms were originally negotiated in a manner where the contractual interest rate was influenced by taxation regulations, the loan agreement could have a clause adjusting the rate in the event of a change in taxation regulations. Based on the proposed wording such a loan would fail the conditions to be classified as basic in a fixed rate loan, as the new fixed rate would not be a market rate of interest at the date of change, and therefore not satisfy paragraph 11.9(c)(ii). In our view, such loans are normally basic in nature, and should be accounted for at amortised cost.

Negative interest rates

It is not clear from the proposed wording what would happen if interest rates became negative. Paragraph 11.9(iii) allows for a combination of a positive variable rate and a negative fixed rate. Example 3 in paragraph 11A.3 considers a loan where interest is payable at the bank's standard variable rate less 1%, but includes a condition that the interest rate can never fall below 1.5%.

If the loan did not include the fixed interest rate floor, this would appear to result in the loan failing the conditions to be classified as basic on the basis that the holder is not protected against the risk of losing the principal amount of the loan, ie the requirement in paragraph 11.9(d) is not met, as the interest payable on the loan could become negative as suggested by the last paragraph of Example 3.

We note that in some parts of the world, market interest rates have been negative. Therefore, even a LIBOR+1% loan could in theory become negative at some point.

In our view such loans are still basic in nature.

Further clarification around negative interest rates either in the final wording of the standard or the examples would be helpful.

Question 3 - It is proposed that the Appendix to Section 11 *Basic Financial Instruments* will contain some illustrative examples. In your view, are the proposed examples helpful? If not, what other examples would you suggest should be included instead?

In our view, the proposed examples are useful in illustrating the requirements of the standard. In addition to our comments above on Example 3, we also believe that it would be helpful to include some further examples.

Two separate financial instruments

An additional example that would be useful is when a variable rate loan is taken out in conjunction with a separate interest rate collar and the interest rate collar is a separate

transferrable instrument that could be sold or transferred independently from the loan. In this case the loan would be classified as basic, provided it met the other conditions, whilst the interest rate collar would be a non-basic financial instrument accounted for at fair value through profit or loss or in accordance with the hedge accounting provisions. This example would be useful to emphasise and contrast the difference in the required accounting when there are two separate financial instruments with the situation when there is just one financial instrument with an embedded fixed interest rate floor, as set out in Example 3.

Early repayment options

Further to our comments above, regarding instruments that contain early repayment options, it would be helpful to include an example of a loan with an early repayment penalty where the prepayment option is at the discretion of the issuer only. The example could illustrate a penalty payable which clearly goes beyond fair value such as a penalty based on a comparison between the contractual fixed rate and the government gilt rate.

Variable premium

It would be helpful to include an example of a loan where there is a variable premium amount payable based on the outcome of a contingent event. In our view, such loans are non-basic in nature and fair value is the most appropriate treatment.

For example, an entity receives a 4% fixed interest rate loan of £10M from a private equity investor that is repayable in 5 years' time at £15M (ie at a premium of £5M). However, if there is a change in control of the entity before the 5 year anniversary, the loan is required to be redeemed at a variable premium amount. If the value for the entire entity that is achieved on change of control:

- is less than £30M, then the entity is required to pay £15M (ie at a premium of £5M); or
- is equal to or more than £30M, then the entity is required to pay £12M (ie at a premium of £2M).

Paragraph 11.9(e) permits a debt instrument to be put back to the issuer before maturity in the event of a change in control. However, in this case due to the variability in the premium that is payable on change of control we believe that the nature of this loan is normally non-basic and should therefore be measured at fair value through profit or loss.

Leveraged inflation linked debt instruments

It is clear from the definition of variable rate in paragraph 11.9(a) and Example 4 in paragraph 11A.4 that leverage of variable rate is not permitted. It is not clear from paragraph 11.9(b) whether debt instruments that are linked to a leveraged inflation rate would qualify as basic. In our view such debt instruments should not qualify as basic. It would be helpful if a further example was included to illustrate this.

Question 4 - The proposed amendments would be effective from 1 January 2015. Do you have reservations concerning the proposed effective date?

No, we do not have any reservations. We strongly support an effective date of 1 January 2015 to be consistent with the effective date for the rest of the standard.

Question 5 - The exposure draft does not contain specific transitional requirements and the requirements of Section 35 Transition to this FRS of FRS 102 will therefore apply. In your view, are any specific transitional provisions in relation to the proposed amendments necessary? If so, please tell us what transitional provisions you would suggest and why?

In our view there are two specific situations where we believe that transitional provisions are necessary.

Entity has not previously designated

When an entity has not designated a debt instrument under paragraph 35.10(s) as at fair value through profit or loss on transition date on the basis that under the existing wording in standard the debt instrument would have been classified as non-basic (and thus measured as at fair value through profit or loss anyway). The debt instrument might now according to the final wording of the standard meet the conditions to be classified as basic, but for most entities the opportunity to designate debt instruments as at fair value through profit or loss at transition date has passed. In such cases the entity should be permitted, with a suitable time limit, to designate the debt instrument at fair value through profit or loss.

Early adopters

Entities that have early adopted FRS 102 and thus made use of the existing requirements in FRS 102 could have debt instruments that are required to be reclassified from non-basic to basic under the amended requirements. In addition to the requirements in Section 10 of FRS 102, relating to changes in accounting policy, transitional guidance provisions for early adopters with such debt instruments would be helpful. Furthermore, early adopters that do not wish to reclassify debt instruments from non-basic to basic should also be permitted to retrospectively designate debt instruments that meet the requirements of paragraph 11.14(b) as at fair value through profit or loss.