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Financial Reporting Council
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30th April 2014

Dear Susanne,

RESPONSE TO FRED 54 EXPOSURE DRAFT

Centrus Advisors LLP ("Centrus") welcomes the proposals of FRED 54 which seek to make the conditions for applying "basic" financial instrument accounting treatment less restrictive. We believe that FRED 54 represents a positive step forward in terms of assisting reporting entities to more easily determine the appropriate FRS 102 accounting treatment for their debt instruments. However, we would like to take this opportunity to highlight to the Financial Reporting Council ("FRC") some common situations where we believe that the amended paragraph 11.9 could still lead to unintended accounting consequences and inconsistency in the application of FRS102.

In our capacity as a treasury advisor to the UK housing, infrastructure and regulated utilities sectors, we have recently been involved in extensive dialogue with reporting entities and their auditors concerning the impact of FRS 102 on the accounting treatment for debt instruments. We have encountered much difference of opinion around whether particular types of debt instrument should qualify as basic under FRED 54 where there is a "variation of the return to the holder during the life of the instrument". We believe these disagreements stem from the fact that the paragraph 11.9 conditions - particularly 11.9(c) - as proposed in FRED 54 are somewhat ambiguous in relation to the categorisation of these instruments. Interpretation seems to be required and (quite understandably) auditors will tend to adopt a conservative position which may result in the application of an inappropriate accounting treatment.

In order to illustrate this problem, in Appendix A we have summarised the economic characteristics of four common real-world examples of bank loans where the "return" may vary during the life of the loan (these examples are not explicitly considered in FRED 54, except for Example 2 which is broadly analogous to Example 2 of FRED 54 and which the FRC considers to be basic). The objective of our examples is to present in an appropriate context some common ways in which returns may vary over the life of a debt instrument so that the FRC can consider the appropriate accounting treatment and the paragraph 11.9 interpretation issues that may arise in each case.

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The four examples that we have considered are as follows:

- Example 1: A bank loan with a periodic margin "re-price" option
- Example 2: A bank loan with an embedded fixed rate hedge which matures before the loan
- Example 3: A bank loan with an embedded cancellable fixed rate hedge
- Example 4: A Lender Option Borrower Option ("LOBO") bank loan

Considering the economic characteristics set out in Appendix A, Centrus believes that each of these loans is fundamentally a basic financial instrument which should therefore satisfy all of the relevant conditions of paragraph 11.9 of FRED 54 and be accounted for at amortised cost. In particular, (i) from the borrower's perspective each instrument will only ever attract a simple fixed or floating rate of interest at any point in time during its contractual life, and (ii) in the event that the contracted rate of interest varies during the life of the instrument, it will in principle be reset to a "market rate of interest"[1].

Based on our interpretation of the FRC's comments in FRED 54, it is our understanding the FRC would also consider each of these instruments to be basic financial instruments although we are aware that other parties have arrived at different conclusions. Therefore, regardless of our own interpretation which we believe to be appropriate, it is clear that conflicts may arise as a direct result of the currently proposed drafting of paragraph 11.9.

The other point that we would like to highlight relates to the FRC's objective of promoting high quality standards of audit and reporting to foster investment. In this regard, Centrus believes that the current drafting of paragraph 11.9 gives rise to a real risk of entities applying fundamentally different accounting treatments to debt instruments where there are only subtle differences in economic characteristics (all the instruments listed in Appendix A are essentially simple bank loans with different hedging terms and interest bases). This would clearly be unhelpful to users of accounts and would run counter to the FRC's objectives. Therefore we believe that the application of paragraph 11.9 should result in each of loans considered in Appendix A being accounted for consistently.

Centrus recognises that it would be difficult (or impossible) for the FRC to unambiguously categorise the entire universe of debt instruments through simplified rules set out in paragraph 11.9 of FRS 102. Therefore, rather than proposing to amend paragraph 11.9(c) to attempt to achieve a clearer categorisation for these specific instruments, we would propose that the FRC provides additional application guidance (i.e. examples) to make clear the accounting treatment that should apply to other types of debt instrument where there is a variation in the return to the holder. This will help to avoid situations where reporting entities have to rely on their auditor's own interpretation of FRS102 which may lead to unintended accounting consequences and inconsistency in the application of FRS102 as a result of different auditors holding different views.

Finally, we would comment that of the six examples set out in FRED 54, we would view the first three examples as useful supporting application guidance, but the latter three examples are in our experience highly unusual and therefore are unlikely to be of any practical use to most reporting entities. In contrast,

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[1] We have had numerous discussions with clients and auditors around what constitutes a "market rate of interest". Centrus' view is that each of the "re-pricing" events considered in Appendix A in principle results in a new market rate of interest. However, since the meaning of market rate of interest is critical in determining the accounting treatment for instruments where there is variability in return to the holder, the FRC might be minded to provide further guidance as to what it considers to be a market rate of interest.

the examples provided in Appendix A to this letter are all relatively common loan structures in the UK and in our experience have been amongst the most problematic instruments to categorise under paragraph 11.9, therefore reporting entities should benefit from clearer guidance in respect of these instruments.

We would be very happy to engage with the FRC to explore this matter further.

Yours sincerely,

Nathan Pickles

Partner
For and on behalf of Centrus Advisors LLP

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Appendix A

Key economic characteristics of selected bank loans where the return to the holder may vary during the life of the instrument

Example 1: Bank Loan with a Periodic Margin Re-price Option

- The debt instrument consists of a simple floating rate (LIBOR + margin) bank loan
- The lender has the ability to vary ("re-price") the contracted loan margin at specific future dates
- In the event that the lender re-prices the loan margin, it would do so in order to move the loan to a new market rate of interest
- There is no contractual provision that could result in the holder losing the principal amount or any interest attributable to the current period or prior periods
- The borrower can prepay the loan at any time subject to any contractual break costs
- There are no contractual provisions that permit the holder to put the debt back to the issuer

Example 2: Bank Loan with Embedded Fixed Rate Hedge

- The debt instrument consists of a simple floating rate (LIBOR + margin) bank loan hedged with an embedded floating to fixed interest rate swap
- The lender cannot vary the contracted fixed rate or contracted loan margin
- The loan interest rate is fixed until maturity of the hedge. After the hedge matures, the underlying rate resets to LIBOR (or alternatively the borrower could procure a new market fixed rate)
- There is no contractual provision that could result in the holder losing the principal amount or any interest attributable to the current period or prior periods
- The borrower can prepay the loan at any time subject to any contractual break costs
- There are no contractual provisions that permit the holder to put the debt back to the issuer

Example 3: Bank Loan with Embedded Cancellable Hedge

- The debt instrument consists of a simple floating rate (LIBOR + margin) bank loan hedged with an embedded floating to fixed interest rate swap and an interest rate swaption which allows the lender to cancel the swap on specific contracted future dates
- The lender cannot vary the contractual loan margin
- The interest rate is fixed until maturity of the fixed rate hedge or until the hedge is cancelled by the lender on a contracted cancellation date
- In the event that the fixed rate hedge is cancelled, or when it reaches maturity, the underlying rate resets to LIBOR (or alternatively the borrower could procure a new market fixed rate)
- There is no contractual provision that could result in the holder losing the principal amount or any interest attributable to the current period or prior periods
- The borrower can prepay the loan at any time subject to any contractual break costs
- There are no contractual provisions that permit the holder to put the debt back to the issuer

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Example 4: Lender Option Borrower Option Loan

- The instrument consists of a simple floating rate (LIBOR + margin) bank loan hedged with an embedded floating to fixed interest rate swap and an interest rate swaption which allows the lender to cancel the swap on specific contracted future dates
- In addition, the lender has the ability to vary the loan margin on those same dates
- The loan interest rate is fixed until final maturity or until the lender chooses to re-price the loan to a new fixed rate at one of the contracted dates
- In the event that the lender re-prices the fixed rate, it would do so in principle in order to move the loan to a new market rate of interest[2] (i.e. on-market underlying rate plus on-market loan margin).
- In the event that the lender re-prices the fixed rate, the borrower has the choice of accepting the new fixed rate which is offered or it can opt to repay the loan at its nominal value (there is no obligation on the borrower to accept an off-market fixed rate)
- There is no contractual provision that could result in the holder losing the principal amount or any interest attributable to the current period or prior periods
- The borrower can prepay the loan at any time subject to any contractual break costs
- There are no contractual provisions that permit the holder to put the debt back to the issuer (the lender can merely re-price the loan, at which point the borrower has a choice of whether or not it wishes to repay the loan)

[2] The principle embodied in the loan documentation is that the lender has the ability to re-price the loan to a new rate in order to ensure its target returns continue to be met. One can speculate that the loan might be re-priced to an “off-market” rate of interest, but that does not seem an appropriate basis to determine its accounting treatment and in that situation the borrower could simply repay the loan in any event

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