BDO

Tel: +44 (0)20 7486 5888
Fax: +44 (0)20 7487 3686
DX 9025 West End W1
www.bdo.co.uk

55 Baker Street
London W1U 7EU

Susanne Pust Shah
Financial Reporting Council
Aldwych House
71-91 Aldwych
London
WC2B 4HN
Email: ukfrc@frc.org.uk

30 April 2014

Your ref: FRED 54
Our ref: 00/JN/Comment letter /FRED 54

Direct line: 020 7893 2980
Email: nicole.kissun@bdo.co.uk

Dear Susanne

FRED 54 Draft Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland - Basic Financial Instruments*

We are pleased to have the opportunity to comment on FRED 54. We agree with question 1 in the invitation to comment. As regards question 4, we have no reservations in terms of the proposed effective date. Responses to questions 2, 3 and 5 are below.

Our main concerns are:

- The lack of a clear principle to drive the classification of an instrument as "basic" or "other";
- The interpretation of "contingent" in terms of 11.9(c) and (e); and
- Unintended consequences arising from the potential for deflation and negative interest rates.

Question 2

Given the absence of any clear principle to drive the classification of an instrument as "basic" or "other", it is difficult to know whether application of the proposals will result in instruments being classified appropriately.

Interpretation of contingent

We do have some reservations in terms of the wording of paragraph 11.9 (c) and (e). In the application of those paragraphs we are aware of different interpretations arising with regards to the word "contingent". We are aware of some interpreting "contingent" in the context of the definition of contingent assets and liabilities in FRS 102, meaning that any agreement with an embedded option to re-price, put or prepay would result in "other" classification for the entity that has written the option because the exercise of the option (by the counterparty) is outside the control of the reporting entity and not one of the stated "contingent" events that would result in "basic" classification. They believe that such an instrument will be classified as "other".

In our view, that interpretation is counter-intuitive because:

- As regards sub-paragraph (c), the lender would classify the instrument as "basic" (provided the criteria in sub-paragraph (a) were met) because their decision to exercise the option to vary the rate is within their control and hence not considered a

BDO LLP, a UK limited liability partnership registered in England and Wales under number OC305127, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. A list of members' names is open to inspection at our registered office, 55 Baker Street, London W1U 7EU. BDO LLP is authorised and regulated by the Financial Conduct Authority to conduct investment business.

contingency. We would have thought that there should be a general principle that the classification of an instrument as "basic" or "other" should be consistent whether looked at from the perspective of the issuer or holder of the instrument.

- In sub-paragraph (e), if the counterparty has an option to put or prepay the instrument, then from the preparer's perspective the early repayment option is always going to be contingent on the counterparty exercising its option to put or prepay. As this is not one of the envisaged contingencies that would result in "basic" classification, if the exercise of the option to put or prepay held by the counterparty is considered a contingency, it would never result in "basic" classification from the perspective of the entity that has written it. This in turn means there is no point referring to the right of either party being able to settle the instrument early, rather should refer only to the preparer's right to put or prepay.

The issue specifically arises in the context of Lender Option Borrower Option (LOBO) and Cancellable Embedded Hedge (CEH) loan agreements entered in to by many registered providers of social housing. These agreements contain options written in favour of the lender as follows:

- In the case of LOBOs, these are fixed rate loans under which the lender can revise the current fixed rate payable to a new fixed rate; and
- In the case of CEHs, these are variable rate loans under which the borrower has already exercised an option to switch to a market based fixed rate. However, there is a further option for the lender to revert back to the original variable rate (plus original credit spread) that was agreed at the inception.

In both cases, the agreements do not necessarily specify that the loan must be re-priced to a current market rate so 11.9 (c)(ii) would not be met. Similarly, 11.9(c)(i) would not be met if it were considered that the lender exercising its option to vary the rate payable is a contingent event (i.e. outside the control of the borrower). Consequently, the borrower would have to classify the loan as "other". In the case of LOBOs, although in theory the lender could revise the rate to anything it wishes, in such eventuality the borrower has a period (typically 1 year) during which time it may prepay the loan penalty free (the borrower option) with the loan attracting a variable rate of interest (LIBOR plus a pre-determined credit spread, which may not be reflective of the current market credit spread of the borrower) until prepaid. In the case of a CEH, the effect of cancelling the fixed rate would result in the rate reverting back to the original variable rate plus original credit spread which again may not be reflective of the current market credit spread of the borrower.

We do not believe that under full IFRS the embedded written options in LOBOs and CEHs would have to be separately accounted for as embedded derivatives at fair value because it is difficult to see that the "double-double rule" in IAS39 AG33(a) or IFRS 9 B4.3.8(a) would be breached. Furthermore, in the case of LOBO's, as the borrower has the option to repay penalty free in the event that the bank revises the rate, the lender option might be considered to lack any real substance as the borrower is not contractually obliged to accept the new rate. If the borrower does accept the new rate, then it seems reasonable to assume that the rate is on market in any case. On the basis that amortised cost treatment for the whole instrument would be available under IFRS we do not think that the application of the rules in FRS 102 should result in an instrument being classified as "other". However, this would not be the case under the proposed revisions for LOBOs and CEHs if a contingent event was taken to include the counterparty's right to re-price or put/prepay an instrument.

Finally on this issue, we also note that LOBO's could be articulated, in substance, as a fixed rate loan for a shorter period with a commitment by the bank to lend for further periods at the same or (if it exercises its option to re-price) a higher fixed rate. Both the initial period of the loan at a fixed rate and the subsequent commitment to lend at a fixed rate would be basic instruments

and therefore it is difficult to see why the analysis should result in "other" classification. Admittedly, thought may need to be given as to whether the repayment profile of the LOBO should only be for the period up to the next re-pricing date under such an analysis, but that of itself should not preclude the instrument from being classified as "basic".

Effects of deflation and negative variable rates

We note that there is a potential conflict between 11.9(b) and 11.9(d) in that in periods of deflation there would be loss of capital where the repayment of principal is linked to an inflation rate, unless the contract provides that notwithstanding the return being linked to inflation there is a floored rate of 0%. There is similarly a conflict between 11.9(a) and 11.9(d) in that market or observable interest rates conceivably can fall (and in some countries have fallen) below 0%, which would similarly result in loss of capital in the absence of the contract specifying a floored rate of 0%. In the case of a rate equal to LIBOR less a fixed margin, this situation could arise even for positive LIBOR rates (as noted in example 11A.3). The FRC may, therefore, wish to ensure such conflict is removed by re-wording sub-paragraph (d) so that:

- there is an exception to the general rule about potential loss of capital resulting in "other" classification (if the FRC considers such circumstances should result in "basic" classification); or alternatively
- sub-paragraph (d) takes precedence in the cases where sub-paragraph (a) gives rise to a negative return resulting in loss of capital (if the FRC considers such circumstances should result in "other" classification).

Our preference would be that these instruments should be considered basic. This is simply because failure to classify them as basic could potentially result in many contracts having to be classified as "other" simply because of the possibility that the return could be negative (due to the absence of a specified floored rate of 0% in contracts), albeit that negative rates might not be anticipated.

Other comments on proposed paragraph 11.9

With regards to other proposed wording of paragraph 11.9, we note the following:

- It is unclear whether the wording of (a)(ii) encompasses a stepped rate loan. We believe that such instruments should be classified as "basic" on the basis that the return can be expressed as a constant fixed rate over the term of the instrument. We note that the change in rate arising on a stepped rate bond could be likened to Example 11A.2. However, that example demonstrates a revision to a contractual variable rate (under 11.9(c)(i)(1)) as opposed to a revision to a contractual fixed rate which both parties have agreed to at inception, and therefore it is not immediately apparent that an analogy could be drawn.
- Given it is proposed that index-linked instruments should be classified as "basic" under 11.9(b), we also believe the variation in rate referred to in 11.9(c)(i) and (ii) should also permit variation of the return to one that is index-linked.
- In the context of index-linked instruments, we are aware of some debt instruments attracting a rate of LPI (a government determined measure often applied in determining pension increases, currently set at the lower of CPI and 5%). It is unclear, however, whether such a rate is considered to be an "observable index of ***general*** price inflation" and we are aware of inconsistent views being formed on this issue. We believe returns linked to LPI should result in classification as "basic". In the same way that a capped

variable rate linked to LIBOR is classified "basic" (under 11.9(c)(i)(1)), so should a capped variable rate linked to inflation.

- Notwithstanding the above discussion on the meaning of "contingent" it is difficult to initially interpret what situations 11.9(c)(i)(1) is trying to deal with. It would be helpful to include clarification in 11.9(c)(i)(1) as is done in 11.9(a)(iii). This might be achieved by a reference to example 11A.3 and also by referring to variable rates which contain caps, collars or floors.
- In relation to 11.9(c), if it is accepted that the exercise of a written option held by a counterparty should not be considered a contingent event (which is what we argue above), and the holder of the option can impose a rate that is expected to be significantly off-market (albeit satisfying the conditions of 11.9(a), e.g. LIBOR plus 100% or a fixed rate of 100%), the instrument would appear to meet the definition of basic because it would meet 11.9(c)(i) and there is therefore no requirement to meet 11.9(c)(ii). This seems inappropriate.
- 11.9(d) could be read so as to require instruments redeemable at a discount to be classified as "other", e.g. where they are purchased in the market at a price above par because passing interest on the instrument is greater than extant market rates. It could be clarified that in some cases returns may encompass repayments of principal as opposed to constituting a loss of capital.
- Notwithstanding the above discussion on the meaning of "contingent", we believe 11.9(e) would be easier to understand if it was written in language similar to 11.9(c).
- It is not clear whether the compensation payable to the holder in 11.9(e) is limited to the amount of lost interest or whether a reasonable penalty fee could also be included. We believe that a reasonable penalty fee should be possible without causing the instrument to be classified as "other".
- Although example 11A.4 demonstrates that a leveraged rate is not considered to be a single observable interest rate, it would be helpful make this explicit in 11.9(a) and 11.9(b).

In the Appendix to this letter we provide a suggested revised wording of paragraph 11.9 to factor in the above comments.

Question 3

We find the examples helpful but feel that they could be expanded upon. An example which demonstrates the interpretation of a contingent event used in 11.9(c) and (e) where the contingent event is the exercise of an option held by the counterparty would be helpful. For example, the LOBO and CEH instruments which we have described above impact a large number of Registered Providers of Social Housing.

Question 5

It is conceivable that an early adopter of FRS 102 may not have applied 35.10(s) to designate an instrument as at fair value through profit or loss because it is currently classified as "other". If, as a result of the proposed amendments, the instrument falls to be classified as "basic" it would appear as though the entity would be precluded from designating it as at fair value through profit and loss as it is not a first time adopter, even though it may want to account for it in this way. The FRC should give consideration as to whether it would be worthwhile including a transitional rule to enable designation of such instruments as being at fair value through profit and loss.

Yours sincerely

Nicole Kissun

BDO LLP
Nicole Kissun
Partner
For and on behalf of BDO LLP

Appendix - Suggested revised wording for 11.9. See response to question 2 above.

11.9 The conditions a debt instrument shall satisfy in accordance with paragraph 11.8(b) are:

a) The contractual return to the holder (the lender), assessed in the currency in which the debt instrument is denominated, is:
   i) fixed, expressed either as an absolute amount, or one or more pre-determined fixed rates (e.g. a fixed rate or stepped rate loan);
   ii) a variable rate over the life of the instrument equal to an unleveraged single referenced quoted or observable interest rate (e.g. LIBOR)
   iii) a variable rate over the life of the instrument equal to an unleveraged single observable index of general price inflation (e.g. CPI or RPI), including any such return attaching to repayments of the principal amount.
   iv) a combination of such a fixed rate and variable rate (e.g. LIBOR plus 200 basis points or LIBOR less 50 basis points, RPI plus 200 basis points or RPI less 50 basis points, but not 500 basis points less LIBOR or 500 basis points less RPI);

b) The contract may provide for a variation of the return to the holder during the life of the instrument, provided that the new rate satisfies condition (a) and:
   i) does not arise as a result of an option being exercised by either party to the contract, and is not dependent on future events outside the control of either the issuer (the borrower) or the holder other than:
      1) a change of a contractual variable rate (e.g. as is potentially the case if the loan attracts a variable rate subject to a cap, collar, or floor); or
      2) to protect the holder against credit deterioration of the issuer; or
   ii) is a market rate of interest or otherwise gives the issuer a reasonable period to source alternative financing to prepay the instrument (or gives the holder the right to demand repayment). In such circumstances:
      1) the total return on the outstanding amount due during the period allowed for prepayment should not be expected to be punitive based on an assessment made on initial recognition of the instrument; and
      2) consideration should be given to the presentation of the instrument's maturity if the repricing mechanism could operate in such a way to result in there being no commercial alternative for the issuer other than to prepay (or no commercial alternative for the holder other than to demand repayment).

c) There is no contractual provision other than the effects of negative rates that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.

d) The contract may provide for the issuer to prepay a debt instrument or permit the holder to demand repayment, provided that:
   i) such provision is not dependent on future events outside the control of either the issuer or the holder other than:
      1) as a result of a change in control of the issuer;
      2) to protect the holder against the credit deterioration of the issuer (e.g. defaults, credit downgrades or loan covenant violations); or
      3) to protect the holder or issuer against changes in relevant taxation or law; and
   ii) compensation payable to the holder is limited to an amount that reflects loss of interest as a result of the early settlement plus a market standard penalty fee.

e) Contractual provisions may permit the extension of the term of the debt instrument, provided that the return to the holder and any other contractual provisions applicable during the extended term satisfy the conditions of paragraphs (a) to (d).