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28 April 2014

Dear Susanne,

FRED 54 - Draft Amendments to FRS 102: Basic financial instruments

We are pleased to respond to the invitation by the FRC to comment on FRED 54 on behalf of PricewaterhouseCoopers LLP.

We welcome the approach taken by the FRC to change the conditions which debt instruments have to satisfy in order to be accounted for as basic financial instruments under Section 11 and be measured at amortised cost. We believe the proposed amendments capture the types of instruments for which amortised cost is a relevant measurement basis.

While supporting the approach taken by the FRC, we provide a number of recommendations which we consider are important for the successful application of the standard.

Major Comments

Negative interest rates

Paragraph 11.9 (d) precludes the treatment of instruments as basic where they have contractual provisions that could result in the holder losing principal or interest attributable to the current period or prior periods. This paragraph might be interpreted to suggest that instruments with a negative interest rate (as has been experienced in Japan and Switzerland in recent years) and certain non-recourse or limited recourse loans (for example notes issued by an SPV whose payments depend on there being sufficient collections from the assets held by the SPV) are not basic. We believe these types of instruments are basic in nature and so should be measured at amortised cost.

Further, example 11A.3 suggests that an interest rate floor protects the holder from losing principal. This example might be interpreted as requiring an interest rate floor so that the condition in 11.9 (d) is not breached. A similar contractual provision is not included in example 11A.2. The example states that this instrument meets the conditions to be classified as basic as, unless there are indications to the contrary, it can be assumed that the interest rate under normal economic conditions will not fall below zero. The principles portrayed in these examples appear contradictory.

We do not believe a negative interest rate erodes principal and consider that the potential for a negative interest rate that reflects market conditions at the time should not mean the instrument is non-basic.

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Typically, if a structured entity does not receive cash flows from its assets (e.g. in a securitisation of a pool of mortgages), the debtors rights to cash flows are restricted to only those collected from the specific securitised assets. The contractual terms could result in the debtor losing principal or accrued interest on occurrence of a credit default event of the underlying assets. The substance of these arrangements is no different from other lending where contractual payments might not be received due to a credit default event. As a result we do not believe such non-recourse or limited recourse loans should be precluded from being measured at amortised cost provided any loss of principal or interest would only be as a result of a credit default event of the underlying non-recourse asset.

We believe there are two potential resolutions:

i) Remove paragraph 11.9(d), as the conditions related to the return in 11.9(a) and 11.9(b) would already suggest the types of features that typically result in a loss of principal or current/prior period interest are not basic; or

ii) Include in 11.9(d) wording to clarify that negative interest rates and non-recourse or limited recourse loans are not excluded by this paragraph. This could also be illustrated through examples.

Returns linked to an observable index of general price inflation

Paragraph 11.9 (b) allows repayments of principal and/or the return to the holder to be linked to a single observable index of general price inflation of the currency in which the debt instrument is denominated. It is not clear whether this permits a positive variable rate such as LIBOR to be linked to an index of general price inflation. If so this would appear to allow a variable rate to be leveraged for inflation as the variable rate already compensates for the nominal time value of money. The wording of this paragraph should be amended to clarify that the inflation link can only be applied to the principal and/or a fixed rate of interest.

It would be helpful for 11.9 (b) to be incorporated into 11.9 (a) as both deal with the type of returns that are permissible for a basic instrument. If this change is not made, 11.9(c)(i) and 11.9(c)(ii) should also refer to 11.9(b) as being an alternative condition which could be met.

Examples included in the body of the standard

Paragraphs 11.5, 11.6, 11.10 and 11.11 all provide examples of financial instruments which are either normally basic or do not normally satisfy the conditions to be classified as basic. Given that examples are being added to an appendix to section 11, we suggest that these examples are removed from the standard and relocated to the appendix with further commentary as to the features that make these instruments either basic or non-basic. We also recommend that the Appendix of examples is an integral part of the section 11; similar to the status of the application guidance in IAS 39.

Paragraph 11.8 precludes a debt instrument from being basic if it is included in the examples of financial instruments included in 11.6(b). We do not believe this cross referencing is required; rather 11.8(b) should just say 'and is not a standalone derivative' as the term 'derivative' is defined in the glossary to FRS 102.

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Responses to consultation questions

Question 1

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

Overall we support the changes to make the requirements less restrictive as we believe amortised cost is a relevant measurement basis for certain more sophisticated financial instruments rather than fair value. Amortised cost captures the risks associated with these instruments adequately.

However, we highlight that the new requirements are relatively complex, and because they are rules based, may be prone to structuring of instruments to reach desired outcomes.

We note that the FRC appreciates that a principles based approach is likely to be more effective than a rules based approach. We understand that one of the reasons a principles based approach has not been taken is that IFRS 9, in its final form, has not been issued and is untested in practice. In addition, the IFRS 9 principle (payments on the instrument are solely principal and interest) only applies to financial assets whereas FRS 102 section 11 applies to both financial assets and financial liabilities and further work would be required to incorporate a principles based approach in to section 11 of FRS 102. Therefore, we agree that in the circumstances a rules based approach is an acceptable short term solution, but encourage this approach to be reviewed as part of the first triennial review of FRS 102.

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.

We support the changes and we expect they will generally give rise to appropriate classification of debt instruments that are basic or non-basic in nature, but as discussed above under 'Major comments', the current drafting is not clear what the correct treatment is for:

- instruments with negative interest rates,
- non-recourse and limited recourse loans.

We believe these instruments are basic in nature and so should be measured at amortised cost.

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?

Given the complexity of the rules based approach, we believe that it is essential that examples are included to aid users in applying the rules to common features found in debt instruments.

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However, we believe the current drafting of example 11A.3 requires some amendment. Example 11A.3 is confusing because it covers four conditions (negative fixed rate, interest rate floor, principal protection and what is an observable rate) which are required to be met to classify an instrument as basic. We believe this adds unnecessary complexity and the examples would be more helpful if each covered only one condition. We would recommend only including examples of instruments with multiple features if common, and if individually those features result in classification as basic but in combination lead to classification as non-basic.

In addition to the examples already provided in the Appendix (including example 11A.3 being broken down into four separate examples), we believe that it would be useful to also illustrate the following features included in some debt instruments:

Basic instruments

- contractual provisions which allow for contingent changes in interest rate due to credit deterioration of the issuer, for example a ratchet interest rate clause which results in a higher interest rate as the ratio of net debt to EBITDA deteriorates

- issuer convertible debt (where the option to convert the debt is into a fixed number of ordinary shares of the issuer) and the debt component is basic and measured at amortised cost

Non basic debt instruments

- holder convertible debt (where the option to convert the debt is into a fixed number of ordinary shares of the issuer)

- profit participation features

- EUR denominated loan linked to a country specific inflation rate (rather than an index of general price inflation in the Eurozone)

Question 4

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

We do not have any concerns and believe it should be effective at the same point as FRS 102 as a whole and similar to FRS 102, available for early adoption.

Page 4 has a typographical error in (viii) as the effective date should be for periods beginning on or after 1 January 2015.

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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?

We do not believe there are any specific transitional provisions required for entities that have not early adopted FRS 102 in respect of the proposed amendments, but we believe the transition requirements of FRED 51 should take into account the expected effective date of FRED 54 so as to allow sufficient time for an entity to apply hedge accounting (and in particular, make the necessary hedge designations) to instruments which will be measured at amortised cost under FRED 54.

For entities that have already adopted section 11 as currently drafted and determined that certain debt instruments are classified as non-basic, but these amendments would result in classification as basic, it is not clear whether the determination of basic is an ongoing assessment (similar to the principles of IFRS 9) or whether it is only made on initial recognition. Transitional guidance would be useful to set out how any change in classification should be dealt with. Additionally, would any change be required to be applied retrospectively or prospectively (for example by taking the current fair value as the deemed amortised cost of the instrument)? We believe it would be appropriate for an entity to have an accounting policy choice in this respect.

Other comments

In paragraph 11.9 (c) (ii) we believe it should be made clear that the new interest rate should be a market rate at the time of the variation of the return.

Paragraph 11.9 (e) permits the issuer to compensate the holder for loss of interest as a result of early termination (prepayment option). We believe that this provision should be extended to cover the situation where the holder would have to compensate the issuer if the holder put the instrument back to the issuer as 11.9(e) also allows the holder to put the instrument back to the issuer.

Additionally, we believe that where prepayment is at the discretion of the issuer, the amount of 'compensation' does not have to be limited to loss of interest. For example, an option for an issuer to prepay may be included in a loan agreement to give the issuer flexibility over its future financing model should business circumstances change even though no such changes are anticipated and it expects to borrow for the set term. The issuer might accept a penalty charge greater than just compensation for loss of interest to have this flexibility. We do not believe such clauses should require the instrument to be classified as non-basic when payment of the penalty is as a result of the issuer exercising its option to prepay.

We believe additional exceptions should be added to paragraph 11.9 (c) (i) as follows:

(3) to protect the holder or issuer against changes in relevant taxation or law; or

(4) to protect the holder against costs of compliance imposed by a relevant central bank or regulator.

We believe (3) is consistent with paragraph 11.9 (e) and is a common term seen in loan agreements. Similarly, many loan agreements allow for interest rates to be varied to pass on certain regulatory compliance costs, often referred to as 'mandatory cost adjustments'. We believe both (3) and (4) are acceptable reasons for a contingent variation in return. It would also be helpful to include examples to illustrate that such clauses do not preclude classification of the financial instrument as basic.

We also believe (4) above should be added to 11.9 (e) as contractual provisions that allow an issuer to prepay a debt instrument in the event of a variation in rate for 'mandatory cost adjustments' should not be precluded from classification as basic.

Although not specifically related to this consultation, preference shares (that are non-puttable and non-convertible) are measured at fair value (or cost where fair value can not be reliably measured) [FRS 102 11.14(b)] from the perspective of the holder but are measured at amortised cost from the perspective of the issuer where the conditions of paragraph 11.9 are met. We believe the treatment should be consistent from the perspective of both the issuer and holder in this case. In our view, fair value measurement in the holder would be appropriate where the preference shares are classified as an equity instrument in the issuer. Similarly, provided the conditions in paragraph 11.9 are met, for a financial liability classified as a basic by the issuer it would be appropriate for the holder to recognise the instrument at amortised cost.

If you have any questions, please do not hesitate to contact Sandra Thompson, Accounting Consulting Services Financial Instruments Leader (020 7212 5697) or Janet Milligan, Accounting Consulting Services Senior Manager (020 78042355).

Yours Sincerely

PricewaterhouseCoopers LLP

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