

IAS 39 Financial Instruments: Recognition and Measurement (January 2016)

Financial Instruments: Recognition and Measurement—Separation of an embedded floor from a floating rate host contract

The Interpretations Committee received a request to clarify the application of the embedded derivative requirements of IAS 39 *Financial Instruments: Recognition and Measurement* in a negative interest rate environment.

Specifically, the Interpretations Committee considered:

(a) whether paragraph AG33(b) of IAS 39 should apply to an embedded interest rate floor in a floating rate host debt contract in a negative interest rate environment; and

(b) how to determine the ‘market rate of interest’ referred to in that paragraph.

The Interpretations Committee observed that:

(a) paragraph AG33(b) of IAS 39 should be applied to an interest rate floor in a negative interest rate environment in the same way as it would be applied in a positive interest rate environment;

(b) when applying paragraph AG33(b) of IAS 39, in a positive or negative interest rate environment, an entity should compare the overall interest rate floor (ie the benchmark interest rate referenced in the contract plus contractual spreads and if applicable any premiums, discounts or other elements that would be relevant to the calculation of the effective interest rate) for the hybrid contract to the market rate of interest for a similar contract without the interest rate floor (ie the host contract); and

(c) in order to determine the appropriate market rate of interest for the host contract, an entity is required to consider the specific terms of the host contract and the relevant spreads (including credit spreads) appropriate for the transaction.

In making these observations, the Interpretations Committee noted the following:

(a) paragraph AG33(b) of IAS 39 makes no distinction between positive and negative interest rates and, therefore, the requirements of that paragraph should be applied consistently in both cases;

(b) paragraph AG33(b) of IAS 39 requires an entity to identify whether an embedded interest rate floor is closely related to a host debt contract and makes no reference to individual components of an embedded interest rate floor (such as the benchmark interest rate); and

(c) the term ‘market rate of interest’ is linked to the concept of fair value as defined in IFRS 13 *Fair Value Measurement* and is described in paragraph AG64 of IAS 39 as the rate of interest ‘for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating’.

The Interpretations Committee also observed that paragraphs B4.3.8(b) and B5.1.1 of IFRS 9 *Financial Instruments* replicate the requirements of paragraphs AG33(b) and AG64 of IAS 39 respectively. Consequently, the observations noted in this agenda decision would be equally applicable to financial liabilities accounted for in accordance with IFRS 9.

In the light of the existing IFRS requirements, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee decided not to add this issue to its agenda.