

STAFF PAPER

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Project	IBOR Reform and its Effects on Financial Reporting—Phase 2		
Paper topic	Accounting implications from derecognition of a modified financial instrument		
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Introduction

1. This paper follows from the staff analysis set out in Agenda Paper 14A for this meeting. As discussed in that paper, applying IFRS 9 *Financial Instruments*, when the contractual cash flows of a financial instrument are renegotiated or otherwise modified as a result of interest rate benchmark reform (IBOR reform),¹ the accounting implications may differ depending on whether such an event result in:
 - (a) *Modification that does not result in derecognition*—that is, the contractual cash flows on a financial instrument have been renegotiated or otherwise modified, but the financial instrument is not deemed to be a substantially different instrument that results in the derecognition of the instrument; or
 - (b) *Modification that results in derecognition*—that is, the modification of a financial instrument results in a substantially different instrument requiring the derecognition of the existing financial instrument and the subsequent recognition of the modified financial instrument.
2. Agenda Paper 14A for this meeting focuses on determining when a modification results in terms that are substantially different and the accounting implications of

¹ Interest rate benchmark reform refers to the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations set out in the Financial Stability Board's July 2014 report 'Reforming Major Interest Rate Benchmarks'. That report is available [here](#).

modifications that do not result in derecognition of a financial instrument in the context of IBOR reform.

3. This paper therefore focuses on those modifications that resulted in the derecognition of the existing financial instrument and the accounting implications arising from the recognition of the ‘new’ modified financial instruments in the context of IBOR reform. The accounting issues arising from the recognition of the modified financial instruments are also relevant to the recognition of new financial instruments entered into (that is, those instruments that are newly recognised and do not follow the derecognition of the existing instrument) and include the following:
 - (a) derecognition of a financial asset or a financial liability from the statement of financial position and the effect in profit or loss.
 - (b) implications of recognising a new financial asset for the purpose of:
 - (i) determining the entity’s business model for managing the financial assets.
 - (ii) assessing the contractual cash flow characteristics of the financial asset, specifically, whether the contractual cash flows of the new financial asset meet the criteria for solely payments of principal and interest on the principal amount outstanding (SPPI).
 - (iii) recognition of the expected credit losses (ECL).
 - (c) potential effects on the accounting for embedded derivatives for financial liabilities in the context of IBOR reform.

4. When analysing the issues in paragraph 3, the staff also considered whether there is sufficient guidance in IFRS 9 for entities to determine how to make these judgements or whether the Board needs to make any amendments to IFRS 9 in order to provide more guidance on these issues and support entities in providing useful information to users of financial statements.

5. Nevertheless, the staff note that IBOR reform progresses in different ways and at a different pace across several jurisdictions, therefore some specific conditions and details of the IBOR reform are not yet known (for example, how and when term rates based on the alternative benchmark rates will develop). As IBOR reform further

develops and alternative benchmark rates are incorporated into contractual terms, new information and accounting implications could be identified that may affect the analysis in this paper.

6. This paper is structured as follows:
 - (a) Summary of staff recommendations (paragraphs 7–8);
 - (b) Background (paragraphs 9–11);
 - (c) Accounting for derecognition of financial assets and liabilities (paragraphs 12–15);
 - (d) Classification of financial assets—Business model (paragraphs 16–29);
 - (e) Classification of financial assets—SPPI (paragraphs 30–50);
 - (f) Recognition of expected credit losses (paragraphs 51–62); and
 - (g) Embedded derivatives for financial liabilities (paragraphs 63–71).

Summary of staff recommendations

7. In this paper the staff recommend that, in the context of IBOR reform, existing requirements in IFRS 9 provide an adequate basis to account for the following issues:
 - (a) derecognition of a financial asset or a financial liability from the statement of financial position and the recognition of the resulting a gain or loss in profit or loss following a substantial modification;
 - (b) determining the entity’s business model for managing the financial assets;
 - (c) determining whether the interest component of the contractual cash flows of the new financial asset referenced to alternative benchmark rates meets the SPPI criteria. However, the staff consider that adding an example to IFRS 9 to illustrate the application of the SPPI assessment in the context of IBOR reform could be useful;
 - (d) recognise the ECL for the new financial asset; and
 - (e) embedded derivatives for financial liabilities.

8. Accordingly, the staff do not recommend amending IFRS 9 with regards to these issues, other than adding a potential example to the application guidance on SPPI.

Background

9. As discussed at the September 2019 Board meeting, the staff engaged with various stakeholders and considered the feedback received in the comment letters on the IBOR Exposure Draft issued in May 2019 to identify and understand which replacement issues to be addressed during Phase 2 of this project.
10. As presented to the Board at the July 2019 meeting, stakeholders suggested the Board consider potential accounting implications arising from IBOR reform on some areas related to the classification and measurement of financial instruments, including the following:
 - (a) *Business model assessment*—whether the derecognition of an existing financial asset following a modification as a result of IBOR reform affects the assessment of the entity’s business model for managing financial assets as required by paragraph 4.1.1(a) of IFRS 9.
 - (b) *SPPI assessment*—whether the contractual cash flows of the new financial asset referenced to alternative benchmark rate represent solely payments of principal and interest on the principal amount outstanding. Specifically, whether the interest component of the contractual cash flows of the financial assets referenced to overnight alternative benchmark rate, is consistent with the requirements in paragraph 4.1.3(b) of IFRS 9.
 - (c) *Recognition of ECL*—whether the derecognition of the existing financial asset and the recognition of the new financial asset, as a result of IBOR reform, affect recognition of ECL. Specifically, potential interaction between the ECL previously recognised for the existing financial asset and the ECL recognised for the new financial asset upon its initial recognition.
11. Another issue raised by two stakeholders is with respect to accounting for embedded derivatives in the context of IBOR reform. Specifically, with respect to contractual terms of financial instruments which contemplate IBOR reform including the

replacement of the interest rate benchmark with alternative benchmark rates using fallback provisions.

Derecognition of the existing financial instrument

Accounting for derecognition of financial assets and liabilities

12. Sections 3.2 and 3.3 of IFRS 9 include specific requirements to assess when a financial asset or financial liability should be derecognised, that is, removed from the statement of financial position following a sale, transfer or extinguishment of the contractual rights and obligations arising from the instrument.
13. However, there is not much guidance on determining what constitutes a substantial modification to the contractual cash flows or terms of a financial instrument that require the derecognition of the instrument. This matter is already discussed in Agenda Paper 14A for this meeting and is not repeated in this paper.
14. On derecognition of a financial asset in its entirety, paragraph 3.2.12 of IFRS 9 requires an entity to recognise in profit or loss any difference arising between the carrying amount (measured at the date of derecognition) of the financial asset being derecognised and the consideration received (including any new asset obtained less any new liability assumed). Similarly, when a financial liability is extinguished, paragraph 3.3.3 of IFRS 9 state that an entity should recognise in profit or loss any difference between the carrying amount of the financial liability and the consideration paid (including any non-cash assets transferred or liabilities assumed).

Staff recommendation

15. Based on the above and subject to the recommendations made in Agenda Paper 14A, the staff consider that the existing requirements in IFRS 9 provide an adequate basis to account for the derecognition of a financial asset or a financial liability from the statement of financial position and the recognition of the resulting gain or loss in profit or loss following a substantial modification. Therefore, the staff do not recommend any amendment to be made to IFRS 9 in this regard.

Question 1 for the Board

Question for the Board

Does the Board agree with the staff recommendation in paragraph 15 on accounting for derecognition of a financial asset or a financial liability from the statement of financial position and the recognition of the resulting gain or loss in profit or loss in the context of IBOR reform?

Classification of financial assets—Business model

What is the problem?

16. Paragraph 4.1.1 of IFRS 9 requires an entity to classify financial assets, unless paragraph 4.1.5 of IFRS 9 applies,² on the basis of both (a) the entity’s business model for managing the financial assets and (b) the contractual cash flow characteristics of the financial asset.

17. As described in paragraph 10(a), given the magnitude of financial assets whose contractual cash flows are affected by IBOR reform, some stakeholders suggested the Board clarify if the derecognition of financial assets following a substantial modification as a result of IBOR reform has any implication on the assessment of the entity’s business model for managing its financial assets. Specifically, whether this derecognition event affects the entity’s ability to conclude that its business model is to collect the contractual cash flows—a condition in both paragraph 4.1.2(a) of IFRS 9 for a business model whose objective is to collect contractual cash flows and

² Paragraph 4.1.5 of IFRS 9 states that an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

paragraph 4.1.2A(a) of IFRS 9 for a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

Current IFRS 9 requirements

18. As explained in paragraph B4.1.2A of IFRS 9, an entity's business model refers to how the entity manages its financial assets in order to generate cash flows. That is, the entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, the business model assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur. Therefore, if cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not change the classification of the remaining financial assets held in that business model.
19. However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information.
20. Paragraph B4.1.2B of IFRS 9 states that an entity will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity in isolation. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:
 - (a) how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;

- (b) the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and
 - (c) how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).
21. Paragraph B4.1.3B of IFRS 9 states that an increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows. Paragraph B4.1.2C of IFRS 9 goes on to state that sales in themselves do not determine the business model and therefore cannot be considered in isolation. More importantly, it states that an entity must consider sales in the context of the reasons for the sales and the conditions that existed at that date compared to what the entity expectations were when the financial assets were initially recognised.
22. With regards to changes in the business model, paragraph B4.4.1 of IFRS 9 explains that changes in entity’s business model for managing financial assets are expected to be very infrequent. Applying this paragraph, a change in an entity’s business model will occur only when an entity either *begins* or *ceases to perform an activity* that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line. Based in staff’s understanding of the IBOR reform and consistent with stakeholders’ comments, would not expect this to be the typical case ie in many cases enacting IBOR reform will not mean the entity is beginning or ceasing a significant activity to its operations; instead entities will transition to alternative benchmark rates necessitated by the IBOR reform, in order to continue managing their financial assets in a way that is consistent to pre-IBOR reform period.

Staff analysis

23. As already established in Phase 1 amendments, IBOR reform refers to the market-wide reform of interest rate benchmarks and/or their replacement with alternative benchmark rates.

24. Furthermore, based on the staff analysis and recommendations in Agenda Paper 14A about how to assess whether a modification of contractual cash flows result in the derecognition of the financial asset, the majority of modifications arising from IBOR reform is not expected to result in substantial modifications. It will only be those modifications that go beyond the changes related to the benchmark rate on which contractual cash flows are based and that result in a new underwriting assessment or repricing of the instrument that is deemed to represent a substantial modification. The staff therefore expect only a subset of modifications to financial assets to result in derecognition of the existing instruments.
25. As noted in paragraphs 18-22, an entity's business model is a matter of fact, determined by the entity's objective in managing the financial assets and based on all available information about the entity's expectations about the future, the frequency and significance of situations in which financial assets were previously derecognised (either as a result of sale, transfer or modification) and importantly, the reasons that led to the derecognitions.
26. Based on this analysis, the staff consider that the fact that the entity derecognised existing financial assets and recognised new financial assets due to IBOR reform, represents a single factor or activity and shall not be considered in isolation. In addition:
- (a) the change in contractual cash flows as a result of the change in interest rate benchmark (ie change from IBOR to alternative benchmark rate) does not in itself indicate that the entity has changed the manner in which it manages its financial assets in order to generate cash flows.
 - (b) consistent with paragraph B4.1.4B of IFRS 9, in a business model other than hold to collect contractual cash flows, selling financial assets is *integral* to achieving the business model's objective instead of being *only incidental* to it. Absent to information that suggests otherwise, it could be argued that in the context of IBOR reform, derecognition of existing financial assets and recognition of new financial assets, is not necessarily integral to achieving the business model's objective; instead, it could be regarded as incidental to it.

27. As a result, the staff are of the view that the mere fact that the entity derecognised the existing financial asset(s) and recognised new financial asset(s) as a result of a substantial modification would not in itself necessarily lead to a change in the entity’s business model.
28. For example, assume an entity’s business model is to hold IBOR referenced financial assets to collect their contractual cash flows. As a result of IBOR reform, the entity modified the contract(s) for these assets to reference alternative benchmark rate(s) along with making other substantial changes to the terms of the financial assets. Following the modification assessment, it concluded that such modification results with derecognition of existing financial asset(s) and recognition of new financial asset(s) in accordance with IFRS 9. In determining the business model for the new financial asset(s), the entity considers how it manages its financial assets in order to generate cash flows. That is, the entity’s business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Assuming the entity’s way of managing assets has not changed and cash flows from the new financial asset(s) will continue to result from collecting contractual cash flows, the entity would not change its business model for managing its new financial assets solely as a consequence of the derecognition event.

Staff recommendation

29. The staff are of the view that IFRS 9 provides an adequate basis for determining the entity’s business model for managing the financial assets in the context of IBOR reform and no amendments to the guidance on the business model assessment is required.

Question 2 for the Board

Question 2 for the Board

Does the Board agree with the staff recommendation in paragraph 29 on determining the entity’s business model for managing the financial assets in the context of IBOR reform?

Classification of financial assets—SPPI

What is the problem?

30. As noted in paragraph 10(b), some stakeholders suggested the Board clarify whether the interest component of the contractual cash flows of the new financial instrument which is referenced to an overnight alternative benchmark rate satisfy the SPPI criteria as required by IFRS 9. Stakeholders highlighted circumstances that in their view could potentially affect an entity's ability to meet these criteria.
31. Specifically, while IBORs are available and used in a range of tenors—from overnight to one year—the currently available alternative benchmark rates are predominantly overnight rates and there are currently no available forward-looking term rates based on these alternative benchmark rates. Stakeholders noted that a potential issue may arise with respect to the consideration for the time value of money required by IFRS 9 in the context of the two main methods for calculation of term rates, currently being explored by some currency working groups. Those are:
- (a) *Backward-looking term rates*—term rates calculated at the end of a period or term based on observed rates during the period ('backward-looking'). Such a calculation would be generally done by compounding the actual overnight rate over the length of the period. So, a compounded overnight rate refers to the realised rate calculated from overnight rates over a given period. The backward-looking nature may mean that in order for the contract parties to know the interest amount already at the start of the period the compounded term rate may be determined in advance and relate to a prior period. For example, a 6-month rate would be calculated as a compounded alternative benchmark rate over a prior 6-month period ending on the last day preceding the current 6-month period. At the start of the current 6-month period the resulting rate would be applied for that period.
 - (b) *Forward-looking term rates*—term rates might be fixed at the outset of a given period, hence capturing expected rates over the period ('forward-looking'). In principle, forward-looking term rates could be based on derivatives referenced to overnight alternative benchmark rates such as futures or overnight index swaps in which case a fixed rate payment is

exchanged (swapped) for the floating alternative benchmark rate, because these provide information on market expectations of the alternative benchmark rates over a forward-looking period.

32. In this context, some stakeholders specifically suggested the Board clarify whether a financial asset that pays a variable rate interest referenced to an overnight alternative benchmark rate (eg either compounded daily or averaged over the coupon period) at periodic intervals other than daily (eg monthly, quarterly or semi-annually) could meet the SPPI criteria in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9.
33. Based in our research and consistent with stakeholders' comment, the staff note that while IBORs are produced at various maturities and most current IBORs are forward looking term rates, the current alternative benchmark rates identified by various currency working groups are overnight rates that are published daily. Furthermore, seemingly, there are currently no forward-looking term rates based on alternative benchmark rates available. However, the staff note that some currency working groups are considering developing term rates based in the alternative benchmark rates.³
34. Respondents to the IBOR Exposure Draft issued in May 2019 told the Board that knowing that the alternative benchmark rates would be overnight rates, market participants expect that when amending contracts to replace the interest rate benchmark with the alternative benchmark rates, a fixed spread adjustment between the alternative benchmark rate and the IBOR rate will be included to minimise economic value transfer and would typically be based on historic average spreads between the IBOR referenced financial instrument and the alternative benchmark rate.

Current IFRS 9 requirements

35. Further to IFRS 9 requirement reproduced in paragraph 16, paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9 require that the contractual terms of a financial asset must give rise on specified dates to cash flows that are solely payments of principal and interest

³ Some publications consulted for this purpose include: (a) a report issued by Financial Stability Board (FSB) 'Interest rate benchmark reform—overnight risk-free rates and term rates' in July 2018, available [here](#) and (b) a statement published in the website of Bank of England on 15 May 2019 'On behalf of the Working Group on Sterling Risk-Free Reference Rates—Progress on adoption of risk-free rates in sterling markets', available [here](#).

on the principal amount outstanding for a financial asset to be measured at amortised cost or fair value through other comprehensive income.

36. Paragraph 4.1.3 of IFRS 9 sets out the meaning of principal and interest when applying paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9. That is, principal is the fair value of the financial asset at initial recognition and interest consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time and other basic lending risks and costs, as well as a profit margin.
37. Paragraph B4.1.7A of IFRS 9 states that contractual cash flows that are SPPI are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement.
38. Paragraph B4.1.7A of IFRS 9 also states that contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are SPPI.
39. As an example of contractual terms that result in contractual cash flows that are SPPI, paragraph B4.1.13 of IFRS 9 cites ‘a variable interest rate instrument (in this example a LIBOR interest rate) with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. It is also mentioned that the fact that the interest rate benchmark is reset during the life of the instrument does not in itself disqualify the instrument. Thus, absent information that suggests otherwise, and in light of the stakeholders’ comments in paragraph 34, one view could argue that it is also possible for an alternative benchmark rate being the successor of IBORs, such as LIBOR, to result in contractual cash flows that are SPPI.
40. With regards to the consideration for the time value of money, paragraphs B4.1.9A and B4.1.9B of IFRS 9 state that time value of money is the element of interest that

provides consideration for only the passage of time and does not provide consideration for other risks or costs associated with holding the financial asset. In order to assess whether the element provides consideration for only the passage of time, an entity applies judgement and considers relevant factors such as the currency in which the financial asset is denominated and the period for which the interest rate is set.

41. However, in some cases, the time value of money element may be modified (ie imperfect). That would be the case, for example, if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a one-year rate) or if a financial asset's interest rate is periodically reset to an average of particular short-term and long-term interest rates. In such cases, an entity must assess whether the time value of money element provides consideration for only the passage of time by performing either a quantitative or qualitative assessment. IFRS 9 does not prescribe when an entity must perform a quantitative versus a qualitative assessment.
42. Paragraphs B4.1.9C–B4.1.9D of IFRS 9 provide application guidance on assessing a modified time value of money element, noting that the objective is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity would compare that financial asset to a financial instrument with identical contractual terms and the identical credit risk except the variable interest rate is reset monthly to a one-month interest rate. If the modified time value of money element could result in contractual (undiscounted) cash flows that are significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the criteria in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9. To make this determination, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument. The reason for the interest rate being set in this way is not relevant to the analysis. If it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different

from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment.

43. In paragraph BC4.178 of IFRS 9 the Board also noted that, as a general proposition, the market in which the transaction occurs is relevant to the assessment of the time value of money element. For example, in Europe it is common to reference interest rates to LIBOR and in the United States it is common to reference interest rates to the prime rate. However, the IASB noted that a particular interest rate does not necessarily reflect consideration for only the time value of money merely because that rate is considered ‘normal’ in a particular market. For example, if an interest rate is reset every year but the reference rate is always a 15-year rate, it would be difficult for an entity to conclude that such a rate provides consideration for only the passage of time, even if such pricing is commonly used in that particular market. Accordingly, the Board believes that an entity must apply judgement to conclude whether the stated time value of money element meets the objective of providing consideration for only the passage of time.

Staff analysis

44. The staff note that the judgements entities will have to make in assessing whether the alternative benchmark rates (including any additional fixed spread agreed upon at transition and the related terms such as frequency of reset, and tenor of reset) satisfy the SPPI criteria, are similar to the judgements that had to be made at initial application of IFRS 9. The staff also note that the Board developed the principle-based application guidance and examples in IFRS 9, especially those addressing the modified time value of money element, to assist entities in making those judgements.
45. Therefore, acknowledging the inherent difficulty in attempting to clarify the accounting consequences for conditions that are under development (in this case the specific details of the development of term rates), the staff focused this analysis in highlighting the guiding principles underpinning IFRS 9 requirements relevant to the SPPI criteria, in particular the meaning of interest including the consideration for the time value of money. The staff expect that doing so may assist entities in assessing whether the interest component of the contractual cash flows of the new financial

asset referenced to an overnight alternative benchmark rate satisfies the SPPI criteria in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9.

46. The staff note that, consistent with paragraph BC4.182(b) of IFRS 9, when applying the requirements described in paragraphs 35 and 36, the assessment of interest should focus on *what* the entity is being compensated for (ie whether the entity is receiving consideration for basic lending risks, costs and a profit margin) and that the contractual terms of the financial asset do not include variability due to risks that are *inconsistent* with a *basic lending arrangement*.
47. If the time value of money element is modified (eg because the interest rate is reset with a frequency that does not match the tenor of the interest rate) consistent with application guidance described in paragraphs 41-42, the entity must qualitatively or quantitatively assess the contractual cash flows against those on an instrument that is identical in all respects, except that the tenor of the interest rate matches the interest period, to determine if the cash flows are SPPI. If an entity concludes that the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the SPPI criteria.
48. The staff note that the principles underpinning the SPPI criteria in IFRS 9 including the application guidance indicate that a range of circumstances including financial assets referenced to fixed interest rates, variable interest rates, or a combination thereof, lagging interest rates⁴ and tenor mismatches possibly meet the SPPI criteria, provided that the outcome of the assessments described in paragraphs 37–42 result in meeting the requirements in 4.1.3(b) of IFRS 9. This suggests that there are no specific conditions or exceptions that in itself automatically disqualify contractual cash flows to be SPPI. Nevertheless, in some circumstances (eg when time value of money element is modified) the entity will need to perform the assessment in order to conclude that the interest component of those cash flows meets the requirements in 4.1.3(b) of IFRS 9.

⁴ An example of lagging interest rate could be a 3-month interest benchmark rate set for a 3-month period, but where the rate is fixed one month before the start of the interest period.

Staff recommendation

49. Based on the current guidance in IFRS 9 and the analysis above, the staff are of the view that IFRS 9 provides an adequate basis to determine whether the interest component of the contractual cash flows of the new financial asset referenced to alternative benchmark rates meets the SPPI criteria in IFRS 9. Consequently, the staff do not consider any amendments to the guidance in IFRS 9 are needed.
50. However, the staff are of the view that adding an example that illustrates application of the SPPI guidance in the context of IBOR reform could be useful for entities when assessing the cash flow characteristics for the new financial assets referenced to alternative benchmark rates. The staff will monitor the progress towards development of term rates based in alternative benchmark rates and consider presenting an example to the Board for discussion before the conclusion of the deliberations for Phase 2 of this project.

Question 3 for the Board

Question 3 for the Board

Does the Board agree with the staff recommendations in paragraphs 49 and 50 on determining whether the interest component of the contractual cash flows of the new financial asset referenced to alternative benchmark rates meets the SPPI criteria in IFRS 9 in the context of IBOR reform?

Recognition of expected credit losses

What is the problem?

51. As noted in paragraph 10(c) stakeholders suggested the Board clarify potential accounting implications on recognition of ECL for the new financial asset recognised following the derecognition of the existing financial asset. Specifically, if the entity recognised a loss allowance for the existing financial asset at an amount equal to the lifetime expected credit losses, should the loss allowance, upon initial recognition of the modified financial asset ie the new financial asset, be recognised at an amount

equal to 12 month expected credit losses despite there being no changes in its credit risk.

Current IFRS 9 requirements

52. Paragraph 5.5.1 of IFRS 9 states that an entity shall recognise a loss allowance for expected credit losses on a financial asset that is measured at amortised cost or fair value through other comprehensive income.
53. In accordance with the general approach to recognition of ECL, the amount recognised as a loss allowance depends on the extent of the credit deterioration since initial recognition. Applying paragraphs 5.5.3 and 5.5.5 of IFRS 9, the ECL amount is an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition or an amount equal to 12-month expected credit losses if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition.
54. Paragraph B5.5.25 of IFRS 9 states that when the renegotiation or modification of the contractual cash flows of a financial asset lead to the derecognition of the existing financial asset and the subsequent recognition of the modified financial asset, the modified asset is considered a ‘new’ financial asset for the purposes of IFRS 9.
55. Paragraph B5.5.26 of IFRS 9 then explains that the date of the modification shall be treated as the date of initial recognition of that financial asset when applying the impairment requirements to the modified financial asset. This typically means measuring the loss allowance at an amount equal to 12-month expected credit losses until the requirements for the recognition of lifetime expected credit losses in paragraph 5.5.3 of IFRS 9 are met. However, in some unusual circumstances, there may be evidence that the modified financial asset is credit-impaired at initial recognition, and thus, the financial asset should be recognised as an originated credit-impaired financial asset.⁵ This might occur, for example, in a situation in which there was a substantial modification of a distressed asset that resulted in the derecognition of the existing financial asset. In such a case, it may be possible for the

⁵ Appendix A of IFRS 9 defines purchased or originated credit-impaired financial assets as purchased or originated financial asset(s) that are credit-impaired on initial recognition.

modification to result in a new financial asset which is credit-impaired at initial recognition.

56. Paragraph 5.4.1(a) of IFRS 9 states that for financial assets that are purchased or originated credit-impaired financial assets, the entity should apply the credit-adjusted effective interest rate⁶ to the amortised cost of the financial asset from initial recognition.
57. Paragraph 5.5.13 of IFRS 9 then states that at the reporting date, an entity should only recognise the cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance for purchased or originated credit-impaired financial assets.

Staff analysis

58. Agenda paper 14A for this meeting discusses the principles in IFRS 9 to be applied when assessing whether the modification of the contractual cash flows of a financial asset results in the derecognition of the existing financial asset and the recognition of the new (modified) financial asset. This will be the case when the modification results in a substantially different instrument from what it originally was, such as when the modification results in a new pricing/underwriting assessment and/or when there is significant value transfer between the counterparties.
59. With respect to the circumstances in the scenario in paragraph 51, the staff consider that applying IFRS 9 requirements described above, the entity should consider whether the new financial asset is originated credit-impaired at initial recognition which is the date of the modification based in paragraph B5.5.26 of IFRS 9. Appendix A of IFRS 9 defines a financial asset as credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred.
60. If following this assessment, the entity concludes that the new financial asset is not originated credit-impaired at initial recognition, this typically means that financial

⁶ Appendix A of IFRS 9 defines credit-adjusted effective interest rate as the rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the amortised cost of a financial asset that is a purchased or originated credit-impaired financial asset. See Appendix A of IFRS 9 for further details on the credit-adjusted effective interest rate.

asset has been repriced so that the entity is compensated for the credit risk associated with the borrower and it would therefore be appropriate to measure the loss allowance at an amount equal to 12-month expected credit losses. Therefore, subsequent recognition of the loss allowance for the new financial asset would be determined based in the extent of credit deterioration since initial recognition, as required by Section 5.5 of IFRS 9.

61. However, if the entity is not being compensated appropriately for the credit risk, because for example the entity has granted a loan based on concessions it would not otherwise consider, it could be an indication that the financial asset is credit-impaired.

Staff recommendation

62. Based on this analysis, the staff are of the view that the requirements in IFRS 9 provide adequate basis to recognise the ECL for the new financial asset (ie the modified financial asset) following a substantial modification.

Question 4 for the Board

Question 4 for the Board

Does the Board agree with the staff recommendation in paragraph 62 on recognition of the expected credit losses for the new financial asset in the context of IBOR reform?

Embedded derivatives

What is the problem?

63. As noted in paragraph 11, a potential issue with accounting for embedded derivatives in accordance with IFRS 9 was raised in circumstances when the contract for a financial instrument contemplates the IBOR reform by way of a fall-back provision. An example of such fall-back provision could be along the lines of ‘when IBOR reform is enacted, the interest rate of this contract will change from 1-month LIBOR + 100bps to alternative benchmark rate + 110bps’ or something similar to this effect.

Current IFRS 9 requirements

64. Paragraph 4.3.1 of IFRS 9 states that ‘an embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.’
65. Paragraph 4.3.3 of IFRS 9 follows that ‘if a hybrid contract contains a host that is not an asset within the scope of IFRS 9, an embedded derivative shall be separated from the host and accounted for as a derivative under IFRS 9 if, and only if: (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host; [...]’.
66. Paragraph B4.3.11 of IFRS 9 provides further information by stating that ‘in accordance with paragraph 4.3.3 of IFRS 9, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.’

Staff analysis

67. On this basis, the staff note that the scope of the concern described in paragraph 63 may be limited to new contracts, including those that relate to financial liabilities that have been substantially modified and resulted in the recognition of a new (modified) instrument. A potential issue could arise if the fall-back provision affects the

economic characteristics and risks of the embedded derivative such that they are not considered to be closely related to the economic characteristics and risks of the host.

68. When considering whether the economic characteristics and risks of the embedded derivative are closely related to the economic characteristics and risks of the host contract, entities should consider paragraph B4.3.8(a) of IFRS 9 which provides the following as an example of an embedded derivative in which the underlying is an interest rate or interest rate index whereby the economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract:

(emphasis added)

An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment **or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.**

69. Applying the above application guidance, in the context of the scenario described in paragraph 63, the staff note that a potential issue could arise if there is a wide basis risk between IBOR and the alternative benchmark rate. More specifically, the economic characteristics and risks of the embedded derivative would not be closely related to the economic characteristics and risks of the host contract and would require the separation of the embedded derivative from the host and accounted for at fair value through profit or loss. For example, if the basis spread between IBOR and alternative benchmark rate could be sufficiently wide such that the rate of return on the contract referenced to an alternative benchmark rate would result in more than double the rate of return of the contract referenced to IBOR.

70. Based on stakeholders’ comments (see paragraph 34) and the staff research it appears unlikely that the basis risk between IBORs and the alternative benchmark rates would be sufficiently wide such that the contract referenced to alternative benchmark rate would result in more than double the rate of return of the contract referenced to IBOR. That is, for it to trigger the requirements resulting in the separation of the embedded derivative from the host contract.

Staff recommendation

71. On this basis and coupled with the fact that this issue has not been raised by many stakeholders lead the staff to the conclusion that the likelihood for this issue to affect the usefulness of the information provided to users of financial statements is reasonably low. The staff is of the view that IFRS 9 provides adequate basis to account for embedded derivatives for financial liabilities and do not recommend that any amendments are made to the requirements in IFRS 9 in this regard.

Question 5 for the Board

Question 5 for the Board

Does the Board agree with the staff recommendation in paragraph 71 on accounting for embedded derivatives, in the context of the IBOR reform?