



Project	<b>Financial Instruments – Recognition and Measurement</b>
Topic	<b>Classification – summary of alternatives for embedded derivative accounting</b>

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## Introduction

### *Background*

1. At its 1 and 5 June 2009 meetings the IASB discussed the classification of financial instruments. The Board decided to discuss at the main IASB June meeting:
  - (a) the interaction between the classification criteria and the current embedded derivative requirements for financial host contracts in IAS 39; and
  - (b) issues relating to concentrations of risk.
2. The Board tentatively decided not to propose changing the embedded derivative requirements in IAS 39 for non-financial host contracts.

### *Purpose of this paper*

3. This paper addresses the interaction between the classification criteria and the current embedded derivative requirements for financial host contracts in IAS 39. It provides an overview of the different alternatives and their pros and cons.

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This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

4. This paper only addresses those hybrid contracts that have host contracts in the scope of the new financial instruments standard (financial hosts)<sup>1</sup>. To remind the Board, many respondents to the discussion paper *Reducing Complexity in Reporting Financial Instruments* highlighted the complexity and practice problems associated with current embedded derivative requirements.
5. This paper includes staff recommendations (see paragraphs 46 and 47 below) and asks the Board for a decision whether to continue using embedded derivative accounting for the purpose of classification in accordance with the new financial instruments standard (see the section Questions to the Board below).
6. Note: While this paper uses current embedded derivative requirements as the starting point for the analysis of the alternatives available to the Board, it does not pre-suppose that the exposure draft proposals would result in the same accounting outcomes achieved today. The paper does, however, highlight how the alternatives available to the Board would change the existing outcomes.

### **Embedded derivative accounting—alternatives for classification**

7. At its 5 June 2009 meeting the Board tentatively concluded that all financial instruments should be classified at fair value except for those that (both):
  - (a) only have basic loan features; and
  - (b) can be demonstrated to be managed on a contractual yield basis.

This approach is referred to as the ‘new classification criteria’ in this paper.

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<sup>1</sup> This paper refers to all host contracts in the scope of the new financial instruments standard as ‘financial hosts’. Thus, host contracts that are lease or insurance contracts are not included in that term as used in this paper even if they meet the definition of a financial instrument (but are scoped out of the new financial instruments standard). The Board has not yet revisited the scope of IAS 39 as part of this project.

8. The interaction between the new classification criteria and embedded derivative accounting *only* relates to the *characteristics* of the financial instrument (ie (a) above). It does not affect the assessment of how a financial instrument is managed (ie (b) above).
  
9. There are the following main alternatives for the interaction between the new classification criteria and embedded derivative accounting:
  - (a) **Alternative 1:** retain the notion of embedded derivative accounting, which means continuing to bifurcate hybrid contracts (if the conditions<sup>2</sup> are met):
    - (i) **Alternative 1A:** use the embedded derivative assessment as a *filter* for the classification assessment; or
    - (ii) **Alternative 1B:** use the embedded derivative assessment as *the classification assessment* (regarding characteristics)<sup>3</sup> for hybrid contracts; or
  - (b) **Alternative 2:** eliminate the notion of embedded derivative accounting for financial hosts.
  
10. Another possible alternative is using the existing criteria and application guidance for an embedded derivative assessment but rather than bifurcate a hybrid contract classify it as at fair value in its entirety. However, this alternative is not further discussed in this paper because the staff believes that if the notion of bifurcation is abandoned there is no technical merit in carrying forward the existing criteria and application guidance for an embedded derivative assessment for the purpose of a new classification approach. This is

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<sup>2</sup> See IAS 39.11.

<sup>3</sup> See paragraph 8 above.

because the application guidance regarding what is ‘closely related’ is not a consistent, principles-based criterion.

***Alternative 1A—using the embedded derivative assessment as a filter***

11. Alternative 1A uses the embedded derivative assessment as a *filter* for the classification assessment. That means:
  - (a) in a first step the embedded derivative assessment and any separations of embedded derivatives work as under existing requirements in IAS 39; and
  - (b) in a second step the separated derivatives, financial hosts and contracts that were not bifurcated resulting from step 1 are all classified using the new classification criteria.
  
12. This two step approach is similar to that used in IAS 39. The equivalent in IAS 39 to the second step is the application of the definitions of the different categories (including the related application guidance)<sup>4</sup> after the embedded derivative assessment.

*Change in classification outcomes*

13. Under Alternative 1A the change in classification outcomes compared to today’s requirements depends on the classification funnel that would be used in the *second step* for the unit of account that is determined by the filter (ie bifurcation of the hybrid where applicable).
  
14. For an overview comparison of outcomes regarding the assessment of the characteristics<sup>5</sup> of a financial instrument see Appendix A.

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<sup>4</sup> See IAS 39.AG14–AG26.

<sup>5</sup> The interaction between embedded derivative accounting and the new classification criteria only relates to the characteristics of a financial instrument (see paragraph 8 above).

*Staff analysis*

15. The consistency of the classification criteria under Alternative 1A is as follows:
- (a) It uses consistent criteria for the classification of financial hosts and non-hybrid contracts (but only) after the embedded derivative filter has been applied.
  - (b) However, when comparing the outcomes for *different hybrid* contracts the difference between the criteria for the embedded derivative assessment and the new classification criteria could result in inconsistent outcomes.
16. The following examples illustrate the second point:
- (a) an interest indexation that is closely related to the financial host on the basis of the ‘double-double’ criterion<sup>6</sup> might still require that the entire hybrid instrument is classified as at fair value on the basis of the new classification criteria. This is because that indexation may be leveraged (by 0.001) and thus not qualify as a basic loan feature based on the previous discussions of the Board.
  - (b) conversely, an extension option might not be closely related to the financial host<sup>7</sup> and thus require separation while the hybrid contract in its entirety might have qualified for amortised cost accounting if the new classification criteria been applied to that hybrid contract (instead of the financial host) because the extension option might still be considered a basic loan feature.
17. The cause of this inconsistency is that the ‘closely related’ assessment in IAS 39 is based on a list of examples that is neither consistent with a clear, single objective nor entirely consistent in itself.

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<sup>6</sup> See IAS 39.AG33(a) and Appendix A, paragraph A3(a).

<sup>7</sup> See IAS 39.AG30(c) and Appendix A, paragraph A2(c)A3(a).

***Alternative 1B—embedded derivative assessment as the classification assessment***

18. Alternative 1B uses the embedded derivative assessment as *the* classification *assessment* rather than merely as a filter. That means there is only one step. The embedded derivative assessment and any separations of embedded derivatives work as under existing requirements in IAS 39. If that results in:
- (a) bifurcation of the hybrid contract the financial host will automatically qualify for amortised cost whereas the separated derivatives will be classified as at fair value; or
  - (b) if no bifurcation of the hybrid contract is required that contract automatically qualifies for amortised cost in its entirety.
19. This one step approach is different from that used in IAS 39, which requires a two step approach.<sup>8</sup>

*Change in classification outcomes*

20. Under Alternative 1B the change in classification outcomes compared to today's requirements results mainly from the consequences of eliminating the held-to-maturity and available-for-sale categories<sup>9</sup> rather than the assessment of the characteristics of the financial instrument. (For example, there is no requirement to show positive intent or ability under the approach being considered by the Board, as compared to today's held-to-maturity requirements.)
21. One exception is that there would be a different outcome based on the characteristics for some interest only strips with embedded prepayment options. While these prepayment options are closely related to the financial hosts they

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<sup>8</sup> See paragraph 12 above.

<sup>9</sup> The new classification criteria would no longer involve a held-to-maturity assertion or consider whether the financial instrument is quoted in an active market. Instead, the new classification criteria are based on whether the financial instrument can be demonstrated to be managed on a contractual yield basis.

still do not qualify for amortised cost measurement under IAS 39<sup>10</sup> but would qualify for that measurement basis under Alternative 1B (ie when using the embedded derivative assessment to automatically determine classification).

22. For a high-level comparison of outcomes regarding the assessment of the characteristics<sup>11</sup> of a financial instrument see Appendix A.

*Staff analysis*

23. The consistency of the classification criteria under Alternative 1B is as follows:

- (a) Because of the automatic classification consequences of the embedded derivative assessment Alternative 1B avoids inconsistencies<sup>12</sup> between that assessment and the overall classification outcome for hybrid contracts (whether bifurcated or not).
- (b) However, when comparing the outcomes for *hybrid* contracts and *non-hybrid* contracts the difference between the criteria for the embedded derivative assessment and the new classification criteria could result in inconsistent outcomes.

24. Let us illustrate (b) above: assume that the variability in the cash flows of a financial instrument does not result from an embedded derivative but a non-financial variable specific to a party to the contract.<sup>13</sup> In that case the assessment of whether that financial instrument qualifies for amortised cost would be made on the basis of the financial instrument in its entirety using the

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<sup>10</sup> See Appendix A, paragraph A3(e)(i).

<sup>11</sup> The interaction between embedded derivative accounting and the new classification criteria only relates to the characteristics of a financial instrument (see paragraph 8 above).

<sup>12</sup> These inconsistencies arise under Alternative 1A (see paragraph 15(b) above).

<sup>13</sup> The staff acknowledges that this element of the definition of a derivative has been the subject of intensive debate and proposed changes to IAS 39, which eventually were not finalised. Under some views that have evolved in practice, examples of a non-financial variable specific to a party to the contract would be an indexation of 'interest' to the profit or other key performance indicators of the issuer or a variable credit margin that depends on the credit quality of the financial instrument. Under these views such features would not be considered to meet the definition of an embedded derivative.

new classification criteria. Consequently, the difference between these criteria and those used for the embedded derivative assessment could result in different outcomes. However, the staff believes such inconsistent outcomes are unlikely to be widespread in practice.

25. Again, the cause of this inconsistency is that the ‘closely related’ assessment in IAS 39 is based on a list of examples that is neither consistent with a clear, single objective nor entirely consistent in itself.
26. Both alternatives 1A and 1B avoid that an ‘insignificant’ embedded derivative feature with little impact on the cash flows of the overall hybrid contract results in a completely different classification outcome for the hybrid contract in its entirety.
27. Compared with the two step approach of Alternative 1A,<sup>14</sup> the one step approach of Alternative 1B involves less classification effort and complexity.

***Alternative 2—eliminate the notion of embedded derivative accounting for financial hosts***

28. Alternative 2 eliminates the notion of embedded derivative accounting for financial hosts. Instead, financial instruments are classified using the new classification criteria irrespective of whether they are hybrid or non-hybrid contracts.
29. This approach is entirely different from that used in IAS 39, which assesses embedded derivatives and requires some to be separated from their host contracts.

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<sup>14</sup> See paragraph 11 above.

*Change in classification outcomes*

30. Under Alternative 2 the change in classification outcomes compared to today's requirements depends on the classification funnel that would be used to replace today's:
- (a) embedded derivative accounting; and
  - (b) the definitions of the different categories of IAS 39 (including the related application guidance)<sup>15</sup> that apply after the embedded derivative assessment.
31. For a high-level comparison of outcomes regarding the assessment of the characteristics<sup>16</sup> of a financial instrument see Appendix A.

*Staff analysis*

32. Because Alternative 2 solely uses the new classification criteria the approach has one consistent set of criteria.
33. However, under Alternative 2 an 'insignificant' embedded derivative feature with little impact on the cash flows of the overall hybrid contract could result in a completely different classification outcome for the hybrid contract in its entirety.
34. This consequence would arise in scenarios in which the effect of the derivative features is that the hybrid instrument does not qualify for amortised cost under the new classification criteria. For example, if a financial liability bears interest that is indexed to a benchmark interest rate and to an insignificant degree also to a commodity price then the *entire* liability would be classified as at fair value

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<sup>15</sup> See IAS 39.AG14–AG26.

<sup>16</sup> The interaction between embedded derivative accounting and the new classification criteria only relates to the characteristics of a financial instrument (see paragraph 8 above).

even though the commodity price indexation might only have an insignificant effect on the cash flows compared to the overall interest payable on that liability.<sup>17</sup>

35. This effect could be mitigated to some degree by including a materiality provision similar to that used for the fair value option (FVO) related to avoiding the separation of embedded derivatives in IAS 39.<sup>18</sup> However, that would make the new classification criteria more complex and judgemental and difficult to apply.
36. Because Alternative 2 does not use embedded derivative accounting as a 'screen' for some embedded contractual features the new classification criteria will have to be robust enough so that they can effectively address these features. In other words, without the embedded derivative screen there is more pressure on the new classification funnel.<sup>19</sup>
37. The Board has accepted that a fixed rate instrument (with fair value variability) and a floating rate instrument (with cash flow variability) should be eligible to be measured at amortised cost (subject to having only basic loan features and being managed on a contractual yield basis).
38. Some common features, that today are addressed in the context of the embedded derivatives screen, result in an instrument simply being changed from a variable

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<sup>17</sup> This means that the fair value changes resulting from the own credit risk of the issuer would be recognised in profit or loss while the fair value changes attributable to the embedded commodity price link (which caused this classification) are insignificant in comparison to the context of the instrument as a whole.

<sup>18</sup> IAS 39.11A(a) refers to 'embedded derivative(s) [that] does not significantly modify the cash flows that otherwise would be required by the contract'.

<sup>19</sup> The effect of the existing embedded derivative screen is demonstrated by the extent of the embedded derivative related guidance compared to the guidance on the definitions of the different classes of financial instruments (that constitute the classification criteria that apply after the embedded derivative screening).

rate instrument towards a fixed rate instrument, or vice-versa. Examples are embedded interest rate caps, floors and collars.

39. That is to say, financial instruments with embedded cap, floor or collar features are a financial instrument with a combination of a fixed and a variable rate that switches between fixed and variable interest depending on the (eg benchmark) interest rate level.
40. Given that the Board in its discussions and tentative decisions so far has agreed that the following plain vanilla financial instruments would qualify for amortised cost on the basis of their characteristics<sup>20</sup>:
- (a) fixed rate instruments; and
  - (b) variable rate instruments,

the staff considers that a financial instrument that is simply a combination of these should qualify for amortised cost as well—as long as there is no other contractual feature that would result in the financial instrument not being simply a combination of a fixed rate and variable rate instrument.

41. In a different context, eliminating the notion of embedded derivative accounting altogether has a significant effect when comparing the overall classification outcomes under Alternative 2 for:
- (a) a hybrid contract with an embedded derivative feature that does not qualify as a basic loan feature (which would be classified as at fair value in its entirety); and

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<sup>20</sup> That is to say, pending the assessment of whether the financial instrument is managed on a contractual yield basis.

- (b) two separate financial instruments where the same non-basic loan feature that precluded amortised cost accounting under (a) above is a standalone derivative.

That is to say, the accounting outcome would depend upon legal form and structure of a transaction. In contrast, the notion of embedded derivative accounting (when bifurcation of the hybrid contract is required) results in a comparable outcome for these scenarios that is less dependent on legal form and structure.

- 42. Compared with the approaches of Alternatives 1A and 1B, both of which use two different sets of classification criteria,<sup>21</sup> the approach of Alternative 2 involves less classification effort and complexity because it uses only one consistent set.

### Staff recommendation

- 43. The above analysis demonstrates that there is no alternative without any drawbacks:
  - (a) For Alternatives 1A and 1B the drawbacks are *inconsistencies* that result from using two different sets of *classification* criteria, and the complexity associated with and arising from the internal inconsistencies arising from today's embedded derivative requirements. When comparing those two alternatives the staff believes that the inconsistencies that arise under Alternative 1B are less severe and that this alternative is less complex than Alternative 1A.
  - (b) The considerations of Alternative 2 are the *accounting outcomes*:
    - (i) insignificant features could have a significant effect on classification (unless mitigated by a materiality overlay that increases complexity); and

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<sup>21</sup> The criteria for embedded derivatives and the new classification criteria.

- (ii) there could be arbitrary outcomes from stand alone features compared to embedded features, which creates differences depending upon legal form and structure (and thus ultimately impairs comparability that—in contrast—substance over form accounting would provide).
  
- 44. The choice between the alternatives depends on how the following aspects are weighted:
  - (a) classification inconsistencies and the complexity associated with current embedded derivative rules (avoiding these implies choosing Alternative 2); and
  - (b) accounting inconsistencies in terms of legal form and structure (avoiding these implies choosing Alternative 1B).
  
- 45. The staff believes that if the criterion ‘basic loan features’ is applied as set out in the staff analysis<sup>22</sup> it would:
  - (a) ensure consistency of classification outcomes resulting from this principle; and
  - (b) strengthen this principle so that it is robust enough to address embedded contractual features without an embedded derivative screen.
  
- 46. On this basis, on balance, the staff recommends Alternative 2. The staff believes that Alternative 2 would reduce the classification complexity while still being robust enough to address some prevalent embedded contractual features that today are addressed by embedded derivative accounting.

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<sup>22</sup> See paragraph 39 above.

47. The staff further recommends using a materiality overlay as contemplated in the staff analysis.<sup>23</sup>

### Questions to the Board

#### Accounting for embedded derivatives and classification

1. Does the Board agree with the staff recommendation of using Alternative 2 for the new classification approach?  
  
If the Board does not agree with the staff recommendation what does the Board prefer instead, and why?
2. If the Board agrees with the first staff recommendation of using Alternative 2 for the new classification approach, does the Board also agree to using a materiality overlay in connection with this approach (see paragraphs 35 and 47 above)? If not, why?

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<sup>23</sup> See paragraph 35 above.

## Appendix A

### Comparison of classification outcomes

A1. Appendix A provides a high-level comparison of the outcomes between:

- (a) the assessment of an embedded derivative as ‘closely related’ on the basis of the application guidance in IAS 39.AG30 and AG33; and
- (b) application of the new classification criteria (as they relate to the *characteristics* of the financial instrument)<sup>24</sup> to a hybrid contract in its entirety.

This comparison is intended to provide a rough indication of when a financial instrument with embedded features that under today’s requirements would be considered as a ‘closely related’ embedded derivative would qualify in its entirety for amortised cost under the new classification criteria. For example, if an embedded derivative qualifies as ‘closely related’ under today’s requirements and the new classification criteria would result in the entire instrument being eligible for amortised cost (and vice versa) this is described as ‘no change’ in the analysis below.

A2. Comparison for IAS 39.AG30:

- (a) Put option with an equity or commodity price linked strike price: no change.
- (b) Issuer call option in an *equity* instrument (*holder* perspective): N/A.<sup>25</sup>
- (c) Extension option:
  - (i) if concurrently reset to market interest rates: no change (ie amortised cost is available)<sup>26</sup>;

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<sup>24</sup> See paragraph 8 above.

<sup>25</sup> Because there is no *debt* host contract amortised cost would be ineligible. (The outcome for *equity* host contracts would change because the available-for-sale category of IAS 39 is no longer available under the new classification approach.)

- (ii) other resets must reflect a repricing that would still result in a lending type transaction (ie constitute a basic loan feature)<sup>27</sup>.
- (d) Equity indexed interest or principal payments: no change.
- (e) Commodity indexed interest or principal payments: no change.
- (f) Equity conversion feature in a convertible debt instrument: no change.
- (g) Put, call, prepayment options: broadly consistent with the version revised by the Annual Improvements in April 2009 regarding prepayment penalties (however, the assessment would be based on wider 'make whole' notion thus becoming less restrictive).
- (h) Embedded credit derivatives: the change depends on how the new classification criteria will be applied to concentrations of credit risk (see agenda paper 3A2).

A3. Comparison for IAS 39.AG33:

- (a) Embedded derivatives with interest rates or indices as the underlying (the 'double-double' criterion): the new classification criteria would be more restrictive because of the 'no leverage' requirement<sup>28</sup> (ie the indexation to a benchmark interest rate cannot involve a multiple but is limited to a factor of '1.0').
- (b) Embedded interest rate floors or caps: on the basis of the staff recommendation on what constitutes basic loan features the restriction that such features must not be in the money at inception would no longer apply under the new classification criteria.
- (c) Embedded foreign currency derivative (dual currency bond): the new classification criteria would be more restrictive because the interest cash

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<sup>26</sup> Regarding the assessment of the *characteristics* pending the assessment of the basis on which the financial instrument is managed (see paragraph 8 above).

<sup>27</sup> This would make the assessment of extension options consistent with that of prepayment options.

<sup>28</sup> See agenda papers 2B and 2C of the 1 June 2009 IASB meeting.

flows in a different currency than the principal payments do not constitute a basic loan feature.

- (d) Foreign currency derivatives embedded in insurance or non-financial contracts: N/A.<sup>29</sup>
- (e) Embedded prepayment options in interest or principal only strips: the new classification criteria would be more restrictive because these investments have not solely basic loan features (after stripping them out of the original financial instrument):
  - (i) Interest only strips: the investor can lose the initial investment owing to contractual provision rather than credit risk;<sup>30</sup>
  - (ii) Principal only strips: these are in substance zero-coupon bonds that are prepayable at any time so that the return is not reflecting in substance interest.
- (f) Embedded derivatives in host lease contracts: N/A.<sup>31</sup>
- (g) A unit-linking feature embedded in a host financial instrument (or a host insurance contract): the new classification criteria would be more restrictive (except for insurance host contracts that are outside the scope of IAS 39)<sup>32</sup> because a performance indexation to a unit fund performance does not reflect a basic loan feature.

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<sup>29</sup> Hybrid contracts with non-financial host contracts would remain unaffected by the first phase of this project on classification.

<sup>30</sup> The staff notes that while such features can be closely related in accordance with IAS 39.AG33(e) amortised cost measurement is still unavailable because of the definition of loans and receivables (see lit (c) of that definition) and IAS 39.AG18 regarding held-to-maturity.

<sup>31</sup> The scope of financial instrument requirements would remain unaffected by the first phase of this project on classification so that lease host contracts would remain unaffected.

<sup>32</sup> The scope of financial instrument requirements would remain unaffected by the first phase of this project on classification so that insurance host contracts that are outside the scope of IAS 39 would remain unaffected.

- (h) Derivatives embedded in insurance host contracts that are so interdependent with that host that the embedded derivative cannot be measured separately:  
N/A.<sup>33</sup>

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<sup>33</sup> The scope of financial instrument requirements would remain unaffected by the first phase of this project on classification so that insurance host contracts that are outside the scope of IAS 39 would remain unaffected.