30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International
Accounting Standards
Board



**INFORMATION FOR OBSERVERS**

**IFRIC meeting:** **March 2009, London**

**Project:** **IAS 39 *Financial Instruments: Recognition and Measurement:* Failed Loan Syndications (Agenda Paper 5F)**

---

## INTRODUCTION

1. In February 2009 the IFRIC received a request for guidance on the application of the definitions of the categories of IAS 39 to the classification of loans originated in the context of loan syndications. Portions of the original submission are included in Appendix C.

2. Specifically, the submission asked how the definitions are applied in the context of loans originated with an intention of syndication where the arranger fails to find sufficient commitments from other participants (failed syndications). This results *initially* in the arranger retaining a larger part of the loan than intended. The arranger *then* tries to sell the surplus loan amount to other parties in the near term rather than holding it for the foreseeable future.

**OUTLINE OF ALTERNATIVES**

3. The submission asked whether a loan resulting from a loan syndication that the originator intends to sell in the near term must:

**View A**: always be classified as held for trading; or

**View B**: only be classified as held for trading if it is held by the originator with a 'speculative intent', ie with the objective of generating a profit from short-term fluctuations in price or dealer's margin (resulting in classification as loans and receivables if there is no speculative intent).

4. "Held for trading" (HFT) is a sub-category of the category "financial assets or financial liabilities at fair value through profit or loss" (FVTPL). Paragraph 9 of IAS 39 defines financial assets or financial liabilities at fair value through profit or loss as [<u>emphasis added</u>]:

> A *financial asset or financial liability at fair value through profit or loss* is a financial asset or financial liability that meets either of the following conditions.
>
> (a) It is classified as held for trading. A financial asset or financial liability is classified as <u>held for trading if</u>:
>
> (i) <u>it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term</u>;
>
> (ii) on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
>
> (iii) it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
>
> (b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. …

5. Paragraph AG14 of IAS 39 provides further guidance on the sub-category HFT:

> Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.

6. Paragraph 9 of IAS 39 defines “loans and receivables” (LAR) as [emphasis added]:

> *Loans and receivables* are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:
>
> (a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;
>
> (b) those that the entity upon initial recognition designates as available for sale; or
>
> (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.
>
> An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

7. The submission notes that the interpretation of this guidance has resulted in diversity in practice. The rationale of proponents of View A is:

   - sub-paragraph (a) of the definition of LAR (see previous paragraph of this paper); and
   - classification as HFT would be consistent with the accounting for loan commitments (refer to paragraph 4(a) of IAS 39).

8. Proponents of View B argue that classification as held for trading is inconsistent with sub-paragraph (a)(i) of the definition of FVTPL in conjunction with paragraph AG14 of IAS 39 (see paragraphs 4-5 of this paper) because in the failed syndication scenario:

   (a) the loan originator does not buy assets but only sells them;

   (b) the originator’s aim is to sell the loans at their nominal value, ie there is no expectation that a profit will be generated from short term fluctuations in price or dealer’s margin; and

(c) if the originator is unable to sell the loans at close to their nominal value it may change its intent and decide to hold them for the long term.

**STAFF ANALYSIS**

9. The classification of financial instruments into the categories of IAS 39 is driven by the definitions of the categories. For the classification of loans in the context of failed securitisations the definitions of HFT and LAR are relevant.

10. The questions are:

    (a) whether the definitions of LAR and HFT are inconsistent; and

    (b) if so, which definition should take precedence.

**Consistency of LAR and HFT definitions**

11. The analysis uses the following criteria in determining the consistency of the LAR and HFT definitions:

    (a) wording;

    (b) context and structure of IAS 39;

    (c) history of IAS 39; and

    (d) purpose of the requirements.

*Wording*

12. The relevant sections of the definitions of HFT and LAR in paragraph 9 of IAS 39 (see paragraphs 4 and 6 of this paper) are:

    (a) HFT: includes a financial instrument 'acquired or incurred principally for the purpose of selling or repurchasing it in the near term';

    (b) LAR: excludes financial instruments 'that the entity intends to sell immediately or in the near term'.

13. The reference in the HFT definition to 'acquired' does not mean that the financial asset must be purchased rather than originated. The use of 'acquired' in IFRSs includes the notion of originated. This is evidenced by the definition of transaction costs in paragraph 9 of IAS 39 [<u>emphasis added</u>]:

> *Transaction costs* are incremental costs that are directly attributable to the <u>acquisition</u>, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

The definition of transactions costs also applies to costs incurred in relation to loans that the holder originates.

14. With regard to the application guidance on the HFT definition in paragraph AG14 of IAS 39 the staff notes that this application guidance:

    (a) does not solely relate to part (a)(i) of the HFT definition but also elaborates on part (a)(ii), ie portfolios with a pattern of short-term profit-taking.

    (b) sets out characteristics that trading <u>generally</u> reflects.

    Therefore, it is invalid to infer from paragraph AG14 that <u>all</u> financial instruments that are classified as HFT under part (a)(i) of the definition must reflect the characteristics set out in that paragraph. This is corroborated by paragraph BC26 of the Basis for Conclusions on IAS 39. It explains that the Board's rationale for allowing amortised cost measurement for an asset classified as LAR irrespective of any intention and ability to hold it to maturity was that there is no liquid market for these instruments. In contrast, the characteristics set out in paragraph AG14 are typical of instruments that have a liquid market. In other words, the intention to sell immediately or in the near term set out in the definition of LAR does not always have to be accompanied by the objective of generating a profit from short-term fluctuations in price or dealer's margin as set out in paragraph AG14 in relation to the definition of HFT in order to result in the classification of a loan as HFT.

15. Consequently, the staff believes that the wording in the two definitions of HFT and LAR is consistent. This means that loans that at the time of their initial recognition are intended to be sold in the near term do <u>not</u> meet the definition of LAR but <u>do meet</u> the definition of HFT. Therefore, the requirement in the definition of LAR (part (a)) that the loans that entity intends to sell immediately or in the near term shall be classified as HFT does <u>not</u> result in a conflict with the HFT definition.

*Context and structure of IAS 39*

16. The guidance on implementing IAS 39, Question IG B.23 explains [emphasis added]:

> **B.23 Definition of loans and receivables: banks' deposits in other banks**
>
> **Banks make term deposits with a central bank or other banks. Sometimes, the proof of deposit is negotiable, sometimes not. Even if negotiable, the depositor bank may or may not intend to sell it. Would such a deposit fall within loans and receivables under IAS 39.9?**
>
> Such a deposit meets the definition of loans and receivables, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the near term, in which case the deposit is classified as a financial asset held for trading.

17. This implementation guidance illustrates the importance of the intention to sell the instrument (immediately or) in the near term in determining whether it must be classified as LAR or HFT. However, it does not reiterate or emphasise the characteristics set out in paragraph AG14 of IAS 39.

18. In accordance with paragraph 4(a) of IAS 39 the scope of the Standard includes [emphasis added]:

> loan commitments that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.

Because loan commitments are derivatives they are classified as HFT (unless they were designated and effective hedging instruments).

19. The requirement to classify as HFT loan commitments when the resulting asset (ie the loan extended on draw down) is sold shortly after origination is consistent with also classifying as HFT loans that are originated with an intention to sell them in the near term irrespective of whether there is a preceding loan commitment.

*History of IAS 39*

20. The classification as HFT of loans that an entity originates with the intent to sell them immediately or in the near term was a requirement of the original version of IAS 39 issued in 1999 and has been carried forward since. This corroborates that classification as HFT does not depend on the loan being purchased but also applies to loans that are originated (refer to paragraph 13 of this paper) [the definitions of the original version of IAS 39 issued in 1999 and the related implementation guidance are included in Appendix A].

21. Question 10-7 of the original implementation guidance corresponds to Question IG B.23 (see paragraph 16 of this paper). It explained that if an entity intends to sell an originated loan immediately or in the short term it is classified as HFT:

> …because the definition of an originated loan in IAS 39.10[*] excludes an instrument intended to be sold immediately or in the short term.

This demonstrates that the loan is classified as HFT by virtue of being excluded from the definition of LAR. Thus, the classification as HFT does not depend on an explicit, separate test of whether the HFT definition is met because it is the obligatory result specified in the LAR definition. Clearly the LAR and HFT definitions were designed to be mutually exclusive and collectively exhaustive for this classification purpose.

*Purpose of the requirements*

22. The classification as HFT or LAR determines the subsequent measurement of a financial instrument. Classification as LAR results in subsequent measurement at amortised cost using the effective interest method. The primary purpose of that method is to allocate interest revenue over the relevant period. The relevant period is the expected life of the instrument or, if that cannot be reliably estimated, the full contractual term of the instrument.

23. However, if on initial recognition there is already an intention to sell the asset immediately or in the near term the primary issue is not the allocation of interest revenue but rather determining the gain or loss that would result from a sale.

[*] Paragraph reference is to IAS 39 (1999).

This is reflected by accounting as FVTPL rather than at amortised cost. Moreover, the estimate of the expected life that is required in applying the effective interest method is not meaningful in such circumstances. For example, if the expected life could not be reliably estimated the full contractual term would apply by default, which would significantly distort the effective interest rate.

24. Paragraph BC16 of the Basis for Conclusions on IAS 39 explains the Board's rationale for scoping certain[†] loan commitments out of the Standard [emphasis added]:

> To simplify the accounting for holders and issuers of loan commitments, the Board decided to exclude particular loan commitments from the scope of IAS 39. The effect of the exclusion is that an entity will not recognise and measure changes in fair value of these loan commitments that result from changes in market interest rates or credit spreads. This is consistent with the measurement of the loan that results if the holder of the loan commitment exercises its right to obtain financing, because changes in market interest rates do not affect the measurement of an asset measured at amortised cost (assuming it is not designated in a category other than loans and receivables).

25. This demonstrates that the rationale for not requiring classification as FVTPL for these loan commitments is that the loans that result from them will be accounted for at amortised cost. However, other loan commitments must be accounted for at FVTPL because they involve selling the loans resulting from them shortly after their origination (see paragraph 19 of this paper). Thus, the logical inference is that FVTPL is the appropriate classification for loans intended to be sold in the near term after originating them.

## STAFF RECOMMENDATION

26. The staff recommends that IFRIC not add the issue to its agenda. The staff thinks that the existing requirements of IAS 39 are clear (for a formal assessment of the IFRIC agenda criteria refer to Appendix B).

---

[†] These are the loan commitments that do not meet any of the criteria in paragraph 4 of IAS 39, ie they are not designated as FVTPL, the entity has no past practice of selling the assets resulting from its loan commitments shortly after origination, the loan commitments cannot be settled net in cash, and the commitments are not about providing a loan at a below-market interest rate.

27. The staff has demonstrated that the result of a thorough and comprehensive analysis of the existing requirements is that

    (a) the definitions of LAR and HFT are consistent; and

    (b) a failure to meet the definition of LAR because of an intention to sell a loan immediately or in the near term <u>automatically</u> results in classification as HFT.

28. The staff thinks that even if the two definitions were considered to be inconsistent, the exclusion from the definition of LAR of loans intended to be sold immediately or in the near term would take precedence because it is the more specific of the two requirements. Part (a) of the LAR definition explicitly specifies classification as HFT as the consequence in those circumstances.

29. Wording for the proposed tentative agenda decision is set out in Appendix D (the staff welcomes drafting changes after the meeting).

**QUESTION FOR THE IFRIC**

30. Does the IFRIC agree that the issue should not be added to the agenda? If not, on what basis should it be added?

## APPENDIX A

### Extracts from the original IAS 39 version issued in 1999 and the related Implementation Guidance:

31. Paragraph 10 [**emphasis added**]:

…

Definitions of Four Categories of Financial Assets

*A <u>financial asset or liability held for trading</u> is one that was acquired or incurred principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin. A financial asset should be classified as held for trading if, regardless of why it was acquired, it is part of a portfolio for which there is evidence of a recent actual pattern of short-term profit-taking (see paragraph 21). Derivative financial assets and derivative financial liabilities are always deemed held for trading unless they are designated and effective hedging instruments. (See paragraph 18 for an example of a liability held for trading.)*

*[<u>Held-to-maturity investments</u> …]*

*<u>Loans and receivables originated by the enterprise</u> are financial assets that are created by the enterprise by providing money, goods, or services directly to a debtor, **other than those that are originated with the intent to be sold immediately or in the short term, which should be classified as held for trading.** Loans and receivables originated by the enterprise are not included in held-to-maturity investments but, rather, are classified separately under this Standard (see paragraphs 19-20).*

*[<u>Available-for-sale financial assets</u> …]*

32. Implementation Guidance, Question 10-7 [<u>emphasis added</u>]:

**Definition of originated loans and receivables: banks' deposits in other banks**

**Banks make term deposits with a central bank or other banks. Sometimes, the proof of deposit is negotiable, and other times not. Even if negotiable, the depositor bank may or may not intend to sell it. Would such a deposit be classified as an originated loan?**

Such a deposit is an originated loan, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the short term, in which case the deposit <u>is a financial asset held for trading because the definition of an originated loan in IAS 39.10 excludes an instrument intended to be sold immediately or in the short term</u>.

| |
|---|
| **Discussed by IAS 39 IGC: 18-19 April 2000**<br>**Published for Public Comment: 8 May 2000**<br>**Discussed by IAS 39 IGC: 29-30 August 2000**<br>**Final Action: Approved** |

## APPENDIX B

### Assessment of proposed agenda item against the IFRIC agenda criteria

33. The assessment against the agenda criteria is as follows:

    (a) *The issue is widespread and has practical relevance:*

    The issue is pervasive in the banking sector because the financial crisis has resulted in an increase in failed syndications.

    (b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice:*

    The submission asserts that significant divergence in practice already exists. However, the staff considers existing IFRSs are clear and, thus, an IFRIC interpretation is unwarranted.

    (c) *Financial reporting would be improved through elimination of the diverse reporting methods:*

    The diverse reporting can have a significant impact that undermines comparability and, thus, the usefulness of financial statements. Hence, eliminating the diversity would improve financial reporting.

    (d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the IFRIC and its constituents to undertake the due process associated with an Interpretation:*

    The issue could be resolved easily, as demonstrated by the staff analysis. Again, the staff considers existing IFRSs are clear and, thus, an IFRIC interpretation is unwarranted.

(e) *It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis:*

Refer to the assessment of criterion (d) above.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC requires to complete its due process:*

The Board decided in November 2008 to add to its active agenda a project on recognition and measurement of financial instruments. That project could affect the classification of financial instruments. However, the project is in a very early stage and it is not foreseeable whether and, if so, how it would affect the issue. If it were required the IFRIC could deal with this issue much sooner (refer to the assessment of criterion (d) above).

## APPENDIX C

## IFRIC POTENTIAL AGENDA ITEM REQUEST

Classification of loans held following a failed syndication

**The issue:**

In an underwritten loan syndication, the lead bank, if it does not receive sufficient loan commitments from other banks, is obliged to advance the shortfall in the amounts lent compared to the customer commitment. Typically, if this results in the lead bank lending more than it had originally intended, the surplus will be sold to other parties rather than held for the foreseeable future.

IAS 39 defines (paragraph 39.9) the category of ‘loans and receivables’ as: “non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading…”

Meanwhile, the standard states (paragraph 39.9) that a financial asset or financial liability should be classified as ‘held for trading’ if it is: “(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term…”

**Current practice:**

It is our understanding that most banks have interpreted these requirements to mean that if a loan is originated with the intention of syndication, any surplus amounts that are expected to be sold in the near term should be classified as held for trading. This treatment would be consistent with the accounting requirements for loan commitments and was a reason why many banks were supportive of the October 2008 amendment of IAS 39 to permit reclassification of certain financial assets from held for trading to loans and receivables.

However, we have become aware that there is diversity of interpretation of these requirements. Some entities only classify such loans as held for trading if they are entered into with speculative intent, drawing on the guidance in IAS 39 AG 14. This states: “Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer’s margin.” It is argued that: (i) the activity does not involve the buying of assets, but only their sale; (ii) the aim is to sell the loans at their nominal value and so there is no expectation that a profit will be generated from short term price fluctuations or a dealer’s margin; and (iii) if they are unable to sell the loans at close to the nominal value they may change their intent and decide to hold them for the long term. As a result they have classified such loans as loans and receivables even if they are intended to be sold in the near term.

IFRIC is requested to interpret whether a loan resulting from a loan syndication which the bank intends to sell in the near term must always be classified as held for trading, or whether this is only the case if they are held with a speculative intent, as illustrated by AG 14.

[Appendix D is omitted from Observer note]