Project **Financial Instruments: Replacement of IAS 39**

Topic **Classification and measurement: basic loan features**

Purpose of this paper

1. Paragraph 4 of the exposure draft (ED) proposes two conditions for classification. This agenda paper discusses the condition in paragraph 4(a)—the instrument has only basic loan features.

2. **The purpose of this paper is to ask the Board whether that proposed condition is appropriate to identify those instruments that should not be measured at fair value through profit or loss—or whether another condition would be more appropriate.**

3. As noted in the cover paper, this set of papers **do not discuss:**

   (a) the interaction between the two conditions—eg whether (i) one condition should have primacy over the other or (ii) one condition needs to be (or should be) applied first;

   (b) measurement issues related to more complex instruments—eg hybrid contracts, structured debt, or contractually subordinated interests;

   (c) what the measurement category should be if an instrument is not measured at FVTPL— ie what the “other” measurement category should be (amortized cost or fair value through other comprehensive income (OCI)); or

   (d) whether there should be exceptions to the approach—ie an option whereby fair value changes for particular instruments would be presented in OCI.

4. Those issues will be discussed in subsequent agenda papers.

Proposals in the ED

5. Paragraphs B1–B8 discuss what it means for an instrument to have “only basic loan features”. Paragraphs BC19–BC30 explain the Board’s rationale for that proposed condition. (As background reading, agenda papers 2B and 2C for the June 1, 2009 meeting might be a helpful refresher on the development of this proposed condition.)

6. A financial instrument has basic loan features if its contractual terms give rise on specified dates to cash flows that are payments of principal and interest on the principal outstanding. For the purposes of this condition, interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time.

Feedback received

General feedback

7. Most respondents agreed that classification should reflect the contractual terms of the instrument, although some respondents thought that this condition is **less** important than how the entity manages the instruments. A small number of respondents thought this condition is unnecessary and that classification should depend solely on how the instruments are managed.

8. While agreeing with the underlying principle, most respondents said that the condition should be more clearly articulated. Many of those respondents asked questions about how to apply the condition to particular instruments.

Question 2 in the ED: Does the exposure draft provide sufficient, operational guidance on the application of this condition?

9. As noted above, many respondents stated that the ED does not provide sufficient, operational guidance on the proposed condition.

Application of the condition to particular instruments

10. Many of those respondents said that they were unable to determine whether particular instruments have "basic loan features" on the basis of the guidance in the ED.

11. Many respondents focused on the list of examples in paragraph B3 of the ED—rather than on the underlying principle described in the first two sentences of paragraph B1.

12. Focusing on the examples in paragraph B3 of the ED, many respondents were concerned that particular contractual terms that they considered to be "basic" were not included in the list of examples. For example, respondents said it was unclear from the ED whether the following have basic loan features:

    (a) inflation-linked instruments (ie an instrument whose principal and interest payments are linked to a particular inflation index)

    (b) instruments that pay interest on the basis of a bank's published variable rate

    (c) perpetual instruments that pay a fixed interest rate

13. Also, some respondents said that the straightforward examples in the ED were not helpful and suggested using more complex examples and explaining how to apply the underlying principle to such examples. For example, respondents raised the following (perhaps less "basic") examples

    (a) dual currency instrument (ie an instrument that has the principal amount denominated in one currency and the interest amounts denominated in another currency)

    (b) instrument with interest payments, which can be (or are required to be) deferred in particular circumstances (eg, if the issuer does not pay dividends on a particular class of stock)

    (c) non-recourse instrument (ie whereby the lender is entitled to repayment from specific assets and cash flows.)

14. Furthermore, some respondents disagreed with paragraph BC29 in the ED, which states that if a financial asset is acquired at a discount that reflects incurred credit losses, it does not have basic loan features. Those respondents said that such instruments can indeed have contractual terms that reflect payments of principal and interest.

Other issues

15. In addition to feedback related to particular instruments, respondents raised other concerns.

16. Some respondents expressed concern that there was not a discussion in the ED about “immaterial” or “insignificant” features. Those respondents said that such features should not affect classification. Respondents were concerned about:

    (a) features that could have a **significant** effect on cash flows but are **very unlikely** to occur (eg, a debtor’s right to defer interest payments when it has solvency issues); and

    (b) features that could have an **insignificant** effect on cash flows but are **very likely** (or certain) to occur (eg, interest that is leveraged at 0.001%).

17. Some respondents said that the notion of “leverage” should be discussed in the standard or application guidance (not just the basis for conclusions, as it is in the ED). Paragraph BC21 of the ED states that leverage is not a basic loan feature because it amplifies the variability of cash flows such that those cash flows do not have the economic characteristics of interest. These respondents noted that including the discussion of leverage in the standard would add clarity to the condition.

Question 3 in the ED: Would other conditions would be more appropriate?

18. As noted above, most respondents supported the proposed condition although a small number of respondents supported eliminating this condition (and instead focusing solely on how the entity manages the instruments).

19. Respondents did not suggest other conditions—other than those related to the entity's business model, which are described in agenda paper 3B.

FASB approach

20. In August the FASB posted on its website a description of its tentative approach to classification and measurement of financial instruments. The FASB's approach also considers the contractual terms of an instrument.

21. Under that approach, instruments must be measured at fair value through profit or loss unless:

    "…the entity's business strategy is to hold **debt instruments with principal amounts** for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party..." (emphasis added)

22. Based on discussions with the FASB staff, we think that the FASB's use of the term "debt instruments with principal amounts" was intended to be similar to "basic loan features". However, there is no expansion of the FASB's principle beyond the words set out above.

23. Moreover, a **hybrid** financial instrument must be measured at fair value through profit or loss unless the hybrid:

    (a) contains embedded derivatives that meet the clearly-and-closely-related criterion under Topic 815 (formally FAS 133) and

    (b) the entity's business strategy is to hold the instruments for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party.

24. In both the comment letters and the outreach activities there was no noted support for the FASB approach with regard to the proposals related to the contractual terms of an instrument. (There was support for the FASB articulation of the "business model", but that is not the subject of this paper.)

Staff analysis and recommendation

25. Based on the feedback received, we think that the proposed condition (ie that the instrument has "only basic loan features") is appropriate—and should be carried forward to the IFRS.

26. We think that the instrument's contractual terms and conditions are a critical factor for determining how an instrument should be measured. We do not think that classification should be determined solely based on how an entity manages its instruments. For example, an entity may hold a complex or risky instrument to collect its contractual cash flows (eg the junior tranche in a securitization or a structured note) but that instrument does not have basic loan features. We think those contractual terms should affect classification.

27. However, to address some of the questions and concerns raised by respondents, we think that the guidance in the ED should be clarified and enhanced. Namely:

    (a) The principle described in the first two sentences of paragraph B1[1] should be included in the standard.

    (b) To support that principle, the discussion of leverage, which is currently in the basis for conclusions, should be in the application guidance.

    (c) Paragraph B3 in the ED should be replaced (or supplemented) with better examples (along with an explanation of how to apply the underlying principle to such examples), and should emphasize that the examples are not an exhaustive list. The examples should include instruments that contain basic loan features, and instruments that do not. The appendix to this agenda paper includes some instruments that could be included in the application guidance as examples.

    (d) The application guidance should state that the notion of materiality applies to this condition—as it does to every item in the financial

[1] Those two sentences state that basic loan features are contractual terms that give rise on specified dates to cash flows that are payments of principal and interest of the principal outstanding. For this purpose, interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time.

statements, ie that there may be some contractual terms that are insignificant enough such that they should not affect classification.

Question 1 – Classification condition: basic loan features
Does the Board agree with the staff recommendation that this condition (ie that the instrument has “only basic loan features”) is appropriate—and should be carried forward to the IFRS?

Appendix

A1. As noted above, many respondents identified particular instruments and asked whether those instruments have basic loan features. This appendix describes some of those instruments and provides our analysis of whether the instruments have basic loan features. We think similar instruments (and the corresponding analysis) should be included in the application guidance to the IFRS instead of the examples in paragraphs B3 and B4 of the ED.

A2. This appendix analyzes the instruments **in their entirety**. If the Board decides to bifurcate some instruments (such as hybrid contracts), we will have to adjust accordingly the examples included in the application guidance.

Instrument A

A3. Instrument A is a loan that pays an inverse-floating rate. That is, the interest rate has an inverse relationship to market interest rates.

Staff analysis

A4. Instrument A does not have basic loan features. An inverse-floating rate does not reflect compensation for time value of money on the principal amount outstanding.

Instrument B

A5. Instrument B is a bond with a stated maturity date. Payments of principal and interest are linked to an inflation index in the currency in which the instrument is issued. The inflation link is not leveraged.

Staff analysis

A6. Instrument B has basic loan features. Linking payments of principal and interest to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects “real” interest.

Thus, the interest amounts are compensation for time value of money on the principal amount outstanding.

A7. However, if the interest payments were indexed to another variable such as the borrower's performance (eg the borrower's net income) or an equity index, the instrument would **not** have basic loan features. That is because the interest payments are not compensation for time value of money and credit risk associated with the principal amount outstanding.

Instrument C

A8. Instrument C is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount.

A9. Instrument C pays a market-based interest rate but payment of interest cannot be made unless the issuer is able to make such payments and remain solvent immediately thereafter. In addition, interest need not be paid if, in the two months immediately preceding the interest payment date, no dividend has been declared or paid on any class of share capital.

A10. Deferred interest does not accrue additional interest. The deferred interest becomes due in full on the earliest of (1) the date upon which a dividend is next paid on any class of share capital; (2) the date that the issuer repays the principal amount; or (3) the date that the issuer winds up.

Staff analysis

A11. Instrument C does not have basic loan features. The contractual cash flows do not represent payments of principal and interest. That is because the issuer may be required or can choose to defer interest payments and additional interest does not accrue on those deferred amounts. As a result, interest amounts do not represent consideration for the time value of money.

A12. The fact that Instrument C is perpetual does not in itself disqualify it from having basic loan features. In effect, a perpetual instrument has continuous (multiple) extension options, which are basic loan features. Also, the fact that

Instrument C is callable does not disqualify it from having basic loan features unless it is callable at an amount that does not reflect payment of outstanding principal and interest on that principal, which may include an amount that compensates the holder for the early termination of the instrument.

Instrument D

A13. Instrument D is a loan that is full-recourse loan and is secured by particular collateral.

Staff analysis

A14. The fact that a full recourse loan is collateralized does not in itself affect the analysis of whether the instrument has basic loan features.

A15. However, if the instrument was a non-recourse instrument, whereby the lender is only entitled to repayment from specific assets and cash flows, it most likely would not have basic loan features. That is because the lender does not have a contractual right to unpaid amounts of principal and interest on that principal. Rather the lender’s claim ultimately is limited to the value of the asset.

Instrument E

A16. Instrument E is a variable rate instrument that permits the borrower to choose the market rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay 3-month LIBOR for a three-month term or 1-month LIBOR for a one-month term.

Staff analysis

A17. Instrument E would have basic loan features as long as the interest rate paid **over the life of the instrument** reflects compensation for the time value of money and credit risk associated with the instrument. The fact that the interest rate is reset during the life of the instrument does not in itself disqualify the instrument from having basic loan features.

A18. However, if the borrower is able to choose to receive 1-month LIBOR for three months and that 1-month LIBOR is not re-set each month, the instrument does not have basic loan features.

A19. The same analysis would apply if the borrower is able to choose between the lender's published 1-month variable rate and the lender's published 3-month variable rate.

A20. However, if the instrument has a contractual interest rate that is based on a term that **exceeds** the instrument's remaining life, that instrument does not have basic loan features. For example, a constant maturity bond with a five-year term that pays a variable rate that is reset periodically but that always reflects a five-year maturity does not have basic loan features. That is because the interest rate payable in each period is disconnected with the term of the instrument (except at origination).

Instrument F

A21. Instrument F is a convertible bond. From the issuer's perspective the convertible bond is a compound instrument pursuant to IAS 32; thus, the issuer separately classifies the conversion feature as equity and the debt host as a liability. The issuer applies the measurement guidance in IAS 32 at initial recognition to those two components.

A22. Instrument F allows the holder to put the instrument back to the issuer if the issuer has a change in control.

Staff analysis

A23. The **issuer** would analyze only the debt host to determine whether it has basic loan features because the equity component is outside of the scope of these classification and measurement requirements. As long as the interest paid reflects compensation for the time value of money and credit risk associated with the principal outstanding, it is consistent with basic loan features. The "principal outstanding" is the amount allocated to the debt host.

A24. The fact that Instrument F is puttable if there is a change in control would not in itself disqualify it from having basic loan features as long as the prepayment amount represents unpaid amounts of principal and interest, which may include an amount that compensates the lender for the early termination of the instrument.

A25. In contrast, the **holder** would analyze the convertible debt in its entirety. Instrument F does not have basic loan features because the interest rate does not reflect only the time value of money and credit risk but the return is also linked to the equity of the issuer.