**IASB Meeting** | Agenda reference **3B**

Staff Paper | Date **29 September 2009**

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

Topic **Classification and measurement: managed on a contractual yield basis**

## 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(b)—the instrument is managed on a contractual yield basis.

**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 assets acquired at a discount that reflects incurred credit losses;

(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

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(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 B9–B13 discuss what it means for an instrument to be "managed on a contractual yield basis". Paragraphs BC31–BC36 explain the Board's rationale for that proposed condition. (As background reading, agenda paper 2D for the June 1, 2009 meeting might be a helpful refresher on the development of this proposed condition.)

6. Financial instruments are managed on a contractual yield basis only if they are managed, and their performance evaluated by the entity's key management personnel on the basis of the contractual cash flows that are collected (or paid) when the instrument is held (or issued). If an entity's business model is to realize fair value changes by transferring (eg selling) the instruments before maturity, those instruments are not managed on a contractual yield basis.

7. Selective sales or transfers of financial instruments before maturity do not change the business model of the entity.

8. Whether financial instruments are managed on a contractual yield basis does not depend on management's intentions for an individual instrument, which can change with circumstances—that is, it is not free choice and is not an instrument-by-instrument approach to classification.

## Feedback received

### *General feedback*

9. Almost all respondents agreed that classification and measurement should reflect how an entity manages its financial instruments. In fact, some respondents stated that an entity's business model for managing instruments is **more**

important than the instruments' contractual terms (ie whether the instrument has "basic loan features").

10. While agreeing with the underlying principle, most respondents said that the condition should be more clearly articulated and expressed concerns about whether the condition was operational as written in the ED.

11. Specifically, many respondents suggested that the Board eliminate the phrase "managed on a contractual yield basis" and suggested alternative wording that they believe more clearly communicates the principle. That suggested wording generally focused on whether the entity's business model was to hold the instruments for collection (or payment) of the contractual cash flows. For example, some respondents preferred the FASB wording, with some changes. (The FASB's wording is reproduced below in paragraph 24.) Respondents noted that such wording is very similar to paragraph BC31 in the ED's basis for conclusions; thus they believed it was consistent with the Board's underlying principle.

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

*The "gray area"*

12. Respondents generally acknowledged that the proposed condition is straight-forward in some circumstances. For example, it is clear that a trading instrument **is not** managed on a contractual yield basis. In contrast, an instrument that is being held to maturity **is** managed on a contractual yield basis. However, many respondents noted that there is a "gray area" in-between those two circumstances and stated that they sometimes were unable to determine on the basis of the guidance in the ED whether such instruments are managed on a contractual yield basis. Many respondents asked for more guidance or examples to help them analyze the instruments that are not straight-forward. They noted that the examples in the ED were not helpful because they were too simple.

13. For example, respondents said it was unclear from the ED whether the following instruments are managed on a contractual yield basis:

(a) An entity manages its business to achieve a spread between the return it receives on its assets (eg loans granted to customers or investments held) and the return it pays on its liabilities (eg customer deposit liabilities or insurance liabilities). The entity will buy and sell its assets to maximize (or re-balance) the spread.

(b) An entity holds a portfolio of investments to meet regulatory liquidity requirements. In the normal course of business, the entity collects their contractual cash flows but, if necessary, it would sell as much of the portfolio as necessary.

(c) An entity buys an asset and enters into a repurchase agreement whereby it sells the asset to a counterparty for cash. The entity continues to receive an amount equal to the interest income related to the asset. However, the entity is obligated to pay interest on the cash received from the counterparty and to "repurchase" the asset for a fixed amount of cash on a specified date. [This assumes that the entity does not derecognize the asset.]

14. Many respondents asked for clarification on how many sales would be "allowable" if an entity asserts that it manages instruments on a contractual yield basis (or similarly, whether an entity must hold instruments for a particular percentage of the instruments' contractual lives)—although almost all respondents want to avoid creating a "bright line" test such as today's "tainting" rule for held to maturity investments.

15. Some respondents asked whether "monitoring" instruments on a fair value basis (or managing particular risks on a fair value basis) would indicate that the instruments could not be "managed" on a contractual yield basis. In other words, respondents wondered how much attention could be paid to instruments' fair values while asserting that those instruments are managed on a contractual yield basis.

16. Other respondents asked questions about the wording "managed on a contractual yield basis". For example, respondents asked whether "managed on a

contractual yield basis" was intended to be the same thing as "**not** managed on a fair value basis". Specifically some of those respondents asked whether:

(a) instruments could be managed **neither** on a contractual yield basis **nor** on a fair value basis (ie they are managed on another basis); or

(b) instruments could be managed on **both** a contractual yield basis **and** a fair value basis.

*Other questions and concerns raised by respondents*

17. In addition to discussing uncertainty about the "gray area", respondents raised other concerns and questions about the proposed condition.

18. Some respondents noted that the ED explicitly states that the proposed condition is **not** assessed on an instrument-by-instrument basis but said that more guidance is needed about the level at which the condition should be assessed (eg portfolio level, reporting entity level, etc). Most respondents felt it appropriate that the entity determine the appropriate level at which the determination should be made, and that such a determination should be made by senior management. Almost all respondents agreed that such a determination should not be at an instrument-by-instrument level, but should instead, at a minimum, be at a portfolio level. A few respondents expressed concerned because they thought that the ED indicated that the condition **must be** applied at the business unit level.

19. Other concerns focused on particular instruments or circumstances:

(a) Many respondents disagreed with paragraph B13(b) in the ED, which states that a financial asset that is acquired at a discount that reflects incurred credit losses is not managed on a contractual yield basis. Those respondents said that such assets can indeed be managed on a contractual yield basis, especially if the assets are part of a portfolio that includes assets that do **not** reflect credit losses. (As noted above, this issue will be addressed in a separate paper).

(b) Some respondents asked whether an **issuer** of a convertible bond can assert that it manages the instrument on a contractual yield basis if the

entity expects that it may have to deliver its own shares (rather than cash) to the holder.

(c) Some respondents were unsure how the condition would be applied in consolidation. Consider an entity that grants loans to customers and subsequently sells those loans to a securitization vehicle. The entity consolidates the securitization vehicle. Respondents asked how the condition should be applied to the consolidated assets (the loan assets) and liabilities (the securities issued by the vehicle). Similarly, some respondents asked how the condition would be applied if an entity sold assets but did not derecognize them (eg there is a failed sale to a securitization vehicle).

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

20. As noted above, almost all respondents agreed with the condition but many either wanted more guidance on how to apply the condition (ie additional examples) or suggested alternative words to describe it.

21. However a few respondents suggested other conditions:

    (a) A few respondents suggested using the definition of *held for trading* as a classification condition (ie, if an instrument **is** held for trading, it would be measured at fair value through profit or loss but if an instrument **is not** held for trading, it would be eligible for the "other" measurement attribute).

    (b) Other respondents suggested retaining the current three-category approach whereby instruments would be measured at

        (i) fair value through profit or loss;

        (ii) fair value through OCI; or

        (iii) amortized cost.

22. Respondents who suggested a three-category approach seemed to use the fair value through OCI category for any instrument that is "available for sale"—that

is, they proposed an approach that would be very similar to IAS 39 requirements.

## FASB approach

23. 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 entity's business model.

24. 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)

25. Based on discussions with the FASB staff, we think that the FASB's proposed condition was intended to be similar to "managed on a contractual yield basis". Also the FASB's proposed wording is similar to the wording in paragraph BC31 in the ED's basis for conclusions.

26. However, the FASB was concerned about whether the IASB's proposed condition was operational so they added explanatory language:

> "…an entity's business strategy for a financial instrument would be evaluated based on how the entity manages its financial instruments rather than based on the entity's intent for an individual financial instrument. The entity also would demonstrate that it holds a high proportion of similar instruments for long periods of time relative to their contractual terms."

## Alternatives

27. We think there are two alternatives that the Board could consider:

**Alternative 1:** use the FASB's condition of "held to collect (or pay) contractual cash flows" **including** a requirement that an entity demonstrate that it holds a high proportion of similar instruments for long periods of time relative to their contractual terms

**Alternative 2**: retain the condition proposed in the ED but articulate it differently

28. The difference between those two alternatives is that Alternative 1 includes additional explanatory language (ie that the entity must demonstrate that it holds a high proportion of similar instruments for long periods of time relative to their contractual terms).

29. We did not re-consider using the notion of *held for trading* as a condition. The Board considered that during the discussions leading to the publication of the ED but rejected it (as discussed in paragraph BC36 of the ED). Many board members stated that the notion of trading is too narrow. The requirements in IAS 39 require fair value for some instruments that are not held for trading (ie, those classified as available for sale) and many board members did not support classifying all of those instruments at amortized cost. The respondents who suggested this alternative did not provide new information or rationale about this alternative.

30. Moreover, we did not reconsider a three-category approach. The respondents who suggested this alternative did not provide an explanation about how this alternative would be an improvement to the existing requirements. We do not think such an approach would meet the objective of this project; it would neither significantly improve nor reduce the complexity of the reporting for financial instruments.

## Staff analysis

31. We think the two alternatives would result in the same classification of instruments in many circumstances. However, as mentioned above, we do not think the alternatives are the same.

32. We think there are two items to consider when analyzing the alternatives:

    (a) How close are the alternatives to the current definition of "held to maturity"?

The definition of *held to maturity* is in paragraph 9 of IAS 39. To classify an asset as held to maturity, an entity must have the positive intention and ability to hold the investment to maturity.

(b) Do either of the alternatives address the uncertainty related to the "gray area"?

### *Similarity to the definition of "held-to-maturity" in IAS 39*

33. While neither alternative makes a cut that is the same as the held-to-maturity definition in IAS 39, we think Alternative 1 makes a cut that is *closer to* that definition than does Alternative 2. That is because Alternative 1 would require that an entity hold a high proportion of similar instruments for long periods of time relative to their contractual terms. As a result, compared to Alternative 2, the instruments described in paragraph 13 would be **less likely** to meet the condition in Alternative 1 and, thus, are **more likely** to be measured at fair value through profit or loss.

34. Alternative 2 does not include explicit guidance on how many sales would be "allowable" if an entity asserts that it manages instruments on a contractual yield basis. An entity would be required to make that decision in the context of its overall business model. Alternative 2 mandates that an entity analyze how it manages its instruments but allows more flexibility in that analysis than does Alternative 1.

### *Uncertainty related to the gray area*

35. The preceding section may seem to indicate that Alternative 1 would require less judgment and would be more consistently applied than Alternative 2. However, we do not think that is true. We think Alternative 1 would require significant judgement because entities undoubtedly will ask questions such as:

    (a) What is a **high** proportion (eg 50%, 75%, or 90% of instruments)?

    (b) What is a **similar** instrument?

    (c) What is a long period of time **relative to a contractual term** (eg 50%, 75%, or 90% of the contractual term?)

36. Indeed, during our outreach programme, this was the focus of much attention from constituents with whom we discussed the different articulations of the business model.

37. Therefore, unless bright lines are included in the standard, we think both alternatives will require judgment and result in uncertainty related to a gray area.

## Staff recommendation

38. We recommend Alternative 2—that the Board carry forward the principle proposed in the ED. We think that Alternative 1 creates a line that is too close to a notion of held-to-maturity and will inevitably result in "bright line" guidance related to the questions listed in paragraph 35. While respondents asked for better articulation (eg better examples) to help them apply the principle in the ED, almost all wanted to avoid creating bright lines.

39. However, to address some of the questions and concerns raised by respondents, we think that the guidance in the ED should be more clearly articulated and enhanced with better examples.

### *Changing the wording of the condition*

40. We propose replacing the phrase "managed on a contractual yield basis" with alternative wording such as:

**"The objective of an entity's business model is to hold the instruments to collect (or pay) contractual cash flows rather than to sell (or settle) the instruments prior to their contractual maturity to realize fair value changes.**

41. Almost all respondents preferred that wording (or something similar) and noted that it is similar to how the Board described the condition in the ED's basis for conclusions. We think that phrase articulates the principle that the Board proposed in the ED; albeit in different words.

***Clarifying some of the guidance in the ED***

42. We think some of guidance in the ED could be more clearly articulated. Namely:

    (a) It is expected that an entity will sell some instruments that it holds to collect contractual cash flows. Very few business models entail holding all instruments until maturity. However, frequent buying and selling of instruments is not consistent with a business model of holding instruments to collect (or pay) contractual cash flows.

    (b) An entity needs to use judgment to determine at what level this condition should be applied. That determination is made on the basis of how an entity manages its business. The proposals do not mandate any particular level other than stating that it is **not** at an individual instrument level.

43. We also think that the Board should clarify that instruments are **either** held to collect (or pay) contractual cash flows **or** managed on a fair value basis. Those two business models are mutually exclusive. An entity may **monitor** fair values (eg to determine which instrument to sell if the need arises) or manage particular risks on a fair value basis (eg interest rate risk) but still **manage** the instruments to collect or pay contractual cash flows.

***Adding additional examples***

44. Finally, we think that the application guidance should provide examples of how this condition would be applied to some instruments. Paragraphs B12 and B13 in the ED provide examples of financial instruments that are (and are **not**) managed on a contractual yield basis. However, respondents said that those examples are not helpful because they are too straightforward and do not address the instruments that require judgment.

45. We think the application guidance should provide examples of circumstances that are in the "gray area" and discuss how to apply the underlying principle to those examples. These additional examples could replace or supplement the

guidance in B12 and B13. The appendix to this agenda paper includes some circumstances that could be included in the application guidance as examples.

| **Question 1** |
| --- |
| Does the Board agree that classification and measurement should reflect how an entity manages its financial instruments and thus that this condition should be carried forward to the IFRS?<br><br>If not, why? What condition does the Board wish to use instead and why? |

## Appendix

A1. As noted above, many respondents said that they were unclear how to apply the guidance in the ED to particular circumstances. This appendix describes some of those circumstances and provides our analysis of whether the instruments are managed on a contractual yield basis. We think a similar analysis should be included in the application guidance to the IFRS instead of (or in addition to) the examples in paragraphs B12 and B13 of the ED.

### Scenario A

A2. An entity manages assets and liabilities to achieve a spread between the return it earns on its assets and the return it pays on its liabilities. To do so, the entity actively manages its asset portfolio based on changes in credit spreads and yield curves. That results in active buying and selling (ie the entire portfolio turns over frequently).

#### *Staff analysis*

A3. We do not think the entity's objective is to hold the instruments to collect contractual cash flows. Rather, the entity is actively managing its portfolio to maximize fair value gains.

### Scenario B

A4. An entity holds investments to collect their contractual cash flows but would sell the investment in particular circumstances. For example, a sale may occur if:

(a) an instrument no longer meets the entity's investment policy (eg the credit rating of the instrument falls below that required by the entity's investment policy);

(b) an insurer adjusts its portfolio to reflect a change in expected duration (ie the expected timing of payouts); or

(c) an entity needs to fund capital expenditures.

#### *Staff analysis*

A5. While an entity may consider the assets' fair value from a liquidity perspective (ie the cash amount that would be realized if the entity needs to sell the instrument), we think the entity's objective is to hold the instruments and collect the contractual cash flows. We do not think the sales described above would be inconsistent with that objective.

## Scenario C

A6. An entity issues convertible debt instruments. From the entity'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.

A7. The entity is unsure whether the holders will exercise the conversion features.

#### *Staff analysis*

A8. Although the contracts may be settled in shares, we think the entity's business model would be consistent with an objective of holding the instruments to pay contractual cash flows as long as the issuer's business model is to hold such instruments to meet the obligations over time, which may either be an obligation to deliver cash or an obligation to deliver shares.