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STAFF PAPER

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Project	**Financial instruments: classification and measurement**		
Paper topic	Bifurcation: closely related bifurcation methodology		
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Introduction

1. This paper is the fourth in a series of papers considering the bifurcation of financial assets and financial liabilities[1].

2. This paper discusses a bifurcation methodology using the 'closely related' bifurcation requirements in IAS 39 *Financial Instruments: Recognition and Measurement*, and Topic 815-15. This paper focuses on the **application** of the closely related bifurcation methodology to financial assets and financial liabilities (ie the mechanics of how it would work). It also discusses specific issues that arise from the holder or the issuer perspective and how they could be addressed if the boards pursue this approach. This paper **does not** discuss the arguments for and against bifurcation or provide our analysis of whether bifurcation should be required[2]. Nor does this paper address the advantages and disadvantages of this approach to bifurcation. These arguments and, the arguments for and against

[1] For an explanation of how this paper fits in the series, see IASB AP 6B/FASB Memo 140.

[2] If the boards decide to pursue bifurcation, the need for the fair value option (FVO) for hybrid financial instruments will be discussed at a future meeting.

bifurcation are set out in IASB AP6B/FASB Memo 140. Staff analysis and recommendation and questions for the boards are provided in IASB AP 6F/FASB Memo 140D.

3. **Financial assets –**For the IASB, this alternative would introduce bifurcation for financial assets to IFRS 9. This approach is consistent with the bifurcation methodology in the FASB's tentative model for financial assets.

4. The closely related bifurcation methodology would be applied in addition to the P&I contractual cash flow characteristics assessment, which was discussed at the February 2012 joint board meeting. Complexities of that interaction are discussed later in this paper.

5. **Financial liabilities –** This bifurcation methodology is currently used for financial liabilities in IFRS 9 and the FASB's tentative model and, thus, would not require any changes to the bifurcation requirements applicable for financial liabilities.

Explanation of the approach

6. Under this approach, the closely related requirements for hybrid instruments in IAS 39 and Subtopic 815-15 would be carried forward to IFRS 9 *Financial Instruments* and would not be amended under US GAAP. Consequently, this approach would be applied as follows:

   (a) An embedded feature would be separated from the host contract if it meets the definition of a derivative[3] and is not closely related to the host contract. The host could be eligible for a measurement category other than at fair value through profit or loss (FVPL) depending on the

[3] The staff notes that the definition of a derivative under U.S. GAAP and IFRSs is different. The definition of a derivative under US GAAP requires a notional amount; however, IFRS does not. Additionally, a notable difference exists with regard to the settlement provisions. IFRS requires settlement at a future date, whereas US GAAP emphasises the characteristic of net settlement.

business model[4], while the embedded derivative would be measured at FVPL[5].

(b) An embedded feature that does not meet the definition of a derivative or is assessed to be closely related to the host would not be separated. As a result, the hybrid contract would be classified and measured in its entirety.

Considerations specific to financial assets

7. The closely related bifurcation methodology does not align well with the P&I cash flow characteristics assessment discussed by the boards at the February 2012 joint board session. Consider an instrument with the following characteristics:

(a) an embedded feature that more than insignificantly modifies the relationship between principal, the time value and the credit risk (ie consistent with the notion of solely principle and interest (P&I)) and thus, must be assessed for bifurcation; and

(b) meets the definition of a derivative and is closely related, and thus would not be eligible to be bifurcated.

8. Hybrid instruments with such characteristics would first be assessed using the cash flow characteristics assessment, and if they did not meet the P&I requirements, would be assessed for bifurcation using the closely related requirements. There is an inherent conflict between these characteristics as discussed in (a) and (b) above. The boards have already decided that instruments with characteristics as discussed in (a) would not be classified in their entirety in a measurement category other than FVPL. However, the boards have not yet

[4] If relevant, the staff will prepare an analysis of the application of a business model assessment for financial liabilities at a future session. Currently, IFRS 9 does not have a business model assessment per se for financial liabilities. The FASB's tentative model has different business model assessments for financial assets and financial liabilities. However, the outcome for held-for-trading liabilities and derivatives are already similar, ie measured at FVPL under both approaches.

[5] The condition assumes that the hybrid instrument is not remeasured at FVPL in its entirety.

decided how instruments with the characteristics discussed in (b) would be measured (issue discussed in the next section).

9. If the boards decide that an instrument that contains both (a) and (b) would be classified in a measurement category other than FVPL, subject to the business model, that would effectively increase how significantly a financial asset's contractual cash flows can deviate from 'perfect' P&I—ie from an insignificant deviation, as discussed at the February 2012 joint board meeting, to that which results under the closely related guidance. For example, under the cash flow characteristics assessment, an instrument with leverage could only be measured at other than FVPL if the leverage was insignificant. However, the closely related bifurcation methodology could allow leverage up to 2x to be measured at other than FVPL. In addition, features which do not represent P&I at all could qualify for a measurement category other than FVPL if they are closely related. Thus, using a closely related bifurcation methodology will lead to inconsistent outcomes when used with the cash flow characteristics assessment.

Measuring a hybrid financial asset with a closely related derivative (ie the hybrid is not bifurcated)

10. If the boards decide to pursue a closely related bifurcation methodology for financial assets, they will need to consider whether a hybrid contract that does not meet the contractual cash flow assessment (as per the February 2012 decisions), but has a closely related embedded derivative should be measured:

    (a) at FVPL in its entirety because it does not meet the contractual cash flow characteristics assessment or

    (b) according to the relevant business model (potentially at amortised cost or fair value through other comprehensive income (FVOCI)) because the embedded derivative is closely related to and, thus, should not influence classification of, the host contract.

11. **Measurement at FVPL –** If an instrument does not meet the P&I assessment and contains an embedded derivative that is closely related, the instrument would not

be eligible for bifurcation under a closely related bifurcation methodology and would be measured in its entirety at FVPL. However, if an instrument does not meet the P&I assessment and contains an embedded derivative that is **not** closely related (and hence would be bifurcated), only the embedded derivative would be measured at FVPL and the host would be measured according to the business model assessment (ie potentially at amortised cost or FVOCI). This outcome is counter-intuitive because more simple hybrid financial assets (ie those with closely related embedded derivatives) will be classified and measured at FVPL in their entirety whereas more complex hybrid financial assets (ie those with non-closely related embedded derivatives) would be bifurcated, with the host instruments qualifying for a measurement category other than FVPL (subject to the business model).

12. **Measurement according to the business model –** Some believe that since the embedded derivative has been determined to be closely related to the host contract, the most relevant measurement attribute for the hybrid instrument in its entirety is that which is appropriate for the host (ie amortised cost or FVOCI depending on the business model). However, this overrides the cash flow characteristics assessment because the hybrid instrument has contractual cash flows that are not solely P&I. This would allow embedded features that do not meet the contractual cash flow assessment (as per the February 2012 decisions), yet pass the closely related requirements to be measured at amortised cost or FVOCI.

Considerations specific to financial liabilities – FASB only

13. If the FASB were to decide on a closely related bifurcation methodology for financial liabilities yet eliminate bifurcation for financial assets, the FASB would need to consider whether a cash flow characteristics assessment would be necessary for financial liabilities. This issue would need to be addressed because the FASB's tentative model includes a cash flow characteristics assessment for financial liabilities. The FASB staff will bring this analysis at a future date.

Key points in this paper

14. The key considerations for a closely related bifurcation methodology are summarised below:

    (a) There are complexities related to how this bifurcation methodology interacts with the contractual cash flow characteristics assessment that is applied to financial assets.

    (b) If the boards pursue a closely related bifurcation methodology, they should consider whether a hybrid financial asset that does not meet the contractual cash flow criteria with a closely related derivative should be measured at FVPL or according to the business model.