STAFF PAPER

16 – 18 September 2013

REG FASB | IASB Meeting

Project	**Financial Instruments: Classification and Measurement**		
Paper topic	Contractual Cash Flow Characteristics: Cover Paper		
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Purpose of the paper

1. This paper introduces the series of papers for the September joint board meeting on the **solely principal and interest ('P&I') condition** in IFRS 9 *Financial Instruments* and the FASB's proposed Accounting Standards Update *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ('the FASB's proposed ASU').

2. To assist the boards in their redeliberations, this paper sets out the objective and the scope of the series and provides a summary of the staff recommendations and questions for the boards that are contained in Agenda Papers 6B–6F/FASB Memos 242–246. Detailed discussion of the relevant feedback from respondents to the boards' recent exposure drafts, staff analysis and conclusions on each topic are presented in the respective papers.

Objective and scope of this series of papers

3. The objective of this series of papers is to consider respondent feedback on the solely P&I condition and propose clarifications and changes to that condition. This series of papers addresses financial assets only, which reflects the scope of the solely P&I condition in the boards' recent proposals. Financial liabilities will be covered at future meetings. Finally, this series focusses on the contractual[1] cash flow characteristics assessment in classifying financial assets that would be measured at amortised cost or fair value through other comprehensive income (FVOCI)[2]. The business model condition is outside of the scope of this series, and will be discussed at subsequent meetings.[3]

4. The specific aspects of the solely P&I condition for the boards' redeliberations have been identified on the basis of the feedback received from constituents and are addressed in the following papers:

   (a) Agenda Paper 6B / FASB Memo 242 *Contractual Cash Flow Characteristics: Amortised Cost as a Measurement Basis*

   (b) Agenda Paper 6C / FASB Memo 243 *Contractual Cash Flow Characteristics: The Meaning of 'Principal'*

   (c) Agenda Paper 6D / FASB Memo 244 *Contractual Cash Flow Characteristics: The Meaning of 'Interest'*

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[1] This series only discusses *contractual* cash flows. As a result of the decoupling of the measurement of impairment and the measurement of the financial asset in the boards' impairment projects, impairment considerations are outside of the scope of the analysis in this series. It is noted however that at least for 'purchased credit impaired' financial assets there can still be an interaction between the measurement of impairment and the measurement of the financial asset but this interaction is set aside for the purposes of the analysis in this series.

[2] Hereinafter in this series, it is understood that if a financial asset qualifies for amortised cost on the basis of its contractual cash flow characteristics, it would also qualify for FVOCI – subject to the business model assessment.

[3] Thus it is assumed that the FVOCI category exists for the purposes of these papers but that decision and the conditions for the business models will be confirmed at a later meeting.

(d) Agenda Paper 6E / FASB Memo 245 *Contractual Cash Flow Characteristics : Contingent Features*

(e) Agenda Paper 6F / FASB Memo 246 *Contractual Cash Flow Characteristics: Prepayment Features*

5. The overview of the papers presented to the boards at this meeting is presented in the following paragraphs.

6. **The below repeats contents from Agenda Papers 6B–6F/FASB Memos 242–246. It does not provide additional analysis and is provided for convenience so that it is possible to see an overview of the effect of this series of papers. This paper must not be considered in isolation of the other papers in the series that provide the full analysis of all factors that are relevant in considering the issues.**

Agenda Paper 6B/FASB Memo 242 *Contractual Cash Flow Characteristics: Amortised Cost as a Measurement Basis*

7. This paper:

(a) Discusses the mechanics and information content provided by amortised cost as a measurement basis.

(b) Reviews the considerations in classifying financial assets at amortised cost and discusses contractual cash flow characteristics compatible with the amortised cost measure, and how these considerations are captured in the solely P&I condition.

(c) Supports the staff analysis and recommendations in the subsequent papers in the P&I series for this meeting.

8. The objective of this paper is to clarify and affirm the conceptual basis for the solely P&I condition and to guide the boards in their re-deliberations. Accordingly, it supports the staff analysis and recommendations in the other papers for this meeting. This paper does not contain questions to the boards.

Agenda Paper 6C/FASB Memo 243 *Contractual Cash Flow Characteristics: The Meaning of 'Principal'*

9. This paper proposes to clarify the meaning of 'principal' for the purposes of the application of the solely P&I condition. The paper identifies the following alternatives for how the meaning of principal could be explained:

   (a) <u>Alternative A</u>—the amount that is **contractually defined** as 'principal';

   (b) <u>Alternative B</u>—the amount that was advanced to the debtor when the debtor **originally issued** the instrument; and

   (c) <u>Alternative C</u>—the amount that was transferred by the **current holder** for the asset.

10. The staff recommend Alternative C. This alternative:

    (a) reflects the economics of the financial asset from the perspective of the current holder, and

    (b) is consistent with the boards' basis that underlies the current description of principal in both IFRS 9 and the FASB's proposed ASU.[4]

Question for the Boards [in Agenda Paper 6C/FASB Memo 243 – Meaning of principal']
Do the boards agree with the staff recommendation to describe principal consistently with Alternative C, as the amount transferred by the current holder for the financial asset?

[4] The staff acknowledge that some board members may disagree that a financial asset should be measured at fair value through profit or loss if that asset was acquired at a discount or a premium and is prepayable at par—and this could be the outcome under Alternative C (if the discount or premium was significant). These assets are analysed and discussed further in **IASB AP 6G/FASB Memo 246.**

Agenda Paper 6D/FASB Memo 244 *Contractual Cash Flow Characteristics: The Meaning of 'Interest'*

11. This paper proposes clarifications of the meaning of interest including:

    (i) The assessment of 'de minimis' features (ie features that could only have a de minimis impact on a financial asset's cash flows in all scenarios),

    (ii) The components and the meaning of interest, and

    (iii) The meaning of 'time value of money'.

12. **De minimis features** – The staff do not believe that the boards intended that a contractual provision affects the classification of a financial asset if the impact of that feature on the contractual cash flows could only be de minimis, regardless of the nature of that feature. Consequently, the staff recommend clarifying that a feature that could impact cash flows on a financial asset in each period and cumulatively only by a de minimis amount is not inconsistent with the solely P&I condition.

Question 1 for the boards [in Agenda Paper 6D/FASB Memo 244 – De minimus features]
Do the boards agree with the staff recommendation to clarify that a feature that could impact cash flows on a financial asset in each period and cumulatively only by a de minimis amount is not inconsistent with the solely P&I condition?

13. **Components and meaning of interest** – The staff do not believe that the boards intended the notion of interest to be interpreted as narrowly as some constituents have suggested and thus recommend that the boards clarify that notion as follows:

    (a) emphasise the underlying rationale for the solely P&I condition – that is, the notion of a basic lending-type return for which amortised cost provides useful information by allocating the return over time,

    (b) confirm that time value of money and credit risk are typically the most significant and universally accepted components of such a basic lending-type return; however they are not the only possible elements of interest,

(c) clarify that such a basic lending-type return could also include consideration for costs associated with the financial asset (for example, servicing or administrative costs) or/and a profit margin, and

(d) emphasise what are *not* components of such a basic lending-type return and why (but not provide an exhaustive list of such components).

14. In addition, the staff recommend that the IASB elevate the discussion of consideration for liquidity risk from the Basic for Conclusions to the application guidance in IFRS 9.

Question 2 for the boards [in Agenda Paper 6D/FASB Memo 244 – The Meaning of 'Interest']
Do the boards agree with the staff recommendation to clarify the application guidance on the meaning of interest as discussed above?

15. **The meaning of time value of money** – The staff recommend that the boards:

(a) clarify the objective of the time value of money – that is, to provide consideration just for the passage of time,

(b) articulate the factors relevant to that assessment – specifically, the tenor of the interest rate and the currency of the instrument, as well as relevant market practices,

(c) clarify that both qualitative and quantitative assessments could be used to determine whether the objective of the time value of money is achieved,

(d) provide guidance on how and why the quantitative assessment should be performed – that is, to qualify for amortised cost measurement, the contractual (undiscounted) cash flows cannot be more than significantly different from the (undiscounted) cash flows that would arise if the time value component of the interest rate were 'perfect' (eg there were a perfect link between the interest rate and the period for which the rate is set),

(e) do not allow a fair value option in lieu of the quantitative assessment of the time value component of the interest rate,

(f) allow regulated interest rates to be accepted as a proxy for the consideration for the time value of money if such rates:

  (i) provide consideration that is broadly consistent with consideration for the passage of time, and

  (ii) do not introduce exposure to risks or volatility in cash flows that:

    1. are inconsistent with the basic lending-type relationship and
    2. for which amortised cost would not provide useful information.

Question 3 for the boards [in Agenda Paper 6D/FASB Memo 244 – The meaning of 'time value of money']
Do the boards agree with the staff recommendation to clarify the meaning of the time value of money as discussed above?

Agenda Paper 6F/FASB Memo 245 *Contractual Cash Flows Characteristics: Contingent Features*

16. This paper discusses alternative approaches to classifying financial assets with the following types of contingent features:

(a) contingent features that result in cash flows that *are* solely P&I, and

(b) contingent features that result in cash flows that are *not* solely P&I.[5]

17. **Contingent features that result in cash flows that *are* solely P&I** – The staff believe that the trigger event and the resulting cash flows must be assessed *in combination* to determine whether the contractual cash flows on the financial asset are solely P&I. That is, the nature of the trigger event in itself is **not a determinative factor** in assessing whether the contractual cash flows are solely P&I throughout the life of the instrument—but rather is **a helpful indicator** in assessing whether the contractual cash flows are solely P&I.

18. The 'nature of the trigger event' and 'the contingent cash flows' are not two unrelated factors that should – or could – be assessed in isolation. Rather, all contractual provisions should be considered holistically in classifying a financial asset. The staff believe that the guidance should be clarified accordingly.

19. In considering the nature of the contingent trigger events, the staff do not believe that the boards intended the requirements for contingent features in general to be different to the requirements for contingent prepayment and extension features. Rather, the staff believe that the examples used for prepayment and extension features were examples of triggers that were expected to typically result in cash flows that are solely P&I. Accordingly, the staff believe that no distinction should be made between contingent prepayment and extension features and other types of contingent features.

20. Finally, the staff acknowledge that the specific example of a punitive rate included in the FASB's proposed ASU may indeed suggest that *any* rate that could be considered 'punitive' in nature does not meet the solely P&I condition. The staff propose that the guidance on punitive rates should be updated to reflect

[5] This paper discusses contingent features other than contingent prepayment and extension features (these are the subject of IASB Agenda Paper 6F/FASB Memo 246)—and is relevant only to those contingent features that impact the contractual cash flows of a financial asset by more than a de minimis amount.

that if a 'punitive' interest rate is consistent with the notion of interest, it should not result in the instrument failing the solely P&I condition.

Question 1 for the boards [in Agenda Paper 6E/FASB Memo 245 – Contingent features that result in cash flows that *are* solely P&I]
Do the boards agree with the staff recommendation that the guidance on the assessment of contingent features that result in cash flows that are solely P&I should be clarified as explained above?

21. **Contingent features that result in cash flows that are *not* solely P&I** – The staff have identified three alternatives for the boards consideration that are summarised in the table below:

	Nature of contingent trigger event	**Probability of occurrence**	**Classification outcome**
Alternative A	Not relevant	Not relevant (except for non-genuine features)	*All* contingencies that result in non-P&I cash flows 'fail' unless non-genuine
Alternative B	Not relevant	Relevant. Need to reassess (for **all** non-P&I contingent cash flows).	*All* **remote** contingencies that result in non-P&I cash flows 'pass.' All contingencies that are more likely than remote 'fail'. That is, lower the non-genuine threshold for all non-P&I contingent cash flows.

Alternative C	Relevant	Relevant. Need to reassess (for **specific** contingent cash flows).	Non-P&I contingent cash flows triggered by **specific** events (ie a failure to meet specified regulatory capital requirements that results in the cancellation of debt or its conversion into equity instruments – the so-called bail-in instruments – 'pass' if **remote**. All other contingencies that result in non-P&I cash flows 'fail' (unless non-genuine).

22. Alternatives B and C would require reclassification of the financial asset into the fair value through profit or loss (FVPL) category if the occurrence of the non-P&I cash flows becomes more likely than remote. However reclassifications out of the FVPL category would be prohibited.

23. Some staff members support Alternative A and others support Alternative B. No staff support Alternative C.

24. The staff members that support Alternative A believe that classifying financial assets at amortised cost by lowering the probability threshold to remote for some or all contingent features would not provide useful information. They believe that the other clarifications made to the solely P&I condition are sufficient. These staff members continue to believe that measuring financial assets at other than FVPL when those assets have contingent non-P&I cash flows that have a remote probability of occurring would be inconsistent with the boards' objective that only

simple financial assets should be measured at other than FVPL. In addition these staff members believe that lowering a probability threshold from non-genuine to remote would create the need for continuous reassessment and reclassifications and thus would increase complexity and impair comparability. Those staff members also note that users are generally not supportive of reclassifications.

25. Staff members that support Alternative B do so because they believe as long as the probability is remote that a contingent feature will occur, such a feature should not determine the classification of the entire financial asset. These staff members believe that if the probability of the occurrence of non-P&I cash flows is remote, there is an expectation of "simple" interest and principal cash flows. These staff members acknowledge that requiring reclassifications might add complexity to the proposed guidance. These staff members believe that not lowering the probability threshold to remote could lead to situations where a remote but genuine feature (which has a de minimis fair value on a standalone basis but could impact cash flows by more than a de minimis amount if the trigger event occurs) causes the entire financial asset to fail the solely P&I condition, resulting in the entire asset being measured at FVPL.

Question 2 for the boards [in Agenda Paper 6E/FASB Memo 245 – Contingent features that result in cash flows that are *not* solely P&I]
Which alternative do the boards prefer for contingent features that result in cash flows that are not solely P&I?

Question 3 for the boards [in Agenda Paper 6E/FASB Memo 245 – Contingent features that result in cash flows that are *not* solely P&I]

If the boards prefer Alternative B or C, do the boards agree with the staff recommendation that the probability threshold should be set at remote?

Do the boards agree with the staff recommendation that reclassifications into FVPL should be required under alternative B and C if the contingent non-P&I cash flows become more likely than that probability threshold however reclassifications out of FVPL should not be permitted?

Question 4 for the boards [in Agenda Paper 6E/FASB Memo 245 – Contingent features that result in cash flows that are *not* solely P&I]

If the boards prefer Alternative C, do the boards agree that Alternative C should only capture the so called bail in financial assets?

Agenda Paper 6G/FASB Memo 246 *Contractual Cash Flows Characteristics: Prepayment Features*

26. The paper discusses:

(a) prepayment features that result in cash flows that *are* solely P&I, and

(b) prepayment features that result in cash flows that are *not* solely P&I.

27. While the paper discusses alternatives in the context of the guidance for prepayment features specifically, consideration of the nature of any contingent trigger event and the probability of the non-P&I cash flows occurring are equally relevant to assessment of extension features. Accordingly, where the proposed approaches and clarifications for prepayment features also apply to extension features the paper acknowledges this fact.

28. Consistent with the analysis provided in IASB Agenda Paper 6E / FASB Memo 245 on contingent features, the staff believe that there is an important interaction

between the nature of the contingent trigger event and the cash flows on the financial asset – and that interaction needs to be considered in assessing a contingent prepayment feature.

29. The staff recommend that the application guidance on contingent prepayment features should be clarified accordingly. The staff note that this clarification will result in a consistent approach to the assessment of contingent trigger events for prepayment features and other contingent features.

Question 1 for the boards [in Agenda Paper 6F/FASB Memo 246 – Prepayment features that result in cash flows that *are* solely P&I]
Do the boards agree with the staff recommendation that the guidance on the assessment of prepayment (and extension) features that result in cash flows that are solely P&I should be clarified as explained above?

30. **Prepayment features that result in cash flows that are not solely P&I** – The staff have identified the following alternatives for the boards' consideration:

(a) **Alternative A** – If the contractual cash flows that result from the prepayment feature are not solely P&I, the financial asset does not meet the solely P&I condition and will be classified at FVPL. Under this alternative, the probability of the occurrence of contractual cash flows that are not solely P&I does not matter, unless the prepayment feature is non-genuine. This alternative is consistent with Alternative A in the non-P&I cash flows section of IASB Agenda Paper 6E / FASB Memo 245. This alternative is also consistent with the current guidance in the FASB's proposed ASU and with IFRS 9.

(b) **Alternative B** – The holder would be required to consider the probability of occurrence of contractual cash flows that are not solely P&I in assessing a financial asset with a prepayment feature. This would apply to **all** prepayment features that could result in non-P&I

cash flows **regardless of the prepayment amount**. Essentially under this alternative the current "non-genuine" probability threshold in IFRS 9 and the FASB's proposed ASU would be replaced with the lower threshold of "**remote**". If the occurrence of non-P&I cash flows becomes more likely than remote, the asset will be required to be reclassified into the FVPL category (however, to reduce complexity reclassifications out of the FVPL category would be prohibited). This alternative is consistent with Alternative B in the non-P&I cash flows section of IASB Agenda Paper 6E / FASB Memo 245.

(c) **Alternative C** – Under this alternative, the guidance in IFRS 9 and the FASB's proposed ASU would be amended to require financial assets that are prepayable at the contractually stated par amount plus accrued and unpaid interest to be classified at amortised cost, *provided* that the fair value of the prepayment feature on initial recognition (by the current holder) is insignificant. All other prepayment features will continue to be treated in accordance with the existing guidance in IFRS 9 and the FASB's proposed ASU. This alternative is similar to Alternative C in the non-P&I cash flows section of IASB Agenda Paper 6E / FASB Memo 245, in that it also applies to only particular types of non-P&I cash flows. This alternative implicitly relies on the probability of occurrence of the non-P&I cash flows because it considers the fair value of the prepayment feature at initial recognition.

31. Some staff support Alternative B and some staff support Alternative C.

32. Staff members that support Alternative B believe that as long as the probability of exercise of a non-P&I prepayment feature is remote, such a feature should not determine the classification of the entire instrument. If the probability of exercise is remote, there is an expectation that the cash flows will be "simple" and consistent with the notion of principal and interest, in which case amortised cost will provide relevant and useful information to financial statement users about the expected cash flows of the financial instrument. These staff members believe that

not lowering the probability threshold to remote could lead to situations where a remote but genuine feature (which has a de minimis fair value on a standalone basis but could impact cash flows by more than a de minimis amount if the trigger event occurs) causes the entire financial asset to fail the solely P&I condition, resulting in the entire asset being measured at FVPL.

33. Other staff members support Alternative C. These staff members generally believe that measuring financial assets at other than FVPL when such assets have non-P&I cash flows that have a genuine probability of occurring would be inconsistent with the boards' objective that only simple financial assets should be measured at other than FVPL. In addition to general concerns about measuring financial assets with genuine non-P&I cash flows at amortised cost, these staff members also question the practical feasibility of assessing on an individual financial asset level the probability that a prepayment will be exercised. These staff members note that in practice the probability of prepayment is usually assessed on a more aggregated (eg portfolio) level. These staff members are also concerned about increased complexity and decreased comparability due to reclassifications.

34. However, these staff members are sympathetic to measuring at amortised cost those financial assets that otherwise meet the solely P&I condition and are prepayable at par. They believe that typically for these assets the probability that the non-P&I prepayment will occur is low (although genuine); notably purchased credit impaired financial assets. These staff members also believe that catch up adjustments required by amortised cost measure will provide information about changing expectations about the likelihood of prepayments.

Question 2 for the boards [in Agenda Paper 6F/FASB Memo 246 – Prepayment features that result in cash flows that are *not* solely P&I]
For prepayment features that result in cash flows that are **not** solely P&I, do the board members prefer Alternative A, B, or C?

Question 3 for the boards [in Agenda Paper 6F/FASB Memo 246 – Prepayment features that result in cash flows that are *not* solely P&I]

If the board members prefer Alternative B:

1. Do the board members agree with the staff recommendation that the probability threshold for the non-P&I prepayment occurring should be established as "remote"?
2. Do the board members agree with the staff recommendation that reclassification into the FVPL category should be required if the probability of the non-P&I prepayment occurring becomes more likely than remote however reclassifications out of the FVPL category should not be allowed?