STAFF PAPER

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Project	**Financial Instruments: Classification and Measurement**		
Paper topic	Contractual Cash Flow Characteristics: The Meaning of 'Interest'		
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Purpose and structure of the paper

1. This paper is the third in a 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. The objective of this paper is to clarify the meaning of 'interest' in the context of the solely P&I condition.

3. This paper:

   (a) Provides relevant background information that includes:

      (i) A summary of—and staff observations on—the current articulation of 'interest' in IFRS 9 and the FASB's proposed ASU, and

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(ii) A brief overview of the relevant feedback received on the IASB's exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) ('the Limited Amendments ED') and the FASB's proposed ASU;

(b) Discusses clarifications to 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),

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

(iii) The meaning of 'time value of money'; and

(c) Provides staff recommendations and questions for the boards on the three topics above.

Background

Current language in IFRS 9 and the boards' proposals

4. Paragraph 4.1.3 of IFRS 9 and paragraph 825-10-25-18 of the FASB's proposed ASU describe interest as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. Under both the FASB's proposed ASU and IFRS 9 (paragraph BC4.22), this may include a premium for liquidity risk. This language reflected the boards' conclusion that consideration for the time value of money and credit risk are typically the primary components of interest in a simple lending-type relationship.

5. Paragraph B4.1.8A of the proposed Limited Amendments to IFRS 9 and paragraph 825-10-55-16 of the FASB's proposed ASU re-enforce the meaning of interest by clarifying that:

> If the contractual cash flows include payments that are unrelated to principal, the time value of money and the credit risk, the contractual cash flows do not represent solely payments of principal and interest.

6. IFRS 9, the Limited Amendments ED and the FASB's proposed ASU do not define time value of money, credit risk or liquidity risk for the purposes of applying the solely P&I condition. However, those documents contain several examples that illustrate the application of that condition.

7. Specifically, paragraph B4.1.13 in IFRS 9 contains an example of a financial asset with an interest rate tenor mismatch (that is, the variable interest rate on the financial asset is reset every month to a three-month interest rate or the variable interest rate is reset to always reflect the original maturity of the asset). That example (Instrument B) concluded that such an instrument would not meet the solely P&I condition because the interest rate does not represent consideration for the time value of money for the tenor of the instrument (or the reset period).

8. Since the issuance of IFRS 9, many interested parties raised application questions and concerns related to that example. Those questions related to the application of the P&I condition to various instruments where the consideration for the time value of money is not 'perfect' (eg due to an interest rate mismatch feature, the use of average or lagging interest rates or a combination thereof).

9. Generally, many IASB stakeholders expressed concerns that the application guidance in IFRS 9 could lead to unduly narrow interpretations of the solely P&I condition. As a result, they noted that some financial assets that they considered 'plain vanilla' would not meet the solely P&I condition and thus would be required to be measured at fair value through profit or loss (FVPL).

10. The boards acknowledged those concerns. Accordingly, the Limited Amendments ED and the FASB's proposed ASU introduced the notion of a modified economic relationship between principal, time value of money and credit risk ('the modified economic relationship')—and the Limited Amendments ED proposed corresponding clarifications to Instrument B in paragraph B4.1.13 of

IFRS 9. Specifically, the boards proposed that if the economic relationship between these components is modified by leverage or an interest rate mismatch feature, that does not automatically result in a financial asset failing the solely P&I condition. Rather, an entity would be required to assess the effect of the modified economic relationship on the asset's contractual cash flows relative to a benchmark instrument in order to conclude whether the asset meets the solely P&I condition. The boards proposed that if the effect of such a modification could not be more than insignificant, the financial asset would meet the solely P&I condition. The boards' proposals provided additional guidance on how the assessment of a modified economic relationship should be performed and what a benchmark instrument is. The basic idea underlying the proposals was to clarify that the economic relationship between principal, time value of money and credit risk does not need to be perfect. However, only relatively minor modifications of that relationship would result in an instrument having payments that are solely P&I.

Feedback received

11. Many respondents to the Limited Amendments ED and the FASB's proposed ASU raised questions and concerns about the meaning of interest and the proposed assessment of a modified economic relationship.

The meaning of interest

12. Many respondents, notably those in the United States, raised questions and concerns about the assessment of **de minimis features** (ie those features that in all scenarios could only impact the cash flows on a financial asset by a de minimis amount) and the impact of such features on the classification of financial assets.

13. Many IASB respondents raised questions about whether consideration for **liquidity risk** is an acceptable component of interest for the purposes of the solely P&I condition. They asked the IASB to consider expanding the description of

interest to include consideration for liquidity risk rather than acknowledging that component only in the Basis for Conclusions.

14. Many respondents asked whether **other components**—such as profit margin, compensation for servicing costs or consideration for the entity's funding costs—are consistent with the solely P&I condition. Specifically:
    (a) From the FASB perspective, the notion of 'solely' principal and interest caused concern. Many FASB stakeholders interpreted that language as being unduly restrictive.
    (b) From the IASB perspective, some respondents were concerned that the new proposed language in paragraph B4.1.8A narrowed the meaning of interest in IFRS 9. That paragraph (reproduced in paragraph 5 of this paper) clarified that contractual payments unrelated to principal, time value of money and credit risk are inconsistent with the solely P&I condition. Finally, some IASB respondents pointed to the Insurance Contracts project and asked the IASB to consider defining interest in IFRS 9 consistently with that project.

15. A number of respondents raised questions about whether consideration for the time value of money and credit risk must be 'appropriate' and provided the following examples in which the interest rate might be considered 'inappropriate':
    (a) Many respondents, notably in the United States, raised questions about the impact of so-called '**punitive rates**'. Those respondents provided various examples of financial assets where the interest rate increases significantly upon the occurrence of an uncertain specific event (for example, a missed payment on a credit card). They noted that the magnitude of the increase in the interest rate might not seem to be commensurate with the change in the conditions (eg the increase in the interest rate upon a missed payment is not commensurate with the increase in expected credit losses on the instrument). These questions were common in the United States, which was likely due to an example

in paragraph 825-10-55-25 of the FASB's proposed ASU. That example described a financial asset with a 'punitive' interest rate introduced in case of a failure to execute an IPO and noted that such an asset would fail the solely P&I condition under the FASB's proposed ASU.

(b) Some IASB respondents raised questions about whether interest-free financial assets or financial assets with **off-market interest rates** could meet the solely P&I condition. In addition, some IASB respondents asked the IASB to clarify whether financial assets with negative yields could be consistent with the solely P&I condition. The latter question arose as a result of the IFRS Interpretations Committee's recent discussions about the *presentation* of a negative yield (ie whether such amounts could be presented as 'interest revenue' or 'interest expense' in the financial statements).

Assessment of a modified economic relationship

16. Even though nearly all IASB respondents welcomed the objective of clarifying the application of the solely P&I condition and noted that classification outcomes would improve relative to IFRS 9, many believed that the proposals have not fully achieved their objective. Many IASB and FASB respondents stated that the notion of a modified economic relationship still implies a narrow and strict interpretation of the time value of money and thus would still result in many common financial assets, that those respondents considered to be plain vanilla, not meeting the solely P&I condition. Many IASB and FASB respondents also raised questions and concerns about both the objective and the application of the modified economic relationship assessment to particular instruments and features. In addition, they requested clarifications about the meaning of time value of money more broadly. Finally, many IASB and FASB respondents expressed concerns about the scope of the modified economic relationship assessment (ie

why it explicitly refers only to interest rate mismatch features and leverage), the threshold used in the assessment ('not more than insignificant') or both.

17. In particular, respondents raised questions about the application of the assessment to financial assets with the following features:

    (a) Average reference interest rates for a specified period (eg 3-month Euribor rate determined as an average of 3-month rates during the previous 1 month);

    (b) Lagging reference interest rates (ie interest rates that are fixed before the start of the interest period, eg 6-month Euribor rate set for a 6 month period, but where the rate is fixed 2 months before the start of the interest period);

    (c) Interest rates indexed to a reference rate that does not have a specified tenor (eg the US prime rate);

    (d) Interest rate tenor mismatches, including:

        (i) An interest rate that is reset to a reference interest rate but the frequency of reset does not match the tenor of the reference rate (eg an interest rate on a retail mortgage is reset annually based on three-month Euribor or residential mortgages in the US that commonly reset to a rate with a tenor that does not reflect the frequency of the reset); and

        (ii) Internal pricing that considers the bank's funding costs where the maturity of the reference funding is different from the frequency of the reset for the financial assets (eg a loan's annual interest rate is derived on the basis of the bank's blended funding costs where the funds comprise instruments with multiple long and short durations);

    (e) A combination of lagging, averaging and mismatch elements (eg an interest rate is reset monthly based on average 12-month Euribor for every working day in the month preceding the reset);

(f) Regulated interest rates that involve interest rate tenor mismatch features, notably:

(i) Loans in China where the rate if reset is reset according to the original maturity of the loan rather than according to the remaining maturity or the period until the next reset date (for example, where the interest rate is reset to a 3-year rate because the instrument has an original maturity of 3 years); and

(ii) 'Livret A' receivables where the interest rate is set semi-annually based on a formula referencing EONIA[1], three-month LIBOR and inflation and where that rate can be further adjusted by the government within specified limits.

18. Finally, some respondents believed that the modified economic relationship assessment is operationally complex or/and the relevant application guidance is unclear or insufficient.

De minimis features

19. This section discusses contractual provisions that could impact a financial asset's contractual cash flows by only a de minimis amount (ie in **all scenarios**, the impact is de minimis).

20. It is important to note that if a feature could have more than a de minimis impact on *a period's* cash flows, it would not be considered de minimis even if its *cumulative* impact on the asset's cash over its life were de minimis. That would be the case even if the feature could lead to a significant increase in cash flows in one period and a significant decrease in another period and these amounts offset

[1] Eonia (Euro OverNight Index Average) is an effective overnight interest rate computed as a weighted average of all overnight unsecured lending transactions in the interbank market. It has been initiated within the euro area by the contributing panel banks. It is one of the two benchmarks for the money and capital markets in the euro zone (the other one being Euribor). The banks contributing to Eonia are the same as the Panel Banks quoting for Euribor.

each other on a cumulative basis. Likewise, if the feature's impact on a period's cash flows is always de minimis but its cumulative effect over time could be more than de minimis such a feature would not be considered de minimis. For such instruments the nature of the variability determines whether amortised cost would provide useful information by allocating cash flows over time.

21. Consider the following example. A financial asset contains a contractual provision that requires the issuer to comply with applicable regulatory requirements, including filing its financial statements with a regulatory body on a timely basis. If the issuer fails to do so, it is required to pay a fixed fee for each day until the financial statements are filed. The amount of such a daily fee is de minimis. The **maximum amount** of the fee that the issuer could be required to pay until the repayment feature is triggered is also de minimis.

22. As discussed in IASB Agenda Paper 6B / FASB Memo 242 for this month's meeting, the solely P&I condition focuses on a financial asset's contractual cash flows and whether amortised cost could provide useful information by allocating those cash flows over time. Accordingly, 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.

23. Therefore in the example discussed above, the existence of a fee that could be triggered if the issuer fails to file its financial statements on time is not inconsistent with the solely P&I condition because its impact on the asset's contractual cash flows is always de minimis. That analysis would apply to any feature regardless of its nature or trigger as long as its impact on the asset's contractual cash flows is always de minimis. Consistent with the analysis above, the staff believe that the boards should clarify that a contractual feature that could impact the financial asset's cash flows in each period and cumulatively by only a

de minimis amount is not inconsistent with the solely P&I condition and thus does not preclude the financial asset from being classified as other than at FVPL.

24. Finally, the staff do not believe that the boards should quantify de minimis or require that an entity performs a quantitative analysis of such features. Rather its application would require judgment. The staff believe that an entity should be able to conclude without a detailed quantitative analysis whether a feature is de minimis. If an entity is not able to conclude without a quantitative analysis that a feature is de minimis, the staff believe that in itself indicates that the feature is not de minimis.

Question 1 for the boards
Do the boards agree with the staff recommendation in paragraph 24 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?

Components of interest

25. The staff do not believe that the boards intended the notion of interest to be interpreted as narrowly as some constituents have suggested. The staff think that some of the confusion relates to the interpretation of the word 'solely' in the solely P&I condition. In the staff view, that language was intended to emphasise that payments on a financial asset cannot include any components other than what represents (a) payment of principal and (b) payment of interest on the principal amount outstanding. However, the word 'solely' was not intended to require that interest cannot include any components other than consideration for the time value of money and credit risk. Rather, the description of interest in the solely P&I condition was intended to capture financial assets with a basic lending type return —and consideration for the time value of money and credit risk are typically the most significant components of such a return. As discussed in IASB Agenda Paper 6B / FASB Memo 242, such a basic lending type return is the

underlying rationale for the solely P&I condition and the necessary characteristic of a financial asset in order for amortised cost to provide complete and useful information. Accordingly, this section discusses the components of interest and the notion of the 'appropriateness' of the consideration for the purposes of applying the solely P&I condition and how the notion of interest could be clarified.

26. **Liquidity risk** – The FASB's proposed ASU and IFRS 9's Basis for Conclusions acknowledge that consideration for liquidity risk is consistent with the solely P&I condition. The staff is sympathetic to the concern expressed by the IASB's stakeholders that the Basis for Conclusions is a not a part of the standard (and thus is not authoritative). Therefore we believe that the IASB should consider acknowledging in the application guidance in IFRS 9 that interest could include consideration for liquidity risk for the purposes of the application of the solely P&I condition. The staff note that constituents would find such a clarification helpful and it would result in greater alignment of the application guidance in IFRS 9 and the FASB's final standard (assuming the FASB decides to carry forward that wording).

27. **Components of interest rate** – As noted in paragraph 25, the staff do not believe that the boards intended that any component of interest other than the consideration for the time value of money and the credit risk would be considered inconsistent with the solely P&I condition. Specifically, the staff do not believe that the boards intended a financial asset with an interest rate that includes a profit margin or consideration for the servicing costs of the financial asset to be classified at FVPL. If that were the case, almost all financial assets would indeed fail the solely P&I condition and classified at FVPL. The staff do not think that was the boards' intention.

28. Rather, as stated in the Basis for Conclusions in the proposed Limited Amendments to IFRS 9 and the FASB's proposed ASU (paragraphs BC37 and BC109, respectively), the solely P&I condition is intended to capture financial assets with simple cash flows that provide basic lending-type returns to the holder

That is because amortised cost provides useful information about the likely cash flows of those assets by allocating the return over time. Accordingly, the staff believe that the boards intended to simply identify the most significant components that are typically included in a basic lending-type return. The staff believe that the boards should consider clarifying the guidance accordingly.

29. **'Appropriate' consideration** – The staff believe that the boards did not intend to challenge how entities price financial assets. In other words, the staff believe that the notion of the 'appropriate' consideration for the time value of money and the credit risk is not intended to scrutinise entities' pricing approaches. That is, the solely P&I condition is not intended to require that a financial asset is measured at fair value through profit or loss if it has a stated interest rate that is above or below market but otherwise plain vanilla. Indeed, as discussed in the IASB Agenda Paper(s) 6B/FASB Memo(s) 242 for this month's meeting, amortised cost can provide useful information about such assets by allocating payments over time. Besides, the initial measurement requirements would ensure that the effective return recognised on such financial assets over time for accounting purposes would be 'appropriate', ie at market terms considering the conditions on origination or purchase.

30. The staff believe that the notion of the appropriate consideration is meant to capture *what* entities price for rather than *how* entities prices for those elements. In other words, it means that the consideration does not include elements inconsistent with the basic lending type return (except when such features are de minimis). Specifically, to be appropriate, consideration for the time value of money must be *just* for the passage of time. The staff note that entities might price their assets differently for the passage of time (the meaning of time value of money is discussed in greater detail in the next section of this paper). Likewise, the appropriate consideration for the credit risk means pricing for *just* credit risk. Even if the interest rate could be described by some as 'punitive' in the sense that the terms of the asset require a significant increase in the interest rate upon a credit event and such feature is intended, in part, to discourage a specific

behaviour (such as missing payments on a credit card), the increased rate could still be commensurate with the consideration for credit risk of the instrument if such behaviour occurs.

Staff recommendation

31. The staff believe that the boards should consider clarifying the application guidance on the meaning of interest, including clarifying the illustrative example of a punitive rate in the FASB's proposed ASU (punitive rates are further discussed in IASB Agenda Paper 6F / FASB Memo 243).

32. The question becomes *how* the boards could clarify the notion of interest to address the feedback from respondents. The staff do not believe that the boards could provide an exhaustive list of possible elements of interest that are consistent with the solely P&I condition. This is because:

    (a) Such an approach would be inconsistent with a principle-based standard and likely would not constitute a simplification compared to the current bifurcation requirements.

    (b) A rule-based, rather than a principle-based, approach could be open to structuring.

    (c) The staff do believe that it is not feasible to identify and list every possible component of interest that could be consistent with the solely P&I condition and would be appropriately reflected by amortised cost—especially because we think the boards would want the guidance to be 'future proof' (that is, stand the test of time) rather than reflecting only the current environment. Therefore the staff think such a list inevitably would be incomplete and would lead to further questions.

33. The staff believe the boards should consider clarifying the principle—and the underlying conceptual rationale— for the meaning of interest. The staff note that the starting point in the IASB deliberations to replace IAS 39 was to identify and measure at amortised cost only those financial assets with 'basic loan features.'

Indeed this is consistent with the FASB's objective to develop a model under which only 'simple' debt instruments would qualify for a measurement category other than FVPL. In other words, both boards intended to identify financial assets with simple cash flows that represent a basic lending-type return for which amortised cost would be able to provide useful information by allocating those cash flows over time.

34. In such a basic lending type relationship, this term being used broadly to capture both originated and acquired financial assets, the lender or the holder is looking to earn a return that compensates him for the passage of time and for credit risk—and that return could also include other elements that provide consideration for other risks or costs associated with the lending relationship or/and provide a profit margin on top of that consideration.

35. In contrast, elements that introduce exposure to risks unrelated to a simple lending relationship (for example, exposure to movements in equity prices) —and thus could create variability in cash flows for which amortised cost cannot provide useful information by allocating the return over time—are inconsistent with the solely P&I condition.

36. Accordingly, the staff recommend that the boards:

    (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,

    (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).

37. 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
Do the boards agree with the staff recommendation to clarify the application guidance on the meaning of interest as discussed in paragraphs 36-37?

The meaning of time value of money

38. As discussed in paragraph 10 of this paper, in the recent exposure drafts the boards proposed to introduce the notion of a modified economic relationship. The basic idea behind these proposals was to clarify that the consideration for the time value of money does not need to be perfect, however only relatively minor modifications would result in an instrument having payments that are solely P&I.

39. As discussed in paragraphs 13-15, respondents continued to raise questions about the application of the notion of time value of money and asked the boards for further guidance. In addition, respondents raised questions the application of the modified economic relationship assessment to particular instruments and features.

40. In light of the feedback received on the proposals, the staff believe that the boards should consider clarifying the meaning of time value of money and, as a result, the need for the assessment of a modified economic relationship. If the assessment is retained, the boards would need to consider clarifying the objective and the scope of that assessment as well as the appropriate threshold to be used in the assessment.

General approach to clarifying the meaning of time value of money

41. Generally, time value of money is the element of the return on a financial instrument that provides consideration for *just* the passage of time, absent a return

for risks (such as credit and liquidity risk) and costs associated with the financial instrument. In traditional economic theory, the time value of money would be reflected by a risk-free rate, which used to be associated with sovereign securities. However, arguably, in the current economic environment there are no instruments that could be considered truly risk-*free*. Rather, there are instruments that could be considered *least*-risk instruments. Even if risk-free instruments existed, the staff do not believe that the notion of time value of money should be limited to *just* a risk-free rate. That would result in a very narrow interpretation of time value of money and would not reflect the different pricing practices and mechanisms that are currently used to determine time value of money.

42. The staff note that IFRS 9 and the FASB's proposed ASU do not require interest to represent a risk-free rate plus a mark-up for credit risk. Rather, the solely P&I condition relies on the notion of *consideration* for the time value of money and credit risk. Arguably, the consideration for the time value of money that is required by different lenders or even by the same lender from the same borrower for the same product (eg a mortgage loan) could be different and influenced by a variety of factors such as the lender's funding costs, the particular jurisdiction and currency in which the transaction occurs, customer preferences and supply and demand considerations. For example, in the United Kingdom a bank could offer a mortgage to its customer with a choice of a fixed rate, the bank's variable published rate or a tracker rate. Arguably, if these rates were decomposed into components, the component representing the consideration for the time value would be similar but not necessarily identical.

43. Accordingly, the staff do not believe that time value of money should be defined by reference to a risk-free rate. Likewise, as discussed above, the staff do not believe that there is a single appropriate way to determine the appropriate consideration for the time value of money for a particular instrument.

44. Instead, the staff believe that the boards should consider clarifying **the *objective* of the consideration for the time value of money – that is, to provide consideration <u>just for</u> the passage of time** (absent a return for the credit risk or

liquidity risk and costs associated with the financial asset) given the currency in which the instrument is denominated.

45. The staff believe that such an articulation would assist in addressing a number of the questions raised. For example, interest rates determined using a bank's reference rate, rates that are determined by averaging observed rates for a particular period and rates that are set by referencing a recent historical interest rate as well as interest rate tenor mismatch features *could* be considered to only provide consideration for the passage of time for a particular currency. This would not remove the need for judgment – for example, a rate that is established today by referencing an interest rate set last week (ie a slightly lagging rate) is not the same as referencing a rate set 5 years ago – but the staff believe that having such a principle-based approach should assist in articulating the concept. At the same time, this approach would screen out structured financial instruments where the relevant objective is *not* to provide consideration for just the passage of time and result in classifying those instruments at FVPL.

46. The staff note that this approach would be consistent with the approach adopted in the IASB's recent Exposure Draft *Insurance Contracts* and the FASB's recent proposed ASU—*Insurance Contracts (Topic 834)*. Those Exposure Drafts require that the *objective* of the discount rate for insurance contracts liabilities is to adjust the future cash flows for the time value of money but does not define time value of money or prescribe a specific rate to be used. To assist in application of those requirements, that Exposure Draft provides guidance on how the discount rate should be determined, including that it must be consistent with observable current market prices for instruments with similar characteristics including timing of cash flows, currency and liquidity.

Consideration just for the passage of time

47. In making the assessment of whether the interest rate provides consideration just for the passage of time, the entity must consider the currency in which the

financial asset is denominated as appropriate interest rates vary by currency. In addition, as a general proposition, there must be **a link between the interest rate and the period for which the interest rate is set** because the appropriate rates for an instrument in the same currency (absent any other considerations) vary depending on the term for which the rate is set. In other words, as a general proposition, the interest rate must be consistent with the tenor of the instrument (or the reset period).

48. However, the staff believes that an interest rate could provide consideration for the passage of time even if the rate contains a mismatch feature; ie such a rate is not necessarily *always* inconsistent with the solely P&I condition and the objective of providing consideration for just the passage of time. In other words, the staff believe that an interest rate mismatch feature does not necessarily always lead to inappropriate consideration for just the passage of time or expose the holder to volatility in contractual cash flows for which amortised cost would not provide useful information. Such a feature may be *a way* to determine a 'blended' interest rate akin to computing an average interest rate, which the staff believe could provide appropriate consideration for the time value of money. For example, an entity may be using a longer-term interest rate in a formula that computes an interest rate that is reset at shorter intervals with the objective to stabilise the consideration for the time value of money and to eliminate excess fluctuations in short-term interest rates.

49. The question arises whether consideration should be given to what is normal in the particular market in which the transaction occurs. The staff believe that **as a general proposition, the market is relevant** – for example, in Europe it is common to reference interest rates to LIBOR and in the United States it is common to reference interest rates to the prime rate. Besides, the passage of time has a link to the funding costs of the lender, which in its turn provides another link to the market. However, just because something is 'normal' in the market, that should not necessarily be accepted as the consideration just for the passage of time. For example, if the interest rate on the financial asset is reset every year but

the reference rate is always a 15-year rate, it would be hard to conclude that such a rate provides consideration for just the passage of time even if such a pricing practice is commonly used in a particular market. Accordingly, an entity will need to apply judgement in concluding whether the stated time value component of the interest rate indeed meets the objective of providing compensation for just the passage of time.

Qualitative and quantitative assessment

50. There are two ways in which an entity could satisfy itself that the time value components of the interest rate meets the objective of providing consideration just for the passage of time. Using:
    (a) qualitative assessment or
    (b) quantitative assessment.

51. The staff do not believe that the boards should prescribe when each method should be used. The staff believe that in many cases, even when the interest rate contains a tenor mismatch feature, entities would be able to conclude without a quantitative analysis whether the interest rate is consistent with providing consideration just for the passage of time. The indicators that could inform the qualitative assessment could include (but are not limited to) the following:
    (a) consistency of the time value component of the interest rate with the observable market prices for the relevant duration and currency – regardless of how the component has been derived (ie whether the resulting consideration for the time value of money is on market terms),
    (b) the type and degree of the 'deviation' of the time value component of the interest rate from what would be considered the most appropriate current rate (eg an interest rate that is reset on a short-term basis by reference to an average of both short-term and longer-term rates would be more appropriate than an interest rate that is reset on a short-term basis by reference to an average of just long-term rates),

(c) whether the feature has meaningful fair value (ie whether the feature results in the premium or discount to contractually stated notional amount – if it does, that would indicate consideration for other risks than just the passage of time).

52. In making the qualitative assessment an entity will need to apply judgement in light of the underlying conceptual rationale for the solely P&I condition – that is, whether amortised cost would provide useful information by allocating cash flows over time.

53. If an entity cannot come to a definite conclusion based just on a qualitative assessment, an entity can perform a quantitative assessment to satisfy itself that the time value of money component of the interest rate provides consideration just for the passage of time. Such a quantitative assessment could establish that while the consideration for the time value of money is not perfect, it is modified to a relatively minor degree—and therefore the financial asset still meets the solely P&I condition and amortised cost would still provide useful information by allocating the contractual cash flows over time.

54. The objective of such a quantitative assessment is to establish how different the contractual (undiscounted) cash flows could be 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). Consistent with the analysis in the IASB Agenda Paper 6B / FASB Memo 242, the assessment focuses on the cash flows because it is the source and the degree of variability in cash flows that determines whether amortised cost would provide useful information by allocating the return over time.

55. If the boards were to retain a quantitative assessment of the time value of money (eg in cases where the qualitative assessment is not conclusive), they would need to establish the threshold for an acceptable difference. Considering the feedback received on the assessment of a modified economic relationship, the staff believe

that the boards should consider whether it is appropriate to be less restrictive than the 'not more than insignificant' threshold, which was proposed in their recent exposure drafts.

56. The staff are sympathetic to the argument that the 'not more than insignificant' threshold could still screen out financial assets in which the time value component of the interest rate provides consideration for just the passage of time. In other words, the staff agree with the respondents that the cash flows on a financial asset could be *more than insignificantly* different from what would be considered the appropriate benchmark but still meet that objective. However, in the staff's view, that would no longer be the case if contractual cash flows could be *significantly* different from the benchmark instrument. That is because, in such cases, the financial asset would not have a simple lending-type return and therefore amortised cost would not provide useful information by allocating that return over time. In other words it would be unlikely that the payments would be solely P&I.

57. The staff believe that the approach discussed in paragraphs 41-49 to assessing the time value component of the interest rate would address one of the main questions raised in response to the boards' proposals – that is, why it was necessary to prohibit an entity from measuring a financial asset at amortised cost in circumstances in which amortised cost could provide useful information about the asset's contractual cash flows.

58. The staff acknowledge that a quantitative assessment of the time value of money component of an interest rate is arguably operationally complex. However, in the staff's view, the proposed clarifications to both the meaning and objective of the time value of money would narrow the population of instruments to which the quantitative assessment would need to be applied (ie compared to the boards' recent proposals). That would alleviate many of the concerns that were raised about operational complexity.

59. In addition, to further alleviate the concerns about the operational complexity, the boards could consider permitting entities to measure the financial asset at FVPL

instead of applying the quantitative assessment in cases where the qualitative assessment is not conclusive. That was suggested by some respondents to the recent boards' proposals. The staff note that such an option would not lead to loss of information content because fair value would provide current information about future cash flows on the financial asset. However the staff note that classification options impair comparability and increase complexity. Besides, the staff believe that clarifications to the time value of money discussed in this paper already alleviate many of the operational concerns raised by respondents. Therefore on balance the staff do not recommend providing a fair value option in lieu of performing a quantitative assessment.

Regulated rates

60. The remaining question for the boards to consider is how financial assets with regulated rates should be assessed in cases where such rates contain *significant* interest rate mismatch features.

61. As noted in paragraph 49, the staff believe that as a general proposition, there must be a link between the interest rate and the period for which the interest rate is set. However sometimes regulated rates that are common in a particular market are not established this way. That would be the case for example where the objective of the 'time value' component of the interest rate is not just to provide consideration for the passage of time but *also* to achieve a specific public policy objective. For example, such government regulation of interest rates may be part of a broad government macroeconomic policy or it may be introduced to encourage investment in a particular sphere of the economy.

62. The staff note that even though strictly speaking the time value component of such regulated rates may not necessarily provide consideration for *just* the passage of time, at the same time they do not typically introduce exposure to risks or volatility in cash flows that are inconsistent with the basic lending-type relationship and for which amortised cost would not provide useful information

by allocating cash flows over time. Accordingly, the staff think that as long as such regulated rates provide consideration that is broadly consistent with the passage of time, that arguably could be *accepted as a proxy* for the consideration for the time value of money for the purposes of the application of the solely P&I condition. as long as the regulation of the interest rate does not introduce exposure to risks or volatility in cash flows that are inconsistent with the basic lending type relationship and for which amortised cost would not provide useful information The proposed approach for regulated rates is broader than for interest rates that are established freely by market participants. However, regulated rates are imposed for public policy reasons and are not subject to structuring. Therefore,therefore on balance, the staff believeare comfortable with such ana broader approach is supportable.

Staff recommendation

63. To summarise, 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, the contractual (undiscounted) cash flows could not 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 provide consideration that is broadly consistent with consideration for the passage of time and do not introduce exposure to risks or volatility in cash flows that are inconsistent with the basic lending-type relationship and for which amortised cost would not provide useful information by allocating cash flows over time.

Question 3 for the boards

Do the boards agree with the staff recommendation to clarify the meaning of the time value of money as discussed in paragraph 63?