

Meeting documentation

World Standard-setters Meeting

Smaller group discussions:
Financial instruments: classification and
measurement, impairment and macro hedge
accounting



World Standard-setters Meeting

Monday 23 and Tuesday 24 September 2013

The Grange City Hotel (London)

Smaller group discussion

Financial instruments:

- Classification and measurement
- Impairment
- Macro hedging

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STAFF PAPER

16-18 September 2013

REG FASB | IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Cover paper		
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This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB Action Alert or in IASB Update.

Purpose of the paper

1. This paper provides a brief background of the boards' respective projects on the classification and measurement of financial instruments and an overview of the joint redeliberations. As these redeliberations progress, this paper is updated to track progress and update the plan.
2. This paper is for informational purposes only and there are no questions for the boards.

Background

3. To increase international comparability in the accounting for financial instruments, the boards decided in January 2012 to jointly deliberate selected aspects of their classification and measurement models. With the objective of reducing key differences, the boards jointly discussed the following topics:
 - (a) the *contractual cash flow characteristics* of financial assets, including the need for bifurcation of financial assets and if pursued, the basis for bifurcation;

- (b) the basis for and the scope of a possible *fair value through other comprehensive income (FVOCI) measurement category* for financial assets; and
 - (c) interrelated issues from the topics above (for example, disclosures and the model for financial liabilities).
4. The boards' joint deliberations resulted in the publication of the IASB's exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) ('Limited Amendments ED') 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').
 5. In May 2013, the staff presented to the boards the summary of the feedback received on the Limited Amendments ED. In June 2013, the staff presented to the boards an update on the IASB's user outreach activities and a summary of the outreach and comment letter feedback received on the FASB's proposed ASU. In July 2013, the staff presented to the boards the plan for joint redeliberations.
 6. The plan has been developed on the basis of the feedback received on both the Limited Amendments ED and the FASB's proposed ASU and reflects the fact that the boards had different starting points in the joint deliberations and therefore the scope of their respective proposals was different. That is, the IASB proposed *limited* amendments to the *existing* classification and measurement requirements in IFRS 9 for financial assets whereas the FASB proposed a *comprehensive new* classification and measurement model for financial instruments.
 7. Accordingly, some of the topics will be re-deliberated jointly whereas other topics will be re-deliberated separately. For example, at the July IASB-only meeting, the staff asked the IASB to consider transition requirements for the 'own credit' provisions in IFRS 9 and IFRS 9's mandatory effective date.

Joint redeliberations

Contractual cash flow characteristics assessment

8. At this meeting, the staff will ask the boards whether they would like to clarify various aspects of the solely principal and interest ('P&I') condition in IFRS 9 *Financial Instruments* and the FASB's proposed ASU.
9. There are six papers on the solely P&I condition presented for the boards' consideration:
 - (a) Agenda Paper 6A / FASB Memo 241 *Cover Paper: Contractual Cash Flow Characteristics*
 - (b) Agenda Paper 6B / FASB Memo 242 *Contractual Cash Flow Characteristics: Amortised Cost as a Measurement Basis*
 - (c) Agenda Paper 6C / FASB Memo 243 *Contractual Cash Flow Characteristics: The Meaning of 'Principal'*
 - (d) Agenda Paper 6D / FASB Memo 244 *Contractual Cash Flow Characteristics: The Meaning of 'Interest'*
 - (e) Agenda Paper 6E / FASB Memo 245 *Contractual Cash Flow Characteristics : Contingent Features*
 - (f) Agenda Paper 6F / FASB Memo 246 *Contractual Cash Flow Characteristics: Prepayment Features*
10. To assist the boards in their redeliberations, Agenda paper 6A / FASB Memo 241 introduces the series of papers, sets out the scope and the objective of the series and provides a summary of the staff recommendations and questions for the boards. Detailed analysis and conclusions on each topic are presented in the respective papers.

Business model assessment

11. At the October meeting, the staff will ask the boards to discuss the business model assessment. In particular, the staff will ask whether the boards would like to clarify:
- (a) the articulation of the business model assessment and the information that should be used to make the assessment;
 - (b) the objectives for the different business models, including whether three measurement categories should be retained; and
 - (c) the application guidance relevant to each business model within which the financial assets are managed.

Other topics

12. At a subsequent meeting, the staff will ask the boards to consider any additional interrelated issues that may arise from the joint re-deliberations. Some of these discussions may need to be joint while others may need to be separate.
13. The staff anticipate that re-deliberations on the joint topics, as well as the IASB only re-deliberations, will be substantially complete by the end of 2013. The FASB will continue to expeditiously consider the feedback received on its proposed ASU during the second half of this year.

STAFF PAPER

16 September – 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.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

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 contractual¹ 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'*

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.

IASB Agenda ref	6A
FASB Agenda ref	241

(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) Alternative A—the amount that is **contractually defined** as ‘principal’;
 - (b) Alternative B—the amount that was advanced to the debtor when the debtor **originally issued** the instrument; and
 - (c) Alternative C—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)	<i>All</i> 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).	<i>All remote</i> 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).
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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?

STAFF PAPER

16-18 September 2013

REG FASB | IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Contractual Cash Flow Characteristics: Amortised Cost as a Measurement Basis		
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Purpose and structure of the paper

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2. This paper:
 - (a) Provides 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 proposed ASU (paragraphs 5-8),
 - (b) Discusses the mechanics and information content provided by amortised cost as a measurement basis (paragraphs 9-12), and

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- (c) 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 (paragraphs 13-29).
3. 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. The focus of this paper as well as the other papers in this series is only the proposals in the recent exposure drafts that would apply the solely P&I condition to financial assets. Accordingly, the discussion in this paper supports the staff analysis and recommendations in the subsequent papers in the P&I series for this meeting.
4. This paper does not contain questions to the boards.

Feedback received

5. Some respondents to the Limited Amendments ED and the proposed ASU expressed the view that the application of the solely P&I condition would be clearer if it were linked closely to the objective of amortised cost measurement. They made some specific suggestions about when amortised cost would provide useful information¹, which includes providing information about:
- (a) ‘the effective return on a financial asset or financial liability by allocating interest revenue...over the expected life of the financial instrument’. They noted that this is consistent with the objective for amortised cost measurement articulated in the IASB's Exposure Draft *Financial Instruments: Amortised Cost and Impairment*.
- (b) the amounts, timing and uncertainty of future cash flows. Along these lines, some respondents noted their view that amortised cost provides the most useful information for financial assets that are ‘plain vanilla’,

¹ Depending on the business model assessment and other aspects of the contractual cash flow characteristics assessment.

‘normal lending’, part of the ‘banking book’, or ‘traditional, unleveraged loans and receivables’.

6. Some respondents specifically stated that clarifying the objective for amortised cost measurement would help to clarify the context of the solely P&I condition and assist in its application and thus improve classification outcomes.
7. Some respondents also raised questions about whether one or more of the following considerations are important for classifying financial assets at amortised cost:
 - (a) **‘Appropriateness’ of the asset’s return** (ie whether the return on the financial asset must be consistent with the market, and whether an entity is required to justify how it prices a financial asset in order for it to be classified at amortised cost).
 - (b) **Variability in cash flows** (ie whether variability in contractual cash flows should preclude a financial asset from being measured at amortised cost measurement and if so, why particular financial assets with variable interest rates are allowed to be so classified).
 - (c) **Variability in fair values** (ie whether susceptibility to changes in fair value should preclude a financial asset from being measured at amortised cost, and if so, why financial assets with fixed interest rates are allowed to be so classified).
 - (d) **The fair value of a particular feature** (ie whether the presence in a financial asset of particular features with a ‘meaningful’ fair value should preclude the asset from being measured at amortised cost).
8. Most respondents who requested that the boards clarify the objective for amortised cost measurement also requested various clarifications to the solely P&I condition. However they believed that any clarifications to the solely P&I condition or its application to particular instruments should be consistent with the clarified objective for amortised cost measurement.

Amortised cost as a measurement basis²

9. Amortised cost of a financial instrument is calculated using the effective interest method. This method is essentially a **spreading mechanism** that allocates interest revenue or interest expense over a relevant period, and in doing so, amortises or accretes the carrying amount recorded on initial recognition to the ultimate contractual cash flows.³ This results in the recognition *in profit or loss* over time of the **effective return** on a financial instrument as the difference between the amount recorded on initial recognition and the ultimate contractual cash flows.
10. Amortised cost is a **cost-based measure**. The carrying value of a financial asset recorded *in the statement of financial position* at any given point in time does not—nor is it intended to—provide information about the fair value of the future cash flows. This is reflected in the fact that the effective interest rate is established at initial recognition.⁴ Rather, it is a measure of the amount invested in the financial asset at any given point in time⁵ that provides a constant link between the amount recorded on initial recognition and future contractual cash flows. In doing so, the measure reflects the value of the expected⁶ contractual cash flows discounted at

² This section 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 paper. 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 this analysis.

³ The staff note that there are particular detailed differences between IFRS and US GAAP in the application of the effective interest method and the calculation of amortised cost. Those differences are outside the scope of this project; however, in the staff's view, they do not change the basic underlying concepts discussed in this paper.

⁴ Although for instruments with floating interest rates part of the interest rate linked to a benchmark rate is updated.

⁵ This amount can remain unchanged over the instrument's life if the instrument was initially recognised at par and is a bullet instrument; or it can change over the instrument's life if the instrument was initially recognised at a premium or discount or is an amortising instrument.

⁶ Here and further in this paper, the reference to expected cash flows relates to variability of the *contractual* cash flows (eg due to prepayments) rather than expectations of shortfalls in those contractual amounts (ie credit losses).

the applicable effective interest rate (EIR). Revisions to the estimates of the timing and/or amount of contractual cash flows result in adjustments to the carrying value of the financial asset (called ‘catch up’ adjustments).

11. The information content provided by the amortised cost measure is determined – and limited – by its allocation mechanics, and therefore this measurement attribute only provides useful information for particular types of instruments⁷. Therefore, in classifying a financial asset at amortised cost it is important to consider:
 - (a) Whether the allocation of the effective return can be performed from a purely mechanical viewpoint, and
 - (b) When such an allocation would provide useful information about the financial asset.
12. Accordingly, the following section discusses the implications of amortised cost allocation mechanics for the determination of:
 - (a) what considerations are relevant to assessing whether a financial asset should be classified at amortised cost, and
 - (b) which features, or contractual cash flow characteristics, are compatible with the amortised cost measure.

Considerations in classifying financial assets at amortised cost

13. This section discusses the relevance of the following considerations in classifying financial assets at amortised cost:
 - (a) Variability in cash flows and the asset’s return
 - (b) Fair value of the asset or a particular feature.

⁷ As noted above, amortised cost allocates the effective return over time. Therefore, in addition to providing useful information only for particular types of financial assets, amortised cost also provides useful information only for particular business models. That is, it is important that financial assets are held for the collection of that effective return, ie the contractual cash flows. Otherwise the allocation mechanism is not relevant to providing information about the asset’s ultimate cash flows. However the business model condition is outside the scope of this paper.

Variability in cash flows and the asset's return

14. As an allocation mechanism, amortised cost works best for financial assets with contractual cash flows that are **fixed** (ie those that are known at contract inception and that are not contingent⁸) both in timing and amount. Common examples of instruments with fixed cash flows include financial assets with fixed interest rates, zero coupon bonds and principal-only strips that are not prepayable. As long as cash flows are fixed, the allocation over time can be performed. This is true regardless of the stated amount of the cash flows or the payment pattern. That is, the allocation could be effectively performed even if:
- (a) the stated fixed rate on the instrument is above or below the market rate on initial recognition, or/and
 - (b) the payments over time are uneven or/and occur at uneven intervals.
15. It is important to also note that regardless of the stated interest rate or stated payment pattern, the effective return recognised over time on a fixed-rate instrument would always be appropriate relative to the market conditions that exist at initial recognition of the instrument. This is due to the initial measurement requirements for financial instruments. That is, financial instruments are initially recognised at fair value, which is typically the transaction price. If the transaction price includes another element, that element will be recognised separately from the financial asset. For example, if an entity provides an interest-free loan to a customer, the entity will recognise the loan at fair value and the rest of the transaction amount will be recognised as an expense or reduction of income unless it qualifies for recognition as some other type of asset.⁹ In the extreme, the yield on a financial asset can even be negative –

⁸ For example, this means that cash flows on an instrument are not considered fixed if the instrument will pay interest at 5% for 5 years and then, depending on a particular event, at either 5% or 6% in year 6.

⁹ The staff acknowledge that there are detailed differences between IFRS and US GAAP related to the initial recognition requirements for financial instruments. Those differences are outside the scope of this project; however, in the staff's view those detailed differences do not change the basic underlying concepts discussed in this paper.

amortised cost can still ‘cope’ with those conditions and reflect that negative effective return.

16. Finally, it is important to note that the effective return that is recognised over time for a financial asset with fixed contractual payments would not include consideration unrelated to a basic lending-type return because there is no variability in the contractual cash flows.
17. Mechanically, amortised cost could also allocate the effective return for financial assets with **variable** contractual cash flows as long as those cash flows are *determinable*. For financial assets with variable cash flows, it is important to consider both the *degree* and the *source* of variability in the contractual cash flows in order to determine whether the amortised cost allocation mechanism would work well and provide useful information. Some hold the view that amortised cost can work for *any* variable cash flows, via the ‘catch up’ adjustments mechanism. That is, at each reporting date an entity would be required to calculate the present value of the current expected contractual cash flows and recognise in profit or loss interest revenue for the period *plus* any required catch-up adjustment that must be made to the carrying value of the financial instrument.
18. However the staff generally believe that as the variability in contractual cash flows increases and is driven by factors unrelated to a basic lending type return, amortised cost essentially ceases to *allocate* the effective return and increasingly becomes a fair value-*like* measure. In such cases, the staff do not believe that amortised cost provides superior information compared to fair value measurement. Besides, for such instruments, amortised cost loses the benefit of being a simple measurement technique and becomes increasingly more difficult to apply.
19. The following paragraphs explore *sources* of variability in a greater detail. Variability in the asset’s contractual cash flows may arise due to factors relevant to a basic lending-type relationship including:

- (a) Compensating the asset holder for just the passage of time (this is the simplest form of interest, absent the risks and costs associated with the asset),
 - (b) Providing consideration for the basic risks associated with holding a financial asset for a particular period of time; that is, credit risk and liquidity risk, and
 - (c) Providing a profit margin and/or compensation for costs associated with the financial asset such as servicing costs.
20. For financial assets with a fixed interest rate all these elements of the effective return are fixed at initial recognition. For such assets, the amortised cost allocation mechanism provides useful information by recognising in profit or loss in each period the basic lending type return consistent with the *conditions on initial recognition*.
21. Likewise, amortised cost would also provide useful information if any variability in the contractual cash flows arises only to **maintain** the holder's return for those basic lending-type considerations as conditions change over time. In each period, amortised cost would recognise in profit or loss the basic lending-type return that is consistent with the *current conditions*. For example, a bank's published variable interest rate or a variable interest rate linked to LIBOR would be consistent with this analysis.
22. In contrast, variability in cash flows may arise due to factors unrelated to a basic lending-type relationship. For example, if the variable interest rate on a financial asset is referenced to an equity index, such variability is outside a basic lending-type relationship and is driven by a factor other than those relevant to such a relationship. In such cases, allocation of the return over time is not appropriate because the return itself is not related to compensating the asset holder for the passage of time and the basic risks and costs associated with holding the asset.
23. Accordingly, the solely P&I condition in IFRS 9 and the proposed ASU is designed to identify financial assets with fixed or variable cash flows that provide

a basic lending-type return to the holder and where any contractual variability in cash flows is intended only to maintain such a return over time consistent with the changing conditions. The solely P&I condition is also designed to screen out (and thus measure at fair value through profit or loss) those financial assets with variability in cash flows that is outside the basic lending-type relationship and driven by factors other than those relevant to such a relationship.

24. As a final observation on the *degree* of the variability of the contractual cash flows, clearly the nature of the feature in itself does not *always* determine the effect on the variability and whether the amortised cost allocation mechanism would work and provide useful information. For example, a financial asset could contain a link to a commodity index that could only impact contractual cash flows by a de minimis amount. Such an asset would be akin to an asset with a fixed interest rate because the variability in cash flows is de minimis.

Fair value of the asset or a particular feature

25. Amortised cost is not a proxy for fair value. That is, amortised cost is not designed to – and does not – provide information about changes in fair value. This is particularly true for instruments with fixed interest rates; however, amortised cost still provides useful information about these instruments' cash flows by recognising the effective return over time. Accordingly, the staff believe that a holder of such an instrument should not be precluded from classifying it at amortised cost simply because over the asset's life its amortised cost could be very different from its fair value—and the holder could therefore realise a gain or loss if the holder were to sell the instrument.¹⁰
26. Similarly, the staff also believe that the impact at initial recognition of a particular contractual feature on the instrument's fair value should not *in itself* determine how the instrument is classified. For example, a contractual provision should not

¹⁰ The staff note that the business model condition for the amortised cost category requires that the assets are held for the collection of contractual cash flows (subject to the re-deliberations of the business model condition).

be automatically considered consistent with the amortised cost measurement simply because it has a negligible impact on the fair value of the financial asset on initial recognition (eg because the provision is unlikely to impact the instrument's cash flows). It may be the case that the feature *could* have a dramatic effect on future contractual cash flows and amortised cost could provide incomplete information about that potential effect. In contrast, amortised cost can still provide useful information about the instrument's cash flows if a financial asset is originated at an interest rate that is below market and the asset's fair value at initial recognition is different from the stated contractual par amount). Regardless of whether a feature (such as an off-market interest rate) has an impact on the asset's fair value on initial recognition, amortised cost can allocate the effective return over time as long as the contractual cash flows are fixed or otherwise determinable.

27. However, the impact of the feature on the asset's fair value on initial recognition could be a helpful *indicator* of whether the feature affects (or could affect) the asset's cash flows such that the amortised cost allocation mechanism would not provide useful information. For example, if a financial instrument contains a contingent feature that requires a revision to the interest rate upon the occurrence of a specified event (eg a change in an equity index), a meaningful fair value to such feature may indicate that the return on the financial asset includes consideration that is unrelated to a basic lending type return. In other words, it is important to understand the reason for the feature's impact on the asset's fair value at initial recognition and how that feature affects the economics and the cash flows on the financial asset—and thus whether amortised cost would provide complete and useful information by allocating the effective return over time.

Key observations

28. To conclude, the key observations in this paper that are relevant to the staff's analysis in the subsequent papers in this series include:

- (a) Amortised cost is a relatively simple mechanism that **allocates the effective return** on a financial asset over the relevant time period.
- (b) The allocation mechanism is easy to apply and would provide useful information (subject to business model) for financial assets with contractual cash flows that are **fixed** (ie known at initial recognition and not contingent). The allocation can also be performed for financial assets with **variable** contractual cash flows as long as those cash flows are determinable. However, for a financial instrument with a variable interest rate, consideration must be given to the degree and sources of variability in cash flows in order to establish whether the amortised cost allocation mechanism would work well and provide complete and useful information.
- (c) If the variability in cash flows relates to **basic lending-type considerations** (for example time value of money and the credit risk) and simply reflects changes in those conditions over time, amortised cost would provide useful information by allocating those cash flows over time. However, if the variability in cash flows is driven by factors outside of a basic lending-type relationship, it would not be appropriate to allocate the return over time because the return itself is not related to compensating the holder for the passage of time and the basic risks and costs associated with holding the asset for a particular period of time.
- (d) The impact of a contractual provision on the **fair value** of the financial asset or the susceptibility of the financial asset to changes in fair value over time in themselves do not determine whether amortised cost is an appropriate measurement attribute for the financial asset. However, the impact of a contractual feature on the fair value of the instrument on initial recognition could be a helpful indicator of its impact on the contractual cash flows and whether the amortised cost allocation mechanism would work well and provide complete and useful information.

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FASB Agenda ref	242

29. Subsequent P&I papers for this month's meeting provide further analysis in light of the discussion in this paper.

STAFF PAPER

16-18 September 2013

REG FASB | IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Contractual Cash Flow Characteristics: The Meaning of ‘Principal’		
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Purpose and structure of the paper

1. This is the second paper in 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. The objective of this paper is to clarify the meaning of ‘principal’ in the context of the solely P&I condition. In that regard, this paper:
 - (a) provides relevant background information, including:
 - (i) a summary of—and staff observations on—the current articulation of ‘principal’ in IFRS 9 and the FASB’s proposed ASU, and
 - (ii) a brief overview of the relevant feedback received on the IASB’s exposure draft ED/2012/4 *Classification and*

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Measurement: Limited Amendments to IFRS 9 (Proposed amendments to IFRS 9 (2010)) ('the Limited Amendments ED') and the FASB's proposed ASU;

- (b) discusses possible alternatives for how 'principal' could be described, and the implications of those alternatives; and
- (c) provides a staff recommendation on the articulation of 'principal' and a question for the boards.

Background

Current language

3. Principal is not defined in IFRS 9. However, paragraph BC4.23 of IFRS 9 states that 'cash flows that are interest always have a close relation to the amount advanced to the debtor (the 'funded amount')'. Agenda Paper 5A/FASB Memo 133 of February 2012 ('the February 2012 paper') refers to this language in IFRS 9 and describes it as 'economic principal.'
4. Consistent with the boards' discussion at their meeting in February 2012, the FASB's proposed ASU (specifically ASC 825-10-15-18) described principal as 'the amount transferred by the holder on initial recognition.'
5. While the language in IFRS 9 and the FASB's proposed ASU is different, the staff believe that the boards did not intend to have different meanings for the term 'principal'. Indeed the staff note that the amount advanced to the debtor (as described in IFRS 9) and the amount transferred by the holder (as described in the FASB's proposed ASU) would be the same on the origination of the instrument.¹
6. In the staff's view, the wording in paragraph BC4.23 of IFRS 9 and the wording in the FASB's proposed ASU are different because they were designed for

¹ The entire amount transferred by the holder *in the transaction* may also include transaction costs. However the amount transferred by the holder *to the debtor for the asset* is the same.

different purposes. Specifically, the language in paragraph BC4.23 of IFRS 9 was not intended to constitute a definition of principal. Rather, it was intended to explain the notion of a simple lending-type return and emphasise the close relationship between ‘principal’ and ‘interest’ in such basic lending transactions. The staff acknowledge that the language in paragraph BC4.23 focuses only on the origination of a financial asset.

7. In contrast, the FASB’s proposed language sought to define the term principal and thus captures *both* the origination of a financial asset and the acquisition of a financial asset in a secondary market.
8. The language in both IFRS 9 and the FASB’s proposed ASU discusses the meaning of principal only on the *initial recognition* of the instrument. In other words, the language in those documents does not reflect the fact that the amount of principal may change over the life of the instrument—for example, if principal is repaid over the instrument’s life.
9. Finally, the language in both IFRS 9 and the FASB’s proposed ASU describes principal by reference to the actual transaction in which the financial asset was originated or purchased (ie the amount advanced to the debtor or transferred by the holder). Neither document describes principal by reference to the contractual terms of the instrument (ie what is contractually defined as ‘principal’).

Feedback received

10. Some respondents to the Limited Amendments ED and the FASB’s proposed ASU asked the boards to clarify the meaning of ‘principal’ and expressed concerns about the current language in IFRS 9 and the FASB’s proposed ASU. Those who advocated convergence emphasised that it is important that the boards develop a common articulation of principal.
11. Much of the detailed feedback from the outreach and comment letter respondents was raised in the context of assessing whether a financial asset has contractual cash flows that meet the solely P&I condition if the asset has a prepayment feature

or has an interest rate that is below or above market. Many respondents offered possible views about the meaning of the term principal—for example, some suggested it is the contractually stated principal amount or the amount that the current holder paid for the asset.

12. Some respondents stated a preference for a particular meaning of principal. Others simply noted the implications for particular instruments of different articulations and asked the boards to consider those implications and to clarify what the boards intended. Yet others did not express a strong view but said that the description of principal should not preclude the following assets from being eligible for amortised cost:
- (a) financial assets that are originated or acquired at a significant premium or discount and are prepayable at par; and
 - (b) financial assets with interest rates that are either below or above market.

Alternatives for describing the meaning of principal

13. The staff agree that the meaning of principal is fundamental to the consistent and appropriate application of the solely P&I condition. Specifically, the meaning of principal is relevant to assessing:
- (a) whether the cash flows on a financial asset are indeed solely payments of principal (and interest on the principal amount outstanding), and
 - (b) whether the prepayment amount on a prepayable financial asset ‘substantially represents unpaid amounts of principal and interest’.
14. The staff are aware that divergent views already exist among interested parties and acknowledge that different meanings of principal will result in different classification outcomes for particular instruments. Accordingly, the staff believe that the boards should consider and clarify the meaning of principal for the purposes of applying the solely P&I condition.

15. The staff have identified the following three alternatives for describing the meaning of principal:
- (a) Alternative A—the amount that is **contractually defined** as ‘principal’;
 - (b) Alternative B—the amount that was advanced to the debtor when the debtor **originally issued** the instrument; and
 - (c) Alternative C—the amount that was transferred by the **current holder** for the asset.
16. A simple example may help illustrate the three alternatives. Consider a bullet loan with the following contractual features:
- (a) The contractually stated principal is CU100. Interest of 5% is computed on this amount.
 - (b) Only interest payments are required to be paid over the life of the asset.
 - (c) At maturity, CU100 is due.
 - (d) The instrument is prepayable at any time before maturity. The prepayment amount is CU100.
17. The debtor originally issued the bullet loan for CU98². The current holder purchased the loan in the secondary market for CU95.
18. From the perspective of the current holder, the three alternatives set out in paragraph 16 would result in the following amounts being considered as ‘principal’:

Alternative A	Alternative B	Alternative C
<i>Principal is the amount that is contractually defined as ‘principal’</i>	<i>Principal is the amount that was advanced to the debtor when the debtor originally issued the</i>	<i>Principal is the amount that was transferred by the current holder for the asset</i>

² For example, this can happen when the interest rate demanded by investors at the time of issuance is slightly different to the contractual interest rate (in this case 5%).

	<i>instrument</i>	
CU100	CU98	CU95

19. To assess whether the bullet loan meets the solely P&I condition, the holder must determine whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. To make that assessment, it is necessary to understand what principal is – so the alternatives are to compare the contractual cash flows to:
- (a) CU100 under Alternative A;
 - (b) CU98 under Alternative B; and
 - (c) CU95 under Alternative C.
20. Consistent with the discussion in paragraph 8, the example—and the analysis below—discusses the principal amount only in the context of initial recognition. This is for simplicity.

Staff analysis and recommendation

Alternative A: the amount that is contractually defined as ‘principal’

21. Alternative A considers only the financial asset’s contractual cash flows. Some would argue that this alternative is consistent with the wording in IFRS 9 and the FASB’s proposed ASU.
22. However, that staff is concerned that this alternative would seemingly prohibit some assets from being measured at amortised cost, even though such assets have simple cash flows—and amortised cost could provide useful information by allocating the effective return over the life of the instrument (assuming that the holder holds the asset to collect the contractual cash flows). For example, read literally, a zero coupon bond would not qualify to be measured at amortised cost under this alternative because that instrument **does not have** a contractually stated

principal amount upon which interest is computed. Rather, the amount that is repaid at maturity clearly is comprised of both economic principal and interest. Therefore this alternative is unworkable for particular financial instruments with simple cash flows.

23. Moreover, the staff think that Alternative A is inconsistent with the real economics of the financial asset because it does not consider the transaction in which the holder acquires the asset. As a result, under this alternative a financial asset with a contractual interest rate that is below or above market might appear to have contractual cash flows that are inconsistent with the solely P&I condition if the *stated contractual* interest rate did not reflect consideration for the time value of money and credit risk. However, *economically*, such an asset may indeed contain payments that are solely principal and interest because the holder would acquire the asset—and thus recognise it on initial recognition—at an amount other than the contractually stated principal amount. Amortised cost would allocate that premium or discount over the life of the instrument, resulting in an effective return that that is economically consistent with the notion of interest.
24. In addition, Alternative A could potentially disregard cash flows that economically are not solely P&I—and conclude that the asset could qualify for amortised cost. To illustrate, an entity may acquire a financial asset in the secondary market at a significant discount—for example, because interest rates have risen sharply since the asset was issued—and the asset is prepayable at par. If the issuer prepays, the holder will receive a significant gain that is inconsistent with an economic notion of solely principal and interest. However, Alternative A will ignore that economic ‘super return’ because it focuses only on the contractual cash flows (ie what is contractually described as principal) —and, as a result, the asset may qualify to be measured at amortised cost. While it may seem illogical for the issuer to prepay in those circumstances (based on a pure economic

analysis), there may be various reasons why the issuer nevertheless decides to do so, and amortised cost likely will not communicate that possibility.³

25. As noted in paragraph 9 of this paper, the staff thinks that neither board intended to describe principal by a reference to the contractual terms of the instrument (ie what is contractually defined as ‘principal’). For the reasons discussed in the paragraphs above, the staff think that such a literal interpretation of principal would be inappropriate.

Alternative B: the amount that was advanced to the debtor when the debtor originally issued the instrument

26. Alternative B considers only the transaction in which the financial asset was **originated**, irrespective of whether the current holder acquired the asset at origination or subsequently in the secondary market. Some would argue that this articulation is appropriate because they believe (subject to the business model assessment) that if the asset would have qualified for amortised cost at origination, then it should always qualify for amortised cost, ie even if the current holder did not acquire the asset at origination because that outcome would always be appropriate due to the *contractual terms* of the asset. Proponents of this alternative also point out that zero coupon bonds, which are problematic under Alternative A, would qualify for amortised cost under this alternative—and they believe that this is an appropriate outcome.
27. However, the staff believe that the conditions that existed at origination **are irrelevant** to subsequent holders. Indeed the staff think the solely P&I condition in IFRS 9 and the FASB’s proposed ASU requires the holder to assess the economics of the asset **that it holds**, which necessarily includes the transaction in which the holder acquired the asset. Moreover, the staff think this alternative

³ A similar logic would apply to an acquisition at a premium although the staff acknowledge that an instrument prepayable at par at any time is generally unlikely to be acquired with a significant premium over that par amount unless the prepayment option is contingent and the occurrence of the contingent event is not likely.

would be very difficult—if not impossible—to operationalise because it would require a subsequent holder to determine the amount that the original holder paid for the asset.

Alternative C: the amount that was transferred by the current holder for the asset

28. This alternative focuses on the amount that the current holder transferred for the financial asset. In other words, it reflects the economics of the financial asset from the perspective of the current holder; ie the holder would assess the solely P&I condition by comparing the contractual cash flows to the amount that it actually invested. As a result, financial assets with contractual interest rates that are significantly above or below market rates (such that the stated contractual interest rates do not reflect consideration for the time value of money and credit risk), zero-coupon bonds and similar instruments could meet the solely P&I condition, as long as they do not contain any non-P&I cash flows. This is because—consistent with the discussion of the objective and mechanics of amortised cost, which is discussed in IASB AP 6B/FASB Memo 242 for this month’s meeting—the transaction amount that is attributable to the financial asset could result in an economic return on that investment that represents solely P&I.
29. The staff think that Alternative C is consistent with the boards’ logic that underlies the current description of principal in both IFRS 9 and the FASB’s proposed ASU—and indeed is consistent with both boards’ intention that principal is the amount that **the current holder** transferred for the financial asset.
30. However, 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 would 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. In that paper, the staff propose alternatives, which include permitting such assets to be measured at amortised cost in particular circumstances.

IASB Agenda ref	6C
FASB Agenda ref	243

Question for the Boards

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?

STAFF PAPER

16 September – 18 September

REG FASB | IASB Meeting

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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IASB Agenda ref	6D
FASB Agenda ref	244

- (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

IASB Agenda ref	6D
FASB Agenda ref	244

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 EONIA¹, 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 just for 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?

STAFF PAPER

16-18 September 2013

REG FASB | IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Contractual Cash Flow Characteristics: Contingent Features		
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Purpose and structure of the paper

1. This is the fourth paper in 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”). This paper builds upon the concepts and clarifications to the solely P&I condition discussed in IASB Agenda Papers 6B and 6D/FASB Memos 242 and 244 for this month’s meeting. Specifically, this paper addresses **contingent¹ features** in financial assets and:
 - (a) provides a summary of the relevant guidance in the FASB’s proposed ASU and IFRS 9,

¹ The Oxford Dictionary defines *contingency* as ‘a future event or circumstance which is possible but cannot be predicted with certainty.’

- (b) summarises the feedback received from the IASB and FASB stakeholders on the assessment of contingent features in applying the solely P&I condition,
 - (c) discusses alternative approaches to classifying financial assets with the following types of contingent features:
 - (i) contingent features that result in cash flows that are solely P&I (paragraphs 15-26), and
 - (ii) contingent features that result in cash flows that are not solely P&I (paragraphs 27-50).
2. 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.²

Summary of the guidance in the FASB’s proposed ASU and IFRS 9

3. Consistent with the approach discussed in IASB Agenda Paper 5A/FASB Memo 133 for the February 2012 joint board meeting (‘the February 2012 paper’) and the tentative decisions that the boards made at that meeting, the guidance in the FASB’s proposed ASU required an entity to consider both:
- (a) the nature of the contingent trigger event, and
 - (b) whether the cash flows that result upon the occurrence of that event are solely P&I.

² The Oxford Dictionary defines *de minimis* as ‘too trivial or minor to merit consideration, especially in law.’ All features (including contingent features) that only result in a de minimis impact on cash flows of a financial asset are discussed in Agenda Paper 6D/FASB Memo 244 for this month’s meeting.

4. The FASB's proposed ASU included the following examples, which were originally set out in the February 2012 paper³:
- (i) A privately issued debt instrument contains a contractual term that requires that if the issuing entity does not become a publicly traded entity within a specified time period, the interest rate on the debt instrument would be reset to a market rate for a comparable privately issued debt instrument...The nature of the contingency is to maintain an appropriate rate of return on the instrument that represents compensation for the time value of money and the credit risk. Therefore, the contingent feature results in cash flows that are solely payments of principal and interest on the principal amount outstanding.
 - (ii) In contrast, if the contractual term of the instrument results in the interest rate being reset to a punitive rate if the issuing entity does not become a publicly traded entity, such a contractual term would result in cash flows that are not solely payments of principal and interest on the principal amount outstanding.
5. Consistent with the February 2012 paper, the FASB's proposed ASU also provided specific guidance for contingent prepayment and extension features.⁴ In particular, it specified that such features could⁵ result in cash flows that are solely P&I if those features protect:
- (a) The holder against the credit deterioration of the issuer (for example, defaults, credit downgrades, or loan covenant violations) or a change in control of the issuer; or
 - (b) The holder or issuer against changes in relevant taxation or law.

³ The FASB's proposed ASU paragraph 825-10-55-25

⁴ The FASB's proposed ASU paragraph 825-10-55-21 through 55-22

⁵ There are additional requirements for such features to be consistent with the solely P&I condition. For prepayment features, the prepayment amount should substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract. For extension features, contractual cash flows over the extension period must be solely P&I.

6. IFRS 9 contains the same requirements for contingent prepayment and extension options.⁶ However, IFRS 9 does not provide explicit guidance on the assessment of other types of contingent features and states that a contractual term that changes the timing or amount of payments of principal and interest does not result in solely P&I unless it is a variable rate that is consideration for the time value of money and credit risk.⁷
7. The guidance in the FASB’s proposed ASU and IFRS 9 does not allow an entity to take into account the probability of a contingent feature occurring, except that it requires an entity to ignore any ‘non-genuine’ features (that is, features that are extremely rare, highly abnormal and very unlikely to occur).
8. Although the IASB did not propose any changes to that guidance in its exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) (‘the Limited Amendments ED’), stakeholder feedback on contingent features has been received on both FASB’s proposed ASU and IFRS 9.

Feedback

9. During stakeholder outreach meetings and in the comment letters, both the IASB and the FASB received feedback about the assessment of contingent features in applying the solely P&I condition, although these concerns were most prevalent in the United States. Many stakeholders who commented on contingent features expressed concerns that some of those features that are commonly included in financial assets could result in the instrument not meeting the solely P&I condition—and thus being measured at fair value through profit or loss (FVPL)—even if the contingent feature has an **insignificant fair value**. The contingent

⁶ IFRS 9 paragraph B4.1.10 and paragraph B4.1.11

⁷ IFRS 9 paragraph B4.1.12

feature could have an insignificant fair value on a standalone basis either because (a) it could only have a de minimis impact on cash flows and/or (b) even though it could have a material effect on cash flows if triggered, the probability of it being triggered is remote.

10. FASB's stakeholders also expressed the view that the FASB's proposed ASU is **inconsistent in its consideration of the probability of outcomes**. That is, in assessing a modified economic relationship between principal, time value of money and credit risk (that arises due to leverage or interest rate mismatch features) the FASB's proposed ASU (and the IASB's Limited Amendments ED), requires consideration of only reasonably possible outcomes. In contrast, the FASB's proposed ASU (and IFRS 9) does not allow an entity to take into account the probability that a contingent event will occur (except for non-genuine features) – so implicitly all potential (genuine) scenarios must be considered.
11. Many stakeholders (notably respondents to the FASB's proposed ASU, although a few IASB stakeholders also raised this point) questioned whether (and if so, why) it is necessary or relevant to consider the **nature of the contingent trigger event if the resulting cash flows are solely P&I**. They also requested clarifications as to which particular trigger events would be considered consistent with the solely P&I condition.
12. Furthermore, the stakeholders noted that they did not understand why the application guidance explicitly discusses **the nature of particular contingent trigger events** in the context of contingent prepayment and extension features (that is, noting that those features that protect the holder from credit deterioration of the issuer, or a change in control of the issuer, or protect the holder or the issuer from changes in relevant taxation or law are consistent with the solely P&I condition), but does not provide such guidance for other types of contingent features. FASB's stakeholders raised a concern that the only example in the FASB's proposed ASU of a contingent feature that meets the solely P&I condition (other than a contingent prepayment or extension feature) is a feature that is included in the instrument to maintain an appropriate rate of return. Those respondents considered that example to be narrower than and inconsistent with the

guidance for contingent prepayment and extension features. Generally, FASB's and IASB's respondents who commented on the nature of the contingent trigger event expressed a view that the boards should either align the guidance on permissible triggers for all contingent features (including prepayment and extension features) or clarify why the guidance is different.

13. Finally, respondents provided specific examples of instruments that they believed would not or may not meet the solely P&I condition in the FASB's proposed ASU and IFRS 9, including:

- (a) A lender provides a loan to a start-up company at a below market interest rate. However, if and when the start-up company's EBITDA reaches a specified level, the contractual terms of the loan require that the interest rate is reset to the current market rate for similar loans. Respondents expressed concern that the nature of the trigger event could affect classification even if the resulting cash flows represent appropriate consideration for the time value of money and credit risk.
- (b) A financial asset is issued at a market interest rate that is fixed at origination. However, if the price of gold exceeds a specified level, the contractual terms of the asset require that the interest rate is reset to the then current market rate for an instrument of a comparable credit quality, liquidity, currency and term structure. Respondents expressed the view that the asset would not meet the solely P&I condition due to the nature of the trigger event, even if the resulting cash flows represent appropriate consideration for the time value of money and credit risk.
- (c) A financial asset is issued at a market interest rate that is fixed at origination. However, it contains a contractual term requiring that the interest rate is reset to the current market rate for a comparable asset if there is change in control of the issuer. Respondents expressed concern that the asset may not meet the solely P&I condition even if the resulting cash flows represent appropriate consideration for the time value of money and credit risk. That concern arose because a change in

control event is discussed only in the context of contingent prepayment and extension features.

- (d) A financial asset is issued at a market interest rate that is fixed at origination. The asset contains a contractual term that provides the creditor with yield protection; that is, in the event of a change in relevant laws or regulations the creditor will charge a fee or increase the interest rate on the asset. Respondents expressed concern that the asset may not meet the solely P&I condition even if the resulting cash flows represent appropriate consideration for the time value of money and credit risk. That concern arose because changes in relevant laws or regulations are discussed only in the context of contingent prepayment and extension features.
- (e) A financial asset is issued at a market interest rate but contains a contractual term that requires the interest rate to be increased by 500 basis points if the issuer is not able to maintain a specified credit rating. Respondents expressed the view that the asset would not meet the solely P&I condition because they believe that the resulting interest rate is ‘punitive’ and therefore the contractual cash flows do not represent appropriate consideration for the time value of money and credit risk.
- (f) An auction rate security is issued with a market interest rate but that rate is reset to a punitive rate, until the next auction, if the auction fails. Respondents expressed the view that the asset would not meet the solely P&I condition because they believe that the resulting interest rate is ‘punitive’ and therefore the contractual cash flows do not represent appropriate consideration for the time value of money and credit risk.
- (g) A financial asset is issued with a fixed interest rate which represents the current market rate at origination. The interest rate on the asset is reset to a punitive rate (or a fixed fee is charged) during the period in which the issuer/borrower is not in compliance with the filing requirements of its financial statements with the regulator (for example, the SEC in the

United States). Respondents expressed the view that the asset would not meet the solely P&I condition because the contingent cash flows do not represent appropriate consideration for the time value of money and credit risk.

- (h) A financial asset is issued with a fixed interest rate which represents the current market rate on origination. The instrument may or will automatically convert into the issuer's own equity instruments upon the occurrence of an uncertain future event. The value of the equity instruments that will be delivered upon conversion is different from the amount of principal and interest outstanding (for example, particular convertible—or contingently convertible—debt instruments).

Respondents expressed the view that the asset would not meet the solely P&I condition because the contingent cash flows are not solely P&I and that this would be the case even if the probability of conversion is very low or remote.

- (i) A financial asset is issued with a market interest rate. The outstanding amount of principal and interest may be partially or wholly cancelled or converted into the issuer's own equity instruments at a ratio that does not reflect the value of the outstanding principal and interest if the issuer fails to meet particular regulatory capital requirements (herein called 'bail-in instruments'). Respondents expressed the view that the asset would not meet the solely P&I condition because the contingent cash flows are not solely P&I and that this would be the case even if the probability of these features being triggered is very low or remote.

14. To summarise, respondents raised the following key concerns and questions:

- (a) The impact of the nature of the contingent trigger event on classification
- (i) Whether (and if so, why) a contingent feature will be considered inconsistent with the solely P&I condition

simply due to the nature of the trigger event, even if the resulting cash flows are solely P&I, and

- (ii) Why there is specific guidance set out for the trigger events for contingent prepayment and extension features but not for other types of contingent features—and whether the guidance on trigger events should be aligned,
- (b) The impact on classification of ‘punitive’ interest rates,
- (c) The impact on classification of the probability that a trigger event will occur; that is, whether it is appropriate to exclude only non-genuine features or whether the probability threshold should be set at a lower level.

Contingent features that result in cash flows that are solely P&I

15. This section addresses contingent features that result in cash flows that are solely P&I. In light of the feedback received, the staff believe that the boards should consider and clarify the following points:
- (a) Whether the nature of the trigger event *in itself* should impact the classification of a financial asset,
 - (b) Whether the boards intended a different approach for
 - (i) trigger events related to contingent prepayment and extension features; and
 - (ii) trigger events related to other types of contingent features, and
 - (c) The assessment of ‘punitive’ rates in classifying financial assets.
16. The staff believe there is an important interaction between the nature of the trigger event and the resulting cash flows—and that interaction needs to be considered in assessing a contingent feature. To illustrate, consider the following scenarios:

- (a) A financial asset has an interest rate set at 5% but that rate is reset to 10% if the credit quality of the financial asset deteriorates below a specified level.
- (b) A financial asset has an interest rate set at 5% but that rate is reset to 10% if a particular equity index reaches a specified level.
17. In both scenarios, the interest rate is fixed at origination at 5% but is reset to – and remains fixed at – 10% upon the occurrence of an uncertain future event. That is, the contractual cash flows in both scenarios are the same both before and after the respective trigger events. However, the trigger event in itself could influence the assessment of whether the instrument is consistent with the solely P&I condition.
18. For example, in the first scenario, based on all the relevant facts and circumstances the entity may conclude that the higher rate represents compensation for the increased credit risk of the instrument. That could be the case even if the contractually agreed increased interest rate is above the market rate for instruments of such credit quality and therefore could be described by some as ‘punitive’. That is because, as discussed in Agenda Papers 6B-D / FASB Memos 242-244 for this month’s meeting, the solely P&I condition does not require an assessment of whether the asset’s interest rate is consistent with or above / below market – the appropriateness of the effective return for accounting purposes will always be ensured by initial recognition requirements for financial instruments. Rather, the solely P&I condition is intended to ensure that the interest rate does not include elements that are inconsistent with the notion of interest in a basic lending-type relationship. That is, the solely P&I condition focuses on whether the interest rate introduces volatility that is unrelated to time value of money, credit risk and liquidity risk—and whether amortised cost would be able to effectively allocate the contractual cash flows over time and provide useful information.
19. Besides, some rates that are described as ‘punitive’ (for example, rates that require higher compensation for credit risk than seemingly should be required considering the increased potential credit losses) could in fact represent appropriate

consideration for credit risk for a basic lending-type relationship for particular products or scenarios. A typical example would be a significant increase in the interest rate that is sometimes charged on a credit card balance when the debtor misses a payment; that is, arguably, that increase in the interest rate is not directly commensurate with the increase in expected credit losses on the financial asset however this is how credit risk is commonly priced in those circumstances.

20. In contrast, in the scenario described in paragraph 16(b) in which the interest rate is reset if an equity index reaches a specified level, the reset in the interest rate is unrelated to the credit risk or liquidity risk of the asset itself. Rather, the return on the instrument is driven by an external factor. So for example, even if the credit quality of the instrument has not deteriorated and benchmark interest rates have not increased, the interest rate on the financial asset would increase if the equity index reaches the specified level. Accordingly, even though the resulting rate is predetermined—that is, it does not introduce any more variability than the scenario described in paragraph 16(a)—it is difficult to argue that cash flows on such a financial instrument provide consideration only for the time value of money, credit risk and liquidity risk associated with the instrument. Rather, the link to equity prices means that the return on the instrument is also affected by equity prices. In other words, such a rate could be viewed as analogous to a variable interest rate that is driven by equity prices, which is inconsistent with the solely P&I condition. Accordingly, amortised cost would not provide useful information by allocating that return over time.
21. In both of the examples discussed above, it is critical to consider both *whether* and *how* the trigger event affects the instrument's cash flows in order to determine whether those cash flows are solely P&I. In the example of the interest rate that is reset due to the issuer's credit deterioration—if that feature does not have a meaningful fair value and does not result in a premium on initial recognition of the financial asset, that would indicate the appropriate consideration for credit risk. This would be the case even if one could view the increase in the interest rate as 'punitive'—and such punitive rates do in fact occur.

22. In contrast, in the case of the instrument described in paragraph 16, the equity index is expected to have an effect on the instrument’s cash flows in one of two ways. Depending on the magnitude of the increase in the instrument’s interest rate, the price that someone would pay to invest in the instrument would be expected to vary—or alternatively, depending on the price at which the instrument is issued, the issuer is likely to agree to a rate of 10% or another rate (depending on the equity index that causes the interest rate to be reset). This means that the contractual cash flows and the assessment of whether they are solely P&I is affected by the trigger.
23. Therefore the staff believe that it is appropriate—and indeed necessary—to consider the trigger event and the resulting cash flows *in combination* to determine whether the contractual cash flows on the financial asset are solely P&I. For example, if the occurrence of the trigger event results in updating components of the interest rate such that the revised interest rate provides appropriate consideration that reflects the change in the conditions relevant to a basic lending relationship (such as a change in the issuer’s credit), the financial asset could meet the solely P&I condition. 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. However, the nature of the trigger is **a helpful indicator** in assessing whether the contractual cash flows are solely P&I.
24. In other words, 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.
25. 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 more restrictive than 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, in clarifying the guidance on contingent features, the staff believe that no distinction should be made between contingent prepayment and extension features and other types of contingent features.

26. 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 because it does not 'appropriately' reflect consideration for the time value of money, credit risk and liquidity risk of the financial asset. Therefore, consistent with the analysis in this paper and IASB Agenda Paper 6D / FASB Memo 244 for this month's meeting, the staff propose that the guidance on punitive rates should be updated to reflect 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

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 in paragraphs 23-26?

Contingent features that result in cash flows that are not solely P&I

27. This section addresses contingent features that result in cash flows that are inconsistent with the solely P&I condition. For example, if the contingent events could lead to a reset of the interest rate to a rate which is clearly not consistent with the notion of interest (for example, a link to a commodity index is introduced) or could result in a conversion into equity instruments⁸—as set out in

⁸ Generally conversions into equity instruments are done using a predetermined ratio. However if the conversion is done such that the fair value of the equity instruments delivered is equal to the value of the principal and interest outstanding, the staff believe that such a debt instrument will meet the solely P&I condition. This is because the *form* of settlement of the outstanding principal and interest (that is, in cash or other financial assets) is not relevant. This section therefore only discusses those debt instruments that can be converted into equity instruments at an amount **other than** the outstanding principal and interest.

the examples in paragraphs 13(h)-(i) — such contingent cash flows would not be considered consistent with the solely P&I condition. This is because, as discussed in Agenda Paper 6C/FASB Memo 242 for this month’s meeting, amortised cost is a simple measurement mechanism that allocates interest over time and therefore cannot effectively cope with—or provide useful and relevant information about—more complex cash flows.

28. As noted in paragraph 7 of this paper, the FASB’s proposed ASU and IFRS 9 generally do not allow an entity to take into account the probability of a contingent feature occurring; however, they require an entity to ignore any non-genuine features. Thus, any contingent feature that results in cash flows that are not solely P&I would require the instrument to be measured at FVPL regardless of the probability of the event occurring (unless the feature is non-genuine).

Overview of the alternatives

29. The staff has identified for the boards’ consideration the following alternatives for assessing contingent features that result in cash flows that are not solely P&I.⁹
- (a) **Alternative A** – If the contractual cash flows are not solely P&I, the financial asset does not meet the solely P&I condition regardless of how likely it is that the non-P&I cash flows will occur (except if they are non-genuine). This alternative is consistent with the current guidance in the FASB’s proposed ASU and IFRS 9.
- (b) **Alternative B** – The holder would be required to consider the probability of the occurrence of contingent contractual cash flows that are not solely P&I for all types of contingent features.¹⁰ In other words, the current ‘non-genuine’ threshold would be replaced with the lower probability threshold of ‘remote’ (lowering the threshold in that assets

⁹ As a reminder, contingencies that have a de minimis effect are outside the scope of this discussion.

¹⁰ Contingent prepayment and extension features are however discussed in the IASB AP 6F / FASB Memo 246 for this month’s meeting.

that have payments that are genuine but remote would also be eligible for amortised cost). Under this alternative, the probability of the contingent non-P&I cash flows would affect the classification, but the nature of the trigger event would not. If the probability of the non-P&I cash flows occurring is no longer remote, the financial asset would be reclassified to FVPL.

- (c) **Alternative C** – The holder would be required to consider the probability of occurrence of contingent contractual cash flows that are not solely P&I for specific contingent features that result in cash flows that are not solely P&I. In other words, the current ‘non-genuine’ threshold would be replaced with the lower probability threshold of ‘remote’ only for specific contingencies. The financial assets captured by this alternative are the so called bail in instruments discussed in paragraph 13(i). This alternative would provide a remote probability threshold for those specific contingent features while retaining the non-genuine threshold for all other contingent features. Under this alternative, both the probability and the nature of the contingent trigger event would affect the classification of financial assets.

	Nature of contingent trigger event	Probability of occurrence	Classification outcome
Alternative A	Not relevant	Not relevant (except for non-genuine features)	<i>All contingencies that result in non-P&I cash flows ‘fail’ unless non-genuine</i>
Alternative B	Not relevant	Relevant. Need to reassess (for all non-P&I contingent cash flows).	<i>All remote contingencies that result in non-P&I cash flows ‘pass.’ All contingencies that are</i>

			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 a specified regulatory capital requirement that results in the cancellation of debt or its conversion into equity instruments) 'pass' if remote. All other contingencies that result in non-P&I cash flows 'fail' (unless non-genuine).

Probability assessment – general observations

30. In essence, all alternatives presented above take into account the probability of the occurrence of contingent non-P&I cash flows. However, the probability threshold is set at either the non-genuine or a lower level—and the lower threshold is applied to either all or specific contingent features that result in cash flows that are not solely P&I.
31. Before discussing those alternatives in detail, the staff would like to discuss the implications of lowering the probability threshold for reclassification

requirements and establish the appropriate level of such a lower probability threshold.

Reclassifications

32. In the staff's view, if the boards decided to pursue an alternative with a probability threshold for some or all non-P&I contingent cash flows that is lower than non-genuine, the boards should **require reclassification** of those instruments into the FVPL category when the probability that the non-P&I cash flows will occur increases beyond that threshold level. This is because, as discussed in Agenda Paper 6B / FASB Memo 242 for this month's meeting, amortised cost only provides useful information about financial assets with simple contractual cash flows by allocating those cash flows over time. The staff do not believe that the same considerations apply to the non-genuine threshold currently used in IFRS 9 and the FASB's proposed ASU due to the very nature of the non-genuine threshold. That is, the extremely low probability of the non-P&I cash flows occurring means that the feature can be disregarded altogether (it is essentially treated as being irrelevant).
33. The staff acknowledge that requiring reclassifications would add complexity to the model and impair comparability of the information provided to users. Nevertheless, the staff believe that these considerations are outweighed by the loss of information content that would occur if non-P&I cash flows were to continue to be measured at amortised cost once their probability of occurrence increases above that acceptable level.
34. In addition, the staff note that the concept of monitoring a feature for changes in circumstances would not be new to the accounting in this area. For example, the staff understand that, in today's practice, embedded derivatives that technically require bifurcation and fair value measurement are deemed to have a de minimis value if they are remote and thus are not recorded and accounted for separately at inception. However, these features are monitored on an ongoing basis to ensure their value remains de minimis. To the extent that circumstances change and the

value of those features becomes other than de minimis, these features are then recorded and accounted for at fair value.

35. However, the staff think that if an entity has (i) reclassified the asset into the FVPL category because the probability of the occurrence of the contingent non-P&I cash flows has increased beyond the threshold level, or (ii) initially classified the asset at FVPL because the probability of the occurrence of the contingent non-P&I cash flows was beyond the threshold level, the boards should require that the asset is measured at FVPL from that point forward (regardless of whether the entity subsequently concludes that the probability of occurrence has decreased below the threshold level). That is, an entity should not be required – or allowed – to reclassify the asset back and forth between FVPL and another measurement category throughout the asset’s life (that is, reclassification out of the FVPL category would be prohibited). The staff acknowledge that such an approach is asymmetrical and note that some may be concerned that this will result in a greater use of fair value. However, if such reclassifications were required – or allowed – the staff believe that would dramatically impair comparability and increase complexity and would ultimately not provide useful information by allocating contractual cash flows over portions of the asset’s life.

Probability threshold

36. The staff believe that for any alternative the probability threshold should **not be lower than remote**.¹¹ This is because as the probability of the non-P&I contingent cash flows increases, the feature acquires a meaningful fair value and the overall return on the instrument ceases to be consistent with the notion of interest in a basic lending-type relationship and thus amortised cost would not provide useful information by allocating such return over time. It would mean that there is a real possibility that cash flows could arise that are not well captured by amortised cost measurement. Accordingly, if the boards decided to require a

¹¹ The Master Glossary of U.S. GAAP defines ‘remote’ as the chance of a future event or events occurring as slight. Remote is not defined in IFRS. The staff are not aware of any differences in interpretation of ‘remote’ between IFRS and US GAAP.

threshold that is lower than remote—such as more-likely-than-not, reasonably possible or probable—the staff believe that this would be inconsistent with the overall conceptual basis for classifying financial assets at amortised cost.

37. Besides, if the boards were to require a probability threshold that is lower than remote, that would result in significantly more instances when reclassification would be required and reclassifications may not happen soon enough to provide timely information to users.
38. Finally, the staff note that the remote threshold is consistent with suggestions received from constituents who believed that the non-genuine threshold should be lowered.

Discussion of the alternatives and classification outcomes

39. **Alternative A** reflects the view that amortised cost is a simple measurement method that can only provide useful information for simple cash flows by allocating those cash flows over time. Accordingly, this alternative applies the non-genuine probability threshold to all contingent features that result in non-P&I cash flows. It is easy to understand and apply and it would not require continuous reassessment of the probability of the occurrence of the contingent feature (or reclassification on that basis) or the assessment of the nature of the contingent trigger event. Under this alternative, information about potential non-P&I cash flows that are genuine is provided to users of financial statements through the fair value measurement. This alternative retains the guidance in IFRS 9 and the FASB's proposed ASU and retains the classification outcomes of that guidance. That is, a financial asset with contingent non-P&I cash flows will be classified at FVPL as long as the feature is genuine even if the probability of the occurrence of the trigger event is remote (and consequently the fair value of the feature on a standalone basis is insignificant).
40. **Alternative B** applies a lower than non-genuine probability threshold to all contingent features that result in non-P&I cash flows. As explained in paragraphs 36-38, the staff believe that a lower probability threshold should be established as

“remote”. A threshold that is lower than remote would, in the staff’s view, be inconsistent with the notion of a basic lending-type return and will create a significant need for reclassifications that will impair comparability and increase the complexity of application.

41. Alternative B does not take into account the nature of the contingent trigger event so it applies to a broad population of instruments. Accordingly, this alternative may allow instruments to be measured at amortised cost even if they indeed have contingent features information about which can only be properly captured through fair value measurement.
42. Some staff think that the remote threshold should still result in many common convertible instruments being measured at FVPL (consistent with the outcome of the guidance proposed under FASB’s proposed ASU and IFRS 9). They take this view because the exercise of the conversion option in those instruments is driven by “economic compulsion” (that is, economic gain to the holder) and the holder’s own behaviour—and therefore it would be difficult for the holder to assert that the probability of conversion is remote. However, based on the facts in some circumstances, some staff are concerned that many will inevitably argue that the probability of conversion will indeed be remote; for example, if the conversion option is deeply out-of-the-money. Thus even some convertible bonds could be measured at amortised cost. Furthermore, some staff note that if the threshold is established as “remote” the concerns raised by stakeholders regarding bail-in instruments may continue to exist under this alternative. For example, some may question whether an entity can assert that the probability of it violating its Tier 1 capital requirement is “remote”, especially in the United States, where many large financial institutions have violated Tier 1 capital requirements during the financial crisis.
43. Therefore, some staff question the benefits of this alternative. They note that this alternative does not necessarily address key concerns raised by constituents and at the same time creates a risk of unintended consequences (ie instruments being measured at amortised cost where amortised cost would not provide useful information), is complex and requires reclassifications.

44. **Alternative C** would only allow particular contingent non-P&I cash flows that are unlikely to occur – so called bail-in instruments discussed in paragraph 13(i) – to be measured at amortised cost. This alternative is similar to Alternative B in that it establishes a lower probability threshold than non-genuine (specifically the remote threshold) however it only applies this threshold to a narrow population of instruments. This alternative effectively proposes an exception to the solely P&I condition in IFRS 9 and FASB’s proposed ASU. Accordingly, the advantage of this alternative compared to Alternative B is that it has a narrow scope and involves a smaller risk of unintended consequences.
45. However, from a conceptual standpoint, the staff are not convinced that the nature of the contingent trigger event is relevant to the classification of a financial asset if the contingent event results in non-P&I cash flows. The staff note that this is different from the assessment of contingent features that result in cash flows that are P&I. That is because in that latter case, as discussed in paragraphs 15-26, the nature of the contingent trigger event, even if not determinative in itself, is a helpful indicator in assessing whether the cash flows are indeed P&I and whether the return is indeed consistent with a basic lending-type return.
46. At the same time, as discussed in paragraph 42, the staff note that this alternative may not necessarily address specific concerns raised by IASB and FASB stakeholders – if the probability threshold is set as remote – because it would be difficult for an entity to assert that, for example, it is remote that the entity will not meet the applicable regulatory capital requirements particularly if the instrument is long dated. If that is the case, the practical impact of this alternative is questionable.

Staff recommendation

47. The staff believe that many of the concerns raised by stakeholders that financial assets that those constituents consider to be plain vanilla would not meet the solely P&I condition are already alleviated by the clarifications to the solely P&I

condition in the IASB Agenda Paper 6D / FASB Memo 244. However some staff members support Alternative A and some support Alternative B.

48. The staff members that support Alternative A believe that classifying financial assets at amortised cost by lowering the probability threshold to remote— or essentially creating an exception for particular types of specified 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.
49. 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, in which case amortised cost is capable of providing relevant information to financial statement users about the expected cash flows of the financial asset by allocating those cash flows over time. These staff members acknowledge that requiring reclassifications might add complexity to the proposed guidance. However, they argue that (a) setting the threshold at “remote” would keep the number of potential reclassifications low (as “remote” is still a high threshold for a contingent feature to meet), and (b) as noted in paragraph 34 many preparers and users already monitor (on an on-going basis) those bifurcated embedded derivatives that have a de minimis fair value at inception due to their low probability of occurrence— therefore a requirement to monitor a specific feature on an on-going basis would not be new).

50. In addition, 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. In those circumstances, entities would effectively be classifying at FVPL a financial asset whose cash flows (which would be used to determine its fair value) meet the solely P&I condition in all but the remote scenario.

Question 2 for the boards

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

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

If the boards prefer Alternative C, do the boards agree that Alternative C should only capture the so called bail in financial assets described in paragraph 13(i)?

STAFF PAPER

16-18 September 2013

REG FASB | IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Contractual Cash Flow Characteristics: Prepayment Features		
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Purpose and structure of the paper

1. This is the fifth paper in 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. This paper:
 - (a) Provides a summary of the guidance for prepayment features in IFRS 9 and the FASB’s proposed ASU;
 - (b) Summarises the feedback received from both the IASB and FASB stakeholders on the assessment of prepayment features in applying the solely P&I condition;

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The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

- (c) Discusses alternative approaches to classifying financial assets with the following types of prepayment features:
- (i) prepayment features that result in cash flows that are solely P&I,
 - (ii) prepayment features that result in cash flows that are **not** solely P&I; and
- (d) Provides staff recommendations and questions for the boards.
3. While this paper outlines issues and discusses alternatives in the context of the guidance for prepayment features specifically, the staff note that some of the considerations discussed in this paper, 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 the assessment of extension features. That is because, in both IFRS 9 and the FASB's proposed ASU, the guidance for the assessment of prepayment features and extension features is consistent. Accordingly, the paper acknowledges where the proposed approaches and clarifications for prepayment features also apply to extension features.

Summary of the guidance in the FASB's proposed ASU and IFRS 9

4. The guidance on prepayment features in IFRS 9 and the FASB's proposed ASU is consistent and requires consideration of the prepayment amount and, for contingent prepayment features, the nature of the contingent trigger event.
5. Specifically, FASB's proposed ASU states the following:

A contractual provision may either permit or require the issuer (the debtor) to prepay a debt instrument or permit or require the holder (the creditor) to put a debt instrument back to the issuer (that is, to demand repayment) before maturity. A financial asset with one of those types of contractual provisions results in contractual cash flows that are solely payments of

IASB Agenda ref	6F
FASB Agenda ref	246

principal and interest on the principal amount outstanding provided that both of the following conditions are met:

(a) The provision is not contingent on future events, other than to protect either of the following:

(i) The holder against the credit deterioration of the issuer (for example, defaults, credit downgrades, or loan covenant violations) or a change in control of the issuer

(ii) The holder or issuer against changes in relevant taxation or law.

(b) The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.

6. That guidance is very similar to IFRS 9 but not identical. Specifically, the FASB’s proposed ASU discusses prepayment features that either “permit *or require*” the issuer to prepay/the investor to demand repayment whereas IFRS 9 only discusses prepayment features that “permit” the issuer to prepay/the investor to demand repayment. Some could argue that contingent prepayment features that are *mandatorily* prepayable upon the occurrence of a contingent event are within the scope of the guidance in the FASB’s proposed ASU outlined above, but are not within the scope of the guidance in IFRS 9. The staff acknowledge that there is a slight wording difference, however the staff believe that the guidance was not intended to apply to different populations of instruments. Specifically, the staff believe the guidance in IFRS 9 was also intended to apply to prepayment features that either “permit *or require*” prepayment and that this should be clarified.

Feedback

Prepayment amount

7. Some respondents, both those in the United States and globally, have raised questions and concerns regarding the application of the guidance on prepayment features in assessing whether the prepayment amount results in cash flows that are consistent with the solely P&I condition. Those respondents believe that the guidance on the prepayment amount will result in some financial assets that these respondents consider to be “plain vanilla” failing the solely P&I condition.
8. For example, some stakeholders note that it is common for financial assets to contain terms that require repayment of the contractually stated par amount (or par plus unpaid accrued interest) if the contract is prepaid prior to its maturity. Given the articulation of “principal” in IFRS 9 and the FASB’s proposed ASU (that the staff recommend be reaffirmed in the IASB Agenda Paper 6C / FASB Memo 243), respondents noted that financial assets that are acquired or originated at a significant discount or premium to par (eg purchased financial assets with deteriorated credit quality and financial assets originated at above or below market interest rates) and are prepayable at par would likely fail the solely P&I condition and thus require classification at fair value through profit and loss (FVPL). This is because principal is understood as the amount transferred by the current holder for the financial asset (that may change over time for example to reflect repayments) and hence prepayment at the contractually stated par amount may represent *more or less than* “unpaid amounts of principal and interest...which may include reasonable additional compensation for the early termination of the contract”. For example, in the extreme, if an asset were purchased at a significant discount and prepaid at par shortly thereafter, the holder’s return could be well in excess of a typical interest-like return.
9. Some stakeholders note that it is also common for financial assets to contain terms that require repayment at an amount other than par if the contract is prepaid prior to its maturity. One example noted by many respondents in the United States was

a financial asset that contains a so called “make whole” provision that allows the issuer to prepay the instrument but, to do so, the issuer must pay the greater of (a) 100% of par, and (b) the sum of the present values of the remaining payments of interest and principal that would have been due if the instrument remained outstanding until maturity, discounted at a risk-free rate plus a small spread. This provision is included in the contract to make it uneconomic for the issuer to exercise the prepayment feature. For the reasons outlined in paragraph 8 above, stakeholders note that financial assets that contain such make whole provisions or other common clauses designed to protect the yield of the investor may not meet the solely P&I condition and thus would be classified at FVPL because the prepayment amount may be an amount that represents more than reasonable additional compensation for the early termination of the contract.

Nature of the contingent trigger event

10. Some stakeholders in the United States, and a few stakeholders globally, have also raised questions regarding a perceived inconsistency between the guidance on contingent trigger events discussed in the context of contingent prepayment (and extension) features and the relevant guidance for other contingent features (this is discussed in more detail in IASB Agenda Paper 6E / FASB Memo 245).
11. In addition, many respondents raised questions about which contingent trigger events could be considered consistent with “protecting the holder against the credit deterioration of the issuer”. Others gave examples of contingent events that would seem to fail the solely P&I condition in IFRS 9 and the FASB’s proposed ASU (eg an instrument is issued at par and is prepayable at par contingent on the credit *improvement* of the issuer) and asked why such contingent events should result in measurement of the entire instrument at FVPL.

Probability assessment

12. Some respondents noted that the guidance in the FASB's proposed ASU is silent on whether an entity is required to consider only reasonably possible outcomes or all possible outcomes in assessing a contingent prepayment feature. This is in contrast to the guidance on other contingent features, which specifically states that the probability of the contingent event occurring should not be considered, unless that event is non-genuine (that is extremely rare, highly abnormal and very unlikely to occur). It was unclear to those respondents whether the probability of the contingent event occurring should be taken into account when determining whether a contingent prepayment feature is consistent with the solely P&I condition.
13. Similar to concerns expressed in relation to contingent features that result in non-P&I cash flows in general, some stakeholders were concerned that a prepayment feature could result in the entire instrument failing the solely P&I condition (and thus being measured at FVPL) even if there is only a remote probability that prepayment will occur .

Staff discussion and analysis

14. The issues that the staff has identified based on stakeholders' comments can be broadly classified into three topics:
 - (a) Assessment of the cash flows resulting from prepayments (i.e., the **prepayment amount**) for *both* contingent and non-contingent prepayment features¹,

¹ Here and throughout this paper, a contingent prepayment feature is one in which the prepayment cannot be exercised until a specified event has occurred (ie this would not include those options where the only uncertainty is whether the holder of the option will choose to exercise its option). In contrast, a non-contingent prepayment feature is one in which the option can be exercised at the discretion of the holder of the option.

- (b) Consideration of the **nature of the contingent trigger event** for *contingent* prepayment features, and
- (c) Consideration of the **probability of the prepayment feature being exercised** for *both* contingent and non-contingent prepayment features if the cash flows resulting from prepayment are not solely P&I.

15. It is important to clarify the point in paragraph 14(c) above. The reason that the phrase “probability of the prepayment feature being **exercised**” is used in this paper (as opposed to “probability of the contingent event occurring”, as in IASB Agenda Paper 6E / FASB Memo 245) is because for contingent prepayment features that are not *mandatorily* prepayable upon the occurrence of a contingent trigger event, the actual probability of exercise (and thus, the potential impact on the cash flows of the instrument) is a dual probability event. That is, in order for there to be an impact on the cash flows of the instrument, both of the following must happen: (a) the contingent trigger event occurs, and (b) the holder of the prepayment option chooses to exercise. Therefore, the probability of the occurrence of the contingent trigger event itself is not all that matters. Specifically, what also matters is the probability that the holder of the prepayment option will choose to exercise that option if and when the contingent trigger event occurs. In this way, contingent prepayment options are different from other typical contingent features (where there is an automatic impact on cash flows once the contingent event occurs). In addition, for non-contingent prepayment options, whether the entity holding the option chooses to exercise that option is also a probability consideration. This makes non-contingent prepayment options different compared to other typical contingent features that have an automatic impact on cash flows upon the occurrence of the contingent trigger event.
16. The staff note that many of the issues discussed in IASB Agenda Paper 6E / FASB Memo 245 are also applicable to the assessment of prepayment features (e.g., consideration of (i) the nature of the contingent trigger event, (ii) the probability of the contingent trigger event occurring, and (iii) the impact of the feature on the cash flows of the financial instrument). Thus the staff analysis and

IASB Agenda ref	6F
FASB Agenda ref	246

alternatives presented in this paper are consistent with the staff analysis and alternatives presented in IASB Agenda Paper 6E / FASB Memo 245. Where applicable, this paper provides references to IASB Agenda Paper 6E / FASB Memo 245 to highlight similar alternatives, issues, and decision points.

Prepayment features that result in cash flows that are solely P&I

17. This section addresses contingent *and* non-contingent prepayment features that:
 - (a) Have the potential to impact cash flow variability of an instrument by more than a de minimis amount, and
 - (b) Result in cash flows that are solely P&I.
18. The relevant issues to consider are whether the nature of a contingent trigger event (if any) is relevant to the assessment of prepayment features that result in cash flows that are solely P&I and if so, how the nature of a contingent trigger event should be assessed.
19. Consider the following example provided by a respondent to the FASB’s proposed ASU: a financial asset is issued at par and is prepayable at par contingent on the credit improvement of the issuer. Even though the cash flows on the financial asset remain solely P&I throughout the asset’s life, this prepayment feature would likely cause the asset to be considered inconsistent with the solely P&I condition under IFRS 9 and the FASB’s proposed ASU because the contingent trigger event is not one that is listed in the guidance on contingent prepayment features (ie prepayment is contingent on the improvement of the issuer’s credit rather than the deterioration).
20. Consistent with the analysis provided in IASB Agenda Paper 6E / FASB Memo 245, the staff believe that, amortised cost would provide relevant and useful information if the cash flows remain solely P&I throughout the life of the instrument (regardless of if/when the prepayment feature is exercised). This logic applies to both contingent and non-contingent prepayment features and is

irrespective of (a) the nature of the contingency (if any) in itself, and (b) the probability of the prepayment feature being exercised.

21. However, as explained in IASB Agenda Paper 6E / FASB Memo 245, 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. While the staff do not believe that the nature of the trigger event in itself should be determinative of the ultimate classification, understanding the nature of the trigger event can inform an entity’s judgement as to whether the cash flows on the financial asset are indeed solely P&I and provide a simple lending type return. Said another way, an entity might not be able to entirely understand the cash flows on the financial asset unless it understands the nature of the contingent trigger event that may cause a prepayment.
22. As explained in IASB Agenda Paper 6E / FASB Memo 245, it is critical to consider both *whether* and *how* the trigger event affects the instrument’s cash flows in order to determine whether those cash flows are solely P&I. If the instrument can or is required to be prepaid due to credit deterioration, that contingent trigger event in itself is not likely to introduce consideration that is inconsistent with a basic lending type return. In contrast, if the instrument can or is required to be prepaid if an equity index reaches a specified level, that contingent trigger event is expected to have an effect on the instrument’s cash flows. That is, even if the *prepayment amount* is solely P&I, the price that someone would pay to invest in the instrument (or the amount of interest that would be paid on the instrument) would be expected to vary because of the contingency. This means that the contractual cash flows and the assessment of whether they are solely P&I is affected by the trigger.
23. Therefore, the staff believe that it is appropriate – and indeed necessary – to consider the contingent trigger event and the cash flows *in combination* to determine whether the contractual cash flows on the financial asset are solely P&I. In other words, all contractual provisions should be holistically considered

in classifying a financial asset. The staff believe that the application guidance on contingent prepayment features should be clarified accordingly. 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. However, the nature of the trigger is **a helpful indicator** in assessing whether the contractual cash flows are solely P&I.

24. The staff note that this recommendation is consistent with the staff recommendation on the corresponding issue in IASB Agenda Paper 6E / FASB Memo 245. The staff also note that this clarification will result in a consistent approach to the assessment of contingent trigger events for prepayment features and other contingent features. The staff also believe that similar logic applies to contingent extension features and a similar clarification should be provided.

Question 1 for the boards

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 in paragraphs 20-23?

Prepayment features that result in cash flows that are not solely P&I

25. This section addresses contingent *and* non-contingent prepayment features that:
- (a) Have the potential to impact cash flow variability of an instrument by more than a de minimis amount; and
 - (b) Result in cash flows that **are not** solely P&I.
26. Common examples of such non-P&I prepayments include financial assets that are originated or acquired at a significant premium or discount and can be prepaid at par, or financial assets that contain a make whole provision which provides more than reasonable additional compensation for the early termination of the contract.
27. As discussed in paragraph 8, financial assets that may or are required to be prepaid at par upon the occurrence of a specified contingent trigger event would

not meet the solely P&I condition *if* they are originated or acquired with a significant premium or discount to par.

28. A simple example may help to illustrate the concept. Consider a financial asset that is issued at par of CU100 at a market interest rate and is prepayable at CU100. That asset would be carried at CU100 in the holder's financial statements and if it is prepaid at CU100, the holder would not recognise a gain or loss. Thus the holder's return in all scenarios –regardless of whether the asset is prepaid – would represent a basic lending type return.
29. In contrast, consider a financial asset that is acquired at CU60 and is prepayable at CU100 at any time before maturity. The holder of such a financial asset would carry it in the financial statements at an amount other than CU100—and that carrying amount would be accreted to CU100. Therefore, if this asset is prepaid at CU100 immediately, the holder would realise a gain that is in excess of a basic lending type return. Hence amortised cost would not provide complete information about such an asset. Even if the financial asset is *not expected* to be prepaid (for example, because the discount on acquisition was due to credit impairment), the prepayment is *contractually possible*.
30. The staff note that a financial asset would not be measured at amortised cost in its entirety under IAS 39 *Financial Instruments: Recognition and Measurement* if it is originated or acquired at a significant premium or discount and is prepayable at par. That is, paragraph AG30(g) of that Standard states that if the exercise price of a prepayment option embedded in a debt contract is not approximately equal on each exercise date to the amortised cost of the financial asset², such a prepayment option must be bifurcated and accounted for separately³.
31. Similar guidance also exists under Topic 815 *Derivatives and Hedging*. However under Topic 815 the determination of whether an embedded prepayment option

² Or does not reimburse the lender for an amount up to the approximate present value of the lost interest for the remaining term of the debt contract.

³ Assuming the holder does not elect to apply the fair value option.

IASB Agenda ref	6F
FASB Agenda ref	246

must be bifurcated from the host contract is often dependent upon which party holds the prepayment option.

Overview of the alternatives

32. 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 (ie the probability of the prepayment feature being exercised) 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 (ie the probability of the prepayment feature being exercised) 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**”. Lowering the threshold means that (assets that have genuine non-P&I cash flows would be eligible for amortised cost if the probability of such payments are 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 with prepayment features 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 guidance in IFRS 9 and the FASB’s proposed ASU (as proposed to be modified by the staff recommendation in the preceding section of this paper). 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 also implicitly considers the probability that the non-P&I cash flows will occur because it looks to the fair value of the prepayment feature on initial recognition. This is because the fair value of the prepayment features captured under this alternative would be insignificant if prepayment is not likely to occur.

Probability assessment – general observations

33. Both Alternative A and Alternative B outlined above take into account the probability that non-P&I prepayments will occur. The former sets the probability threshold at the non-genuine and the latter sets the threshold at a lower level. In addition, as explained in paragraph 32(c), there is also an implicit probability threshold that applies to specific non-P&I prepayment features under Alternative C.
34. Consistent with the approach in IASB Agenda Paper 6E / FASB Memo 245, before discussing the alternatives in detail, the staff would like to re-iterate the implications of lowering the probability threshold—specifically, related to

establishing reclassification requirements and establishing the appropriate probability threshold for Alternative B.

Reclassifications

35. In the staff's view, if the boards decide to pursue Alternative B, which proposes to lower the non-genuine probability threshold for all non-P&I prepayment features, the boards should **require reclassification** of those instruments into the FVPL category when the probability that the non-P&I prepayment will occur increases beyond that threshold level. This is because, as discussed in Agenda Paper 6B / FASB Memo 242 for this month's meeting, amortised cost only provides useful information about financial assets with simple contractual cash flows by allocating those cash flows over time.
36. The staff do not believe that the same concerns apply to the non-genuine threshold currently used in IFRS 9 and the FASB's proposed ASU. This is due to the very nature of the non-genuine threshold. That is, a non-genuine feature can be disregarded altogether (it is essentially treated as being irrelevant) due to the extremely low probability that the non-P&I cash flows will occur.
37. In addition, the staff do not believe that reclassifications should be required – or permitted – under Alternative C. That is because that alternative already represents an exception to the solely P&I condition. In addition, the non-P&I cash flows that could result from prepayment at par (plus accrued and unpaid interest) are different from other types of non-P&I cash flows because the only element of return that is inconsistent with the solely P&I condition is the consideration for the time value of money. For example, if an instrument is acquired at a significant discount and is prepaid at par, the holder receives interest attributable to the discount at the point of prepayment rather than over time. In addition, changes in the holder's expectations about prepayment would be captured by amortised cost via catch up adjustments to the carrying value so less information content is lost than would be the case if there was greater variability in potential cash flows.

38. In contrast, if an instrument is prepayable at fair value (which could qualify for amortised cost under Alternative B if prepayment is contingent on a trigger event which has a remote probability of occurring), the return the holder *could* receive if the instrument does prepay could be very different from a basic lending type return. Accordingly, the staff think it is appropriate and necessary to require reclassifications under Alternative B but not under Alternative C.
39. The staff acknowledge that requiring reclassifications would add complexity to the model and impair comparability of the information provided to users. Nevertheless, the staff believe that these considerations are outweighed by the loss of information content that would occur if non-P&I cash flows were to continue to be measured at amortised cost after the probability of occurrence increases above the threshold level.
40. In addition, the staff note that the concept of monitoring a feature for changes in circumstances would not be new to the accounting in this area. For example, the staff understand that, in today's practice, embedded derivatives that technically require bifurcation and fair value measurement but have a de minimis value due to their remote nature are not recorded and accounted for separately at inception. However, these features are monitored on an ongoing basis to ensure that their value remains de minimis. To the extent that circumstances change and the value of those features becomes other than de minimis, these features are recorded and accounted for at fair value.
41. However, the staff think that if an entity has (i) reclassified the asset into the FVPL category because the probability that the non-P&I cash flows will occur has increased beyond the threshold level, or (ii) initially classified the asset at FVPL because the probability that the non-P&I cash flows will occur was beyond the threshold level, the boards should require that asset be measured at FVPL from that point forward (regardless of whether the entity subsequently concludes that the probability of occurrence has decreased below the threshold level). That is, an entity should not be required – or allowed – to reclassify the asset back and forth between FVPL and another measurement category throughout the asset's life (ie,

reclassification out of the FVPL category would be prohibited). The staff acknowledge that such an approach is asymmetrical and note that some may be concerned that this will result in a greater use of fair value. However, if such reclassifications were required – or allowed – the staff believe such treatment would dramatically impair comparability and increase complexity and would ultimately not provide useful information by allocating contractual cash flows over portions of the asset’s life.

Probability threshold

42. The staff believe that the probability threshold under Alternative B should **not be lower than remote**⁴. This is because as the probability of the non-P&I contingent cash flows increases, the feature acquires a meaningful fair value and the overall return on the instrument ceases to be consistent with the notion of interest in a basic lending-type relationship and thus amortised cost would not provide useful information by allocating such return over time. Establishing a threshold lower than remote would mean that there is a real possibility that cash flows could arise that are not well captured by amortised cost measurement. Accordingly, if the boards decided to require a threshold that is lower than remote—such as more-likely-than-not, reasonably possible or probable—the staff believe that this would be inconsistent with the overall conceptual basis for classifying financial assets at amortised cost.
43. Besides, if the boards were to require a probability threshold that is lower than remote, there would be a significantly higher number of instances when reclassification would be required and reclassifications may not happen soon enough to provide timely information to users.

⁴ The Master Glossary of U.S. GAAP defines remote as the chance of a future event or events occurring as slight. Remote is not defined in IFRS. The staff are not aware of any differences in interpretation of ‘remote’ between IFRS and US GAAP.

44. Finally, the staff note that the remote threshold is consistent with suggestions received from constituents who believed that the non-genuine threshold should be lowered.

Discussion of the alternatives and classification outcomes

45. **Alternative A** reflects the view that amortised cost is a measurement method that can only cope with simple cash flows that have low variability. If a financial asset can be prepaid at an amount other than the outstanding amount of principal and interest, that may result in an economic return in excess of a basic lending type return and hence cash flows that are not solely P&I. For such financial assets, amortised cost would not provide information to users of financial statements about the potential gain (or loss) that the holder could realise upon prepayment.
46. Alternative A would not require an assessment of the probability of exercise of the prepayment feature (other than to determine whether the feature is not genuine), nor would it require potential reclassification on that basis. This alternative and its classification outcomes are consistent with IFRS 9 and the FASB's proposed ASU. This alternative results in information about potential non-P&I cash flows that are genuine provided to users of financial statements through the fair value measurement.
47. **Alternative B** would allow more financial assets with prepayment features to be classified at amortised cost than Alternative A. For example, it would allow purchased credit impaired (PCI) financial assets that are prepayable at par to be classified at amortised cost if the probability of prepayment is remote (which staff think would often be the case for such assets). In addition, financial assets with make whole provisions that are designed to be very uneconomic such that their exercise by the issuer is remote may qualify for amortised cost under this alternative. The staff also think that Alternative B could capture contingent prepayments at fair value if the probability of the occurrence of the contingent trigger event is remote. However this alternative likely would not capture *non-contingent* prepayment features where prepayment is at fair value (as it would be

very unlikely that an entity would be able to argue that the probability that prepayment at fair value will occur is remote).

48. Similar to Alternative A, Alternative B acknowledges that amortised cost is a simple measurement mechanism that allocates interest over time and does not provide useful and relevant information about instruments with more complex cash flows; ie those that are inconsistent with the basic lending type return. However, Alternative B would accommodate all prepayment features whose exercise is remote. In those circumstances (ie where the probability of exercise is remote), it can be argued that amortised cost as a measurement basis provides useful information. That is, because the event that would cause the non-P&I cash flows is remote, there is an expectation that the cash flows will be “simple” and consistent with ‘solely P&I’.
49. Alternative B applies to **all** prepayment features (i.e., contingent and non-contingent); therefore, a prepayment feature does not necessarily need to be contingent on a remote event in order for the probability of its exercise to be remote. Rather, an unfettered prepayment feature can also be considered remote if the possibility that it will be exercised is remote—which could be the case, for example, if it is very uneconomic for the holder of the prepayment feature to exercise it due to the prepayment amount.
50. Alternative B relies on the assertion that amortised cost would provide useful information because – and only as long as – the probability that the prepayment feature will be exercised is remote. Therefore, if the probability of exercise increases such that the exercise is no longer remote, amortised cost would no longer provide useful information. Hence, as noted in paragraph 28, the staff believe it would be critical for the boards to require continued monitoring of the probability of exercise and require reclassification of the financial asset into the FVPL category if the non-P&I prepayment is no longer remote. The staff believe that for Alternative B to result in useful information, the probability assessment and reclassification (where applicable) must be performed on a timely basis.

51. Some staff are concerned that since Alternative B applies to **all** non-P&I prepayment features (ie a broad population of instruments), financial assets may be measured at amortised cost even if they have features for which only fair value measurement can provide useful information. There is judgment to be applied in determining whether the exercise of a prepayment feature is “remote” (especially eg when the option to prepay is non-contingent), and some staff are concerned whether entities are able to perform this analysis (and potentially reclassify instruments if there is a change in circumstances) on a timely basis.
52. The staff also believe that the probability assessment in Alternative B would apply equally to extension features. That is, if the non-P&I cash flows that would result from an extension feature are remote, the financial asset can qualify for amortised cost treatment. If the occurrence of those non-P&I cash flows becomes more likely than remote, the asset will be required to be reclassified into the FVPL category (however, reclassifications out of the FVPL category would not be permitted).
53. **Alternative C** retains the current guidance on non-P&I prepayment features in IFRS and the FASB’s proposed ASU but provides a narrow scope exception for particular types of non-P&I prepayment features. Specifically, it requires financial assets that otherwise meet the solely P&I condition but are prepayable at par (plus accrued and unpaid interest) to be measured at amortised cost regardless of the amount transferred by the current holder for the financial asset (as adjusted for repayments and / or amortisation of the premium or discount) as long as the fair value of the prepayment feature on initial recognition is insignificant. As discussed above, in that way, Alternative C captures the remote probability of the prepayment occurring. Consistent with the analysis in paragraph 30 (and unlike Alternative B), this alternative does not require the continuous reassessment of the probability of the prepayment feature being exercised, nor does it require reclassifications.
54. Similar to Alternative B, this alternative would allow some common financial assets that do not meet the solely P&I condition under IFRS 9 and the FASB’s

proposed ASU to be measured at amortised cost. For example, PCI financial assets and other financial assets that are originated or purchased at a significant premium or discount (to the contractually stated par amount) and are prepayable at par could qualify for amortised cost.

Staff recommendation

55. Some staff support Alternative B and some staff support Alternative C. Staff members that support Alternative B believe that as long as the probability is remote that a non-P&I prepayment feature will be exercised, such a feature should not determine the classification of the entire instrument. When 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 acknowledge that requiring reclassifications might add complexity to the proposed guidance. However, they argue that (a) setting the threshold at “remote” would minimise the number of potential reclassifications (as “remote” is a high probability threshold for prepayment features to meet to begin with), and (b) as noted in paragraph 34, many preparers already perform the ongoing monitoring of particular bifurcated embedded derivatives that have a de minimis fair value at inception (so the concept of ongoing monitoring of a specific feature would not be new).
56. In addition, prohibiting entities from performing a probability assessment could lead to situations where a remote feature (which has a de minimis fair value on a standalone basis) causes the entire financial asset to fail the solely P&I condition and to be classified at FVPL. In those circumstances, entities would effectively be classifying at FVPL a financial asset whose cash flows (which are used to determine the fair value measurement) meet the solely P&I condition in all but the remote prepayment scenario.

57. Other staff members support Alternative C. These staff members generally believe that classifying financial assets at amortised cost by lowering the probability threshold to remote for non-P&I features would not provide useful information—and therefore they do not support Alternative B. They also believe that measuring financial assets at other than FVPL when such assets have genuine non-P&I cash flows 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 financial assets with genuine non-P&I cash flows being measured at amortised cost, these staff members also question the practical feasibility of assessing on an individual asset level the probability that the a prepayment feature will be exercised. These staff members note that in practice the probability of prepayment is usually assessed on a more aggregated level (eg portfolio level).
58. Finally, these staff members believe the need for continuous reassessment and reclassifications, which would result from lowering the probability threshold to remote, would increase complexity and impair comparability. Those staff members also note that users are generally not supportive of reclassifications.
59. However, these staff members are sympathetic to measuring financial assets that otherwise meet the solely P&I condition and are prepayable at par at amortised cost. They acknowledge that if a financial asset is originated or acquired at a significant premium or discount to the contractually stated par amount, prepayment at par may result in an excess gain or loss to the holder that would generally be inconsistent with the solely P&I condition. However, these staff members believe that typically for these types of assets the probability that the non-P&I prepayment will occur is generally low (although genuine); notably purchased credit impaired financial assets. This consideration is reflected by the requirement that the fair value of the prepayment feature on initial recognition must be insignificant (ie rather than using an assessment of remoteness). These staff members also note that this would not lead to increased operational complexity compared to the current guidance in IAS 39 because, under that

Standard, entities are required to bifurcate such prepayment features and account for them separately at FVPL (or continuously monitor their value if they are deemed insignificant at inception).

60. In addition, these staff members note that for such financial assets the only element of the return that could be inconsistent with the solely P&I condition is the time value of money—ie because the interest represented by the premium or discount would be received immediately upon prepayment, rather than over the life of the asset. However, these staff note that the information about the holder’s changing expectations about the probability that the asset will be prepaid would be captured by amortised cost via the catch up adjustment mechanism. The staff supporting Alternative C would emphasise this in the application guidance.
61. Therefore, on balance, these staff recommend measuring financial assets at amortised cost if the prepayment amount is the contractually stated par amount plus accrued and unpaid interest, regardless of the amount transferred by the holder for the financial asset, as long as the fair value of the prepayment feature on initial recognition is insignificant. All other financial assets with non-P&I prepayment features would be measured at FVPL (unless non-genuine), consistent with the solely P&I condition.

A final observation

62. Finally, the staff would like to remind the boards, as explained in paragraph 32, that Alternatives A and B outlined in this paper are generally consistent with the respective alternatives presented in IASB Agenda Paper 6E / FASB Memo 245 for cash flows that are **not** solely P&I. Alternative C is also similar to the respective alternative in that paper in the sense that it proposes an exception for particular types of non-P&I cash flows. However, more importantly, the scope of Alternative C in this paper is different from the scope of the respective alternative in IASB Agenda Paper 6E / FASB Memo 245. This is because this paper proposes an exception for those non-P&I cash flows where the only element of the return that is inconsistent with the solely P&I condition is the consideration

for the time value of money. In contrast, Alternative C in IASB Agenda Paper 6E / FASB Memo 245 captures non-P&I cash flows that can be significantly different from a basic lending type return (ie cancellation of debt or conversion into equity instruments of the issuer).

63. Accordingly, the boards may want to consider whether the decisions they make on non-P&I prepayment features discussed in this paper should be consistent with the decisions they make on other types of contingent features (discussed in IASB Agenda Paper 6E / FASB Memo 245). For example, if the boards decide to pursue Alternative B in IASB Agenda Paper 6E / FASB Memo 245 for non-P&I contingencies, they could consider whether their decision for non-P&I prepayment features in this paper should be aligned with that decision.

Question 2 for the boards

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

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 that the non-P&I prepayment will occur becomes more likely than remote; however reclassifications out of the FVPL category should not be allowed?

International Financial Reporting Standards

Financial Instruments: Classification & Measurement

Taking the proposed model forward

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

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IFRS 9 as proposed

2

Business model

Contractual cash flow characteristics

Amortised cost*

FVOCI*

FVO for accounting mismatch

Reclassification required if business model changes

All other instruments:

- Equities
- Derivatives
- Some hybrid contracts
- ...

Fair Value (No impairment)

Equities: OCI presentation available (alternative)

* Same impairment model

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Feedback statistics

3

- 168 comment letters
- More than 60 outreach meetings – Including jointly with the FASB
- Online user survey – Over 40 responses from users

Comment letters by respondent type

Comment letters by region

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Clarifying solely P&I

4

- Nearly all welcomed the proposals and agreed 'modified economic relationship' can be solely P&I

BUT

- Proposals do not go far enough
- Comments and questions on topics outside the scope of the proposals
- Regulated rates

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Clarifying solely P&I

5

- Discussion of the objective, mechanics and information content provided by amortised cost.
- Questions and suggestions on meaning of:
 - Principal
 - Interest (including the components of interest and assessment of 'de minimis' features); and
 - Time value of money, including application to regulated rates
- Questions about application to particular items such as contingent, prepayment and extension features.

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Amendments to 'hold to collect'

6

- Many respondents agreed 'hold to collect' is clearer

BUT

- Some disagreed with the outcome
- Many challenged particular details of the proposals

- Most frequent comments:
 - Most notably, the emphasis on selling activity
 - Treatment of sales to meet regulatory requirements and for credit risk concentration

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Proposed FVOCI category

7

- The majority of respondents supported FVOCI category
- Views broadly equally split between
 - Support FVOCI category as proposed
 - Support FVOCI with a variation
 - Do not support FVOCI
- Concerns about clarity of distinction between business models
- Some questioned whether holding to sell or collect is really a business model

Clarifying business model criteria

8

Business model assessment

- Meaning
- Information
- Level assessed
- Role of sales
- Restatement risk
- Changes in model

Amortised cost

- When does AC give relevant and useful information?
- Cash flows realised = collection of contractual CFs
- How is it different from FVOCI business model?

FVOCI

- When does FVOCI give relevant and useful information?
- Cash flows realised = collection & selling
- How is it different from FVPL business model?

FVPL

- When does FVPL give relevant and useful information?
- Residual or not
- Cash flows realised = FV changes (selling)
- FV option

Transition

9

- Nearly all supported early application of just 'own credit' requirements
- BUT**
- Requested it be available before IFRS 9 is completed e.g. by incorporating in IAS 39 or IFRS 9 (2010)
 - Many asked the IASB to confirm the deferral of the mandatory effective date of IFRS 9 as soon as possible
 - Currently 1 January 2015

IASB July '13 meeting:

- Own credit to be available when General Hedge Accounting issued
- Deferred effective date, new date to be determined later

Thank you

10



STAFF PAPER

17– 18 September 2013

REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Cover note: Background information and progress report		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. This cover note provides a summary of this month's Agenda Papers and the IASB's next steps.
2. In addition, Appendix A provides a brief overview of the proposals in the Exposure Draft (ED) *Financial Instruments: Expected Credit Losses*.
3. This paper is for information purposes only and there are no questions for the Board.

Background to this meeting

4. At the July 2013 meeting the staff from both the IASB and FASB presented to the boards the feedback received on their respective proposals. At that meeting the boards were not asked to make any decisions.
5. During September the boards will hold a joint meeting. However:
 - (a) Agenda Papers presented by the IASB staff will only be for IASB decision-making; and

- (b) Agenda Papers presented by the FASB staff will only be for FASB decision-making.

The purpose of having the joint meeting is to allow each board the opportunity to consider how the other would enhance its proposed model to address the feedback received.

6. The staff are not asking the IASB for a decision on whether they want to proceed to redeliberate the proposals in the ED with the aim of finalising it. Instead the papers ask the IASB to make decisions about changes they would like to make to the proposals in the ED on the assumption we were to proceed to finalise the ED.

Overview of Agenda Papers for this meeting

7. The IASB staff will present the following papers this month for IASB decision making:

- (a) Paper 5A—Responsiveness of the impairment model
- (b) Paper 5B—Not discussed at this meeting
- (c) Paper 5C—Stage 1 measurement objective
- (d) Paper 5D—Definition of default
- (e) Paper 5E—Report on the Fieldwork

The FASB staff will present the following paper this for FASB decision making:

- (f) Paper 5F/Memo Number 239—Clarification of Expected Credit Losses

Paper 5A—Responsiveness of the impairment model

8. This paper addresses the concern raised by some that in practice the impairment model as articulated in the ED may not capture significant increases in credit risk since initial recognition on a timely basis when such increase is not evident at the individual exposure level. This is particularly the case for retail loans when credit risk is not reassessed on an on-going basis at an individual exposure level before loans become delinquent. The paper considers how to capture all significant increases in credit risk even when it is not yet evident at the level of individual financial instruments, considering both if default expectations materialise as

initially expected and if there are changes in credit risk factors from initial expectations.

Paper 5B – Not discussed at this meeting

Paper 5C—Stage 1 measurement objective

9. This paper considers the measurement objective for financial instruments in Stage 1 of the proposed model, and evaluates the feedback received on the 12-month expected credit loss (ECL) measurement objective and alternative suggestions.

Paper 5D—Definition of default

10. This paper addresses the feedback received from constituents that the notion of default, and what would constitute a default event within the context of the proposals, should be clearly described or defined.

Paper 5E—Report on the Fieldwork

11. This paper follows up on the discussions held during the July 2013 joint IASB and FASB meeting about the fieldwork (July Agenda Paper 5B). It presents in more detail the observations, results and feedback received from the fieldwork. This paper does not ask the IASB to make any decisions.

Next steps

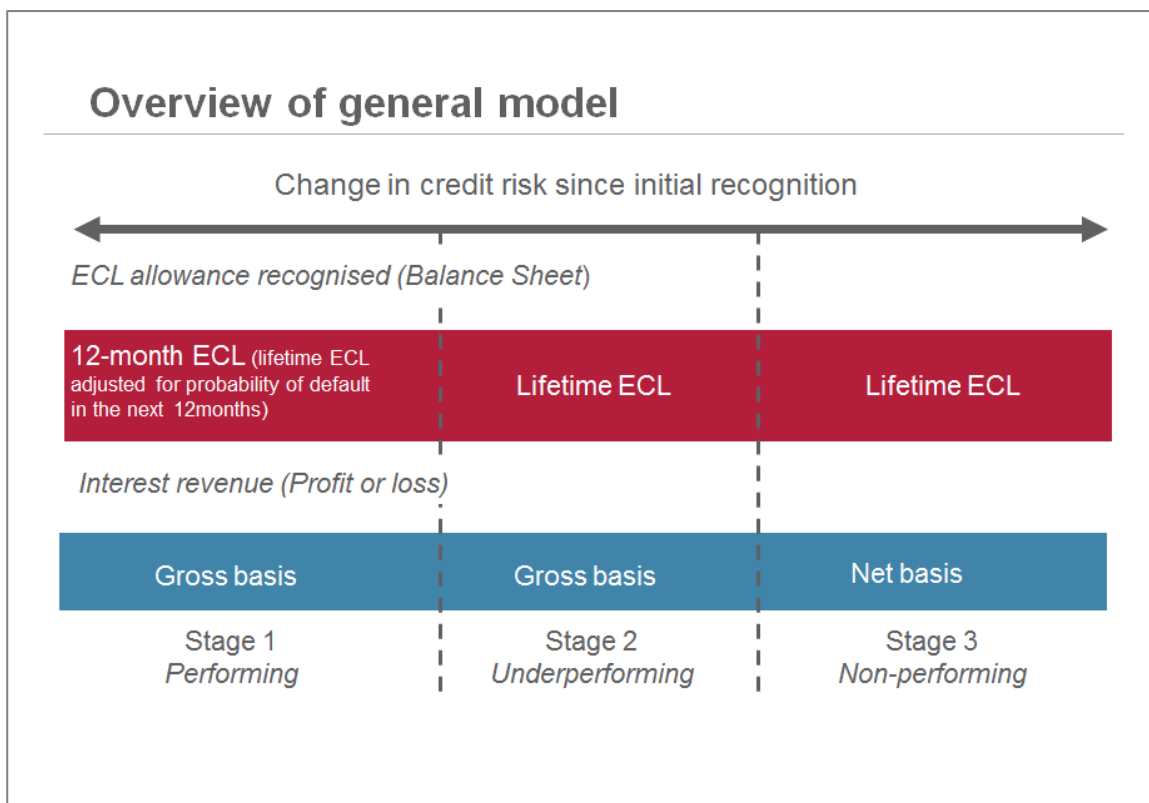
12. The staff propose that the IASB should further consider possibilities for convergence after considering any amendments to the proposals in the IASB's ED and any changes that have been made by the FASB to their own proposals.
13. The staff intend to discuss with the IASB the following topics at the October 2013 meeting:
 - (a) The timing of recognition of lifetime expected credit losses (ie when to recognise lifetime expected credit losses);
 - (b) The operational simplifications included in the proposals, namely the 30 days past due and the 'low credit' risk exemption;
 - (c) Modifications of financial instruments and interaction with impairment proposals;

- (d) Loan commitments and financial guarantee contracts;
- (e) Purchased or originated credit-impaired financial assets.

Appendix A: Exposure Draft (ED) *Financial Instruments: Expected Credit Losses*

Overview of the general model

- A1. The ED proposed a single impairment model that aimed to provide users of financial statements with more useful information about an entity's expected credit losses.
- A2. We can summarise the general model graphically as follows:



- A3. The proposals require that an entity shall recognise for financial instruments (other than those that are credit-impaired on initial recognition):
- (a) lifetime ECL for financial instruments if there has been a significant increase in credit risk since initial recognition (Stage 2); and
 - (b) 12-month ECL for all other financial instruments (Stage 1).
- A4. The ED proposed that an entity would generally present and calculate interest revenue using the effective interest method on the gross carrying amount. However, the way that interest revenue is calculated and presented changes if there is objective evidence of impairment (Stage 3). An entity would then

present and calculate interest revenue using the effective interest method on the net carrying amount (ie the gross carrying amount less allowance for the ECL).

- A1. To estimate the ECL and the changes in credit risk, an entity shall consider information that is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions. The degree of judgement that is required for the estimates depends on the availability of detailed information. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgement to estimate ECL increases. The estimate of ECL does not require a detailed estimate for periods that are far in the future – for such periods, an entity may extrapolate projections from available, detailed information.

Recognition and measurement of the 12-month ECL and the lifetime ECL

Recognition of the 12-month ECL

- A2. Most financial instruments would generally have a 12-month ECL allowance on origination or purchase. This stage would also capture those instruments that have not have a significant increase in credit risk since initial recognition.
- A3. The 12-month ECL is the full (lifetime) amount of credit losses that would result if default occurs in the next 12 months, weighted for the likelihood of the default occurring. The losses are therefore *not*:
- (a) the expected cash shortfalls in the next 12 months; or
 - (b) the losses on those assets that are expected to default in the next 12 months.
- A4. At each reporting period the entity would remeasure the 12-month ECL (ie update the 12-month expected loss allowance) for the financial instruments that have not had a significant increase in credit risk since initial recognition.

Recognition of the lifetime ECL

- A5. The ED proposed that an entity shall recognise a lifetime ECL allowance when credit risk has increased significantly since initial recognition.

Assessing significant deterioration

- A6. The ED proposed that an entity assesses whether there has been a significant increase in credit risk by comparing the:
- (a) credit risk at the reporting date; to
 - (b) the credit risk at initial recognition of the financial instrument.
- A7. In assessing credit risk, the entity considers the likelihood of not collecting some or all of the contractual cash flows over the *remaining maturity* of the financial instruments (ie the probability of a default occurring over the remaining life).
- A8. Generally, a financial instrument would have a significant increase in credit risk before there is objective evidence of impairment or before default occurs.
- A9. The proposals introduced an operational simplification for financial instruments with ‘low credit risk’ at the reporting date (for example, a loan that has an internal credit risk rating equivalent to the external credit rating of “investment grade”). For those instruments the entity would continue to recognise the 12-month ECL. The IASB’s intention was to reduce the operational burden of tracking the increase in credit risk for those high quality investments. The intention was not that the ‘low credit risk’ should be treated as an absolute threshold test for significant deterioration.
- A10. The ED includes a rebuttable presumption that there is significant increase in credit risk when contractual payments are more than 30 days past due as backstop. However, typically information that is more forward looking than past due information will be available and shall be considered in determining whether there has been a significant increase in credit risk at the reporting date.
- A11. The ED did not prescribe a particular method to assess increases in credit risk. It proposed that an entity could perform the assessment for financial instruments that have shared credit risk characteristics.

Measurement of the ECL

- A12. The ECL is the *present value* of the expected cash shortfalls over the life of the financial instrument.
- A13. The ED did not prescribe a method to measure the ECL. However, it proposes that an entity’s estimate of expected losses reflects:

- (a) the best available information;
- (b) an unbiased and probability-weighted estimate of cash flows associated with a range of possible outcomes; and
- (c) the time value of money.

A14. The ED proposed an entity can use a discount rate between, and including, the risk-free rate and the effective interest rate when discounting expected losses. The choice of rate must be applied consistently in the accounting for the impairment allowance of a financial asset over its life.

Loan commitments and financial guarantee contracts

A15. An entity would apply the impairment proposals to

- (a) loan commitments when there is a present legal obligation to extend credit, except any loan commitments that are measured at fair value through profit or loss in accordance with IFRS 9; and
- (b) financial guarantee contracts to which IFRS 9 is applied and that are accounted at fair value through profit or loss.

A16. The ED proposed that an entity should recognise a liability for the ECL for those loan commitments and financial guarantee contracts. When estimating the ECL of loan commitments an entity considers the remaining contractual period, or shorter period, over which it is exposed to credit risk.

A17. The proposals in the ED did not propose to change the accounting for revenue that arises from loan commitments or financial guarantee contracts.

Credit impaired financial assets on initial recognition

A18. When there is objective evidence of impairment as a result of one or more events that occurred on or before the initial recognition of an financial asset, the ED proposed that an entity shall:

- (a) include lifetime expected losses in the estimated cash flows when computing the effective interest rate on initial recognition (ie a credit-adjusted effective interest rate); and

(b) recognise subsequent changes in lifetime expected losses in profit or loss.

- A19. This treatment is similar to the accounting treatment of purchased credit impaired financial assets in paragraph AG5 of IAS 39 *Financial Instruments: Recognition and Measurements*.
- A20. The ED proposed that an entity should present and calculate interest revenue using the effective interest method on the amortised cost (ie net carrying amount, or gross carrying amount less allowance for the ECL) of those financial instruments.

Simplified approach for trade and lease receivables

- A21. The proposals relating to trade and lease receivables interact with the Revenue Recognition and Leases projects.
- A22. The ED proposed an operational simplification for those financial instruments, which would allow for recognising lifetime ECL at initial recognition and throughout the life of the instruments, as they are often held by entities that do not have sophisticated credit risk management systems. This would provide relief by eliminating the need to calculate 12-month ECL and to determine when a significant increase in credit risk has occurred.

Trade receivables with a significant financing component

- A23. The ED proposed that an entity could be allowed to make an accounting policy election to apply the simplified approach to measure the loss allowance at an amount equal to lifetime expected credit loss allowance at initial recognition and throughout the trade receivables' life.

Trade receivables without a significant financing component

- A24. For trade receivables that do not have a significant financing component, the ED proposed a mandatory requirement that an entity should measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout the trade receivables' life. As a practical expedient a provision matrix could be used to estimate expected credit losses for these trade receivables.

A25. In addition to the above, the ED proposed that the entity should measure trade receivables that do not have a significant financing component (in accordance with the Revenue ED) at the transaction price as defined in the Revenue ED on initial recognition. In many cases this would be the invoice amount.

Lease receivables

A26. For lease receivables an entity could make an accounting policy election to apply the simplified approach to measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout the asset's life.

A27. The simplified approach aims to reduce complexity in practice because an entity would not need to identify increases in credit risk. The cash flows used in the measurement of the lease receivables would be used as the contractual cash flows when assessing the lease receivables' expected loss allowance. When selecting the discount rate to be used, the upper limit of the permissible range is the discount rate used in the measurement of the lease receivable

Presentation

A28. The ED proposed that an entity should present in the statement of profit or loss and other comprehensive income separate line items for the following amounts:

- (c) interest revenue, calculated using the effective interest method on the gross carrying amount unless paragraph A29 applies; and
- (d) gains and losses resulting from changes in the ECL.

A29. An entity calculates interest revenue using the effective interest method on the amortised cost (ie net carrying amount, or gross carrying amount less allowance for the ECL) if:

- (a) as at the reporting date, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset; or
- (b) the asset was purchased or originated credit-impaired on initial recognition.

Application of the model to modified financial assets

- A30. The ED proposed that modified financial assets (that do not result in derecognition) should be considered in the same way as other (non-modified) assets within the model.
- A31. When an entity evaluates significant increase in credit risk an entity should compare the credit risk at the reporting date (based on the modified contractual terms) and the credit risk at initial recognition (based on the original contractual terms).
- A32. The gross carrying amount should be recalculated on the basis of the modified contractual cash flows and a modification gain or loss should be recognised in profit or loss.

Uncollectability/Write-off

- A33. The ED proposed that an entity considers a financial asset to be uncollectable if the entity has no reasonable expectation of recovery. Consequently, an entity would write off a financial asset, or part of a financial asset, in the period in which the entity has no reasonable expectation of recovery of the financial asset (or part of the financial asset).
- A34. A write-off requires the entity to reduce directly the gross carrying amount of a financial asset resulting from uncollectability. A write-off constitutes a derecognition event.

Disclosure

- A35. The ED proposed disclosures that would identify and explain:
- (a) the amount of the ECL that arises in the financial statements; and
 - (b) the effect of changes in credit risk of financial instruments that are within the scope of the proposals.
- A36. To meet this objective, the ED included proposed disclosure requirements such as:
- (c) reconciliation of gross carrying amounts and allowance balances;

- (d) disclosures on credit risk grading; and
- (e) disclosures on techniques, assumptions and policies (for example, write-off policy).

Transition

- A37. The ED proposed that an entity should use the credit quality at initial recognition for existing financial assets when initially applying the new impairment model, unless obtaining such credit quality information requires undue cost or effort.
- A38. If the credit quality at initial recognition is not used at the date of initial application (as per the relief outlined above), the transition provisions proposed that those financial assets should be evaluated only on the basis of whether the credit risk is low (as per the ‘investment grade’ exception) at each reporting date until those assets are derecognised.
- A39. The ED proposed to permit, but not require, a restatement of comparative periods if the information is available without the use of hindsight. In addition, the disclosures in paragraph 28(f) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would be permitted, but not required, for prior periods if the information is available without the use of hindsight.
- A40. The ED proposed that on the date of initial application of IFRS 9 the entity should disclose a reconciliation of the ending impairment allowances under IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the opening impairment allowances under IFRS 9 by measurement category, showing separately the effect of reclassifications on the allowance balance at that date.

STAFF PAPER

16-20 September 2013

REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Responsiveness of the general model		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

Purpose of the paper

1. The general impairment model proposed in the March 2013 Exposure Draft (ED) *Expected Credit Losses* (the ‘proposed model’) uses different measurements objectives for expected credit losses (ECL) for financial instruments that have significantly increased in credit risk since initial recognition and those that have not. A key objective of that model was to recognise lifetime expected credit losses on all financial instruments that had increased significantly in credit risk.
2. This paper addresses the concern raised by some that in practice, as articulated in the ED the proposed model may not fully capture the effect of significant increases in credit risk on a timely basis. This concern arises because of the information used to apply the model. In particular, when credit risk systems are heavily dependent on delinquency information a significant increase in credit risk may not be evident at the individual financial instrument level before financial instruments become delinquent – thus there may be a delay between recognising significant increases in credit risk and when it has actually occurred. Any delay is minimised when credit risk systems capture a comprehensive range of credit risk information that is forward-looking and is updated on a timely basis at the individual instrument level. The delay is most appar-

ent for portfolios that are managed on the basis of delinquencies with payment obligations that are ‘back ended’.

Scope

3. This paper does not address whether an entity should assess changes in credit risk by considering the increases in risk:
 - (a) over the life of the loan¹;
 - (b) or just over the next 12 months.

This topic was raised in particular within the context of loans with payment obligations that are ‘back ended’. This will be discussed at a later meeting.

Summary

4. The objective of the proposed model was to capture lifetime ECL on all financial instruments that have significantly increased in credit risk since initial recognition. When determining whether the recognition of lifetime ECL is required, an entity needs to consider the best information available that might affect the credit risk of the financial instrument. Typically, information that is more forward-looking than past-due information will be available, and that information should be used, together with delinquency information.
5. However, many respondents and field participants noted that they don’t have updated information on retail products *at an individual exposure level* prior to delinquency. These respondents understood our proposals to mean they could assess a significant increase in credit risk by only applying the 30 days past due rebuttable presumption for retail products even where forward looking factors are available, if those forward looking factors cannot be applied at an individual exposure level. However, a significant increase in credit risk gen-

¹ In this paper the term ‘loan’ is used as shorthand. The analysis would in fact apply to all financial instruments within the scope of the impairment model for which lifetime ECL are recognised when there is significant increase in credit risk since initial recognition.

erally occurs before loans become delinquent. This is because delinquency is a lagging indicator. This application therefore risks underestimating the extent to which a significant increase in credit risk has occurred.

6. Increases in credit risk can occur due to the crystallisation of initial expectations or as a result of a worsening of expectations. This paper considers the timeliness of identifying increased credit risk separately for these issues:
 - (a) Issue A—Capturing significant increases in credit risk if portfolio default expectations materialise as initially expected, before a loan becomes delinquent. See paragraphs 24 - 38.
 - (b) Issue B—Capturing significant increases in credit risk arising because of *changes* in credit risk factors (including forward-looking factors) from initial expectations, before a loan becomes delinquent. See paragraphs 39 – 52.

Alternatives considered and staff recommendation

7. The staff considered the following Alternatives in relation to this issue (see paragraph 58):
 - (a) **Alternative A – Clarify the proposals on significant increases in credit risk in the ED**
 - (b) **Alternative B: Clarify the proposals on significant increases in credit risk in the ED and prescribe methods to address Issue A and Issue B**
 - (c) **Alternative C: Clarify the proposals on significant increases in credit risk in the ED and include Illustrative Examples to reflect the intention of the proposals**

The staff recommends Alternative C (see paragraph 58(c)).

Background

8. This section provides the relevant proposals, the reason for the proposals and the related question asked in the ED:

[Par 5] The impairment model requires entities to measure the expected credit losses for a financial instrument at an amount equal to lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition.

[Par. B20] When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider the best information available that might affect the credit risk of the financial instrument. ... Consideration of the following may assist the entity when making that determination:

(p) past-due information as set out in paragraph 9.

[Par. 9] Typically, information that is more forward looking than past-due information will be available that shall be used to determine whether there has been a significant increase in credit risk at the reporting date. However, there is a rebuttable presumption that [there has been a significant increase in credit risk at the reporting date]... when contractual payments are more than 30 days past due.

[BC 75] Ideally, and consistently with the forward-looking nature of expected credit losses, an entity should use forward-looking information, such as the price for credit risk, probability of default occurring and internal or external credit ratings, when assessing whether it should recognise lifetime expected credit losses. However, many entities manage credit risk on the basis of information about past-due status and have a limited ability to assess credit quality on an instrument-by-instrument basis in more detail. Thus, the

IASB decided that an entity may consider information about past-due status, together with other, more forward looking information, in its assessment of the deterioration in credit quality, if appropriate. To supplement and to ensure that the criterion does not revert to an incurred loss notion, the IASB decided to include a rebuttable presumption that the criterion for the recognition of lifetime expected credit losses shall be met if an asset is more than 30 days past due and no other borrower-specific information that is forward-looking is available.

9. The IASB asked respondents the following question in the ED:

Question 5(b): Do the proposals provide sufficient guidance on when to recognise lifetime ECL? If not, what additional guidance would you suggest?

Feedback from comment letters and fieldwork

Feedback from comment letters

10. Some respondents to the ED commented about how ‘responsive’ to changes in macroeconomic conditions they thought the model:
- (a) *would be*, taking into consideration the different levels of system sophistication (ie their interpretation of the proposals and how they would be applied); and
 - (b) *should be* (ie their view on whether and how the requirements should be made more responsive).

Based on this, respondents suggested clarifications to the proposals.

How responsive the model would be

11. On the one hand, some respondents (including some preparers) thought the proposed model would not be responsive enough. Some were of the view that if an entity's credit risk management is less sophisticated, it would not be possible to identify increases in credit risk on individual financial instruments on a timely basis due to changes in economic conditions. A significant increase in credit risk would only be identified on an individual instrument level when the loan became delinquent. Related to this some raised concerns that the inability to identify increased credit risk at an individual financial instrument level would be used as an 'excuse' or justification that lifetime ECL need not or even must not be recognised. Others, for example the Basel Committee of Banking Supervision (who provided comments that have been prepared by the Committee's Accounting Expert Group), were concerned that the model would not result in allowances for ECL building up sufficiently before a payment default occurs. They state "determination of when to transfer loans from stage 1 to stage 2 ... must consider all information reflecting the build-up of credit risk in a banking portfolio." They further state that this assessment should not only include consideration of deterioration of the specific borrower's credit quality but also "institution-specific factors... and macroeconomic risk or risk drivers outside of the borrower's control (such as market interest rates, housing prices, or unemployment)". They also urge the Board to clarify the Board's intent regarding the past due criterion. "Otherwise there is a potential for this concept to be interpreted similarly to the discovery of a loss event in the incurred loss model, which delays loss recognition. We are concerned that institutions will resort to using "30days past due" as the primary indicator, without due consideration of whether other credit risk indicators are present"².
12. Conversely, other respondents were concerned that the proposed model would be *too* responsive and that changes in macroeconomic indicators alone could cause lifetime ECL to be recognised for a segment, or even a whole portfolio,

² See Comment letter from Basel Committee on Banking Supervision (BCBS).

of instruments even if there was no expectation that credit risk had actually significantly increased for that whole segment or portfolio. They were concerned this would result in an overstatement of lifetime ECL and that it would result in the allowances exaggerating cyclicality.

How responsive the model should be

13. Within the context of a deterioration model, respondents agreed that significant increases in credit risk should ideally be captured on a timely basis on individual financial instruments. However, there were different views on what to do when an entity does not have the information or sophistication to detect significant increases in credit risk on an individual instrument on a timely basis (eg before a loan becomes delinquent).
14. In particular, respondents had different views on how macroeconomic factors should influence the assessment of credit risk. Some felt that the final requirements should be specific about capturing *all* increases in credit risk, even when not individually identifiable. For example, the Basel Committee on Banking Supervision states “Pools of instruments with similar risk characteristics should be transferred to lifetime loss measurement if credit risk has increased significantly. This determination would consider historical experience and forward-looking macroeconomic factors and should take place even though objective evidence of a significant credit risk increase is not yet observable on an individual asset level”. Others stated that in particular, if an entity does not have sophisticated systems in place something additional should be done to make sure that all significant increases in credit risk are identified on a timely basis. Some suggested a management overlay to address the gap between the occurrence and identification of significant increases in credit risk.
15. Other respondents were of the view that the proposed model should not be *too* responsive to changes in macroeconomic indicators alone. They commented that this would cause undue volatility in loss allowances, feared that whole portfolios would need to move to lifetime ECL even when the whole portfolio

has not increased significantly in credit risk, would give rise to significant systems costs and they questioned whether it would provide useful information because it would not be closely linked to the credit risk of the entity's individual financial instruments.

Feedback from fieldwork

16. Many participants in our fieldwork said it was difficult to link macroeconomic data to a significant increase in credit risk for specific individual retail exposures. Because those participants could not identify which specific exposures have increased significantly in credit risk, they were concerned that applying a portfolio approach would result in them having to move entire portfolios to a lifetime ECL measure causing them to overstate the effect of increased credit risk. These participants therefore generally adjusted the 12-month allowance for the changes in macroeconomic conditions and moved loans to lifetime ECL only on the basis of delinquency information or sometimes based on other borrower-specific information such as restructurings.
17. To address the timing issue the fieldwork participants raised similar suggestions to address these issues as respondents in the comment letters (see paragraphs 14 - 15).

Issue for discussion

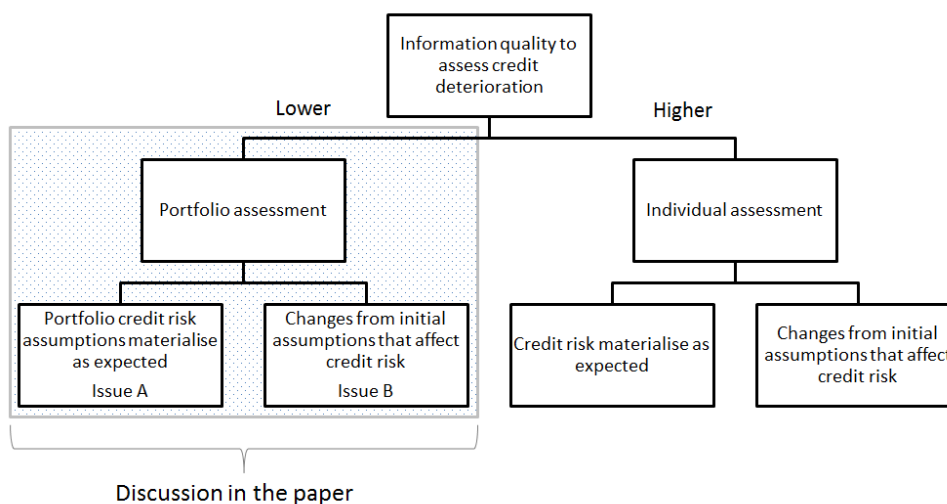
18. The objective of the proposed model was to recognise lifetime ECLs on all financial instruments that have significantly increased in credit risk since initial recognition. The IASB did however acknowledge that the availability of data needed to be considered – in particular at a minimum the ED included a presumption of a significant increase in credit risk when a financial instrument was 30 days past due. However, based on feedback from respondents, the staff are concerned that in practice the impairment model as articulated in the ED may not capture significant increases in credit risk since initial recognition on a timely basis when such increases are not evident at the individual exposure

level. This is particularly the case for retail loans when credit risk is not reassessed on an on-going basis at an individual exposure level before loans become delinquent.

19. However, for many portfolios significant increases in credit risk can occur well before delinquency or restructuring occur. In the staff's view, relying solely on past due status (or other non-forward-looking borrower-specific factors such as restructuring) and restricting the identification of increases in credit risk to an analysis at an individual facility level is contrary to the principles of the ED. It fails to capture lifetime ECL on items that have experienced a significant increase in credit risk on a timely basis.
20. The timeliness of capturing significant increases in credit risk primarily depends on whether the entity has the information available and can identify increases in a timely manner before loans become delinquent. So the extent to which efforts need to be made to identify significant increases in credit risk in addition to that identified at an individual financial instrument level in order to capture all significant increases in credit risk will vary by entity and product.
21. There are clearly different levels of sophistication in this respect and differences in the availability of data. At one end of the spectrum are entities and/or portfolios for which an entity is able to capture all significant increases in credit risk on a timely basis for individual financial instruments, including as a result of current and future expected macroeconomic conditions. This would be for example for portfolios where non-borrower-specific and borrower-specific information (including forward-looking information) is updated on a timely basis allowing a timely assessment about which financial instruments are affected by a significant increase in credit risk. At the other end of the spectrum are entities or portfolios for which entities do not have information to identify the signals of a significant increase in credit risk or where they cannot link these signals to an individual borrower level before a loan becomes delinquent (or other lagging borrower-specific factors occur such as a restructuring). When this lagging data is used in isolation to assess changes in credit risk the population for which lifetime ECL is calculated would be inadequate

to truly capture on a timely basis all financial instruments that have experienced a significant increase in credit risk.

22. This paper focuses therefore primarily on situations in which the information captured by credit risk management systems in itself does not enable significant increases in credit risk to be captured at an individual instrument level on a timely basis. This population can be reflected as shown below.



23. In considering the approaches, the staff sought input from some constituents. The feedback obtained is included in the analysis below.

Issue A: Portfolio default expectations materialise as initially expected

24. Issue A considers situations in which a significant increase in credit risk/default expectations arise on a portfolio basis *as initially expected* but cannot be identified at an individual loan level before a loan becomes delinquent. In contrast to Issue B, the concern is not to capture changes in the credit risk of financial instruments caused by unexpected *changes* in factors and conditions relevant to credit risk after initial recognition. Instead, Issue A considers the significant increases in credit risk that was initially expected at a portfolio level (and priced in at a portfolio level) but that cannot be identified at an individual instrument level on a timely basis because credit information about the borrowers is limited. This is perhaps best illustrated using a simple example as set out below.

Example 1

Company A originates 100 loans with a 5-year term in Region ABC. The loans are bullet loans with no significant payments due until maturity. At origination the loans are homogeneous—nothing differentiates them from a risk perspective. Assume for simplicity that

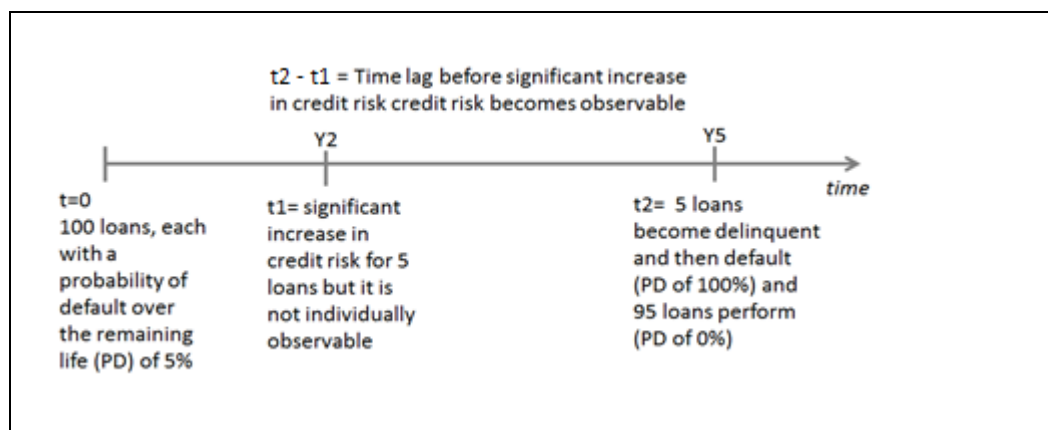
- (1) only the unemployment rate is a relevant credit risk factor;
- (2) a loan increases significantly in credit risk if the borrower loses his job even though the borrower can still service any of his loans for some time from his savings; and
- (3) the current unemployment rate in Region ABC is expected to remain constant over the next 5 years.

On the basis of current and forecast unemployment rates, the entity prices each loan based on its portfolio assessment. From a portfolio perspective it estimates that 5 out of the 100 loans will default at the end of the 5th year. Because nothing differentiates the loans from a risk perspective at origination, the entity estimates that each loan has a 5 per cent probability of default during its life. Assume the entity's expectations materialise as expected (so there is no variation from initial expectations).

If the entity managed the loans on an individual basis and always had up-to-date information about individual borrowers' employment status (ie had perfect information), information would materialise over time that would identify the 5 borrowers that have lost their job (for example, 5 borrowers lose their jobs 2 years into the loan). In other words, the entity would be able to identify the 5 loans that have increased significantly in credit risk (as initially expected) in Year 2 and would recognise lifetime ECL on them.

However, if the entity managed the loans on a portfolio basis and has no information about individual borrowers' employment status, it would not be able to identify this significant increase in credit risk before a loan becomes delinquent. It would only identify a significant increase in credit risk when the loans become delinquent at maturity (Year 5) instead of being able to identify them in Year 2 when the job loss occurs. Until maturity no lifetime ECL would be recognised and the portfolio would still seem homogeneous even though in reality it is not. The following graph illustrates this situation³:

³ For the purpose of simplification it is assumed that only 5 obligors lose their jobs and default. In reality the analysis would be more complex if, for example, the credit risk factor is such that more



25. If an entity had credit risk information (including forward looking information) that is updated on a timely basis and is based on a comprehensive set of information about the credit risk of the individual financial instrument, this increase in credit risk would be captured on a timely basis and an additional portfolio-based assessment would not be necessary. However, where the credit risk information is less timely, actual significant increases in credit risk occur that are not being faithfully represented.
26. In practice, issues about the timeliness of recognition of increases in credit risk are particularly relevant for product types for which reliance is placed on delinquency to identify increased credit risk and for which a long period of time elapses between the significant increases in credit risk and when delinquency arises (such as for non-amortising or bullet loans with insignificant payment obligations prior to maturity for which there could be a significant delay in the recognition of lifetime ECL relative to when the significant increases in credit risk actually occurs if delinquency forms the sole basis of the analysis). Some have in fact suggested that if we want to focus on solutions for Issue A the scope of any solution would be best restricted to this population.
27. The question arises whether there is a way to try to improve the timeliness of the identification of such increases in credit risk if it isn't being captured on a timely basis directly by credit risk information. The staff thinks that in princi-

obligors may show a significant increase in credit risk than ultimately default (ie if some of those obligors subsequently improve in credit quality again).

ple statistical methods could be used to estimate an undetected significant increases in credit risk before a loan becomes delinquent. For example, on the basis of its historical and current (including forward-looking) information, an entity could estimate the proportion of the performing book that experiences a significant increase in credit risk and expected timing. So using example 1, an estimate could be made of how quickly job losses occur.

28. However, the process would be challenging and critical to the success of approaches that look beyond information at an individual credit exposure level is the ability to identify
 - (a) the key drivers of significant increases in credit risk;
 - (b) the period when a significant increase in credit risk occurs; and
 - (a) the extent of undetected significant increases in credit risk in the portfolio (ie what proportion of the portfolio is affected).

29. To estimate the increased significant credit risk an entity would need to understand the drivers of that risk historically and to build from that information. However, often, translating and linking key credit risk factors and assumptions (for example GDP, interest rates or unemployment rates and assumptions) to specific borrowers is difficult. This is because at origination they are viewed as being homogeneous and over time the entity does not have access to information that distinguishes the borrowers from a credit risk perspective before they are delinquent. This means that it may also be difficult to apply a statistical approach which needs to start with historical information to identify the proportion of the portfolio that might be affected by increases in credit risk over time that were initially expected.

30. In addition estimating when increased credit risk occurs would be difficult. The period over which a significant increase in credit risk arises may be difficult to observe and/or to confirm, because the information available is inadequate and the entity does not have sufficiently sophisticated systems. Entities that rely only on delinquency would be unable to estimate the time lag between a relevant credit risk factor (eg unemployment) and delinquency. If

they were able to make such estimates, they would probably use more leading indicators than merely delinquency and Issue A would not arise.

31. Thus, there is a concern about feasibility, that diverse methods will be used and that they will lack empirical rigour. This will have a very real effect on the accuracy of the timing of recognition of lifetime ECL. For example, if the entity's estimate of the period between a significant increase in credit risk and a delinquency is too short (eg an entity assumes that a delinquency occurring at year 5 is preceded by a significant increase in credit risk occurring (for example the job loss in example 1) 2 years prior to delinquency, but in fact the significant increases in credit risk occurs 3 years prior to delinquency), the approach is not responsive enough to capture significant increases in credit risk on a timely basis. In other words, the entity recognises lifetime ECL on the basis that a significant increase in credit risk occurs 2 years instead of 3 years prior to delinquency. As a result, the allowance balance may be understated.
32. Although the approach described here is different to the incurred but not reported (IBNR) approach in IAS 39,⁴ it may be prone to similar application challenges due to the estimations involved and also similar issues of inconsistency in application. Thus, during outreach it was suggested that such an approach may not be the best way to measure the additional lifetime ECL but may nevertheless be a good way to explain the issue to emphasise why just an individual delinquency based assessment can be inadequate.
33. While using statistical approaches are likely to require significant judgement, it is arguably preferable to relying solely on information such as delinquencies to capture significant increases in credit risk, because of that approach's delayed recognition of lifetime ECL. This is particularly the case for portfolios with backended payment profiles (such as when payments are skewed toward

⁴ The IBNR approach in IAS 39 captures the incurred loss on the entire portfolio by considering the average amount of time from the point at which a loss event is incurred to the point at which it is identified. In contrast, this approach aims to capture the proportion of the portfolio that has increased significantly in credit risk but where the significant increase in risk has not been identified yet on an individual obligor level—this requires assessing the average time period significant increase in credit risk becomes known.

the maturity date) because problems with the timeliness of identifying significant increases in credit risk would be most pronounced.

34. From our outreach, we understand that entities may not have—at least for some of their portfolios—access to information to identify ‘expected’ significant increases in credit risk on a timely basis and prior to delinquencies arising.
35. Some questioned whether they could leverage their Basel data to identify the time lag between when a significant increase in credit risk occurs and when it is identified. Currently, all modelling and back testing for regulatory and credit risk management purposes is calibrated to data based on default rather than increases in credit risk. An approach that requires identification of the period between which (i) a significant increase in credit risk occurs and (ii) when a significant increase in credit risk becomes observable is thus not considered to be consistent with credit risk management systems. Availability of data would thus be a real issue.
36. During our outreach the concern was raised that generally the 12-month allowance already recognises the initial ECLs and the question was raised whether Issue A needed to be addressed. However, staff notes that the 12-month allowance would be low for instruments such as those with back-ended payment profiles such as non-amortising loans with little or no interest charges in the first few years of the instrument’s life. Because of the 12month PD focus in the proposed model for stage 1 the responsiveness of the assessment of increased risk is critical in this case. The staff acknowledges that this would not however be a significant issue when the time lag between a significant increase in credit risk and default is short as the difference between a 12month expected loss and lifetime expected loss would be insignificant.
37. Because of the interaction between capturing initial expectations in the 12month allowance and Issue A some think that if Issue A is addressed, the 12-month allowance may not be needed. Others think that Issue A should only be addressed in those circumstances where the 12month loss allowance does not adequately capture the initial loss expectations (eg for financial assets with

back ended payments) and note the benefits of the relative simplicity of the 12-month ECL calculation.

38. Finally, some banks raised the concern that it is unclear how this approach interacts with Issue B. These banks think that there is an interaction between the sub-portfolios that Issue A is seeking to identify and those that Issue B is seeking to identify, but because individual items are not identified the impact of that interaction will be difficult to quantify. They suggest that it may be more practical for Issue A and Issue B to be captured collectively. This approach would essentially have an objective of capturing all financial instruments that have significantly increased in credit risk, taking into account both initial expectations and changes in expectations since initial recognition.

Issue B—Changes in factors that affect credit risk (including forward-looking factors)

39. Issue B considers situations in which credit risk increases significantly because of *changes* in reasonably available credit factors (including forward-looking information), but when the increases in credit risk is not observable at an individual loan level before the loans become delinquent.⁵ If an entity has credit risk information that is updated on a timely basis and is based on a comprehensive set of information about the credit risk of the individual financial instrument. This significant increase in credit risk would be captured on a timely basis and an additional portfolio-based assessment would not be necessary.
40. For entities that capture changes in credit risk for individual financial instruments on a less timely basis the model would not faithfully represent the significant increases in credit risk in the loan book if increases are assessed solely on the basis of identifying specific deteriorated loans. For example, the gross

⁵ While Issue A aims to capture on a timely basis the credit risk/ default expectations that was initially expected on a portfolio basis (and priced in on a portfolio level), Issue B aims to capture timely changes in the credit risk of financial instruments caused by *changes* in factors and conditions relevant to credit risk *after* initial recognition.

domestic product (GDP), unemployment rate and house prices may be considered to affect defaults on mortgage loans. These credit risk factors can be considered to be reasonably available without undue cost or effort. Thus, changes in these macroeconomic credit risk factors after initial recognition should be considered when assessing whether there has been a significant increase in credit risk since initial recognition. However, because retail loans are typically managed on a portfolio basis before they become delinquent, entities may have little information with which to identify individual retail exposures that have increased significantly in credit risk because of changes in current and future macroeconomic factors. The following examples illustrate this:

Example 2: Significant increases in credit risk for mortgage loans, due to falling house prices

Bank B has issued a series of long-term residential mortgage loans with an average loan to value (LTV) of 80% in Region X. The mortgage loans are non-recourse beyond the property, have a minimal interest payment obligation prior to maturity and are non-amortising in the first 5 years. At the end of the second reporting period, the economic conditions deteriorate significantly in Region X and the value of properties in State Y (which is part of Region X) start to fall. Bank B estimates that housing prices will not recover in the short term because of the wider economic situation in Region X. Bank B does not observe any delinquency or default related to the respective mortgage loans in State Y but observes that the mortgages' LTVs have increased significantly from 80% to 100%.

If Bank B managed all loans in Region X on a portfolio basis and would recognise lifetime expected credit losses only when specific mortgage exposures become more than 30 days past due, Bank B would not recognise lifetime expected credit losses at the end of Period 2 for any of its loans.

However, if Bank B uses past-due status information as the only borrower-specific information *and* in addition considers other forward-looking information that is available without undue cost or effort to assess whether lifetime expected credit losses should be recognised, Bank B would recognise lifetime expected credit losses sooner. In such a situation, Bank B would assess the impact of falling house prices on its loans. Historically, falling house prices have been an indicator of future defaults on mortgages. Thus, as a result of the falling house prices in State Y, Bank B deter-

mines that the credit risk over the life of the loans in State Y have increased significantly since initial recognition and recognises lifetime expected credit losses at the end of the second reporting period for those loans.⁶

Example 3: Significant increases in credit risk for mortgage loans because of increase in interest rates

Bank C issues a series of residential variable rate interest mortgage loans with an average LTV of 80% and an interest margin of 250 bps. At the end of reporting period interest rates are expected to rise significantly during the term of those loans.

If Bank C assesses credit risk by means of past-due status and recognises a lifetime expected credit loss allowance only for loans that have a past-due status of more than 30 days past due, it does not recognise a significant increase in credit risk in its portfolio right away. However, if Bank C uses past-due status information as the only borrower-specific information *and* in addition considers other forward-looking information that is available without undue cost or effort, Bank C would recognise lifetime expected credit losses right away taking into consideration the future pressure on servicing when interest payment obligations rise. That is because historically, a rise in interest rates has been a lead indicator for future defaults on variable rate mortgage loans. On the basis of past behavioural data, Bank C expects that more mortgage borrowers will default at some point in the future as a consequence of those interest projections. Thus, despite there not yet being any delinquencies related to the mortgage loans, the credit risk of mortgage loans within the portfolio has increased significantly but Bank C cannot identify which specific loans are affected. Issue B considers this issue and how entities could assess significant increases in credit risk in such situations to ensure changes in credit risk are fully considered.

⁶ In practice Bank B may further divide State Y into further sub-portfolios for example based on past code or bands of LTV and determine that only particular sub-portfolios have significantly increased in credit risk.

41. To better reflect the true extent of the significant increases in credit risk, an entity could estimate (starting with historical data updated for current information including the effect of reasonable and supportable forward-looking information) the proportion of the portfolio that has experienced a significant increase in credit risk since initial recognition but that is not yet delinquent. It recognises lifetime ECL on that proportion of its performing book and a 12-month allowance (updated for current information including forward-looking information) for the rest of it. (We refer to this below as the ‘top down approach’). A simple example of this is as follows:

Example 4

Interest rates increase by 2 per cent. On the basis of historical information, the entity estimates that the change in interest rates will result in a significant increase in credit risk for x per cent of the portfolio. The entity recognises lifetime loss on x per cent of the portfolio and 12-month allowance on the remaining portfolio (100 per cent-x per cent) based on the notional value of the portfolio.

42. The most difficult aspect is determining the portion (ie the percentage) of the portfolio that shall be considered to have deteriorated significantly in credit risk. One approach would be to consider the marginal impact of the macroeconomic changes on the expected increase in delinquencies or default rate.
43. The advantage of the top down approach is that it would make it objective and individual loans would not need to be identified. However, if the entity does not have the sophistication to determine the proportion of the portfolio that has increased significantly in credit risk, this determination becomes highly judgemental and arbitrary, because any portion could be chosen.
44. One concern raised by some during our outreach about the practicability of this approach was that it could create a tracking problem. In subsequent periods, as increased credit risk of specific loans is actually identified, there would need to be an adjustment to the lifetime loss allowance to avoid double counting. However, this was not noted as a significant concern.

45. Another concern raised during our outreach was how the increases in credit risk relates to the proportion of the loans that would be treated as having significantly deteriorated (ie how to make the determination of the portion of the portfolio that has increased significantly in credit risk as suggested in paragraph 42). The concern raised was that the approach could result in having to divide the portfolio into segments to a much more detailed level, effectively turning the approach into a bottom-up approach (see below—Additional consideration, paragraphs 47 - 48), to determine the proportion of loans with lifetime ECL.
46. Finally, the concern was raised by some that conceptually the top down approach is not compatible with the proposals because it modifies the unit of account from an individual loan basis to a portfolio basis in a way that seems impossible to reconcile and to explain.

Additional consideration relating to Issue A and Issue B

47. In some cases using segmentation of portfolios may assist in determining significant increases in credit risk. For example, individual exposures could be grouped into subportfolios on the basis of common borrower-specific characteristics (eg geographical location or postcodes, headroom/access affordability at origination, behavioural scoring etc) (a so-called bottom up approach) and then the effects of macroeconomic indicators (eg house price indices/levels, unemployment rates, GDP) affecting the probability of default could be considered for the sub portfolios.⁷
48. Depending on the information the entity has to segregate the portfolio, it could address Issue A and Issue B either only for a portion of the notional of the portfolio (ie combining a bottom up with a top down approach) or by recognising lifetime ECL for a particular subportfolio if it still has shared risk characteristics that affect all those loans homogeneously and all are considered to have significantly increased in credit risk (applying a bottom up approach on-

⁷ As another aspect of segmentation, additional segmentation (cross-segmentation) may be necessary to avoid moving newly originated loans to lifetime ECLs when they are adequately priced for credit risk.

ly). This concept is described further below using situations akin to those set out in examples 2 and 3.

Example 5⁸

The entity segregates its loans into two sub-portfolios: high-loan-to-value (LTV) loans and other loans. Interest rates increase by 2 per cent. According to the entity's forecasting analysis, the increase in interest rates by 2 per cent significantly increases the probability of default for high-LTV loans but does not affect other loans. The entity recognises lifetime ECL on the high-LTV subportfolio for all loans that are not newly originated, even though these loans are not delinquent yet. All other loans remain at 12-month allowance (with appropriate re-estimation of 12-month allowance).

Example 6⁹

Interest rates increase by 2 per cent. According to the entity's forecasting analysis, the increase of interest rates by 2 per cent significantly increases the average PD of loans in a specific rating category (eg loan grade X). The entity recognises lifetime ECL on all loans of this specific rating category that are not newly originated.

49. The advantage of further segmentation is that the more detailed the segmentation, the higher the level of accuracy in
- (a) assessing whether there is a significant increase in credit risk since initial recognition; and
 - (b) estimating/measuring ECLs.
50. However, a concern raised in practice is that the more detailed the segmentation, the more difficult it will be to obtain sufficient data to model the ECL in a statistically robust manner for the population of loans on which lifetime ECLs are recognised.

⁸ This example assumes that the higher default expectations are priced into the new loans.

⁹ This example assumes that the higher default expectations are priced into the new loans. The example is also based on an increase in interest rates that has occurred. The same process would apply if an increase in interest rates were to be forecast.

51. Conversely, the larger the segments, the higher the level of inaccuracy when assessing significant increases in credit risk and when measuring ECLs. The inaccuracy is particularly pronounced for portfolios with greater heterogeneity (increases in credit risk may be masked or overemphasised). However, the larger the segments, the more data is available to model the ECLs in a statistically robust manner for the population of loans on which lifetime ECLs are recognised.
52. As a result, in practice entities are most likely to strike a balance between the ability to segment at a detailed level and the availability of data to model ECL.

Staff analysis and recommendation

53. Issue A and Issue B are closely related. Issue A deals with the situation in which a lifetime loss allowance needs to be recognised in line with initial expectations. Issue B is essentially an extension of Issue A. Issue B reflects a significant change in credit risk that is incremental (positively or negatively) to initial expectations and thus incremental to the lifetime allowance that would be established by virtue of Issue A.
54. In addition, Issue A and Issue B are closely related because good information will result in success in (and inadequate information will result in a failure to) recognise changes in credit risk whether that was caused by initial expectations that materialise as expected (Issue A) or due to changes in expectations after initial recognition (Issue B). As a result, the staff believes that it is best if the analysis focuses on how to address both Issues A and B in combination.
55. As a practical matter staff believe that Issue B is a concept more closely aligned with credit risk concepts and thus is more capable of being implemented. The staff also note that arguably the key concern this project seeks to address is timely recognition of changes in credit expectations, ie risks not priced for. Of the two issues, the staff believe that it is most important that Issue B is addressed for all types of loans. The staff agrees with the initial feed-

back received that Issue A is primarily a problem for financial instruments such as those with back-ended payment patterns (see paragraph 36).

56. The methods discussed in this paper would make the model more responsive compared to assessing increases in credit risk on a delinquency-only factor (or using factors such as restructuring) at an individual instrument level. They would also enable financial instruments that have increased significantly in credit risk to be included more comprehensively in the lifetime ECL measurement. The approaches would also avoid having to apply lifetime ECL to the entire portfolio if only a portion of the portfolio has increased significantly in credit risk.

57. Finally, the level of detail and accuracy of the analysis would be very different depending on the information available and the sophistication of the entity. This would lead to different outcomes and reduce comparability—ie the less detailed the approach, the greater the differences in outcome compared to a loan-level analysis based on good quality updated obligor-level information. The staff note however that the concept of comparability is somewhat elusive in any ECL model anyway. However, the staff think it is very important to retain a link with credit risk management concepts and to maintain the concept that application be based on information that is reasonably available without undue cost or effort to ensure the model remains operational.

58. The staff think that the Board could consider at least the following alternatives when considering whether the model adequately captures significant increases in credit risk :

(a) **Alternative A – Clarify the proposals on significant increases in credit risk in the ED:**

Clarify that the objective is to recognise lifetime ECLs on *all* financial instruments for which there has been a significant increase in credit risk and that information that is forward-looking and reasonably available needs to be considered. In other words, if forward-looking information is reasonably available, an entity cannot rely merely on delinquency information when assessing significant increases in credit risk and

emphasise that the model is not limited to identifying significant increases in credit risk where it is evident at an individual instrument level. Disclosure is required if the assessment is based on non-forward-looking information such as delinquency or restructuring.

(b) Alternative B: Clarify the proposals on significant increases in credit risk in the ED and prescribe methods to address Issue A and Issue B

Clarify that the objective is to recognise lifetime ECLs on *all* financial instruments for which there has been a significant increase in credit risk—whether on an individual or portfolio basis and that all reasonably available information including that which is forward looking needs to be considered. Clarify that the objective is to capture lifetime ECL to reflect all significant increases in credit risk. This would therefore include increases that are not identified on an individual exposure level before delinquency or other non-forward-looking borrower-specific information (for example restructuring). Alternative B would prescribe methods or techniques to address the lack of individual exposure information.

(c) Alternative C: Clarify the proposals on significant increases in credit risk in the ED and include Illustrative Examples to reflect the intention of the proposals

Clarify that the objective is to recognise lifetime ECLs on *all* financial instruments for which there has been a significant increase in credit risk—whether on an individual or portfolio basis and that all reasonably available information including that which is forward looking needs to be considered. Thus the final Standard would remain principle-based. The final Standard would note that entities have various degrees of sophistication in capturing significant increases in credit risk on a timely basis taking into account current and future macroeconomic conditions. It would emphasise clearly that credit risk can increase significantly before delinquency or other lagging borrower specific factors are observed. For

portfolios, for which credit risk information is such that significant increases in credit risk cannot be identified on individual items on a timely basis it would be noted that particular attention should be made to ensure that the objective of capturing all significant increases in credit risk is satisfied. The final Standard would include examples of the type of increases in credit risk to be considered (such as examples 2 and 3) and note that portfolios analysis may be required. The staff is of the view that both Issue A and Issue B need to be addressed for loans with back-ended payment profiles and for financial instruments where a long period of time elapses between significant increases in credit risk and delinquency. For all other loans the staff believes that it is most important that Issue B is addressed. Finally, it would note that estimation techniques can be used to ensure that significant increases in credit risk are properly captured on a timely basis.

59. While Alternative A takes into account that entities are naturally limited in their assessment of significant increases in credit risk, based on the information available and the sophistication of its credit risk systems, it does not introduce concepts of specific estimation techniques to address shortfalls in information. Instead, it relies on the signals about increases in credit risk that the entity can pick up and acknowledges that some entities will lack the forward look in their assessment because the increases cannot be identified on a timely basis. However, it would emphasise that the assessment of increases in credit risk is NOT limited to where it is evident at an individual facility level so would assist in preventing entities from arguing that they are unable or not required to recognise lifetime ECLs on financial instruments in the absence of evidence of significant increases in credit risk at a facility specific level. **At a minimum the staff believe that this clarification is important and would alleviate many of the concerns raised about the responsiveness of the proposed model.**
60. Arguably, at a purely conceptual level, Alternative B is most beneficial from a decision usefulness perspective if the bottom-up approach is prescribed (ie where an entity identifies significant increases in credit risk based on an analy-

sis of the effects of credit relevant factors on particular items in portfolios based on their characteristics). It results in the highest level of accuracy when assessing increases in credit risk compared to the other alternatives. It best reflects the economics of significant increases in credit risk if it cannot be specifically identified at the facility level. However, it risks adding significant operational costs and complexity. Not all entities will have the resources, information and capability to do this for all of their portfolios – and ironically those with the biggest issues in terms of timeliness of identifying significant increases in credit risk would probably have the greatest difficulty applying these approaches. However, some argue that for entities that do not have the systems to capture increases in credit risk at a detailed level should build that capacity. They think that not having detailed systems is a weakness in internal control and provides little information that is useful for helping to make decisions.

61. However, the staff note that any approach described in this paper would require an additional layer of complexity to be introduced beyond simply using information that is easily captured in credit risk systems now, such as delinquency information. In addition, the staff do not consider that prescribing a specific approach is feasible because entities have different levels of sophistication and availability of information. As a result, entities may not be able to apply a detailed approach such as the bottom-up approach (described in paragraphs 47 - 48) as the information is simply not available.
62. Further, requiring a specific detailed approach would contradict the approach taken in the ED and preferred by the IASB to date. Throughout the development of the ED, the IASB took into account different levels of sophistications of entities. The ED reflects this—it proposes that the estimates shall be based on information that is reasonably available without undue cost or effort. In addition, the ED does not prescribe a specific method to assess significant increases in credit risk. Finally, prescribing a particular approach would be contrary to the approach taken in the ED of establishing a measurement objective and allowing entities to decide how best to meet that objective.

63. The clarifications in Alternative C would prevent entities from having an excuse not to recognise lifetime ECL, on the basis that at an individual exposure level a significant increase in credit risk cannot be identified on a timely basis. Although the ED did not require that a significant increase in credit risk had to be identifiable at an individual instrument level, the staff are aware that some have read the words in the ED as limiting their ability to make the assessment at a portfolio level or that they are restricted to using delinquency information. Alternative C makes clear that relying only on delinquency as the factor to assess a significant increase in credit risk is insufficient, even if the assessment becomes judgemental. Alternative C is based on the view that the benefit of making the model more responsive is greater than the cost of the measurement being only an approximation in some cases.
64. Alternative C also takes into account the different levels of sophistication and information available to the entities. It acknowledges that the need (and the extent of the need) to make adjustments to fully reflect increases in credit risk would vary by entity and product and also would enable entities to determine how best to meet the measurement objective (ie what techniques and information to use).
65. However, the disadvantage of Alternative C is that the allowance recognised may differ depending on the approach applied, resulting in a lack of comparability. The staff do not believe this should however be a key consideration given the inherent subjectivity of all ECL measurements.
66. On the basis of the discussion above, the staff recommend Alternative C, because:
- (a) it addresses the concern that the model is not sufficiently responsive, clarifying that the objective of the model is to recognise lifetime ECLs on *all* financial instruments for which there has been a significant increase in credit risk—whether on an individual or portfolio basis — and that all reasonably available information including that which is forward looking needs to be considered, even if the assessment becomes judgemental;

- (b) it confirms specifically that particular effort needs to be made to assess changes in credit risk for financial instruments with back-ended payment profiles;
- (c) it does not prescribe a specific approach or mandate when estimation techniques are required and takes into account different levels of sophistications and information available to entities; and
- (d) providing examples will help reinforce the objective of the model to capture significant increases in credit risk even when not evident at an individual facility level.

Question

Does the IASB agree with the staff recommendation (Alternative C) to clarify the proposals on significant increases in credit risk in the ED and include Illustrative Examples to reflect the intention of the proposals?.

STAFF PAPER

16-19 September 2013

IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Stage 1 Measurement objective		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

Purpose of this paper

1. The Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* ('the ED') proposed that 12-month expected credit losses (ECL) be recognised for financial instruments for which there has not been a significant increase in credit risk since initial recognition. 12-month ECL are the expected shortfalls in contractual cash flows over the life of a financial instrument that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring.
2. The purpose of this agenda paper is to consider whether the IASB would want to retain the 12-month ECL measurement objective for financial instruments in Stage 1 of the proposed general model. The paper does not consider any alternative expected credit loss impairment models, such as recognising lifetime ECL on all financial instruments. It also does not consider the measurement of expected credit losses which will be discussed at a future meeting.

Summary

3. The vast majority of respondents supported the proposals in the ED as an appropriate balance between faithful representation of credit losses on financial instruments and the costs of producing that information. Most specified that they agree with the IASB that initial credit loss expectations are priced into assets when originated or purchased and supported an approach that considers increases in credit risk when deciding the extent to which expected credit losses should be recognised. Furthermore, most accepted the 12-month ECL as an operational simplification of reflecting the initial credit loss expectations and welcomed the ability to use different methods to calculate it. However, some did not agree with recognising any expected credit losses for financial instruments where credit risk has not increased significantly since initial recognition. Others suggested alternative measurement objectives that would address some of the concerns raised about the conceptual justification and/or operability of the proposed measurement objective.
4. The staff note that the IASB has already considered and rejected some of the alternatives suggested. This agenda paper therefore considers the suggested alternatives as follows:
 - (a) Alternatives previously considered:
 - (i) Foreseeable future or reliably estimable and predictable period (paragraph 24-26);
 - (ii) Loss emergence periods (paragraph 27-30);
 - (iii) Outlook period longer than 12 months (paragraph 31-33).
 - (b) Other alternatives
 - (i) Option 1: No ECL allowance for Stage 1 (paragraph 34-40);
 - (ii) Option 2: Retain 12-month ECL measurement objective (paragraph 41-48);

Staff recommendation

5. The staff consider the 12-month ECL (Option 2) to be superior to all the other alternatives considered as the Stage 1 measurement objective, for the reasons set out in the ED and for the reasons discussed in paragraphs 43 and 44: The staff therefore recommend that the IASB retain the measurement objective for financial instruments in Stage 1 as proposed in the ED and reaffirm why this measurement objective is considered appropriate a proxy for:
 - (a) the measurement and allocation of initial expected credit losses; and
 - (b) subsequent changes in credit risk that are not considered significant.
6. This paper is set out as follows:
 - (a) What the ED proposed and why (paragraphs 7-9)
 - (b) Detailed feedback received (paragraphs 10-22);
 - (c) Analysis of alternatives suggested (paragraphs 23-48); and
 - (d) Staff recommendation and questions to the IASB (paragraphs 49-51).

What the ED proposed and why

7. This section provides the relevant proposals, the related Basis for Conclusions and the question asked in the ED:

[Par 4] Subject to paragraphs 12–15, at the reporting date an entity shall measure the expected credit losses for a financial instrument at an amount equal to the *12-month expected credit losses* unless the requirements of paragraph 5 are met.

[Par 5] At the reporting date, the entity shall measure the expected credit losses for a financial instrument at an amount equal to the *lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition.

[App A] 12-month expected credit losses: The expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date.

8. Extract from the Basis for Conclusions:

[BC29] The IASB concluded that a recognition mechanism is required that preserves, to as great an extent as possible, the objective of the 2009 ED and reduces the effect of double-counting. Thus, the IASB decided to pursue a model that recognises two different amounts for different phases of deterioration in credit quality. Such a dual-measurement model would require that an entity must recognise:

(a) a portion of the lifetime expected credit losses from initial recognition as a proxy for recognising the initial expected credit losses over the life of the financial asset; and

(b) the lifetime expected credit losses when credit quality has deteriorated since initial recognition (ie when the recognition of only a portion of the lifetime expected credit losses is no longer appropriate because the entity has suffered a significant economic loss).

[BC30] The IASB considered the timing of the recognition of the full lifetime expected credit losses together with the size of the portion of the lifetime expected credit losses that are recognised from initial recognition. The IASB considered the interaction between these decisions to be a determinant of what would provide a more faithful representation of the economic loss, and what would best approximate the outcome of the model in the 2009 ED. Thus, if an entity recognises a smaller portion of the lifetime expected credit losses initially, it should recognise the full lifetime expected credit losses earlier than if it were

required to recognise a larger portion of the lifetime expected credit losses initially.

[BC40] While the proposal to require an entity to recognise 12-month expected credit losses for financial instruments that have not significantly deteriorated in credit quality will be less costly and complex than estimating the full expected cash flows for all financial instruments, the calculation will increase the cost and complexity compared to current requirements (see paragraphs BC61–BC66). This cost will be lower for entities that are already required to measure a similar amount to comply with prudential regulations. However, even those entities would have to adjust the measurement to meet the requirements of the proposals in this Exposure Draft. The requirements will increase the costs of implementation for entities that are not required to measure 12-month expected credit losses to comply with prudential regulations, because it will be a unique calculation that would not normally be required for other purposes. Notwithstanding these costs, measuring 12-month expected credit losses will be less costly and complex than a measurement that would require the entity to estimate all expected cash flows, such as the 2009 ED and the model in the SD. In addition, in some cases, entities can use information such as credit loss rates for measuring 12-month expected credit losses, thus building on information that they have already used for credit risk management purposes.

[BC61] The IASB considered what measure of expected credit losses would be both appropriate and cost-effective for financial instruments at initial recognition and before significant deterioration in credit quality has occurred. The IASB accepted the concerns of interested parties about the operational complexity of the methods proposed in the 2009 ED and the SD. The IASB also accepted that significant judgement would be required for any estimation

technique that an entity might use. Consequently, the IASB decided that an entity should measure the loss allowance at 12-month expected credit losses. In the IASB's view, the overall result of such a measurement, combined with the earlier recognition of the full lifetime expected credit losses, would achieve an appropriate balance between the benefits of a faithful representation of expected credit losses and the operational costs and complexity. The IASB acknowledges that this is an operational simplification, and that there is no conceptual justification for the 12-month time horizon.

[BC62] The IASB considered whether an entity should recognise a larger portion of expected credit losses before there is significant credit deterioration. However the IASB rejected requiring a larger portion of expected credit losses to be recognised because:

- (a) a larger portion would increase the overstatement of expected credit losses at initial recognition and thus, when considered with the much earlier timing of the recognition of the lifetime expected credit losses, would be a less faithful representation of the underlying economics; and
- (b) 12-month expected credit losses are similar to a measurement that some regulated financial institutions already apply, and would therefore be less costly to implement for those entities.

[BC63] To address concerns raised about the ambiguity of the 'foreseeable future' definition in the SD, the IASB decided to define the portion of the lifetime expected credit losses that are to be recognised initially in a better way than the SD did. 12-month expected credit losses is the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring. Thus, 12-month expected credit losses are a portion of the lifetime expected credit losses. An entity would measure both

amounts consistently at an expected present value (see paragraphs BC81–BC97). 12-month expected credit losses are not the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months. The IASB observed that if an entity applies the proposals properly, it would recognise lifetime expected credit losses on financial instruments on which it predicts a default to occur in the next 12 months, because they would have deteriorated in credit quality since initial recognition (unless they are purchased or originated credit-impaired financial assets). 12-month expected credit losses are not the cash shortfalls that are predicted over the next 12 months.

[BC64] The similarity between the 12-month expected credit losses calculation and some prudential regulatory requirements for the 12-month probability of default also reduces the cost of implementation for some sophisticated financial institutions. However, an entity will have to adjust these regulatory measurements of the probability of default to comply with the proposed requirements in this Exposure Draft. For other entities, the measurement of the 12-month expected credit losses is a calculation that would not normally be required for other purposes. However, in some cases, the cost can be minimised by building on information that an entity already uses for risk management purposes, such as credit loss rates.

[BC66] The IASB acknowledges that the 12-month expected credit losses proposal in this Exposure Draft would result in an overstatement of expected credit losses for financial instruments, and a resulting understatement of the value of any related financial asset, both at and immediately after initial recognition of those financial instruments. In particular, the initial carrying amount of financial assets would be below their fair value. However, isolating initial credit loss expectations for recognition over

the life of financial instruments is operationally complex and this measurement of expected credit losses serves as a practical approximation. The recognition of a portion of expected credit losses for financial instruments that have not deteriorated significantly in credit quality also limits the requirement to perform the more costly and complex calculation of the lifetime expected credit losses. In addition, in the IASB's view, measuring 12-month expected credit losses for some financial instruments would be less costly than always calculating the lifetime expected credit losses as proposed in the SD.

9. Questions from the ED:

Question 2 [extracted from ED]

(a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?

Question 4 [extracted from ED]

Is measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

Detailed feedback received

Stage 1 measurement objective

10. Most respondents, including users of financial statements accepted the 12-month ECL as a pragmatic solution to achieve an appropriate balance between faithfully representing the underlying economics and the cost of implementation. Most users considered 12 months a reliable period to estimate expected credit losses for financial instruments that have not significantly deteriorated. Additionally some user representative groups stated that a 12-month ECL allowance provides them with useful information, as they consider that on a portfolio level some expected credit losses may arise during the reporting period that were not adequately priced in.
11. However, some respondents did not agree with recognising any expected credit loss allowance for financial instruments that have not experienced significant credit deterioration since initial recognition. These respondents considered initial expectations of credit losses to be included in the pricing of a financial instrument and they were conceptually opposed to the recognition of a loss allowance on initial recognition ('Day 1 losses'). A few others were only opposed to recognising 12-month ECL on financial assets such as high quality debt securities that would be measured at fair value through other comprehensive income (FVOCI) in accordance with the Classification and Measurement ED.
12. Jurisdictional differences and/or preferences have also emerged, whereby preparers in some jurisdictions were concerned that the 12-month ECL would result in a reduction of overall allowance balances. This is because entities in these jurisdictions have applied current accounting requirements (including in some cases IAS 39) more broadly.
13. One respondent noted that replacing the term 'probability of default' with the probability of 'significant deterioration' would in their view ensure that the 12-month ECL is not linked solely to payment default but instead captures indicators or loss expectation that precipitate eventual non-payment.

14. The staff note that in some cases concerns about the adequacy of the 12 month allowance may have been related to a misconception about when such financial instruments would move to a lifetime ECL measure or a concern about how the proposals might be applied in practice. The ED proposed that changes in credit risk should be assessed over the life of the instrument and not just over the next 12 months so the outlook period for the assessment of deterioration extended beyond 12 months.

Foreseeable future or reliably estimable and predictable period

15. Some respondents explicitly commented that they do not support concepts such as ‘foreseeable future’ or ‘reliably estimable and predictable’ as a measurement objective. These respondents consider the foreseeable future to be open to manipulation because it cannot be clearly defined and is not founded in credit risk management. They also consider a foreseeable future or reliably estimable and predictable period to weaken the link to the 2009 ED of expected credit losses reflecting the economics of lending.
16. Others were concerned that a period that is reliably estimable and predictable during favourable economic circumstances may not remain the same under less favourable circumstances (ie it may contract in periods of increased uncertainty). Respondents also expressed concern that such an approach would penalise more sophisticated entities that are capable of longer range forecast and may discourage entities from properly developing expected credit loss models.

Outlook or loss emergence period longer than 12 months

17. A small number of respondents, in particular some regulators and users of financial statements, were concerned that the 12-month ECL would not adequately reflect the expected credit losses inherent in some financial instruments such as interest-only mortgages or bullet repayment loans (instruments that require that significant payments only be made at maturity). Some of these respondents considered an outlook or loss emergence period of more than 12 months to be a potential way in which to achieve convergence.

18. Others specifically commented that they were strongly opposed to extending the loss allowance for financial instruments that have not significantly deteriorated to encompass an outlook period beyond 12 months. They were willing to accept the 12-month ECL as a pragmatic solution (see paragraph 10) to recognise the initial expected credit losses and measure changes in expected credit losses resulting when those changes are not significant.

Operability

19. Although most respondents considered the 12-month ECL to be without conceptual justification, many accepted it as a pragmatic solution to achieve the objectives of the proposed model.
20. Most respondents, including some who did not support the 12-month ECL as the measurement objective for Stage 1, considered it to be operational. This was because entities would be able to leverage existing credit risk management systems and data, including regulatory models, as the basis from which to apply the proposed approach.
21. Among the respondents that considered the 12-month ECL to be operable were insurance entities and corporate entities, as well as financial institutions that were using less sophisticated credit risk management systems. These respondents did however request additional guidance and examples on how to implement the proposals.
22. Some respondents have commented that for Basel-regulated entities, the operational complexity could be further reduced if the 12-month ECL were fully aligned to the expected credit loss measure applied for prudential regulatory purposes¹.

¹ This agenda paper does not consider the measurement of expected credit losses. This will be considered at a future meeting.

Alternatives previously considered and rejected

23. During the development of the expected credit loss model proposed in the ED, the IASB considered alternative measurement objectives for those financial instruments where credit risk has not increased significantly since initial recognition. The following alternatives suggested by respondents in their comment letters have been previously considered and rejected by the IASB for the reasons set out below and no further analysis of these alternatives are performed.

Foreseeable future or period that is reliably estimable and predictable

24. The Supplementary Document *Financial Instruments: Impairment* ('the SD') published in January 2011 proposed that financial assets should be divided into two groups: those for which the recognition of lifetime expected credit losses over time would be appropriate ('the good book') and those for which the immediate recognition of lifetime expected credit losses would be appropriate ('the bad book'). The loss allowance for the good book would have been calculated as the greater of:
- (a) a time-proportionate loss allowance and
 - (b) expected credit losses for the foreseeable future, ie a 'floor' for expected credit losses.
25. The feedback received about the floor for the good book was geographically split, with respondents outside the US generally opposing it and respondents from the US generally supporting it. Furthermore, respondents expressed concerns about the calculation of expected credit losses for the foreseeable future, with many expressing confusion about the underlying conceptual basis for such a limitation to the time period². Many also noted that, notwithstanding the conceptual concerns, the boards had not sufficiently defined the term 'foreseeable future' to ensure consistent application.

² In contrast, the 12-month ECL measure considers the lifetime ECLs that would arise if a default arose in the next 12 months, weighted by the probability of such default occurring.

26. In response to the concerns raised about the foreseeable future, the IASB rejected the approach. To address these concerns about the ambiguity of the foreseeable future definition in the SD, the IASB decided to define the measurement objective for financial instruments in Stage 1 as 12-month ECL.

Loss emergence period

27. During the development of the proposed model, the IASB considered defining the Stage 1 measurement objective as the total amount of shortfalls in cash flows expected to materialise on financial assets for which there has been no meaningful deterioration in credit quality, based on expected loss emergence patterns³. Under this alternative, entities would consider all reasonable and supportable information available to it, including historical information in order to determine the average period of time over which meaningful deterioration is expected to occur.
28. In considering the loss emergence period, the IASB considered the following three approaches:
- (a) not defining boundaries for the emergence period;
 - (b) a floor of 12 months but with no upper boundary; and
 - (c) defining a range for an emergence period (eg between 12 and 24 months).
29. The IASB considered that different asset classes have different loss patterns and different loss emergence periods, therefore estimating expected credit losses over the relevant period of time it takes for an event to happen and for the effects to be known, may be conceptually correct. However, the IASB noted that ‘emergence’ notions fit more naturally in an incurred loss model where it is difficult to identify when a loss has been incurred on an individual items.

³ Agenda paper 6A, Topic 2, December 2011

30. The IASB also noted that emergence periods may change over the life of financial instruments and depend on the economic cycle. As a result, the IASB considered that this approach would be more operationally difficult than one that has a defined period because an entity would have to continually assess that it was using the appropriate emergence period using all information available to it.

Outlook period of more than 12 months

31. The IASB also considered whether to require expected credit losses to be estimated over an outlook period of more than 12 months, in particular 24 months was considered. The IASB rejected this approach for the following reasons as set out in paragraph BC62 of the ED:
- (a) A longer outlook period would increase the overstatement of expected credit losses at initial recognition and thus, when considered with the much earlier timing of the recognition of the lifetime expected credit losses (when significant increases in credit risk occur), would be a less faithful representation of the underlying economics; and
 - (b) 12-month ECL are similar to the measurement that some regulated financial institutions already apply, and would therefore be less costly to implement for those entities than a measure that requires a period of more than 12 months.
32. As noted in paragraph 18, some respondents specifically commented that they would not support a period of more than 12 months as the measurement objective for Stage 1. They consider a 12 month period to be consistent with the period used for credit risk management and regulatory purposes. Some also noted that for some products a period of more than 12 months, eg 24 months may be close to or more than the expected lifetime of the product, which would result in lifetime ECL being recognised without a significant increase in credit risk since initial recognition.

33. The staff are of the view that the only circumstance in which the IASB should reconsider extending the outlook period would be if that provided an opportunity for convergence (ie if the FASB were to consider making a distinction in the measurement of ECL based on changes in credit risk and were to use an outlook period of more than 12 months for those items where credit risk has not increased significantly).

Other alternatives (not previously considered by the IASB)

Option 1: No ECL allowance for Stage 1

34. Most of the respondents that did not support the measurement objective for Stage 1 did so because they disagree conceptually with recognising expected credit losses on initial recognition of a financial instrument that is initially measured at fair value (as is always the case under IFRS) as this does not faithfully represent the economics of the transaction.
35. Some also noted that the proposed model is not responsive enough to changes in credit risk and that the effect of significant increases in credit risk are not captured on a timely basis⁴. They noted that if the responsiveness of the proposed model is improved so that significant increases in credit risk are captured even if it is not evident at the individual exposure level, no allowance balance would be required for financial instruments for which credit risk has not increased significantly.

Staff analysis:

36. Paragraph BC66 of the ED acknowledges that the 12-month ECL would result in an overstatement of expected credit losses and a resulting understatement of the initial carrying amount of financial assets which would be below their fair value. Recognising no allowance balance for financial instruments for which credit risk has not increased significantly, would in fact be consistent with the requirement in IFRS 9 *Financial Instruments* that financial instruments should be recognised at fair value on initial recognition.

⁴ See Agenda Paper 5A for this meeting

37. The staff does acknowledge that there is a relationship/balance to be struck between the recognition of ECLs for financial instruments in Stage 1 and for other financial instruments. Therefore if the IASB decides to make changes to the proposals in the ED that result in earlier recognition of significant increases in credit risk⁵ there is arguably less need to capture ECLs for items that have not significantly increased in credit risk that are essentially still appropriately priced for their credit risk. However, only recognising lifetime ECL when there has been a significant increase in credit risk, without recognising any expected credit losses before that to reflect the changes in initial expectations since initial recognition, would still fail to appropriately reflect the economic losses experienced as a result of those changes (even if not significant). As explained in paragraph BC19 expected credit losses are implicit in the initial pricing for the instrument but subsequent changes in those expectations represent economic losses (or gains) in the period in which they occur. Not reflecting increases in credit risk before the change is considered significant, will fail to recognise those economic losses.
38. Regulators and users of financial statements were particularly concerned that changes in loss expectations since initial recognition may not be adequately recognised and measured until significant credit deterioration occurs. Recognising expected credit losses only when there has been a significant increase in credit risk will further delay the recognition of expected credit losses compared with the ED. It would also risk being subject to the same criticisms as the incurred loss model that the recognition of expected credit losses would be delayed until the occurrence of an event, even if the event represents a significant increase in credit risk rather than an incurred loss.

⁵ See Agenda paper 5A for this meeting.

Staff conclusion

39. The staff agree with the reasons provided in paragraphs BC19 and BC66. More importantly, the staff consider not recognising the economic losses that arise from changes in initial expectations before they are considered significant, as inconsistent with the objectives of the proposed model. They also note that in the absence of the recognition of some ECLs for financial instruments in Stage 1 the full contractual interest would be recognised with no offset for initial credit loss expectations. While the recognition of the 12-month ECL is a very crude approximation for the yield adjustment achieved by the IASB's 2009 ED, the staff think that it would be inappropriate to have no adjustment at all.
40. The staff believe that if no loss allowance is required for financial instruments in Stage 1, the point at which lifetime ECL is recognised should be earlier than when credit risk has increase significantly. However, most respondents agreed that it is appropriate to recognise lifetime ECL when there has been a significant increase in credit risk. The staff therefore does not recommend changing the timing of recognition of lifetime ECL in conjunction with having no allowance for Stage 1 financial instruments.

Option 2: Retain 12-month ECL subject to clarification

41. As stated in paragraph 10, most respondents, including users of financial statements accept the 12-month ECL as a pragmatic solution to achieve an appropriate balance between faithfully representing the underlying economics and the cost of implementation.
42. However, respondents raised the following concerns and proposed that these matters be clarified to improve the understanding and application of the Stage 1 measurement objective:
- (a) lack of conceptual understanding about what the 12-month ECL represents;
 - (b) limiting the outlook period to 12 months only considers the probability that a default will occur within the 12-months after the reporting date and ignores the subsequent periods; and

- (c) the information that should be considered and how the 12-month ECL should be measured.

The discussion below considers (a) and (b) above. The information that should be considered and the measurement of expected credit losses ((c) above) will be considered at a future meeting.

Staff analysis

(a) Understanding what the 12-month ECL represents

43. With the 2009 ED, one of the IASB's objectives was to address concerns that the existing incurred loss model in IAS 39 results in overstating interest revenue in periods before a credit loss event occurs. Because of operational challenges and the desire of users of financial statements to see the contractual interest revenue separately from the accounting for expected credit losses, the IASB decided to decouple the measurement and allocation of initial expected credit losses from the determination of the effective interest rate. The 12-month ECL therefore serves as a crude proxy for the measurement and allocation of initial expected credit losses.
44. In addressing the operational challenge of having to estimate the full expected cash flows for all financial instruments as required by the 2009 ED, the proposed model only requires lifetime ECL to be recognised when credit risk has increased significantly. However, as explained in paragraph 37, changes in credit loss expectations subsequent to initial recognition give rise to economic losses. Only recognising lifetime ECL when there has been a significant increase in credit risk, without recognising any expected credit losses before that to reflect the changes in initial expectations since initial recognition, would fail to appropriately reflect the economic losses experienced as a result of those changes. The 12-month ECL therefore also serves as a proxy to measure those subsequent changes in expectations in a way that is operational and less costly than the proposals in the 2009 ED.

(b) Limited to 12 month outlook period

45. One of the main areas for concern expressed about the 12-month ECL is that it only considers the probability of a default occurring within the 12 months after the reporting date and ignores those that are expected to occur in later periods.

46. The staff note that although 12-month ECL is measured based on the probability of a default occurring in the next 12 months, the period over which changes in credit risk should be assessed is the remaining life of the instrument and is not limited to 12 months. Thus it was not the case that the ED ignored default risk beyond a 12 month period. As explained in paragraph 44, the 12-month ECL was a pragmatic solution to recognise changes in credit risk that are not significant. **Agenda paper 5A** considers concerns that the significant increases in credit risk are not identified on a timely basis.

Staff conclusion

47. The staff consider the 12-month ECL to be superior to all the other alternatives considered as the Stage 1 measurement objective, for the reasons set out in the ED and in the above paragraphs.
48. The staff therefore recommend that the IASB retain the measurement objective for financial instruments in Stage 1 as proposed in the ED and reaffirm why this measurement objective is considered appropriate⁶.

Staff recommendation

49. The staff **recommendation** is to retain the 12-month ECL as the measurement objective for financial instruments in Stage 1 (**Option 2**) for the reasons set out in the ED and as explained in paragraphs 43-46.
50. The staff **rejected** not recognising a loss allowance for Stage 1 financial instruments (**Option 1**) because the staff consider that not recognising the economic losses that arise from changes in initial expectations before they are considered significant is inconsistent with the objectives of the proposed model which aims to reflect changes in credit risk on a timely basis.

⁶ Some suggested a modification to focus on the probability of significant deterioration. However this would be inconsistent with credit risk management systems and thus would require recalibration of risk parameters which would involve significant costs. Furthermore, if the expected credit losses measured for accounting purposes are not consistent with the information used for credit risk management purposes, relevant and useful information will not be provided to the users of financial statements. While the staff acknowledge it would result in more timely recognising lifetime ECL, they do not think that this approach is viable due to the cost of producing this information and the disconnect with credit risk management.

51. The staff further believe that if no loss allowance is required for financial instruments in Stage 1, the point at which lifetime ECL is recognised should be earlier than when credit risk has increased significantly. However, this would be inconsistent with the feedback received from respondents regarding what is operational.

Question to the IASB

Does the IASB agree with the recommendation to retain the 12-month ECL as the measurement objective for financial instruments in Stage 1 of the proposed model? If not, why not and which measurement objective does the IASB prefer?

STAFF PAPER

16-19 September 2013

IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Definition of default		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Purpose of this paper

1. At the July 2013 joint board meeting, the staff provided a high level summary of the main messages received during the outreach activities and comment period on the Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* ('the ED').
2. Although the vast majority of participants and respondents supported the proposals in the ED, constituents have identified certain areas/topics where the ED proposals should be improved and/or clarified. One such area was the notion of default and more particularly, what would constitute default in the context of the proposals.
3. In particular respondents to the comment letters and some participants in the field work and outreach activities noted that default should be clearly defined in order to promote consistency as it is fundamental to the measurement of the probability of a default occurring. Respondents in particular highlighted the measurement of the 12-month expected credit losses ('ECL') and the assessment of significant deterioration to be dependent on how default is defined.

4. Both the 12-month ECL (Stage 1) and the lifetime ECL (Stages 2 and 3) are measured based on the probability of a default occurring. Financial instruments are classified as Stage 1 when credit risk has not increased significantly since initial recognition.
5. The assessment of whether credit risk has increased significantly is determined by comparing the probability of a default occurring at the reporting date with the probability at initial recognition.
6. The ED did not propose a definition of default or provide any application guidance on what constitutes a default event or how it should be interpreted. This is because the IASB did not expect that expected credit losses would change as a result of differences in the definition of default because of the counterbalancing interaction between the way an entity defines default and the credit losses that arise given that definition of default¹. In accordance with paragraph BC97 of the ED, entities are therefore able to apply their own definitions of default including, where applicable, regulatory definitions of default.
7. The purpose of this paper is to consider the views expressed during the outreach activities and comment period and to discuss the following approaches identified from the feedback received:
 - (a) **Approach 1:** Define default as payment default only (paragraphs 34 – 43);
 - (b) **Approach 2:** Define default by including qualitative factors (paragraphs 44 – 53);
 - (c) **Approach 3:** Define a rebuttable presumption to act as a backstop (paragraphs 54 – 60);
 - (d) **Approach 4:** Do not define default (similar to ED) (paragraphs 61 – 67).

¹ Said differently, if a broader definition of “loss event” is used, the “loss realised as a result of the loss event” (ie, the severity) is smaller.

8. The staff's preferred approach is **Approach 3** as this allows entities to apply the definition used for internal credit risk management purposes, but provides a backstop of 180 days past due that will improve the consistency of application.

Structure of this paper

9. This paper is set out as follows:
- (a) Detailed feedback received (paragraphs 10 – 16);
 - (b) How default is defined in practice (paragraphs 17 – 20);
 - (c) Importance of default in the context of a the model proposed in the ED (paragraphs 21 – 31);
 - (d) Analysis of alternatives suggested (paragraphs 32 – 67); and
 - (e) Staff recommendation and questions to the IASB (paragraphs 68 – 71).

Detailed feedback received

10. Although the ED did not include a specific question on default, some respondents specifically commented on this. It has also been raised by some participants during outreach events and as part of the field work. The majority of these respondents recommended that default should be clearly described or defined. These respondents disagreed with the IASB's presumption in paragraph BC97 that expected credit losses would not change depending on the definition of default because of the counterbalancing interaction between the definition of default and the credit losses that arise given that definition. They noted that the notion of default is fundamental to the application of the proposed model; in particular, to the measurement of 12-month expected credit losses (ECL) and the assessment of significant deterioration (see paragraphs 21 – 31 for a detailed discussion).

11. Furthermore, some respondents considered the term ‘default event’ to be ambiguous and considered it not clear whether the notion of default is intended to align more closely with the indicators about when there has been a significant increase in credit risk (Stage 2) or with objective evidence of impairment (Stage 3).
12. Some respondents were concerned that in the absence of more prescriptive guidance about what the IASB intended, differences in interpretation could lead to inconsistent application in different periods and a lack of comparability between entities.
13. Regulators in particular were concerned that default may be interpreted solely as non-payment (payment default) instead of capturing indicators of loss expectations that accelerate eventual non-payment. They were concerned that relying on payment default alone to determine the changes in the probability of a default occurring would result in the delayed recognition of lifetime expected credit losses, especially for financial instruments where non-payment is expected towards maturity when principal amounts become contractually due.
14. Some seemed to be concerned that focussing on payment default would result in no change in loss allowance balances until payment defaults actually occur. While (as set out below) using payment defaults or a broader definition would have an effect on allowance balances, the staff notes that the model focuses on a change in the probability or likelihood of a default occurring. So allowance balances should change to reflect changes in the likelihood of [payment] defaults occurring not just to reflect whether [payment] defaults have actually occurred.
15. However, some respondents noted that the point of default will be different for different products and across jurisdictions. These respondents welcomed that default has not been specifically defined but recommended that additional guidance is provided on what would constitute a default event within the context of the proposals.

16. A few of the respondents that specifically commented on default agreed with the IASB's presumption in paragraph BC97 and noted that there is generally a common understanding about what constitutes default, any attempt to be more prescriptive or provide guidance will add confusion and may result in a difference in default definition for credit risk management and accounting purposes. They recommended the IASB retain paragraph BC97 and make it clearer that entities should apply their own definition of default.

How default is defined and applied in practice

17. The term default is a key element of managing credit risk and is generally used to refer to any instance in which an obligor fails to comply with the contractual conditions of an obligation. The term default can be interpreted in various ways and it is important to understand the difference between the various types of default. For example:
- (a) **Payment default** – this is a relatively narrow interpretation of default and refers to the failure to make a contractual payment of principal and/or interest on time (or the failure to make payment within x number of days of the due date). This includes administrative/accidental defaults where a customer accidentally fails to make a payment on time, for example the customer went on holiday and makes the payment upon his return.
 - (b) **Technical default** – this is a broader interpretation and arises not just from the failure to make a contractual payment on time but from the failure to uphold some other aspect of the contractual terms, for example breach of financial covenants or failure to submit audited financial statements within a specified period after the reporting date.
18. While the definitions of default applied in practice vary from entity to entity, the following observations can be made:
- (a) Rating agencies apply a fairly narrow definition which focusses mainly on payment default and other related indicators such as bankruptcy and

distressed restructurings. Technical defaults are usually excluded from their definitions.

- (b) Regulators, such as Basel, apply a broader definition which in addition to non-payment also considers an obligor's ability (likeliness) to pay future contractual payments in full. This can include among other indicators, technical defaults.

19. On one end of the spectrum, there is therefore a judgemental definition that considers qualitative factors and on the other end a non-judgemental definition that only focusses on non-payment. In practice, the definition of default applied by entities depends on the information they have available. For example, if an entity does not have updated borrower-specific information that could indicate an obligor's ability to satisfy future contractual payments, the entity will only focus on non-payment. However, if an entity has access to borrower-specific information (ie bureau data, cross-defaults), it will be able to assess an obligor's ability to satisfy future contractual obligations before the obligor misses a payment.
20. The definition of default applied could also depend on the nature of the financial instruments. For retail lending products (ie credit cards, unsecured personal lending, mortgages), the contractual terms do not typically include qualitative default clauses (such as technical defaults) and an entity may only define default based on the days past due. In contrast, for some financial institutions payment default is less relevant for certain products/exposures (such as corporate lending products) where the contractual terms include a number of technical default events designed to be triggered prior to a payment default occurring. In these situations default is mainly defined based on a combination of technical defaults and usually considers the point at which an entity ceases trying to impose or re-impose the contractual conditions, and instead focuses on contract(ual) termination, renegotiation or other remedy. For example, if an obligor breaches a certain number of technical default clauses, the obligor is considered to be in default even if no contractual payments have yet been missed.

Importance of default in the context of the proposed deterioration model

Assessment of significant increase in credit risk

21. Paragraph 8 of the ED requires that changes in the probability of a default occurring should be used to determine whether there has been a significant increase in credit risk since initial recognition. To make this assessment, an entity should compare the probability of a default occurring at the reporting date with the probability of a default occurring at initial recognition of the financial instrument².
22. The definition of default is therefore the parameter against which the probability of that event occurring is calibrated. In other words, if default is defined as 90 days past due ('dpd'), a significant increase in credit risk is determined by reference to the probability of a financial instrument becoming 90 dpd. An entity's assessment of significant deterioration could therefore be different depending on the definition of default applied (for example the assessment for the same financial instruments could differ if a 90 dpd deflection is used or a 180 dpd definition is used).
23. The assessment of significant deterioration is also impacted by whether a narrow or broad definition of default is applied. A broad definition that incorporates qualitative factors will consider an obligor to be in default earlier than one only based on non-payment. For example, the probability that an obligor will breach a number of technical default clauses over the life of an instrument could be much higher than the probability of payment default (eg 90 dpd) occurring over its life. Changes in those probabilities of a default occurring for a broad definition will therefore also be different from changes in the probabilities of non-payment occurring. Because the assessment of significant deterioration is based on the change in that probability since initial recognition, it may affect the population of financial instruments for which lifetime ECL are recognised.

² The key principle is that the risk of default be considered rather than that a specific probability of default be determined. This will be addressed in at a future meeting. 'Default' risk is however still the focus.

Measurement of 12-month ECL

24. Appendix A of the ED defines 12-month ECL as:

The expected credit losses that result from those default events on the financial instruments that are possible within the 12 months after the reporting date.

25. For the purpose of measuring 12-month ECL the definition of default is important as the measurement needs to reflect the probability of that default event occurring in the 12 months after the reporting date. While it is true that an earlier definition of default (eg 30 dpd rather than 90 dpd) would normally be associated with a reduction in the severity of the loss, the effect of the interplay between the definition of default and the recognition of lifetime ECL is not completely eliminated by this off-setting effect. Differences in how default is defined will therefore drive variations in the measurement of the loss allowances because of the different population of financial instruments captured inside and outside of Stage 1.

26. Considering the same example as in paragraph 22 above, a broad definition of default results in instruments to be considered in default earlier than a narrow definition. The probability that an instrument may default within the 12 months after the reporting date, will therefore also be higher. For example, if an entity uses a statistical (PD) approach to measure expected credit losses, the higher lifetime PD will result in a higher 12-month PD, which in turn, will result in a higher 12-month allowance when compared to a narrow definition.

27. Similarly, if an entity uses delinquency to define default, a definition of default of 90 dpd or 180 dpd can have a material impact on the number of loans that could be expected to default within the 12 months after the reporting date. More instruments would have a probability of becoming 90 dpd than would be 180 dpd or 360 dpd. The more narrowly default is defined, the later it is identified, and the lower the probability will be that an instrument will be in default.

28. Respondents therefore considered it important to ensure a common understanding of what constitutes default in the context of the proposed model to prevent diversity in the interpretation and application of the model.

Interaction with objective evidence of impairment

29. Some respondents have noted that the definition of default is important to define the population of financial assets for which interest revenue should be recognised on the net carrying amount (ie Stage 3 assets). They have questioned the interaction between the definition of default and the indicators for objective evidence of impairment.
30. They have noted that a current reading of the ED indicates that financial assets in Stage 3 include those that have defaulted, but will also include other financial assets, for example, those for which an active market has disappeared. These respondents recommended that Stage 3 be defined as financial assets that have defaulted.
31. The staff note that the interaction between default and objective evidence of impairment, as well as the population of financial assets for which interest revenue recognition should be different, will be discussed at a future meeting and will not form part of this agenda paper.

Analysis of alternatives identified

32. The following approaches were identified from the feedback received on the notion of default:
 - (a) **Approach 1:** Define default as payment default only;
 - (b) **Approach 2:** Define default by including qualitative factors;
 - (c) **Approach 3:** Define a rebuttable presumption to act as a backstop;
 - (d) **Approach 4:** Do not define default (similar to ED).
33. The IASB could also consider a combination of the above approaches, ie Approach 2 combined with Approach 3, or Approach 1 combined with Approach 2.

Approach 1: Define default as payment default only (quantitative)

34. As discussed in paragraph 10 above, most of the respondents that commented specifically on default, recommended that default should be clearly defined. However, respondents were split about whether it should be defined on a ‘principle’ basis or as a specified number of days past due. Most of the respondents that supported defining a specific number of days, recommended that such a definition should be consistent with the quantitative element of the definition used for regulatory purposes (ie 90 days past due), as this will enable them to leverage the models and systems used for regulatory reporting. These respondents consider this element of the regulatory definition to be well understood and applied consistently.

Advantages

35. One of the main advantages of having an explicit definition of default, ie 90 dpd, is that it ensures a consistent application of default and would increase comparability between entities. This is because the probability that an instrument will go into default will be calibrated consistently for all entities.
36. A further advantage is that a consistent definition of default will ensure that a consistent population of instruments that could go into default within the 12 months after the reporting date is considered for the measurement of 12-month ECL.
37. Users of financial statements expressed concern about an apparent lack of comparability between similar entities because of differences in definitions and assumptions. During outreach meetings, users have recommended that default be defined explicitly to ensure consistency and comparability. This approach will eliminate the differences in how default is defined and address some of the users’ concerns.

Disadvantages

38. In developing the proposals in the ED and addressing concerns about operability, one of the IASB's objectives was to allow entities to leverage existing credit risk management systems and models as much as possible. A definition that only focusses on payment default may not be consistent with the default definition applied internally for credit risk management purposes or even externally for regulatory reporting purposes.
39. As noted by some respondents, default for credit risk management purposes may be defined in different ways for different instrument types. For example, as stated in paragraph 20 above, for some entities payment default is not relevant for some financial instruments such as corporate lending instruments where an obligor may be in default before any payments are missed. For these instruments, qualitative factors are also considered.
40. Defining a specified number of days past due as default may also not capture what risk managers consider to be a default. This is because although some entities apply payment default only, the number of days past due that is considered to constitute a default may differ among various types of instruments. For example, default on an unsecured personal loan may be regarded as 90 dpd whereas for a mortgage it may be 180 dpd.

Staff analysis

41. Even with a clearly defined quantitative element to the default definition, the Basel Committee on Banking Supervision noted in a recent report on risk weighted assets that the quantitative element is not necessarily applied in a consistent way. This is because of the discretion exercised by some jurisdictions in the application of the quantitative element³. The report noted the following:

³ See *Regulatory Consistency Assessment Programme (RCAP) Analysis of risk-weighted assets for credit risk in the banking book*, section 5.1.2, published in July 2013. Available externally at:

<http://www.bis.org/publ/bcbs2>

[.pdf](#)

5.1.2 Definition of default

The regulatory framework incorporates discretionary elements into the definition of default for some asset classes. Differences in the definition of default affect all estimated risk parameters, [...]

For retail obligors and public sector entities, explicit discretion is granted for supervisors to choose to extend the past due period in the default definition from 90 up to 180 days, and about half of the jurisdictions exercise discretion in this regard. [...].

Another significant difference is whether days past due is defined on a “time” basis, eg a borrower is in default when 90 days have passed since the borrower was up to date, or a “money” basis, when amounts overdue are equivalent to 90 days’ payments.

42. The staff believe that defining default as a specified number of days past due would be arbitrary. There is no set number that will work in all circumstances and for all instruments. Furthermore, even defining default on a principle basis as payment default only, will for many entities not be consistent with their internal definitions and will require a separate set of risk parameters to be maintained for accounting purposes only.
43. The costs involved in recalibrating existing measures of probabilities of a default event occurring may far outweigh the benefits of having consistency and comparability particularly in the context of the measurement of expected credit losses which is inherently subjective. Furthermore, the usefulness and relevance of expected credit loss information to users of financial statements will be diminished if it is merely an accounting construct and not representative of how an entity manages credit risk internally. The staff therefore do not recommend this Approach.

Approach 2: Define default by including qualitative factors

44. For many of the reasons set out in paragraphs 38-40, some respondents recommended that the IASB define default in a broad sense that consider qualitative factors as well.

45. As explained in paragraphs 17-20 above, a broader interpretation of default considers qualitative indicators about a customer's ability to meet future contractual obligations in addition to payment default. These qualitative indicators can include technical defaults as described in paragraph 17(b) and usually considers the point at which an entity ceases trying to impose or re-impose the contractual conditions, and instead focuses on contractual termination, renegotiation or other remedy.
46. There could also be some interaction between the definition of default and the indicators of objective evidence of impairment for the purposes of recognising interest revenue on financial assets in Stage 3 (as noted in paragraphs 29-31 above) but this will be discussed at a future meeting.

Advantages

47. The advantage of defining default in a qualitative manner is that it will allow those entities that apply similar qualitative definitions for regulatory purposes to leverage those systems and models without requiring significant changes. This will mitigate the cost of implementation and the need to maintain a separate set of risk parameters for accounting purposes only.

Disadvantages

48. Being able to apply a qualitative definition of default is dependent on the availability of the necessary information. As noted in paragraphs 19-20 above, most entities typically manage instruments such as retail products on a portfolio basis and do not have access to updated borrower-specific information necessary to make an assessment about terminating an individual position prior to payment default occurring.
49. It is also questionable whether a qualitative definition of default will address the concerns raised about consistent application as entities' interpretations of qualitative factors may differ. There may also be jurisdictional differences in the timing of when an entity may take such action which will hamper consistency and comparability.

50. The other disadvantages of this approach are similar to those listed for Approach A. The broader definition of default may not be consistent with an entity's internal credit risk management practices in certain circumstances giving rise to recalibration issues and information about expected credit losses will therefore not being useful and relevant to the users of the financial statements.

Staff analysis

51. Although the staff consider this approach to be conceptually superior to Approach 1 and consistent with how the IASB intended default to be applied, we are concerned about the implications for entities that do not have access to the necessary information and that apply a narrow default definition for credit risk management purposes.
52. Furthermore, the ED proposed that entities use information that is currently used for credit risk management purposes and that is available without undue cost or effort.
53. In light of this, the staff do not think entities can be required to apply a definition of default for accounting purposes that is broader than that currently used for credit risk management purposes. The staff therefore do not recommend this approach.

Approach 3: Rebuttable presumption of 180 days to act as a backstop

54. The objective of Approach 3 is to allow entities to apply their internal credit risk management definition of default but with a rebuttable presumption that financial assets are considered to have defaulted no later than when they are 180 dpd. If an entity has other more timely measures (eg 90 dpd or other qualitative indicators) of default relevant to a portfolio they could use that. In other words, 180 dpd would be seen as the latest point at which a financial asset could be considered to be in default, unless an entity has reasonable and supportable information to support more lagging default criteria.

Advantages

55. The rebuttable presumption of 180 dpd will allow entities to apply default in a way that is consistent with their internal credit risk management systems, however narrowly or broadly that is defined. However, the 180 dpd quantitative limit will serve as ‘backstop’ to ensure a more consistent population of financial instruments are considered when measuring the 12-month ECL and in assessing significant deterioration. The purpose of the rebuttable presumption is not to delay default until 180 dpd but instead to ensure that entities will not define default as later than 180 dpd without reasonable and supportable information to substantiate the assertion. Furthermore, jurisdictions where default can legally only be considered to have occurred after contractual payments become x number of years (eg 5 years) past due would estimate expected credit losses on a basis that is more consistent with other jurisdictions.

Disadvantages

56. Similar to defining the specific number of days past due for the purposes of Approach 1, defining it for the purpose of the rebuttable presumption will be arbitrary. As mentioned under Approach 1, even regulatory definitions are not uniform and contain discretionary elements. There is no conceptual basis to determine the number of days past due that would be appropriate for all financial asset types and across all jurisdictions. This is alleviated somewhat in that the 180 days is a backstop.

Staff analysis

57. The staff acknowledge that allowing entities to apply the definition used for credit risk management purposes with a backstop of 180 dpd could result in an outcome that is similar to combining the advantages of Approach 1 and Approach 2 while minimising their disadvantages. This would also result in an outcome that is similar to the definition applied by some regulators where default is defined as payment default (eg 90 days) and on the basis of qualitative indicators.

58. Most respondents to the comment letters and participants in the outreach and fieldwork indicated that where default is defined by reference to non-payment, it is usually based on 90 dpd. These entities would therefore be able to rebut the presumption on the grounds that their credit risk management systems reflect default earlier and more responsively than 180 dpd.
59. However, the staff note that respondents to the comment letters have raised some concerns about the conceptual basis for the proposed rebuttable presumption that credit risk has increased significantly when an instrument is more than 30 dpd. These respondents consider rebuttable presumptions to introduce apparent bright lines to a principles-based model. Some interested parties are also concerned that regulators, auditors and users of financial statements will expect the rebuttable presumption to be applied consistently by all entities and that an entity that has rebutted it will be penalised for having done so.
60. This approach could address most of the concerns raised by those respondents that requested a definition of default to be included in the proposed model. It also provides at least some discipline around this important concept.

Approach 4: Do not define default

61. Approach 4 is similar to the ED in that default is neither defined nor is guidance provided on how it should be interpreted. BC97 already makes it clear that entities should apply their own definition of default without placing any limitations or restrictions.

Advantages

62. This approach is consistent with the proposals in the ED that allow entities to use information that is currently used for credit risk management purposes and that is available without undue cost or effort. Information will be the most relevant and useful if it faithfully reflects how an entity manages credit risk. It also enables entities to select a measure that best reflects default given the financial instruments in question.

63. As some respondents have noted, flexibility is key to the definition of default because it is inherently industry, product and jurisdiction specific and any attempt to be more prescriptive may contradict that, which will result in misleading information being reported.

Disadvantages:

64. The disadvantages of this approach are reflected in the concerns raised by respondents that requested a definition be provided. Because of the differences in credit risk management practices and regulations, default may be applied in a number of ways which will lead to a lack of comparability among entities.
65. For the reasons set out in paragraphs 24-28 above, inconsistent definitions of default will lead to differences in the expected credit losses represented by the 12-month ECL.

Staff analysis

66. The staff acknowledge the concerns raised by constituents about the lack of consistency and comparability in the absence of a default definition, and the importance of this definition to the application of the model proposed in the ED.
67. The staff think that some of the concerns raised could be addressed by explaining in the application guidance that default has not been defined because it is not possible to define default in a way that will be consistent with credit risk management and appropriate for all entities in all circumstances. Furthermore, entities could be required to apply the definition of default used for credit risk management purposes and disclose how it has been applied.⁴ Credit risk managers could then use a definition of default that is relevant and meaningful for the instrument in question (ie that appropriately reflects the real economic default). This should result in the use of information that provides decision useful information about credit quality.

⁴ Paragraph 39 of the ED already requires disclosure of how an entity has defined default.

Staff recommendation and questions to the Board

68. The staff have **rejected** Approach 1 and Approach 2 on the grounds that one of the objectives of the proposed model was to consider and allow the use of information that is used for credit risk management purposes. Both these approaches would define default in a way which may not be consistent with the internal definition applied by an entity, that may not capture the credit quality of products in a meaningful way, and that therefore result in information that is not relevant or useful to the users of financial statements.
69. The staff consider **Approach 3** to be the most appropriate and **preferred** approach as it allows a default definition to be applied that is consistent with internal credit risk management practices but provides a backstop of 180 days. This will result in the most relevant and useful information for users of financial statements and improve consistency of application.
70. Approach 4 has many of the advantages of Approach 3, but is not the staff's preferred approach because it is too open ended given how important the default concept is in the proposed model. However, should the IASB not wish to set an arbitrary backstop, the staff would recommend Approach 4 as it addresses most of the concerns raised.
71. In the staff's view, irrespective of the alternative selected, disclosure of the definition of default applied should be required as proposed in the ED.

Questions to the IASB

1. Does the IASB agree with the recommendation for a rebuttable presumption to act as a backstop (Approach 3), as set out in paragraph 69?
2. If the IASB does not agree with the staff recommendation, which approach does the IASB prefer?
3. If the IASB prefer Approach 1 or Approach 2, how should default be defined?

STAFF PAPER

17 – 18 September 2013

REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Report on the Fieldwork		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. During the July 2013 joint IASB and FASB meeting the staff presented Agenda Paper 5B *Impairment: Outreach Summary Feedback—Fieldwork*. The paper summarised some of the main observations that were made during the IASB's fieldwork. It also included, as an Appendix, the instructions and the hypothetical scenario that was provided to participants. The Appendix is not reproduced in this paper.

Structure of the paper

2. The flow of the paper is:
 - (a) reasons for and benefits of undertaking the fieldwork (see paragraphs 3-5)
 - (b) overview of field work participants and portfolios (see paragraphs 6 - 12)
 - (c) Fieldwork: Operability of proposals, feedback and observations
 - (i) Operability and feedback on having a model with different measurement objectives based on changes in credit risk (see paragraph 13)

- (ii) Operability and feedback on the identification of the significant increase in credit risk (including use of operational simplifications) (see paragraphs 14 -24)
 - (iii) Operability and feedback on measuring the loss allowance for assets that did not have a significant increase in credit risk (see paragraphs 25 -30)
 - (iv) Operability and feedback on the measurement of expected credit losses (ECL) (including use of discount rate, behavioural life on credit cards, lifetime ECL on day 1) (see paragraphs 31 - 37)
 - (v) Operability and feedback on the treatment of financial instruments for which there is objective evidence of impairment (see paragraphs 38 - 41)
 - (vi) Operability and feedback on the use of the simplified approach for trade and lease receivables (see paragraphs 42 - 48)
 - (vii) Time and resources required to implement new standard (see paragraphs 49 - 50)
- (d) Responsiveness and directional impact of proposals – compared to IAS 39 on transition and over time (see paragraph 51)
- (e) Next steps (see paragraph 52); and

Reasons for and benefits of undertaking the fieldwork

3. The IASB believes that a wide consultation with interested and affected parties enhances the quality of IFRS. This consultation can include fieldwork (see paragraph 3.41 of the *Due Process Handbook* (as published in February 2013)). The IASB therefore decided that the staff should undertake fieldwork as part of the consultation on the proposed Exposure Draft: *Financial Instruments: Expected Credit Losses* during the comment period.
4. The primary objective of the fieldwork was to determine how the proposed impairment model responds to changing economic circumstances over time. It also provided us with an understanding of the operational challenges for the implementation of the proposals, specifically the operability of:
 - (a) a model with different measurement objectives based on changes in credit risk;
 - (b) assessing significant increases in credit risk;
 - (c) measurement of ECL; and
 - (d) the simplified approach applied to trade and lease receivables.

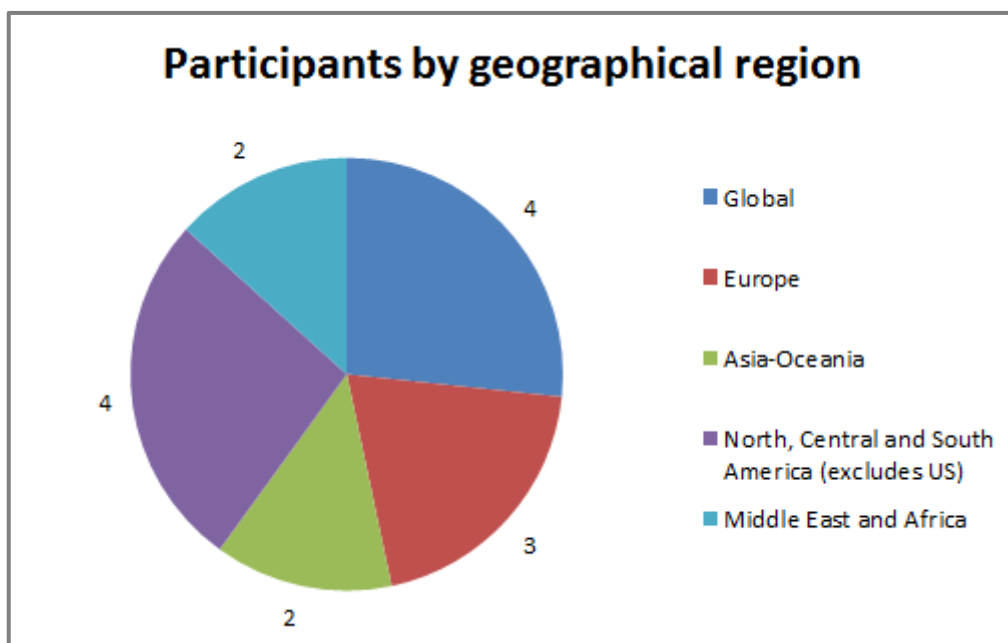
In addition, the fieldwork provided us with directional information on the allowance balances compared to current IFRS.

5. We believe that the benefits of the fieldwork undertaken, *which included simulations using real economic data*, were:
 - (a) it allowed the field participants to actively engage with us to better understand the proposals and to provide us with enriched and valuable feedback based on their experience, as they had to consider in detail how they will implement our proposals (and alternative models); and
 - (b) by working with field participants the staff have obtained a more thorough understanding of the mechanics of measuring expected credit losses (both 12 month and lifetime), techniques to adjust forward-looking information, potential approaches to assess credit deterioration and the effects and relevance of discounting.

Overview of fieldwork participants and portfolios

Participants

6. The IASB invited a small number of preparers who represented the major geographical regions across the world and who were at different levels of sophistication of internal credit risk management systems to participate in the fieldwork.
7. In total 15 participants were involved in the fieldwork. These participants included both financial and non-financial entities and both ‘global systemic important banks’¹ and regional/ country based businesses.



8. Only a small group of entities were used for the fieldwork because we asked for detailed numbers to be provided. The fieldwork also required significant investment of resources from the participants. The man-hours utilised during the fieldwork included:
 - (a) For field participants: 200-250 manhours (smaller businesses), 400-450 manhours (larger businesses) and even 500-550manhours for a few; and
 - (b) for IASB staff to develop the fieldwork, meetings with fieldwork participants and portfolio analysis approximately 400manhours.

¹ These are banks considered by the Financial Stability Board (FSB) to be global systemic important banks as per the November 2012.

Portfolios

9. The portfolios selected by participants comprised the following, which in aggregate have a total carrying amount in excess of US\$500 billion:
- (a) retail mortgages including:
 - (i) normal amortising loans (ie payment of both interest and principal from the first payment);
 - (ii) interest only loans; and
 - (iii) equity-line loans.
 - (b) corporate (wholesale) loans;
 - (c) revolving credit products, for example credit cards;
 - (d) lease receivables, for example vehicle finance; and
 - (e) other unsecured lending, for example personal loans/ payday loans.
10. Generally, the portfolios excluded derivatives and guarantees to make the calculations easier and to help participants to meet the short deadlines for the fieldwork.
11. The portfolios selected had an average behavioural life of:

< 1 year	1 - 2 years	2 - 5 years	> 5 years (up to 30 years)
<ul style="list-style-type: none"> • Revolving credit products • Lease receivables 	<ul style="list-style-type: none"> • Lease receivables 	<ul style="list-style-type: none"> • Lease receivables • Corporate loans • Retail loans • Unsecured lending products 	<ul style="list-style-type: none"> • Corporate loans • Retail loans/ mortgages • Unsecured lending products

12. The portfolios tested were often data rich. This allowed participants to gain a better understanding of what information they would need to implement the proposals. It also challenged participants to think about how they would implement the proposals for portfolios that do not have this rich data.

Fieldwork: Operability of proposals, feedback and observations

Operability and feedback on having a deterioration model

13. Participants confirmed that a model that distinguishes between financial instruments based on changes in credit risk reflects their internal credit risk management systems; particularly the distinction between performing and underperforming/non-performing financial instruments. Participants agreed that where there is a significant increase in credit risk, the credit risk management system should capture this change and reflect it in the measurement of the allowance.

Operability and feedback on identifying significant increases in credit risk

Main observations

Participants supported the operability of the proposals for a model that where the measurement of the allowance changes as there is an increase in credit risk. Participants stated that this is similar to their credit risk management.

Participants used a number of methods to assess significant increases in credit risk. Some used more sophisticated information (for example an increase in PD) whereas others may use delinquency information.

A few participants observed that although changes in the 12month PD often served as a good proxy to changes in the lifetime PD, it will not be appropriate for financial instruments that have back ended payment profiles.

Participants supported the operational simplifications introduced. They observed that 30 days past due was a good indicator of a significant increase in credit risk. Although supporting the exemption for low credit risk financial instruments some participants suggested making this a rebuttable presumption.

Participants did identify some challenges to identifying a significant increase in credit risk; including (i) identifying significant increase on a transactional level; (ii) credit risk information is currently performed at a counterparty level; (iii) including forward looking information; and (iv) limited information about credit risk at origination.

Determining significant increases in credit risk

14. Participants applied different methods to identify significant increases in credit risk.
- (a) participants that apply PD-based models (ie models adjusted for probability of default) today often built on that knowledge and assessed significant increases in credit risk from the relative changes in the probability of a default occurring.
 - (b) Some participants used approaches that also aim to identify increases in credit risk early, being:
 - (i) internal watch lists (particularly in wholesale/ corporate lending) to identify significant increases in credit risk. Internal watch lists are used to identify borrowers that a lender considers to be at risk of default based on internal assessment; and
 - (ii) an absolute approach where a significant increase in credit risk occurs when the credit quality drops below the lowest level at which the lender would originate a new asset.
 - (c) Others with less sophisticated systems (often in retail lending) relied more on directly observable information, being:
 - (i) delinquency information (the 30 days past due presumption), together with loans that are restructured or where a forbearance² arrangement has been entered into.
15. Participants that use Basel/Internal Ratings Based (IRB) approaches today, benefited as they were able to leverage their existing models. However, they still made adjustments to the PD factors to reflect point-in-time (PIT) information (ie actual expectations for the relevant outlook period). Some participants suggested that the IASB should permit them to use the ‘through the cycle’ PD information (which is explicitly required by Basel) that is captured currently in their systems to further leverage their existing information.

² Forbearance is an arrangement between lender and borrower to modify the terms and conditions to allow the borrower to meet its debt servicing obligations (such as postponing repayment).

16. To identify significant increases in credit risk, participants considered forward looking information, including macroeconomic factors. In doing so, participants observed such forward looking data must be:

- (a) statistically relevant (a large enough sample to perform statistical analysis); and
- (b) statistically correlated (must show a dependent relationship with credit risk).

Some macroeconomic factors participants considered were:

Retail	Corporate	Other
<ul style="list-style-type: none"> • GDP (Gross domestic product) • House price index • Unemployment • Interest rates • Inflation 	<ul style="list-style-type: none"> • GDP • Commercial real estate • Equity market index • Commodity prices 	<ul style="list-style-type: none"> • Manufacturing output • Construction put in place • Tonnage index (logistics)

17. A number of participants used the operational simplification of changes in the 12-month PD as a proxy for the change in the lifetime PD to assess significant increases in credit risk as proposed in the ED. Participants thought that in most instances this would be a good proxy, however they noted that in instances where products develop losses in the latter part of the product life (for example bullet loans), it would not be applicable.

18. A few participants also considered how different levels of change in the lifetime PD represent a significant increase in credit risk and the impact thereof. In one sample the participant compared a significant increase in credit risk using a 40 per cent change in PD (2 per cent–2.8 per cent) versus a 200 per cent change in PD (2 per cent–6 per cent).

- (a) They observed that for the financial instruments they were considering a relative 40 per cent change in PD might result in the loss allowance becoming overly sensitive and causing items to move too easily when

significant increase in credit risk may not in fact have occurred. That is, the loss allowance would react to ‘model noise’. An entity therefore would need to carefully consider what in PD would be to be considered to reflect a significant increase in credit risk.³

Feedback on operational simplifications introduced

19. Fieldwork participants supported the two operational simplifications proposed in the Exposure Draft. These were:
 - (a) a rebuttable presumption that there is a significant increase in credit risk when a borrower is 30 days past due; and
 - (b) that an entity would continue to recognise a 12month allowance on financial instruments that have low credit risk.
20. A number of participants relied on the 30 days past due presumption to identify significant increases in credit risk in the retail loan portfolios. However, some participants noted that this was a lagging indicator to identify significant increases in credit risk. Some participants observed the following relative increases in the probability of default, substantiating that 30 days past due leads to a significant increase in credit risk:
 - (a) a 124 per cent increase in PD from being current (ie not past due) to past due (but less than 30 days past due); and
 - (b) a 400 per cent increase in PD from being past due to 30 days past due (a 700 per cent increase from being current).
21. Participants particularly made use of the low credit risk exemption for their wholesale/corporate portfolio. Participants mapped their internal credit grades to those of external rating agencies. On the retail side (eg mortgages) the use of the low credit risk exemption was limited. This was because participants often:
 - (a) did not originate to individuals who are low credit risk; or
 - (b) were unable to map internal ratings to external ratings.

³ The relevant change will also be situation specific.

22. Most participants treated a deterioration in credit quality from above to below 'low credit risk' as a trigger for the recognition of lifetime ECL. Others combined this increase with an assessment of the relative change in credit risk.
23. Some participants stated that they would prefer the low credit risk exemption to be rebuttable. They would recognise lifetime ECL when a significant increase in credit risk occurs regardless of the credit quality. They believe this would also be more aligned to the principle of a significant increase in credit risk and their credit risk management.

Difficulties in identifying significant increases in credit risk

24. While participants were generally able to operationalise the assessment, identifying significant increases in credit risk was not without its obstacles. Participants raised the following difficulties in the assessment:

- (a) *Being able to identify significant increases in credit risk on a transactional level*, particularly for retail products. For those portfolios participants were often able to only identify a significant increase in credit risk on a transaction level once there has been delinquency/ forbearance.
 - (i) Participants observed because of the limited timeframe for fieldwork they were not able to better perform work to identify a significant increase in credit risk for a portfolio. This would require further work to better segment portfolios. They believe such an approach would be beneficial in better identifying significant increase in credit risk.
 - (ii) Some participants noted that there could be instances where a significant increase in credit risk has occurred but has not yet been identified on a transaction level. Participants argued that a type of 'management overlay' may be appropriate in these circumstances.
- (b) *Being able to identify a significant increase in credit risk on a transactional level where the assessment is currently done for credit risk purposes on a counterparty level*. To deal with this:
 - (i) some participants followed an absolute approach, ie if the credit risk/credit quality of a counterparty reached a

specified level, all loans to the counterparty were transferred to lifetime ECL;

- (ii) some participants combined a counterparty credit risk/credit quality assessment with a relative increase in credit risk compared to the origination of each individual loan to identify financial instruments with a significant increase in credit risk.
- (c) *Incorporating forward looking information into the assessment, particularly for retail loans.* Often credit risk systems today do not incorporate macro-factors for various products and portfolios. Participants indicated that more work is needed to understand the relevant factors and the impact these factors would have on credit risk to identify significant increases in credit risk.
- (d) *Limited information available on the credit quality at origination.*
 - (i) On transition participants noted that they would not have the information to determine whether there had been a significant increase in credit risk. Participants indicated that without this information based on the ED, they would often measure lifetime ECL on financial instruments on transition;
 - (ii) Tracking information on a transaction level versus counterparty level. Often systems track the credit quality on a customer level. As the credit quality information is updated, both the customer information and the transaction level information is updated too. The result is that the information used to assess a significant increase in credit risk is not done on a facility/transaction level.

Operability and feedback on measuring the allowance for assets that did not have a significant increase in credit risk (12month allowance)

Main observations

Participants considered the 12month allowance to be operational as information on the 12m PD is readily available and already often used (albeit sometimes requiring adjustments) for internal credit risk or regulatory purposes.

Where information was not readily available internally, participants indicated that information is obtainable in the market to enable this to be determined.

Participants did not support increasing the period beyond 12months as this would require additional modifications to current internal credit risk management systems.

Participants applied different alternatives when considering default.

25. Participants were asked to calculate the 12month allowance for the financial instruments that did not have a significant increase in credit risk since initial recognition. Those participants that elected to measure the allowance on lease receivables at lifetime ECL did not provide feedback on this aspect.
26. To determine the 12month allowance, participants needed to determine the probability that the borrower would default in the next 12 months (12m PD). Almost all participants had the information available as it is currently used for internal credit risk management and/or regulatory purposes. The participants that did not have the information available indicated that they were able to obtain the relevant information or make reliable estimates of the 12m PD using data that was available internally or in the market (for example, from credit rating agencies). Participants would not readily have the information when:
- (a) for internal credit risk management and regulatory purposes they do not report using a 12m period; or
 - (b) for internal credit risk management and regulatory purposes they do not adjust the 12m PD for forward looking information.
27. Participants made the following observations:

- (a) even when a 12m PD was readily available, this often needed to be adjusted. The Exposure Draft proposed that the PD be adjusted for point-in-time (PIT) information. Consequently, participants had to adjust their available PD information. No specific concerns have been raised; however some participants did suggest that the 12m PD be permitted to be the unadjusted through-the-cycle (TTC) number.
- (b) Where 12m PD information was not available participants used other representative information to derive the PIT 12m PD. For example:
 - (i) the PD of an instrument with a one year term/ maturity; or
 - (ii) the TTC 12m PD adjusted with information that was obtainable in the market (for example Moody's Expected Default Frequency) to adjust the 12m PD for more forward looking period specific information.
- (c) One participant observed that when measuring the allowance the entity considers information for the next 12months (to determine the PD) and the lifetime of the asset (to determine the ECL). This creates complexity due to the different time horizons that the entity has to consider.

28. Participants generally did not support the adjustment of the ECL for stage 1 for a probability of default beyond 12months as this would require the majority of them to develop and calculate new information. This would add to the operational burden as they would not be able to utilise regulatory and internal credit risk management for such a measurement.

Considering the definition of default

- 29. During the fieldwork participants had to consider what 'default' means. Defining what default is directly impacts the measurement of the financial instruments in Stage 1 (see further Agenda Paper 5D).
- 30. Participants applied different criteria for default. A number of participants indicated that they do not automatically use the default definition consistent with regulatory requirements for credit risk management purposes. Some of the alternatives for default used by participants were:

Retail	Corporate
<ul style="list-style-type: none"> • 90 days past due • 180 days past due • Point where charge off starts/ work out period 	<ul style="list-style-type: none"> • 90 days past due • Basel definition of ‘unlikely to meet obligation’ • Forbearance

Operability and feedback on the measurement of ECL

Main observations

Participants applied different methods to measure lifetime ECL, however, the LGDxEAD method was the most frequently used.

The main challenges were the effects of discounting, incorporating forward-looking information and considering the maturity of financial instruments.

Generally, participants supported having the ability to use a range of discount rates as it allowed them to leverage existing information.

Participants did not support the calculation of lifetime ECL on all financial instruments as they argue that this is too complex operationally.

Participants suggested calculating the allowance for credit cards using behavioural information, rather than contractual rights.

31. One of the benefits of the fieldwork was that it allowed the staff to gain a better understanding of the various methods used by participants to calculate the ECL and the various challenges of those models. During the fieldwork the staff also facilitated a call with interested participants to discuss the various methods and their suitability in meeting the measurement objectives in the Exposure Draft.
32. The various methods used by participants to calculate ECL were:
 - (a) migration matrices: a method that estimates the losses that would arise from a financial instrument if the instrument defaults given a specific credit risk grading/ credit quality.
 - (b) loan loss rates: the ECL are calculated using the losses that occurred during a specified period in the past (for example 12 months). Includes

elements of write-offs, changes in incurred losses and the incurred but not reported (IBNR) allowances.

- (c) LGDxEAD methods: a method that requires the lender to determine what it estimates the exposure at date of default (EAD) to be. The loss given default (LGD) relevant for that EAD is then determined based on; (i) the percentage of loss expected on default; (ii) time value of money; and (iii) collateral held⁴.

33. In determining the ECL using the various methods, the following issues were raised:

- (a) Timing of ECL: the proposals require an entity to discount to the current value at the reporting date. Current systems do not discount at all or discount only to the date of expected default. Participants indicated that systems would need to be modified to:
 - (i) better capture the expected timing of credit losses; and
 - (ii) to discount future amounts to the reporting date.
- (b) adjustment for forward-looking data, including macroeconomic data. Some models are easier to update to reflect future estimates and macroeconomic data than others.
- (c) maturity: the proposals require that lifetime ECL should be modelled for financial instruments with a significant increase in credit risk. Entities could use long term averages to assist in estimating ECL beyond an outlook period in which more specific estimates can be made, however it still requires significant estimates and judgement.

34. Participants supported the range of discount rates the proposals in the Exposure Draft permitted. They stated that some models, for example the EADxLGD model, already implicitly include a discount factor. The discount factor is often a weighted average discount rate, rather than an individual effective interest rate for each loan. Although participants acknowledge that the best conceptual approach is

⁴ So for example for an EAD on 100 an entity may determine that on a default it would expect to lose 60 per cent of that exposure given the counterparty, timing of loss and collateral provided.

the effective interest rate range, allowing the range of discount rates enables them to better leverage information in their internal credit risk management systems;

35. Support for the range of discount rates was however not unanimous. The participants that did not support the range stated that in high interest yielding markets the range of discount rates would result in materially different ECL estimates. Participants in those jurisdictions prefer to require all entities to use the effective interest rate to increase comparability.
36. We also requested that fieldwork participants calculate lifetime ECL on all financial instruments. Apart from those that elected this option for lease receivables, participants did not support this approach. They noted:
- (a) that from an operational perspective this is challenging. This is because it required the use of supportable forecast data over a large number of exposures for their full lives. Currently, entities do not have supportable data for performing ('good') loans over the life of the asset. This feedback was received even though participants were aware that beyond the period that more specific estimates could be made ECL could be measured using mean reversion concepts (subject to any necessary adjustments).
 - (b) recognising lifetime ECL where significant increase in credit risk has not occurred is not reflective of the business of a lender.
37. During the fieldwork we also requested that some participants include credit cards as one of the portfolios to test. Participants that tested credit cards requested more clarity on how to perform calculations for those products. They stated that in general the contractual cancellation period of these products is one day, but in practice credit is offered for a longer period based on the entity's business practice (eg conducting an annual limit or facility review). Facilities are generally not immediately withdrawn. Using the contractual period may therefore lead to an understatement of ECL and would not represent the expected exposure for the financial instruments. Participants recommended that the ECL on loan commitments should be estimated over the behavioural life as this would more faithfully represent their credit risk exposure.

Operability and feedback on the treatment of items for which there is objective evidence of impairment (stage 3)**Main observations**

Participants considered the proposals to measure interest revenue on the net basis operable for those assets with objective evidence of impairment.

A few participants requested that interest not be accrued for the financial assets with objective evidence of impairment.

38. An entity would change the measurement of interest revenue to the net basis (ie calculated on the gross carrying amount less allowance) when it considers there to be objective evidence of impairment on the financial asset.
39. For the purposes of the fieldwork, participants treated the point of default (refer paragraph 29- 30) as the point of objective evidence of impairment. However, in practice, there will be objective evidence of impairment prior to default.
40. Participants considered that it was operational to measure interest revenue on a net basis. This was because the calculation is consistent with the current treatment of financial instruments under IAS 39 *Financial Instruments: Recognition and Measurement* for financial instruments that are individually determined to have objective evidence of impairment.
41. Regardless of the operability of measuring the interest on a net basis, a few participants raised their preference to present interest on a non-accrual basis. This would be similar to how those respondents report information for regulatory purposes. The participants did acknowledge that this will be an operational simplification and not conceptually consistent with the notion of accrual accounting and time value of money.

Operability and feedback on the simplified approach for trade and lease receivables**Main observations**

Participants supported the inclusion of the accounting policy election for lease receivables.

Participants requested clarity on the level at which an entity should make this accounting policy election.

42. The fieldwork included portfolios of lease receivables. The level of sophistication of the current internal credit risk varied for these portfolios.
43. The portfolios on which the fieldwork was performed for lease receivables were high credit quality portfolios and short term in nature (average life of less than two years).
44. Because of the short term nature of these portfolios and their unsophisticated internal credit risk management systems, the participants elected to measure the allowance at lifetime ECL. For these portfolios the participants indicated that a lifetime ECL would easily fit into their current credit risk management system and allowance measurement models.
45. However, one participant observed that having a lifetime ECL on initial recognition would result in higher capital requirements for the lender. This would be burdensome for start-up businesses, growing businesses or new markets.
46. Participants requested clarification as to the level at which the entity needs to make the accounting policy election, ie ie should an accounting policy election be:
 - (a) on a consolidated group level; or
 - (b) on an entity-by-entity basis.
47. Participants stated that such clarification would be needed because, in some groups of entities some:
 - (a) with sophisticated systems, for example a finance entity, have more PD-based models, which enables them to track significant increases in credit risk; and

- (b) others do not have sophisticated models and are not able to track credit deterioration.

48. Regardless of the support for the accounting policy election for lease receivables, one participant did state that monitoring is still required for increases in credit risk. This is because the entity still needs to change the measurement of the interest revenue to a net basis (ie gross carrying amount less allowance) once there is objective evidence of impairment.

Time and resources required to implement a new Standard

49. Participants were asked what they think the cost of implementation would be.

50. Most participants did not specify details of resources that would be required.

Those that did respond noted:

- (a) a three-year lead time would be required to ensure that their current systems could be upgraded, tested and implemented to report under the new requirements;
- (b) significant efforts would need to go into the design of the credit risk management systems and the reporting; and
- (c) significant costs would be incurred to modify systems (and configure warehouse databases) to retrieve and maintain information of credit quality/credit risk on origination.

Responsiveness and directional impact of proposals – compared to IAS 39 on transition and over the period tested

51. We refer the IASB back to Agenda Paper 5B *Impairment: Outreach Summary Feedback—Fieldwork* paragraphs 14-26 which provided a detail overview of the responsiveness and directional impact of the proposals.

Next steps

52. The staff do not intend to perform further work in the future on the fieldwork.

However, they will utilise the feedback received:

- (a) in considering the effect analysis of the final Standard; and
- (b) during redeliberations as input in the feedback received and the staff .

International Financial Reporting Standards

Financial Instruments: Expected Credit Losses

Taking the Impairment model forward

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2

Overview of general model

Change in credit quality since initial recognition

Expected credit losses recognised	← Change in credit quality since initial recognition →	
12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Interest revenue		
Gross basis	Gross basis	Net basis
Stage 1 Performing	Stage 2 Underperforming	Stage 3 Non-performing

3

Feedback statistics

- 190 comment letters
- Extensive outreach activities, some jointly with FASB

Respondent type

Region

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4

Impairment—way forward

- Overall there is a lot of support for our proposals
 - Support for distinction based on significant increases in credit risk
 - Confirmation of operability
 - 12-month ECL (Stage 1) accepted as reasonable compromise
- Convergence remains important but not at all cost
- Despite positive feedback additional work is needed, including:
 - Responsiveness to significant increases in credit risk
 - Stage 1 measurement objective
 - Definition of default

How do we improve the model?

5

Responsiveness to changes in credit risk

- If significant increase in credit risk - recognise lifetime ECL
- Model aims to be more responsive than IAS 39 by requiring
 - Identification of significant increases in credit risk
 - considering forward-looking information (eg macro-economic factors)
- The better an entity is at identifying significant increases in credit risk and incorporating forward-looking information
 - The more responsive the model becomes
 - The more accurate measurement becomes
- Different entities have different of levels of sophistication to identify significant increases in credit risk

6

Responsiveness to changes in credit risk

How do you capture significant increases in credit risk when not able to identify on individual instrument level?

- Portfolio default expectations materialise as initially expected; or
- Changes in factors that affect credit risk ie unemployment

- Emphasise:
 - objective is to capture all significant increases in credit risk
 - need to consider all reasonably available information
 - need not be identifiable at an individual level
- Three ways:
 - Clarify on principle level only;
 - Prescribe specific methods; or
 - Illustrate through examples

Stage 1 Measurement objective

7

- Recognising 12-month ECL for performing assets
 - ✓ Represents a crude proxy for adjusting for initial expected credit losses
 - ✓ Results in recognising changes in credit risk before significant
 - ✗ Results in overstatement of ECL included in original pricing
 - ✗ Results in carrying amount on initial recognition being below fair value

Is there another measurement objective?

Stage 1 Measurement objective

8

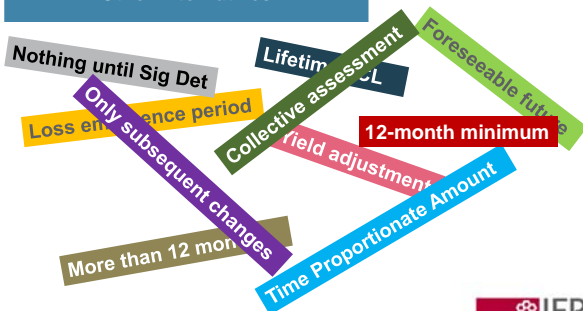
Alternatives previously considered



Stage 1 Measurement objective

9

Other Alternatives



Definition of default

10

- ED did not define default
 - Apply own definition that aligns with credit risk management policies
- Definition of default impacts:
 - Population of defaults considered in Stage 1
 - Assessment of significant deterioration
 - Interaction with Stage 3
- Alternatives identified:
 - Quantitative definition, ie 180 days
 - Qualitative definition, ie technical defaults
 - Rebuttable presumption
 - Do not define default (similar to the ED)

To be discussed at future meetings

11

- Measurement of expected credit losses
- Expected life of off-balance sheet exposures
 - Contractual vs behavioural
- Interest revenue and definition of Stage 3
- Operational simplifications
 - Low credit risk/investment grade
 - > 30 days past due rebuttable presumption
- Simplified approach for trade and lease receivables
- Disclosure and transition
- Effective date

Next steps

12

- Objective is to complete substantive deliberations in 2013
- Publication of final requirements expected in H1 2014

Thank you

13

individual views
expressions of individual views
questions or individual views
feedback
question
expressions of individual views
individual comments
questions or individual views
feedback
questions
expressions of individual views
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International Financial Reporting Standards

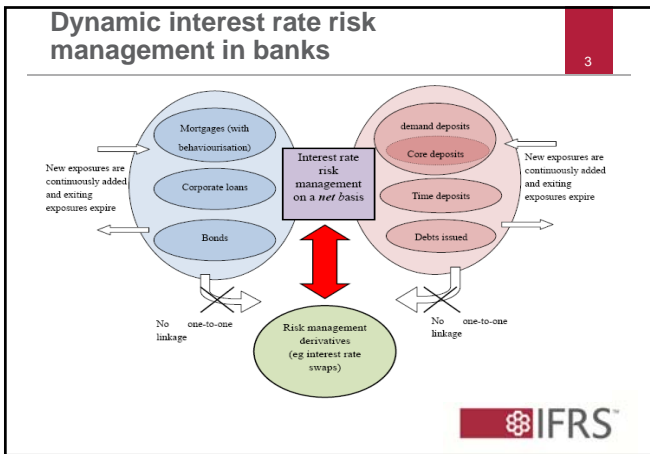
Accounting for Macro Hedging Update September 2013

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Project overview

- Accounting for **open** portfolios that are **dynamically** managed.
- Hedge accounting is difficult to apply.
- Considering a variety of dynamic risk management activities. Not restricted to banks' interest rate risk management, eg commodity and FX risk.



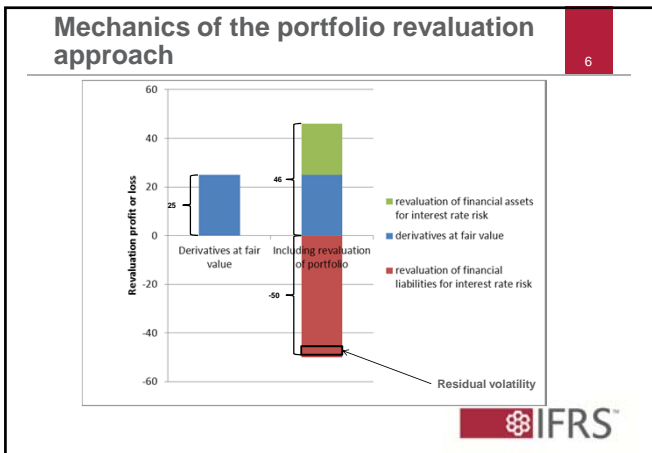
Portfolio revaluation approach overview

- The portfolio revaluation approach itself is simple.
- Exposures are revalued with respect to the managed risk.
- No change to accounting for hedging instruments (FVTPL).
- Offset arises in profit or loss, to the extent of offsetting risk positions. Economic volatility is portrayed consistent with risk management.
- Operational feasibility. No requirement for specific linkage of exposures and hedging instruments.

How to revalue

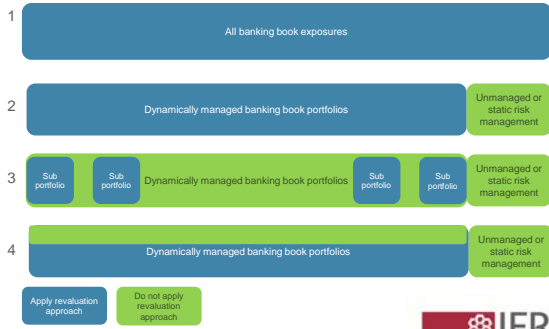
- Individual exposures revalued by calculating **net present value (NPV)** of cashflows with respect to prevailing market **benchmark** interest rates (eg LIBOR-SWAP).

- This approach is **NOT** a full fair value model.



What to be revalued (scope alternatives) – key question

7



Thank you

8



World Standard-setters Meeting

Monday 23 and Tuesday 24 September 2013
The Grange City Hotel (London)

NOTES