STAFF PAPER

January 2015

IFRS Interpretations Committee Meeting

Project	**IAS 39 *Financial Instruments: Recognition and Measurement***
Paper topic	**Negative interest rates: implication for presentation in the statement of comprehensive income**

CONTACT(S)	Yuji Yamashita	yyamashita@ifrs.org	+44 (0)20 7246 6470
	Kumar Dasgupta	kdasgupta@ifrs.org	+44 (0)20 7246 6902

Background

1. In September 2012[1], the IFRS Interpretations Committee discussed the ramifications of the economic phenomenon of negative interest rates for the presentation of income and expenses in the Statement of Comprehensive Income. The Interpretations Committee considered the situation where, against the backdrop of the economic crisis, the overall effective interest rate on some assets (on some of the remaining high quality government bonds), has turned negative.

2. The Interpretations Committee noted that interest resulting from a negative effective interest rate on a financial asset does not meet the definition of interest revenue in IAS 18 *Revenue* because it reflects a gross outflow, instead of a gross inflow, of economic benefits. The Interpretations Committee also noted that this amount is not an interest expense because it arises on a financial asset instead of on a financial liability of the entity. Consequently, the expense arising on a

[1] http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2012/September/141209AP14%20-%20IAS%2039%20-%20presentation%20of%20income%20and%20expense.pdf

financial asset because of a negative effective interest rate should not be presented as interest revenue or interest expense, but in some other appropriate expense classification. The Interpretations Committee noted that in accordance with paragraphs 85 and 112(c) of IAS 1 *Presentation of Financial Statements*, the entity is required to present additional information about such an amount if that is relevant to an understanding of the entity's financial performance or to an understanding of this item.

3. The Interpretations Committee considered that in the light of the existing IFRS requirements an interpretation was not necessary and tentatively decided not to add the issue to its agenda.

4. In January 2013[2] the IFRS Interpretations Committee considered the comments received on its proposed agenda rejection wording and based on the comments received it decided against finalising the tentative agenda decision as it could have unintended consequences on the classification of financial assets in accordance with IFRS 9 which was then subject to limited scope amendments. The Interpretations Committee therefore decided to refrain from finalising the tentative agenda decision until the IASB has completed its redeliberations on the Exposure Draft *Classification and Measurement: Limited Amendments* to IFRS 9.

Purpose of this paper

5. This paper considers the presentation of negative interest rates in the Statement of Comprehensive Income. The paper builds on the previous discussions of the Interpretations Committee on the topic. It addresses the additional issues that have arisen as a result of recent economic developments that had not been previously considered by the Interpretations Committee. The paper also addresses the issues

[2] http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/January/081301AP08%20-%20IAS%2039%20Negative%20interest%20rates.pdf

that had previously prevented the Interpretations Committee from finalising an agenda decision on the topic.

6. The paper recommends that the Interpretations Committee proceed towards finalising an agenda decision on the topic, after the process of re-exposure.

7. The paper includes the following Appendices:

   (a) Appendix A: 'Presentation of negative interest rates in the statement of comprehensive income' (the letter from EBA)

   (b) Appendix B: Proposed wording for final agenda decision

Recent Developments

8. In June 2014, the ECB lowered one of its policy rates (ie deposit rate) from 0.0% to -0.1%. This was based on the ECB's monetary policy judgement that it needs to lower interest rates, taking inflation expectation in the euro area into consideration. In September 2014, the ECB again lowered the rate to -0.2%. Recently, negative rates have spread to interbank market transactions such as EONIA (Euro Overnight Index Average) and EURIBOR (Euro Interbank Offered Rate), which are broadly used for pricing of various financial products including derivatives.

9. As is evident from above the issue has now broadened beyond assets with negative effective interest rates. The Financial Times as of 8th January 2015 estimates that the amount of assets earning negative yields to be in the range of Euro 1.2 trillion.

10. There is no clear economic explanation as to the reason behind negative interest rates and its transmission mechanism in the economy. Custody costs could be one such explanation whilst it has also been argued that the economic nature of negative interest rates may be better understood as a sort of tax to penalise entities (eg banks) for their failure to extend loans to borrowers or for holding cash. In this context, a custody fee works as a 'floor,' below which entities would choose to

hold cash rather than pay a negative rate to another entity for holding their cash. Although negative interest rates are not a new phenomenon, the scale of the phenomena being experienced today is indeed new. Consequently, theories and explanations will develop over time as it is studied.

11. Whilst previously custody cost was considered to be the driver of negative interest rates, which was appropriate given the circumstances existing at that point in time, given the economic situation today it can no longer be considered to be the case. For instance, it would not be the driver behind the ECB’s policy decision on setting negative interest rates.

Analysis

Previous Reasoning behind not finalising the agenda decision

12. One of the key reasons behind the Interpretations Committee not finalising the tentative agenda decision was that it could have unintended consequences on the classification of financial assets in accordance with IFRS 9 which was then subject to limited scope amendments. The IASB has finalised IFRS 9 and the Standard was issued in July 2014.

13. As mentioned in previous papers, although a formal agenda request has not been received, the staff have received several informal requests for guidance on how such amounts should be presented. The latest request for clarification was received from the EBA (the letter attached in Appendix A) noting that the issue is becoming significant for certain jurisdictions and also there is diversity in practice. The staff believe, as before, that clarification should be provided and the issue has become all the more pertinent given recent economic developments.

Interaction with the amortised cost criteria in IFRS 9

14. IFRS 9 paragraph B 4.1.7A states ‘*in extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and the*

fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs).' For the purposes of *classification* IFRS 9 clarifies that having a negative interest rate does not prevent the contractual cash flows from being solely payments of principal and interest on the principal amount outstanding. Also, under IFRS 9 negative interest rates are considered as interest.

15. The staff note that the issue addressed by the Interpretations Committee related only to the appropriate *presentation* of negative interest rates. The primary question raised was whether a negative return can be properly presented as revenue and, if the answer to that question is no, whether a negative return on a financial asset can instead be presented as interest expense.

16. IFRS 9 does not deal with *presentation*. The presentation when interest rates are negative should be considered in the light of the requirements in IAS1 *Presentation of Financial Statements*[3], to present income and expense on a gross basis, prohibiting offsetting of income and expenses unless it is required or permitted by an IFRS.

17. Also, the current issue arises as a result of the application of IAS 18 and IAS 39 and not IFRS 9. Whilst the staff agree that we can consider the decisions in IFRS 9 to get an inclination of the Board's thinking on the issue, it is not directly pertinent to the issue.

Interaction with the impairment requirements in IFRS 9

18. One of the concerns was the implication of the tentative agenda decision on the impairment model being developed by the IASB, where it was proposed that an entity would be able to use as a discount rate, any rate between a risk-free rate and the financial asset's original effective interest rate. The Board in finalising IFRS 9 decided to require the use of the effective interest rate (or an approximation of it) when discounting expected credit losses.

[3] See IAS 1.32.

Implications of the latest development on negative interest rates

19. The effective interest rate on a financial instrument is determined by discounting all contractual cash flows on the instrument to its fair value and thus comprises both the coupon and any premium or discount. Previously the issue addressed by the Interpretations Committee dealt only with situations where the overall effective interest rate is negative. However, as of today the situation is more pervasive and includes items that could also have actual negative coupons or contractual interest rates that are negative.

20. The staff note that even under the new circumstances the issue being asked to be addressed by the Interpretations Committee relates only to the appropriate *presentation* of a negative yield or interest rate on a financial asset and the question does not change. Consequently, the analysis applies equally under both circumstances; when effective interest rates and coupon or contractual interest rates are negative.

Negative interest rates for financial assets and financial liabilities

21. IFRSs include requirements for interest revenue in IAS 18 *Revenue* and IAS 39 *Financial Instruments: Recognition and Measurement*. As discussed with Interpretations Committee previously it is clear from the description of interest revenue in IAS 18 that it cannot be 'negative' in terms of an outflow of economic benefits.[4] It follows that interest revenue cannot arise from an asset that has a negative interest rate because that means there is an outflow of economic benefits arising from the use by others of the entity's asset. Similarly an inflow of economic benefits arising from a liability cannot be characterised as revenue under IAS 18.

---

[4] Revenue can only be reduced by discounts or rebates (see IAS 18.10) but not be negative as a whole for a transaction. When uncertainty arises about collectibility of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of revenue originally recognised. (see IAS 18.34).

22. In addition IAS 1 requirements prohibit offsetting of income and expenses unless it is required or permitted by an IFRS[5] and explicitly mention revenue.[6] Consequently, negative amounts arising on some assets when applying the effective interest method cannot be offset against interest revenue arising on other assets.

23. The requirements of IAS 18 only apply to revenue. IFRSs do not have an equivalent standard for interest expense that is as specific. However the general offsetting requirements of IAS 1 apply equally to interest expense[7] as does the effective interest method.[8] Therefore, despite the absence of an equivalent to IAS 18 for interest expense the staff consider that the above analysis regarding interest revenue also applies to interest expense.

24. The staff also believe that the presentation when interest rates are negative for financial assets (ie gross *outflow* from assets) and financial liabilities (ie gross *inflow* to liabilities) can be considered symmetrically. Interest that a lender bank *pays* for its *assets* corresponds to interest a borrower bank *receives* for its liabilities. These also arise from assets and liabilities that would be considered to be earning or paying what has been termed as a basic lending return. Using the thinking in IFRS 9 as a guide which considers negative interest rates as interest the staff believe it is possible to include these separate line items as part of net interest income or its equivalent.

Staff recommendation

25. The staff recommend confirming the tentative agenda decision that the expense arising on a financial asset because of a negative interest rate should not be

[5] See IAS 1.32.

[6] See IAS 1.34.

[7] See IAS 1.32–33.

[8] See IAS 39.9.

presented as interest revenue or interest expense because it does not meet the definition of interest revenue or expense under IAS 18. Instead, it should be presented in some other appropriate expense classification. The staff also recommends that the Interpretations Committee clarify that an entity can include these separate line items as part of net interest income or its equivalent in the Statement of Comprehensive Income.

26. Given the change in circumstances and potentially wider impact of the issue, the staff is recommending that the agenda decision be re-exposed for comments prior to finalisation.

27. The staff also acknowledge that it is likely that IAS 18 did not envisage the circumstance of negative interest rates and consequently the requirements may not provide the optimal solution in the new circumstances. However, in the staff view any change will require an amendment IAS 18 rather than an interpretation. Consequently, if the Interpretations Committee agrees with the staff view and also thinks that the issue is pervasive enough to merits such attention it could recommend the same to the Board.

Question to the Interpretations Committee

Question for the Interpretations Committee
Does the Interpretations Committee agree with the staff's analysis and the staff's recommendation to re-expose the tentative agenda decision for 60 days? Do you agree with the proposed rejection wording in Appendix B?

Appendix A— Letter from EBA

THE CHAIRPERSON

EUROPEAN BANKING AUTHORITY

Floor 46, One Canada Square,
London E14 5AA UNITED KINGDOM
t: +44[0) 20 7382 1770
f: +44(01 20 7382 1771
www.eba.europa.eu
+44(0120 7382 1765 direct
andrea.enria@eba.europa.eu

Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
London EC4M 6XH

07 January 2015

Presentation of negative interest rates in the statement of comprehensive income

Dear Mr Upton

The European Banking Authority (EBA) has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA has considered IFRS Interpretations Committee's (IFRS IC) decision[1] on the presentation of negative interest rates in the statement of comprehensive income. The EBA acknowledges the IFRS IC decision to consider the interaction of the presentation of income and expenses arising on financial instruments with a negative yield with the requirements in IFRS 9 Financial Instruments and to refrain from finalising its decision on this issue until the completion of the redeliberations on IFRS 9. However, considering that the final IFRS 9 was published in July 2014, we believe that the issue could now be reassessed and a final decision could be made.

Since the last IFRS IC decision, the ECB decided to apply negative interest on the amount of deposits which are above a certain limit, and the recent macro-economic developments in EU have created uncertainty regarding the time period during which the negative yields may exist. We also understand that negative yields may affect a broader scope of financial instruments (such as sovereign debt securities).

In the absence of clarity on the presentation of negative interest in IFRS, divergence of accounting practices on this matter might develop. This was also noted by IFRS IC based on an informal outreach with some audit firms. In this regard, the EBA is concerned that the diversity of accounting practices could have an adverse impact on the comparability and transparency of banks' financial statements and disclosures related to the performance of their assets and some commonly used financial ratios of banks (such as the net interest margin).

These would in turn have an impact on the comparability of the banks' regulatory returns to supervisors, especially where IFRS is used as the basis for these returns (for instance FINREP regulatory reporting in the EU).

For these reasons, the EBA encourages the IFRS IC (or the IASB) to reconsider this issue and to provide clarification on the presentation for these instruments in the financial statements.

If you have any questions regarding the above, please do not hesitate to contact us. We look forward to hear your views on this issue.

Andrea Enria

Yours sincerely

1 http://media.ifrs.org/2013/IFRIC/January/IFRIC-Update-January-2013.html#10

Appendix B—Proposed wording for final agenda decision

B1. The staff propose the following wording for the final agenda decision.

IAS 39 *Financial Instruments: Recognition and Measurement* Income and expenses arising on financial instruments with a negative yield—presentation in the statement of comprehensive income

The Interpretations Committee discussed the ramifications of the economic phenomenon of negative interest rates for the presentation of income and expenses in the Statement of Comprehensive Income. In the discussions, the Interpretations Committee considered recent developments in the area and the finalisation of IFRS 9 *Financial Instruments*.

The Interpretations Committee noted that interest resulting from a negative interest rate on a financial asset does not meet the definition of interest revenue in IAS 18 *Revenue* because it reflects a gross outflow, instead of a gross inflow, of economic benefits. The Interpretations Committee also noted that this amount is not an interest expense because it arises on a financial asset instead of on a financial liability of the entity. Consequently, the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue or interest expense, but in some other appropriate expense classification. Similarly interest resulting from a negative interest rate on a financial liability, would not be presented as a part of interest expense. Nor should it be presented as interest income as it does arise from an asset.

The Interpretations Committee noted that in accordance with paragraphs 85 and 112(c) of IAS 1 *Presentation of Financial Statements*, the entity is required to present additional information about an amount if that is relevant to an understanding of the entity's financial performance or to an understanding of the item.

The Interpretations Committee considered that the following presentation in the Statement of Comprehensive Income would be appropriate:

(1) presenting amounts resulting from a negative interest rate on a financial asset as an expense other than 'interest expense';

(2) presenting amounts resulting from a negative interest rate on a financial liability as income other than 'interest revenue.'

The Interpretations Committee also noted that an entity could include both (1) and (2) as part of net interest income or its equivalent in the Statement of Comprehensive Income.

The Interpretations Committee considered that in the light of the existing IFRS requirements an interpretation was not necessary and consequently [decided] not to add the issue to its agenda.