

STAFF PAPER

September 2015

IFRS Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	IAS 39 <i>Financial Instruments: Recognition and Measurement</i> —Separation of an embedded floor from a floating rate host contract in a negative interest rate environment		
CONTACT(S)	Bernadette Whittick Yuji Yamashita	bwhittick@ifrs.org yamashita@ifrs.org	+44 (0)20 7246 0552 +44 (0)20 7246 6470

This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request regarding IAS 39 *Financial Instruments: Recognition and Measurement*. The issue relates to whether an interest rate floor at zero per cent should be separated from a floating rate host contract and accounted for as a derivative in a negative interest rate environment.
2. The objective of this Agenda Paper is to provide the Interpretations Committee with a summary of the issue and the staff's research, analysis and recommendation.

Structure of the paper

3. This paper is organised as follows:
 - (a) Background;
 - (b) Summary of outreach conducted;
 - (c) Extracts from the Standards;
 - (d) Staff analysis;
 - (e) Assessment against the Interpretations Committee's agenda criteria;

- (f) Staff recommendation;
- (g) Questions for the Interpretations Committee;
- (h) Appendix A—Proposed wording for tentative agenda decision; and
- (i) Appendix B—Submission.

Background

The issue

4. In accordance with paragraph 11(a) of IAS 39, an embedded derivative is required to be separated from a host contract and accounted for as a derivative if the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract (assuming that the other requirements stipulated in paragraphs 11(b) and 11(c) of IAS 39 are also met). Paragraph AG33(b) of IAS 39 states that an embedded floor on the interest rate on a debt contract is closely related to the economic characteristics and risks of the host contract, provided that the floor is at or below the market rate of interest when the contract is issued and the floor is not leveraged in relation to the host contract. This means that an embedded interest rate floor is required to be separated from the host contract if the floor is in the money when the contract is issued (ie if the intrinsic value of the floor is positive) even if the floor is not leveraged.
5. The question raised in the submission relates to how the requirements of paragraphs 11(a) and AG33(b) of IAS 39 should be applied in a negative interest rate environment. In order to illustrate the issue, the submitter sets out the scenario below for consideration by the Interpretations Committee.
6. The submitter notes that coupons on floating rate debt instruments (eg loans) are commonly linked to a benchmark rate of interest and also include a fixed spread above this rate. In addition, lenders will often incorporate clauses in these instruments that specify a minimum interest rate (ie floor) for the benchmark rate of interest component of the coupon. For example, a five-year loan may have a contractual interest rate of six-month LIBOR in the currency of the loan plus a

three per cent a year margin, but with the six-month LIBOR component floored at zero. Under the recent negative interest rate environment, the submitter notes that there are cases in which the floor is specified at zero per cent – ie the floor is higher than the current benchmark interest rate.

7. Consequently, the question arises as to whether the embedded floor should be separated from the host contract. The submitter has identified two views relating to the appropriate accounting treatment.

View 1—the embedded floor should be separated and accounted for as a derivative

8. Proponents of View 1 would argue that the accounting treatment should follow the IAS 39 guidance, even under a negative interest rate environment. Furthermore, they consider that the market rate of interest referred to in paragraph AG33(b) of IAS 39 is equal to the relevant measure of the benchmark interest rate. Consequently, in cases in which the floor is considered to be above the relevant measure of the benchmark interest rate, it should be separated and accounted for as a stand-alone derivative.

View 2—the embedded floor should not be separated

9. Proponents of View 2 consider that an embedded floor at zero per cent is closely related to the host contract and should not be separated. They argue that a floor of zero per cent is a special case, which the IASB is not thought to have considered in drafting the guidance in IAS 39. Supporters of this view are of the opinion that a negative interest rate represents a fee that a holder of a financial asset pays for the deposit of its money (e.g. for safekeeping or convenience). Consequently, they believe that a floor of zero per cent is a sensible commercial pricing mechanism, ensuring that lenders receive ‘positive’ coupons, even in a negative interest rate environment and should be considered closely related to the host contract.

10. Furthermore some proponents of this view consider that this is consistent with paragraph AG33(b) of IAS 39 on the basis that it is appropriate to consider pricing practices for similar financial instruments in determining whether the floor is at or below the market rate of interest. For example if a zero percent floor is a standard feature of that type of financial instrument in the market concerned and the transaction is at arms-length, then the floor of zero per cent is closely related to the host debt contract.

Summary of outreach conducted

11. In order to gather information about the issue described in the submission, we sent requests to securities regulators, members of the International Forum of Accounting Standard-Setters (IFASS) and the global IFRS technical teams of the international networks of the large accounting firms (hereafter, ‘accounting firms’). Specifically, we asked:

Q1. In your jurisdiction, is the phenomenon of negative market rate of interest and a floor at zero per cent described in the submission commonly observed?

Q2. If you answer ‘yes’ to Question 1, what is the predominant accounting treatment for this? In addition:

(i) could you please describe the rationale for that accounting treatment?

(ii) if possible, please provide examples of the predominant approach you observe. Ideally, this should be examples from publicly available financial statements, but those on a confidential basis would also be helpful.

Q3. On the basis of your response to Question 2, to what extent do you observe diversity in the accounting treatment?

Responses received

12. We received 18 responses from the following respondents:
- (a) 2 regulators;
 - (b) 11 national standard-setters; and
 - (c) 5 accounting firms.
13. The views received represent informal opinions and do not reflect the formal views of those organisations.
14. The geographical breakdown for the responses received from national standard-setters is as follows:

Geographical region	Number of respondents
Asia	3
Europe	5
Americas	1
Oceania	2
Africa	..
Total respondents	<hr style="width: 50%; margin: 0 auto;"/> 11

15. We summarise the results of the outreach in the following paragraphs.

Summary of outreach responses

16. Some (predominantly European) IFASS members together with a number of accounting firms commented that negative interest rates and zero per cent floors had been observed in some European countries, though it was noted that the phenomenon is relatively recent and consequently not yet widespread.
17. In contrast, many other respondents commented that they had not yet observed the phenomenon of negative interest rates.

18. Summing up the responses to Question 2, the predominant accounting treatment in Europe is **not** to separate an embedded zero per cent floor from a host contract in a negative interest rate environment.
19. Respondents cited two main arguments in support of not separating an embedded zero per cent floor.
20. Some respondents consider that a floor of zero per cent is a special case. They are of the view that a negative interest rate does not represent interest but rather a fee for the safekeeping of money or a penalty for not extending loans. In support of this view, respondents presented a number of arguments including:
 - (a) a negative interest rate does not meet the economic understanding of interest (ie compensation received by the lender from the borrower for lending funds);
 - (b) one prudential regulator has already stated that negative interest is not interest but a penalty; and
 - (c) certain European civil codes have been interpreted by banks in these jurisdictions as implying that the interest rate on a loan cannot go below zero.
21. Consequently, proponents of this view argue that interest is paid until the benchmark interest rate reaches zero per cent, and below that threshold, a fee or penalty is paid. Thus it follows that the embedded floor at zero per cent is not considered to be above the market rate of interest (as the negative element is not considered to be interest) and should therefore not be separated from the host contract.
22. Other respondents argue that the market rate of interest referred to in paragraph AG33(b) of IAS 39 is an overall interest rate that includes spreads (eg credit spread) above the benchmark interest rate. Proponents of this view would therefore compare the floor of zero per cent to the overall (positive) rate of interest rather than the negative benchmark rate. As a result, the zero percent floor would be out of the money.

23. Consequently, proponents of this view would argue that as long as the embedded floor is at or out of the money in relation to the overall interest rate, there is no requirement to separate the embedded floor from the host contract.
24. Notwithstanding the predominant view not to separate the embedded floor, some respondents noted that in some cases, the embedded floor was separated; evidencing that there is diversity in practice to some extent. These respondents noted that this treatment is considered appropriate where the market rate of interest referred to in paragraph AG33(b) of IAS 39 is considered to equal the benchmark rate of interest. Consequently, a zero per cent floor is in the money if the benchmark rate is negative when the contract is issued.

Extracts from the Standards

25. Paragraph 11 of IAS 39 sets out general guidance around the circumstances under which an entity should separate an embedded derivative from a host contract:

11 An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG30 and AG33);

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

If an embedded derivative is separated, the host contract shall be accounted for under this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. This Standard does not address whether an embedded derivative shall be presented separately in the statement of financial position.
[emphasis added]

26. More detailed application guidance relating to embedded derivatives is set out in paragraph AG33 of IAS 39. In particular, paragraph AG33(b) of IAS 39 provides specific guidance pertaining to an interest rate cap or floor:

AG33 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

(b) **An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and**

the cap or floor is not leveraged in relation to the host contract... *[emphasis added]*

27. In addition to paragraph AG33(b) of IAS 39, some other examples of where the term ‘market rate of interest’ is used in IAS 39 are as follows:

Definitions of the four categories of financial instruments

9 [...]...An entity shall not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications that:

(a) are so close to maturity or the financial asset’s call date (for example, less than three months before maturity) that **changes in the market rate of interest would not have a significant effect on the financial asset’s fair value**; *[emphasis added]*

[...]

Initial measurement of financial assets and financial liabilities

AG64 The **fair value** of a financial instrument on initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also IFRS 13 and paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing **market**

rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset. *[emphasis added]*

Impairment and uncollectability of financial assets

AG84 Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current **market rate of interest would, in effect, impose fair value measurement** on financial assets that are otherwise measured at amortised cost... [...] *[emphasis added]*

28. Fair value is defined in Appendix A of IFRS 13 *Fair Value Measurement* as:

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

29. Paragraph 11 of IFRS 13 goes on to note that a fair value measurement is for a particular asset or liability:

11 A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, for example, the following:

- (a) the condition and location of the asset; and
- (b) restrictions, if any, on the sale or use of the asset.

30. In the context of hedge accounting, paragraph 81 of IAS 39 notes that a benchmark interest rate is a component of the total interest rate exposure which could be eligible for hedge accounting in certain circumstances:

81 If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, **an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).** [*emphasis added*]

Staff analysis

31. In order to analyse the question put forward by the submitter, we will first consider whether the requirements of paragraph AG33(b) should apply to a zero per cent floor in a negative interest rate environment. We will then consider how those requirements should be applied.

Should the requirements of paragraph AG33(b) of IAS 39 apply?

32. We note that the Interpretations Committee previously discussed the implications of negative interest rates on the presentation of income in January 2015¹. In paragraph 14 of Agenda Paper 4, the staff analysis noted that ‘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’. This analysis was based on paragraph B4.1.7A of IFRS 9:

B4.1.7A [.....] 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 that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs) [.....].

33. Consequently, we are of the view that negative interest is a form of interest.

34. Furthermore, we note that paragraph AG33(b) of IAS 39 refers to the ‘interest rate on a debt contract’ and does not distinguish between negative and positive interest rates. Consequently, we do not think that there is any justification in IAS 39 not to apply the requirements of that paragraph in a negative interest rate environment.

35. Based on the above analysis, we do not consider that it is appropriate for the accounting treatment of the embedded zero percent floor to be based on the

¹ [Agenda Paper 4 – January 2015 Interpretations Committee Meeting](#)

assumption that a negative interest rate represents a special case – ie that it represents a fee or tax rather than a form of interest. Accordingly, we are of the view that paragraph AG33(b) of IAS 39 should be applied to a floor in a negative interest rate environment in the same way as it would be applied in a positive interest rate environment.

How should the requirements of paragraph AG33(b) of IAS 39 be applied?

36. In accordance with paragraph AG33(b) of IAS 39, an entity is required to compare an interest rate floor with the ‘market rate of interest’ when the contract is issued in order to determine whether the floor is in the money.
37. We note that the results of the outreach suggest that there are differing views regarding how the ‘market rate of interest’ should be determined, namely:
- (a) some respondents consider that the ‘market rate of interest’ is the benchmark rate of interest which is subject to the floor (eg LIBOR); whereas
 - (b) other respondents are of the view that the ‘market rate of interest’ is the overall interest rate that includes any spreads (eg credit spreads) above the benchmark rate.
38. We note that the requirement to compare the interest rate floor with the ‘market rate of interest’ arises regardless of whether the interest rate environment is positive or negative. Furthermore, because we consider that the requirements of paragraph AG33(b) of IAS 39 should be applied consistently in both environments, we see no reason why the appropriate ‘market rate of interest’ should be determined differently in a negative interest rate environment.
39. As noted in paragraph 27, the term ‘market rate of interest’ is used in a number of instances throughout IAS 39, including paragraphs 9, AG64 and AG84 of IAS 39:
- (a) paragraph 9 of IAS 39 deals with the tainting rules associated with financial assets classified as held-to-maturity. In this context, reference is made to changes in the ‘current market rate of interest’ and the impact this could have on the financial asset’s *fair value*;

- (b) paragraph AG64 of IAS 39 deals with initial recognition. It refers to the ‘prevailing market rate of interest’ and describes it as the rate of interest ‘for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating’. This rate is noted as being the appropriate discount rate to use in order to determine the *fair value* of a financial instrument that carries no interest rate; and
- (c) paragraph AG84 of IAS 39 deals with impairment. It notes that applying the ‘current market rate of interest’ would have the effect of imposing a *fair value* measurement on assets otherwise measured at amortised cost.

40. Based on the above analysis, we make the following observations:

- (a) the references to ‘market rate of interest’ are closely linked to the concept of fair value in accordance with IFRS 13 ie price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date; and
- (b) paragraph AG64 describes the prevailing market rate of interest as the rate of interest ‘for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating’.

41. Consequently, we think that in order to determine the appropriate ‘market rate of interest’ when the contract is issued for the purposes of applying paragraph AG33(b) of IAS 39, an entity is required to consider the specific terms of the contract, including the relevant credit or other spreads appropriate for the counterparty and the market in which it is operating.

42. Based on the above, we think that in many circumstances, the ‘market rate of interest’ will be unlikely to equal a benchmark rate such as LIBOR as this rate would not reflect the rate that another market participant would charge for lending on similar terms and to a similar counterparty. However, where the benchmark rate does reflect the rate at which another market participant would charge for lending on similar terms and to a similar counterparty, then in those circumstances we think the ‘market rate of interest’ would equal the benchmark rate.

43. In our view, this would be consistent with:
- (a) the guidance in respect of other interest rate derivatives set out in paragraph AG33(a) of IAS 39 which requires an entity to compare what the ‘market return would be for a contract with the same terms as the host contract’ with the initial rate of return on the hybrid instrument;
 - (b) the definition of fair value in IFRS 13 and specifically paragraph 11 of IFRS 13 which notes that when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date; and
 - (c) paragraph 81 of IAS 39 which notes that a benchmark rate is a component of the total interest rate exposure (see paragraph 30).

Conclusion

44. Based on the analysis set out in paragraphs 31-43 above, we are of the view that:
- (a) paragraph AG33(b) of IAS 39 should be applied to a zero percent floor in a negative interest rate environment in the same way that it would be applied in a positive interest rate environment; and
 - (b) in order to determine the appropriate ‘market rate of interest’ when the contract is issued for the purposes of applying paragraph AG33(b) of IAS 39, an entity is required to consider the specific terms of the contract, including the relevant credit or other spreads appropriate for the counterparty and the market in which it is operating.

Agenda criteria assessment

45. The staff’s assessment of the Interpretations Committee’s agenda criteria is as follows:²

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	No. On the basis of our analysis of the outreach results received, we consider that this issue is widespread only in Europe.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	No. Diversity in practice is limited. Furthermore, we consider that there is sufficient guidance in existing IFRSs.
that can be resolved efficiently within the confines of existing IFRSs and the <i>Conceptual Framework for Financial Reporting</i> .	Not applicable.
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable.
The solution developed should be effective for a reasonable time period. (paragraph 5.21)	Not applicable.

² These criteria can be found in the [IFRS Foundation Due Process Handbook](#) .

Staff recommendation

46. We are of the view that paragraphs 11(a) and AG33(b) of IAS 39 provide sufficient guidance in respect of the requirement to separate an embedded floor if the floor is above the market rate of interest when the contract is issued, even in a negative interest rate environment. We do not think there is any reason to see a negative interest rate environment as a ‘special’ case.
47. Furthermore, we consider that IAS 39 also provides sufficient guidance regarding how an entity should determine the appropriate ‘market rate of interest’ in accordance with paragraph AG33(b) of IAS 39.
48. On the basis of the outreach results received and our assessment of the Interpretations Committee’s agenda criteria, we recommend that the Interpretations Committee should not take this issue onto its agenda.
49. We have set out proposed wording for the tentative agenda decision in **Appendix A** of this paper.

Questions to the Interpretations Committee

Questions to the IFRS Interpretations Committee

1. Does the IFRS Interpretations Committee agree with the staff recommendation set out in paragraphs 46 – 49?
2. Does the IFRS Interpretations Committee have any comments on the drafting of the tentative agenda decision set out in Appendix A?

Appendix A—Tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

IAS 39 *Financial Instruments: Recognition and Measurements*—Separation of an embedded floor from a floating rate host contract in a negative interest rate environment

The Interpretations Committee received a submission regarding the separation of an embedded floor from a floating rate host debt contract. Specifically, the question is whether an embedded floor at zero per cent should be separated from the floating rate host debt contract when the floor is above the market rate of interest when the contract is issued under a negative interest rate environment.

The Interpretations Committee observed that:

- paragraph AG33(b) of IAS 39 should be applied to a zero percent floor in a negative interest rate environment in the same way that it would be applied in a positive interest rate environment; and
- in order to determine the appropriate ‘market rate of interest’ when the contract is issued for the purposes of applying paragraph AG33(b) of IAS 39, an entity is required to consider the specific terms of the contract, including the relevant credit or other spreads appropriate for the counterparty and the market in which it is operating.

In drawing this conclusion, the Interpretations Committee noted the following:

- paragraph AG33(b) of IAS 39 makes no distinction between positive and negative interest rates and consequently, the requirements of that paragraph should be applied consistently in both cases; and
- the term ‘market rate of interest’ is linked to the concept of fair value as defined in IFRS 13 and is described in paragraph AG64 of IAS 39 as the rate of interest ‘for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating’.

In the light of the existing IFRS requirements the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary and therefore [decided] not to add this issue to its agenda.

Appendix B—Submission received

B1. We reproduce below the submission that we received. We have deleted details that would identify the submitter of this request.

Director of Interpretation Activities, IASB
First Floor
30 Cannon Street,
London
EC4M 6XH
United Kingdom

5 May 2015

Dear Sir

Potential Interpretations Committee Agenda Item Request

This letter describes an issue that we believe should be added to the agenda of the IFRS Interpretations Committee. We have included a summary of the issue, alternative views and an assessment of the issue against the Interpretations Committee criteria.

The issue

In a negative interest rate environment, should an embedded derivative be separated from a floating-rate debt instrument with a floor of zero on the benchmark component?

In the past few months, certain benchmark interest rates have become negative for some maturities in some currencies (for example, Swiss Franc LIBOR). The economic phenomenon of negative yields has affected a range of European debt – mostly government bonds from countries such as Switzerland, Denmark and Germany – but also in a few cases corporate bonds of multinational entities. On 21 April 2015, it was reported that, for the first time, three-month EURIBOR had been fixed at a negative rate. A floating-rate debt instrument with a negative interest rate effectively means that the lender pays interest to the borrower – i.e. the borrower obtains funding at a negative cost.

Coupons on floating-rate instruments are commonly linked to a benchmark interest rate or index and also include a fixed spread above that benchmark rate. Lenders

often include clauses in floating-rate debt agreements that specify a minimum interest rate or floor for the benchmark component of the coupon.

For example, a five-year loan may have a contractual interest rate of six-month LIBOR in the currency of the loan plus a 3% a year margin, but with the six-month LIBOR component floored at zero. In this case, if six-month LIBOR is negative at the interest rate reset date, then the interest rate on the loan is equal to 3% a year.

IAS 39.11 requires an embedded derivative to be separated from the host contract and accounted for as a stand-alone derivative if the following conditions are met:

- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss.

Assuming that a separate instrument with the same terms as the embedded floor would meet the definition of a derivative and the hybrid instrument is not measured at fair value through profit or loss (FVTPL), the focus is on whether the embedded floor is closely related to the host debt contract.

IAS 39.AG33(b) contains specific guidance for embedded derivatives that are caps or floors. It states that an embedded floor on the interest rate on a debt contract is closely related to the host contract provided that the floor is at or below the market rate of interest when the contract is issued (i.e. out of the money), and the floor is not leveraged in relation to the host contract. However, different views have emerged in practice as to the interpretation of this paragraph because there is no definition of 'market rate of interest' and there are different views on whether or to what extent the precise wording in AG33(b) was intended to be applied to a negative interest rate scenario, or to a floor of zero.

The assessment of whether to separate the embedded derivative is performed when the entity first becomes a party to the contract, and is not revisited unless there is a significant change in the terms of the contract (IFRIC 9.7).

The above requirements of IAS 39 apply to debt instruments irrespective of whether the host contract is a financial asset or a financial liability. When an entity adopts IFRS 9, these requirements will no longer apply to financial assets; however, the same requirements, as incorporated into IFRS 9, will continue to apply for financial liabilities (i.e. IFRS 9.4.3.3 and IFRS 9.B4.3.8(b)).

Current practice

We believe that this issue has started to become significant for some entities only in recent months, with the occurrence of negative benchmark interest rates. As mentioned above, there are currently different views on applying AG33(b). We believe that the Interpretations Committee should consider the issue because the potential outcomes (separation vs non-separation of the embedded derivative) could have a significant effect on financial statements, and consistency in this area is desirable.

Here we outline two interpretations of which we are aware.

View 1: The embedded floor should be separated and accounted for as a derivative

The embedded floor of zero should be separated if the floor is in the money at the time of issue of the debt instrument – i.e. when the relevant measure of the benchmark rate is less than zero.

Different approaches are possible for determining whether the floor is at or below the market rate of interest (i.e. in the money) when the contract is issued. Taking the above example of a five-year loan and six-month LIBOR, the assessment of whether the floor is in the money could be made by comparing the LIBOR floor in the contract with:

- i. the actual six-month or ‘spot’ LIBOR rate for the six-month period from initial recognition of the instrument;
- ii. the forward six-month LIBOR rate for each interest reset date (plus the comparison in (i) for the first interest rate setting); or
- iii. the average six-month LIBOR forward rate at each interest reset date across the life of the contract (including the actual six-month spot LIBOR rate for the first interest rate setting).

Under approach (i), the floor would be in the money if actual six-month LIBOR is below zero at initial recognition. However, under approach (iii), even if actual six-month LIBOR is below zero on initial recognition, the floor would be considered out of the money if the market-projected average six-month LIBOR rate across the five-year term of the instrument was above zero.

Under approach (ii), the floor would be evaluated as a series of separate floorlets, one for each interest repricing period over the life of the loan. Floorlets where the

forward six-month LIBOR rate is below zero would be considered in the money at the time of issue of the debt (requiring separation) and those where the forward six-month LIBOR rate is above zero would be considered out of the money. Under this approach, applying the guidance in IAS 39.AG29 on treating multiple embedded derivatives as a single compound embedded derivative may result in all the floorlets being separated if even one (e.g. the first floorlet) is in the money, depending on how that paragraph is interpreted.

View 2: The embedded floor should not be separated

A floor of zero is a special case. A negative benchmark interest rate might be argued to represent mainly a fee that a holder of a financial asset pays for the deposit of its money (e.g. for safekeeping or convenience) and to be different from a positive benchmark interest rate that reflects mainly the time value of money. Such a fee is not a component of many lending relationships and a zero-rate floor is therefore a natural feature that merely operates to prevent a lender having to pay such a fee to a borrower (or reduce its margin with a similar effect) when this is not part of the economic characteristics of the host debt instrument (i.e. the floor is closely related).

A floor of zero seems to be a sensible commercial pricing mechanism, ensuring that a bank or other commercial lender receives income on its lending, even when the relevant benchmark rate is negative. If there were no such floor, providing floating-rate loans may not be a viable business model because commercial lenders would risk having to pay borrowers rather than receive interest on the resulting loans.

It does not appear that the phenomenon of negative interest rates was an issue that the IASB considered when drafting the guidance in IAS 39.AG33(b). Some proponents of View 2 argue that this view is consistent with AG33(b) on the basis that, in the case of a zero-rate floor, it is appropriate to consider pricing practices for similar financial instruments in determining whether the floor is ‘at or below the market rate’. These proponents therefore believe that a zero-rate floor is closely related if the financial instrument is issued on arm’s length terms and such a floor is a standard feature in financial instruments of that type in the market concerned (e.g. residential mortgage loans in a particular jurisdiction).

IAS 39.BC37 explains that a rationale for the embedded derivatives requirements is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract. This paragraph further mentions that when the embedded derivative bears a close economic relationship to the host contract, such as a cap or a floor on the interest rate on a loan, it is less likely that the derivative was embedded to achieve a desired accounting result. As noted above, inserting a zero-rate floor in loan agreements is a sensible commercial pricing

mechanism used by lenders and is not intended to circumvent the recognition and measurement requirements for derivatives.

Reasons for the Interpretations Committee to address the issues

- a) ***Is the issue widespread and has, or is expected to have, a material effect on those affected?*** Yes. Negative interest rates are appearing in the currencies of several countries and becoming more common. Similarly, we believe that embedded zero-rate floors are widespread and are becoming more common as awareness of the phenomenon of negative interest rates increases. Depending on the interpretation applied, the decision on how to account for the embedded derivative could have a significant effect on an entity's financial statements, accounting systems and valuation processes.
- b) ***Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?*** Yes. The comparability of financial statements would be improved if entities apply the guidance on separating embedded derivatives in the same manner.
- c) ***Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?*** Yes. It is concerned with the interpretation of specific paragraphs in IAS 39 and IFRS 9.
- d) ***Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs?*** Yes. It is concerned with specific concepts in IAS 39 and IFRS 9.
- e) ***Will the solution developed by the Interpretations Committee be effective for a reasonable time period?*** Yes. The issue does not relate to a current or planned IASB project. As explained above, the issue is relevant under both IAS 39 and IFRS 9.