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Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
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23 November 2015

Dear Mr Upton

Tentative agenda decision – IAS 39 *Financial Instruments: Recognition and Measurement*: Separation of an embedded interest rate floor from a floating rate host contract in a negative interest rate environment

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the September IFRIC Update of the tentative decision not to take onto the Committee's agenda a request for clarification on the application of the embedded derivative requirements of IAS 39 in a negative interest rate environment.

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda and that paragraph AG33(b) of IAS 39 should be applied consistently in negative and positive interest rate environments, but believe that additional clarity should be added to the analysis in the tentative agenda decision.

Specifically, we recommend that in respect of loans with a contractual interest rate of a benchmark rate (for example, LIBOR) floored at zero plus a fixed margin the tentative agenda decision explain whether the comparison required by paragraph AG33(b) is performed on a 'like for like' basis by comparing the floor on the *overall* contractual rate (i.e. benchmark rate plus fixed margin) to a market rate of interest for the issuer or whether the comparison is made with the floor on the *benchmark component* alone. We also note that this distinction is equally important for an assessment of interest rate floors in positive interest rate environments and interest caps in either positive or negative interest rate environments.

In addition, we believe it would be helpful to specify in the agenda decision whether the comparative market rate is the rate for a debt instrument that has a floor or for an instrument that does not (which will be lower due to the absence of a premium payable to the borrower for the floor feature and, as a result, more likely to lead to a conclusion that the embedded floor is closely related).

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

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Our ref MV/28
Contact Mark Vaessen

23 November 2015

Dear Sirs

Tentative agenda decision: *IAS 39 Financial Instruments: Recognition and Measurement - Separation of an embedded interest rate floor from a floating rate host contract in a negative interest rate environment*

We appreciate the opportunity to comment on the above IFRS Interpretations Committee (the Committee) tentative agenda decision included in the September 2015 IFRIC Update. We have consulted with, and this letter represents the views of, the KPMG network.

We understand the Committee's tentative agenda decision to mean that it is the Committee's view that a zero-rate embedded floor usually would not be required to be separated from a floating rate host contract when similar loans to borrowers of similar credit quality generally are being made with an overall positive (or nil) interest rate. We would support the Committee in endeavouring to clarify that separation generally is not required in these circumstances.

However, we do not find the reasoning set forth in the tentative agenda decision to be entirely clear or comprehensive. Therefore, a reader may be unable to determine how the Committee intends the requirements of IAS 39 to be applied in the fact pattern raised in the submission. In particular, the tentative agenda decision states that IAS 39.AG33(b) should be applied in the same way that it would be applied in a positive interest rate environment but does not indicate what the latter means.

We observe two different types of interest rate floors designed to address negative interest rate environments:

1) Instruments where the benchmark component is floored at zero. This is the type of instrument that was described in the original submission and about which the Committee appears to have been asked. The example cited was a loan that bears interest equal to the sum of: (i) the higher of (a) 6-month LIBOR and (b) zero; plus (ii) a fixed spread of 3% - thus, if 6-month LIBOR were minus 1%, the contractual interest rate would be 3%.

2) Instruments where the total interest rate is floored at zero. This is different from the instrument described in the original submission. An example would be a loan that bears interest equal to the higher of (a) 6-month LIBOR plus a fixed spread of 3% and (b) zero – thus, if 6-month LIBOR were minus 1%, the contractual interest rate would be 2%.

We believe that in a scenario where the total interest rate on an instrument is floored at zero and lenders are generally originating loans to similar borrowers with a positive total yield (even though the benchmark rate is negative), it is clear that the floor of zero on the total interest rate is less than the market rate of interest for such loans. In such cases, applying paragraph IAS 39.AG33(b) generally would not result in separation of an embedded derivative.

However, we do not believe that the tentative agenda decision clearly indicates how the Committee believes IAS 39 would apply to instruments where only the benchmark component is floored at zero. Paragraph 22 of Agenda Paper 9 presented at the Committee's September meeting suggests comparing the floor of zero on the benchmark component with an overall positive or total market rate of interest that includes credit and other spreads. This would not be a like-for-like comparison and would allow instruments with a floor on the benchmark rate and a positive spread above the benchmark rate to be considered closely related merely because of that spread – even if the floor on the benchmark rate is above the current "market" benchmark rate.

Because the tentative agenda decision advocates the same application of paragraph IAS 39.AG33(b) irrespective of the interest rate environment, it is necessary to consider its possible application in the context of a positive interest rate environment.

Consider the following example: a five-year loan has a contractual interest rate of six-month LIBOR in the currency of the loan plus a 2.5% a year fixed spread, but with the six-month LIBOR component floored at 5%; six-month LIBOR at inception (on both a spot and forward basis for the life of the loan) is 4%; the market rate of interest (including credit and other spreads) for a similar instrument with no floor is 8%. In this case, the lender accepts a lesser initial rate of return on the loan (i.e. 7.5%) because the floor protects it against declines in the LIBOR rate – i.e. the reduction in yield compared to an identical loan with no floor represents the implicit premium being paid by the lender for the floor.

It is not clear whether, in applying IAS 39.AG33(b) to such a scenario, the Committee believes that the total market rate for a similar loan with no floor of 8% should be compared to the floor on the benchmark rate (i.e. 5%) or the floor plus the spread (i.e. 7.5% including the 2.5% fixed spread).

If the total market rate for a similar loan with no floor of 8% is compared to the floor on the benchmark rate of 5%, then this would generally never result in separation of a floor even if the fixed spread on the loan was increased and the initial return on the loan was above 8%.

If the total market rate of 8% for a similar loan with no floor is compared to the sum of the floor and the contractual spread (i.e. 7.5%), then this would also generally never result in separation of a floor because, as explained above, the spread on the loan is generally reduced to reflect the premium that is implicitly being paid by the lender to enjoy the floor – i.e. the total market rate would usually always be the higher rate.

The tentative agenda decision could even be read to mean comparing the actual market yield on the actual loan including the floor (i.e. a minimum of 7.5%) with the floor plus the contractual spread (i.e. 7.5%). This would seem a pointless comparison that would lead to the floor never being considered in the money assuming arm's length pricing.

All of these applications to a positive interest rate environment produce counter-intuitive results. We believe that - in the positive interest rate scenarios described - it would generally be concluded that the floor was in the money because it is a floor on 6-month LIBOR of 5% and this is above the market rate for LIBOR at inception of the contract of 4% - i.e. the floor on the benchmark rate is compared to the market benchmark rate of interest.

It is possible that the Committee intended such an approach but the tentative agenda decision does not clearly convey this. For example, the Committee might have intended that when the floor is on a benchmark rate, the "market rate of interest" considers the market level(s) of that benchmark rate and how the component would be reflected in the price of the floating rate instrument – i.e. this component would be supplemented by a spread when pricing a similar loan but the spread is not part of the rates which are being compared pursuant to AG33(b).

If this is the case, then we doubt that many readers would understand this from the wording of the tentative agenda decision (as indicated above, it is not our understanding of the tentative agenda decision). Also, this approach would imply a result for a zero-rate floor similar to View 1 as presented in the submission – i.e. separation of a zero-rate benchmark floor would be required if the relevant measure of the benchmark rate is less than zero at the time of issue of the instrument. We have seen no substantial support for such a conclusion. Given the more natural readings of the wording of the tentative agenda decision described above, the potentially inconsistent and counter-intuitive results that they yield in a positive rate environment and the Committee's, the IASB staff's and other constituents' difficulties in analysing this question, we believe that View 2 may reasonably reflect both predominant expected practice in a negative-interest rate environment and a more coherent view of the scope of IAS 39.AG33(b).

Based on the above, we recommend that the final agenda decision and technical analysis clearly explain whether and, if so, how the Committee believes that IAS 39.AG33(b) should be applied when the benchmark component is floored at zero, in particular, what "market rate of interest" (including whether this rate relates to the actual floored instrument or a similar host contract with no floor) is compared on a like-for-like basis with the floor or with the floor plus a spread.

We also note that when the tentative agenda decision refers to considering "the specific terms of the contract, including relevant credit or other spreads appropriate for the counterparty and the market in which it is operating," it seems to imply that "the relevant credit or other spreads appropriate for the counterparty" and "the market in which it is operating" are "specific terms of the contract" whereas this is not the case. Further, it is unclear whether "the market in which it is operating" is a primary factor to consider – along with the contractual terms – or is merely a factor in determining the appropriate spreads and whether "it" in that phrases refers to the entity or to the counterparty. To the extent it remains relevant, we recommend updating the wording of the tentative agenda decision in this respect.

Finally, we note that, as explained in the submission, the issue raised is relevant under both IAS 39 and IFRS 9. We suggest that the final decision is updated to refer to both standards and the relevant paragraphs therein.

Please contact Mark Vaessen or Chris Spall on +44 (0) 20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG IFRG Limited

KPMG IFRG Limited

cc: Reinhard Dotzlaw, KPMG LLP (Canada)

MAZARS

Mr. Wayne Upton

IFRS Interpretation Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Paris, November 23, 2015

RE: IFRS Interpretations Committee tentative agenda decisions, September 2015

Dear Wayne,

MAZARS is pleased to comment on the various IFRS Interpretations Committee tentative agenda decisions published in the September IFRIC Update.

We have gathered all our comments as appendices to this letter. Should you prefer us to prepare separate comment letter for each tentative agenda decision, please let us know.

Should you have any questions regarding our comments, please do not hesitate to contact Michel Barbet-Massin (+33 1 49 97 62 27) or Edouard Fossat (+33 1 49 97 65 92).

Best regards,

Michel Barbet-Massin
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Appendix 1

IAS 39 –*Financial Instruments: Recognition and Measurement*– Separation of an embedded interest rate floor from a floating rate host contract in a negative interest rate environment (Agenda Paper 9)

We support the view of the IFRS Interpretations Committee that the requirements of the paragraph AG33(b) of IAS 39 should be applied consistently to an interest rate floor in a negative and positive interest rate environment.

We agree as well 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.
However attention should be paid when it comes to taking into account the relevant credit or other spreads in determining whether an embedded floor is "in the money" at inception.

In our view, regarding the requirements of AG33(b) the following situations are equivalent:

A. Debt instrument paying: 3-month Euribor floored at zero + 2%. This pay off can be written as well as: Max [0; E3M] + 2%. In this case the strike of the floor is contractually at 0% but is applied to the interest rate before taking into account any credit or other spread.
B. Debt instrument paying: [3-month Euribor + 2%] floored at 2%. This pay off can be written as well as: Max [2%; E3M + 2%]. In this case the strike of the floor is contractually at 2% but is applied to the total coupon (interest rate + credit and other spreads).

Both situations shall lead to the same conclusion regarding the requirement of paragraph AG33(b). Indeed, economically the underlying of the floor is the Euribor component and not the credit or other spreads[1]. This is our understanding of paragraph AG33(b) which deals with embedded floor or cap "on the interest rate" of a debt instrument.

In situation A, one may find interesting to compare the strike of the floor (0%) to the instrument total rate of interest. In the context of a low or negative interest rate environment this approach will minimize the risk that the floor would be "in the money" at inception and thus bifurcated. We disagree with this approach from an economic and contractual point of view.
We encourage the Committee to clarify this issue in its wording for rejection to avoid any misunderstanding. Therefore, we do not consider that references to IFRS 13 and IAS 39.AG64 on the concept of "market rate of interest" are relevant to the issue. We would favor a clarification on the interaction between the moneyness of the floor and the way its underlying is defined.

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[1] We assume that the credit and other spreads are fixed. In our experience, when the credit or other spreads may be adjusted, the coupon payoff is contractually written as described in situation A.