STAFF PAPER

Week beginning 15 October 2012

REG IASB Meeting

Project	**Financial instruments: Classification and measurement**		
Paper topic	Sweep issue – regulated interest rates		
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Background

1. IFRS 9 *Financial Instruments* requires that, subject to the business model assessment, a financial asset is eligible for a measurement category other than at fair value through profit or loss (FVPL) if its contractual cash flows solely represent payments of principal and interest (P&I) [1]. Interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time. IFRS 9 provides application guidance, including illustrative examples, on how the principle should be applied.

2. Since the publication of IFRS 9, the IASB has received questions as to how the principle should be applied to particular instruments, notably financial assets that contain an interest rate mismatch feature. That is, an interest rate on the financial asset is reset (or is resettable) but the frequency of the reset does not match the tenor of the interest rate (for example, the interest rate is reset monthly to a three-month interest rate). Constituents expressed a concern that application guidance in IFRS 9, notably Instrument B discussed in paragraph B4.1.13

[1] Under the proposed limited amendments to IFRS 9, a financial asset with contractual cash flows that are solely P&I could be classified as subsequently measured at amortised cost or at fair value through other comprehensive income depending on the business model within which it is held.

could be interpreted in a way that would result in some financial assets being classified at FVPL even though their contractual cash flows economically solely represent P&I.

3. The IASB has considered the feedback received from constituents and tentatively decided to propose an amendment to IFRS 9. This would clarify that if the financial asset only contains components that are principal, the consideration for the time value of money and for credit risk but the economic relationship between these components is modified (eg by an interest rate mismatch feature) the financial asset may still qualify for a measurement category other than at FVPL (subject to the business model). This would be the case if its cash flows are not more than insignificantly different compared to cash flows on a financial asset identical in all respects, except that it does not contain the modification in economic relationship. For example, to assess a financial asset that contains an interest rate that is reset (or is resettable) monthly to a three-month rate, an entity would need to compare its cash flows to cash flows on a financial asset that is reset (or is resettable) monthly to a monthly rate but that is otherwise identical[2].

4. After this tentative decision was made, the staff have received preliminary feedback that the proposed amendment to the contractual cash flow characteristics assessment would in many instances address the concern previously expressed by constituents. However, this tentative decision would not change the classification conclusion in those cases where cash flows do not economically solely represent P&I as that concept is described in IFRS 9. The staff believe that there may be a limited number of cases that warrant an exception to allow instruments that do not have solely P&I features as defined in IFRS 9, to be eligible to be classified as other than FVPL.

[2] The test is whether the cash flows could be more than insignificantly different so the analysis is not limited only to interest rates at the time of initial recognition.

Issue

5. The staff have received feedback that in a particular jurisdiction[3] pricing of financial assets is extensively regulated by the central bank and that interest rates set by the central bank ('official rates') represent the basis for pricing all retail and commercial loans[4] denominated in local currency in that jurisdiction.

6. It is the staff's understanding that interest rates in that jurisdiction are set as follows:

   (a) The government sets a one-year lending rate that applies to financial instruments with the following *original* maturities:

      (i) 6 months

      (ii) 6-12 months

      (iii) 1-3 years

      (iv) 3-5 years

      (v) More than 5 years

   (b) Interest rates on retail and commercial loans must be set with reference to this structure of rates[5]. Contractual terms of loan agreements specify that the interest rate is reset according to the *original* maturity of the loan when the official rates are reset. For example, a 5-year loan with a remaining maturity of 1 year will re-price to the new official rate set for 5-year loans, whereas a 3-year loan with a remaining maturity of 1 year will re-price to the new 3-year rate.

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[3] The feedback received by the staff relates to a particular jurisdiction. The staff are not aware of other jurisdictions where the issue arises. However, the staff have not performed an exhaustive search to ascertain whether this is the only jurisdiction in the world where the issue arises.

[4] The staff understand that a similar term structure is applied to customer deposits. However, a different pricing approach is applied to interbank lending. Short-term interest rates for interbank lending up to 1 year are set with reference to the market (Interbank Offered Rate). Interest rates on interbank lending for more than 1 year are determined on a bilateral basis with reference to the official term structure.

[5] Banks are allowed to adjust the rate for credit risk, subject to a floor to the interest rate that can be charged, but not to a ceiling.

(c) The timing of interest rate resets are at the discretion of the central bank.

(d) The staff understands that a similar term structure is applied to customer deposits. However, a different pricing approach is applied to *interbank lending*. For example, short-term interest rates for interbank lending up to 1 year are set with reference to the market (Interbank Offered Rate).

7. As outlined above, financial instruments with the same *remaining* maturity and reset period can have different (base) interest rates set depending on their *original* maturity. That is, the interest payable on the financial asset is disconnected from the term of the instrument except at origination. In addition, the tenor of the interest rate is necessarily disconnected from the interest rate reset period because the interest rate is not fixed whereas the rate reset always reflects the original maturity of the financial asset.

Purpose of the paper

8. The purpose of the paper is to ask the IASB to consider whether the issue discussed in paragraphs 5-7 should be addressed as part of the limited modifications to IFRS 9 and if so how.

9. The focus in this paper is not so much on who sets the rates. Governments and central banks are involved in determining interest rates in various ways in numerous (if not all) jurisdictions. It is rather on *how* the term structure of interest rate works in this case.

Staff analysis and question for the IASB

10. The staff are of the view that loans discussed in paragraphs 5-7 would not be eligible for a measurement category other than at FVPL notwithstanding the IASB's tentative decision to propose an amendment to the contractual cash flow characteristics assessment in IFRS 9. This is because cash flows described as 'interest' are disconnected from both the term of the instrument (other than at origination) and the interest rate reset period. The IASB's tentative decision was to retain the principle in IFRS 9 that contractual cash flows must solely

represent the payment of P&I. The only proposed amendment is to ensure that IFRS 9 is *drafted* to properly accommodate instruments that only have such cash flows even if they are insignificantly modified from the 'perfect' instrument. In this case, in the staff's view the instrument does not properly reflect the time value of money. So instruments priced in this way do not appear to satisfy the contractual cash flow requirements in IFRS 9. In addition, even if comparison were made to a benchmark instrument in accordance with the Board's earlier decision, firstly a benchmark does not really exist and also it is most likely that the instrument would be considered to deviate more than insignificantly from the benchmark.

11. The staff acknowledge that the interest rate mechanism included in the financial assets in that jurisdiction is set by law rather than at the lender's choice. The objective is not to achieve a particular (structured) economic outcome. The staff also understand that this is the pricing basis available in that jurisdiction for instruments priced in the local currency (except for transactions that are interbank). However, the staff note that these considerations are not relevant to the assessment of the contractual cash flow characteristics under IFRS 9 and do not change the classification conclusion.

12. The staff acknowledge the severity of the outcome for the jurisdiction. The staff also note that the interest rates vary based on the original maturity of instruments so there is an element of consideration of time value. In a sense in this jurisdiction this has become the accepted structure for the time value of money. However, it is inconsistent with that notion as it is expressed in IFRS 9.

13. The staff do not think it would be appropriate to consider loosening the concept of solely P&I in IFRS 9 to try to accommodate this fact pattern. In the staff's opinion one of the strengths of IFRS 9 is its reliance on the commonly understood economic concept of interest, including the concept of the time value of money.

14. If the IASB would like to address the issue, one way to do it would be to create a narrow-scope exception to the classification and measurement model in IFRS 9. The staff note that based on our analysis, the issue is unique to the particular jurisdiction. In other markets, *particular financial instruments* exist (sometimes in large volumes) where interest rates are

set by the government or central bank in a manner that is disconnected from the economic structure of the time value of money. This occurs for example for purposes such as consumer protection (by averaging out interest rates) or to attract funds to particular products. But in these jurisdictions, other products and a broader market is available in the relevant currency that is based on interest rates that reflect the time value of money in a manner consistent with the concept in IFRS 9. There is a time value of money structure in such markets (in IFRS 9 terms) – and in addition some product specific exceptions. Accordingly, the IASB could scope the exception such that it would allow an entity to classify a financial asset at other than FVPL (subject to business model) if the base interest rate is consistent with and required by a stated interest rate structure that is set by the government or central bank and **that represents the legal pricing basis for domestic currency transactions available in the jurisdiction**.

15. The staff believe that exceptions generally undermine the conceptual purity of the accounting model. In addition, if the IASB were to provide an exception to accommodate a particular fact pattern, it could be asked to provide exceptions for other fact patterns. However, the staff are of the view that an exception as discussed in paragraph 14 would accommodate the issue discussed in this paper and could be contained within a narrow scope. The exception as drafted would mean that a financial asset with an interest structure that meets these criteria would effectively be blessed as being appropriate to be measured at other than at FVPL (depending on business model). However, given a country would need to be comfortable with that feature forming the legal basis for pricing its domestic currency transactions it would seem that the risk of abuse is extremely low.

Question for the IASB
Does the IASB wish to create a narrow scope exception to the classification and measurement model in IFRS 9 to allow an entity to classify a financial asset at other than FVPL (subject to business model) if the base interest rate is consistent with and required by a stated interest rate structure that is set by the government or central bank and that represents the legal pricing basis for domestic currency transactions available in the jurisdiction? If not, what does the IASB wish to do?