STAFF PAPER

January 2016

IFRS Interpretations Committee Meeting

Project	**IAS 39 *Financial Instruments: Recognition and Measurement*—Separation of an embedded floor from a floating rate host contract in a negative interest rate environment**		
Paper topic	Comment Letter Analysis and Finalisation of Agenda Decision		
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Introduction

1. In September 2015, the IFRS Interpretations Committee ('the Interpretations Committee') discussed an issue relating to the embedded derivatives requirements of IAS 39 *Financial Instruments: Recognition and Measurement*.[1] More specifically, the Interpretations Committee discussed whether an interest rate floor should be separated from a floating rate host contract and accounted for as a derivative in a negative interest rate environment.

2. The Interpretations Committee considered the analysis prepared by the staff together with the feedback received from the outreach which indicated that the issue was not yet widespread and that diversity in practice was limited.

3. On the basis of the requirements in IAS 39 and in the light of the outreach results received, the Interpretations Committee determined that neither an Interpretation nor an amendment to the Standard was necessary. Consequently, the Interpretations Committee decided to issue a tentative agenda decision not to add this issue onto its agenda, which can be found in the IFRIC Update of September 2015.

[1] September 2015 Interpretations Committee meeting - Agenda Paper 9.

Purpose of the paper

4. The purpose of this paper is to:

   (a) provide a summary of the comments received on the tentative agenda decision;

   (b) set out our analysis of the comments received; and

   (c) propose amended wording for the final agenda decision.

Summary of Comment Letters

5. The comment period for the tentative agenda decision ended on 23rd November 2015. We received three comment letters which are reproduced in Appendix C.

6. None of the respondents disagreed with the Interpretations Committees' tentative decision not to take this matter onto its agenda.

7. Two respondents (Mazars and Deloitte) agreed that paragraph AG33(b) of IAS 39 should be applied consistently in a negative and positive interest rate environment. The remaining respondent (KPMG) did not directly address this point but noted that:

   (a) in a positive interest rate environment if an interest rate floor (based on the benchmark rate) was above the market benchmark rate of interest, the interest rate floor would be in the money – ie separation would be required; whereas

   (b) their understanding of the tentative agenda decision was 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.

8. All three respondents suggested some additional clarification regarding the wording of the tentative agenda decision.

9. The main clarification requested related to how an entity should make the comparison between the *interest rate floor* and the *market rate of interest* in accordance with paragraph AG33(b) of IAS 39. In particular, respondents commented that it was not clear from the wording of the tentative agenda decision whether the comparison should be done on a 'like for like' basis or not, ie whether an entity should compare:

   (a) the interest rate floor based on the *overall rate of interest* (ie the benchmark rate of interest plus the contractual spread) to the market rate of interest; or

   (b) the interest rate floor based on the *benchmark rate of interest* to the market rate of interest.

10. Some respondents noted that the above distinction is important because there are different types of interest rate floors, for example instruments that contain a floor on the benchmark rate of interest and instruments that contain a floor on the overall rate of interest. It was also noted that this distinction is equally relevant to the appropriate treatment of interest rate floors in a positive interest rate environment.

11. In order to illustrate the application of paragraph AG33(b) of IAS 39 in a positive interest rate environment, one respondent (KPMG) provided the following example of an instrument with the benchmark rate of interest floored at 5 per cent:

   (a) a five-year loan with a contractual interest rate of six-month LIBOR in the currency of the loan plus a 2.5 per cent a year fixed spread, but with the six-month LIBOR component floored at 5 per cent; and

   (b) at inception, six-month LIBOR is 4 per cent (on both a spot and forward basis for the life of the loan) and the market rate of interest (including credit and other spreads) for a similar instrument with no floor is 8 per cent.

12. The respondent observed that in this example, the lender accepts a lesser initial rate of return on the loan i.e. 7.5 per cent because the floor protects it against declines in the LIBOR rate – i.e. the reduction in yield (or spread) compared to an identical loan with no floor represents the implicit premium being paid by the lender for the floor.

13. Within the context of this example, and taking into account the wording of the tentative agenda decision, the respondent asked how paragraph AG33(b) of IAS 39 should be applied. Specifically, the respondent questioned whether the market rate of interest for a similar loan with no floor ie 8 per cent should be compared to:

    (a) the interest rate floor on the *benchmark rate of interest* ie 5 percent; or

    (b) the interest rate floor based on the *overall rate of interest* ie 7.5 per cent (5 per cent plus 2.5 per cent).

14. The respondent also observed that both of the above comparisons would generally never result in separation of an embedded floor. This is because:

    (a) the benchmark rate of interest is only a component of the market rate of interest and consequently the benchmark rate of interest would generally always be less than the market rate of interest; and

    (b) as pointed out in paragraph 12 above, the spread on a loan which contains a floor will have been reduced to reflect the cost of the option premium and consequently the overall interest rate on a loan which contains a floor would generally always be less than the market rate of interest.

15. Respondents also raised a number of comments regarding how to determine the *market rate of interest* in accordance with paragraph AG33(b) of IAS 39:

    (a) two respondents (Deloitte and KPMG) commented that it would be useful if the agenda decision clarified whether when determining the appropriate market rate of interest in accordance with paragraph AG33(b) of IAS 39, an entity should consider a similar debt instrument that has an interest rate floor (ie the hybrid instrument) or a similar debt instrument that does not have an interest rate floor (ie the host instrument);

    (b) one respondent (Mazars) did not agree that the references to IFRS 13 and paragraph AG64 of IAS 39 were appropriate and considered that this could cause confusion over how an entity determined whether an interest rate floor was in the money or not at inception; and

(c) another respondent (KPMG) suggested that the agenda decision should clarify its description of the factors to consider when determining market rate of interest. Specifically, they noted that the tentative agenda decision states that when determining the market rate of interest, 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 their view, this wording requires clarification because:

(i) it implies that 'relevant credit or other spreads appropriate for the counterparty and the market in which it is operating' are part of the specific terms of the contract, which is not the case; and

(ii) it is not clear whether 'the market in which it is operating' refers to the market in which the entity *or* the counterparty is operating in and furthermore it is not clear whether this is a primary factor to consider.

16. Finally, one respondent (KPMG) commented that because the issue in question is also relevant for financial liabilities under IFRS 9 *Financial Instruments*, the final agenda decision should be updated to reflect this.

Staff Analysis of Comment Letters

17. We firstly note that none of the respondents disagreed with the Interpretations Committees' tentative decision not to take this matter onto its agenda.

18. Regarding the comments received on the content of the tentative agenda decision, we note that whilst two of the respondents agreed that paragraph AG33(b) of IAS 39 should be applied consistently in a negative and positive interest rate environment, it was not clear whether the remaining respondent shared this view (as explained in paragraph 7 of this agenda paper). However, we do not intend to address this point further in this paper because this issue has already been addressed in paragraphs 32-35 of Agenda Paper 9[2] which was presented at the September 2015 Interpretations Committee meeting.

19. We also note that all of the respondents requested that the wording of the tentative agenda decision be clarified in some way. We have summarised the clarifications requested into the following key areas:

    (a) the application of paragraph AG33(b) of IAS 39 – specifically what is meant by the *interest rate floor* and what is meant by the *market rate of interest*; and

    (b) IFRS 9 – whether the tentative agenda decision should also make reference to the accounting treatment under IFRS 9.

20. We set out below our analysis of each of the areas of clarification requested. The relevant accounting guidance is reproduced in Appendix B.

[2] September 2015 Interpretations Committee meeting - Agenda Paper 9.

Application of paragraph AG33(b) of IAS 39

21. As noted above, respondents requested clarification regarding what is meant by the *interest rate floor* and what is meant by the *market rate of interest* in accordance with paragraph AG33(b) of IAS 39. In particular, respondents noted that it was not clear whether the comparison between these two rates of interest should be done on a 'like for like' basis or not. We address these points in the following paragraphs.

Interest rate floor

22. As noted in paragraph 9 of this agenda paper, respondents suggested that the wording of the tentative agenda decision should clarify whether the *interest rate floor* referred to in paragraph AG33(b) of IAS 39 should be understood to mean the *overall interest rate floor* (ie benchmark interest rate plus contractual spread) or the *benchmark interest rate floor*.

23. In considering this issue, we note that paragraph AG33(b) of IAS 39:

    (a) refers to an embedded *interest rate floor* on a debt instrument and requires an entity to determine whether that interest rate floor it is in the money at inception; and

    (b) does not refer to components of an embedded *interest rate floor* (such as the benchmark interest rate component) and does not require an entity to determine whether such components of an interest rate floor are in the money at inception.

24. Consequently, we are of the view that in accordance with paragraph AG33(b) of IAS 39, an entity is required to compare the *overall interest rate floor* to the market rate of interest. Therefore, within the context of the example described in paragraph 11 of this agenda paper, we observe that the appropriate comparison should be on a 'like for like' basis as set out in paragraph 13(b) of this agenda paper – i.e. the overall interest rate floor of 7.5 per cent should be compared with the market rate of interest of 8 per cent.

25. We also noted the concern highlighted in paragraph 14 of this agenda paper, ie whether a comparison of the *overall interest rate floor* to the market rate of interest would mean that an entity would generally never be required to split out the embedded interest rate floors.

26. We have considered this concern and whilst we agree that the spread on a loan which contains a floor should be less than the spread on the same loan without the floor, we do not agree that this would mean that an entity would generally never be required to separate embedded interest rate floors. We are of the view that this will depend on the level at which the LIBOR floor is set and the associated fixed spread as illustrated by the example presented below (which is based on the example described in paragraph 11 of this agenda paper):

EXAMPLE 1

Relevant facts

- Six-month LIBOR is 4 per cent (on both a spot and forward basis for the life of the loan)
- Market rate of interest (including credit and other spreads) for a similar instrument with no floor is 8 per cent.

Scenario 1 (a)

A five-year loan with a contractual interest rate of six-month LIBOR in the currency of the loan plus a 2.5 per cent a year fixed spread but with the six-month **LIBOR component floored** at 5 per cent.

Application of paragraph AG 33(b) of IAS 39:

Compare the overall interest rate floor of 7.5 per cent (5 per cent plus 2.5 per cent) to the market rate of interest for a similar instrument with no floor of 8 per cent ie 7.5 per cent – 8 per cent = - 0.5 per cent

Conclusion => interest rate floor is out of the money and consequently the embedded derivative is not required to be separated.

Scenario 1 (b)

A five-year loan with a contractual interest rate of six-month LIBOR in the currency of the loan plus a 2 per cent a year fixed spread but with the six-month **LIBOR component floored** at 6.5 per cent.

Application of paragraph AG 33(b) of IAS 39:

Compare the overall interest rate floor of 8.5 per cent (6.5 per cent plus 2 per cent) to the market rate of interest for a similar instrument with no floor of 8 per cent ie 8.5 per cent – 8 per cent = + 0.5 per cent

Conclusion => interest rate floor is in the money and consequently the embedded derivative must be separated

27. Considering the two scenarios outlined in Example 1 above, we note that:

    (a) the LIBOR rate and the market rate of interest for a similar instrument with no floor (ie the host) remain constant in both scenarios; and

    (b) the terms of the loans which contain the LIBOR floors (ie the hybrids) are different in both scenarios– ie as the value of the LIBOR floor increases, the associated spread reduces reflecting the increased implicit option premium costs.

28. We observe that in scenario 1(a), a comparison of the *overall interest rate floor* to the market rate of interest leads to the conclusion that the interest rate floor is out of the money whereas in scenario 1(b), that same comparison leads to the conclusion that the interest rate floor is in the money.

29. Consequently, we do not agree that applying paragraph AG33(b) of IAS 39 by comparing the *overall interest rate floor* to the market rate of interest would mean that an entity would generally never be required to separate embedded interest rate floors.

30. Furthermore, we observe that applying paragraph AG33(b) of IAS 39 by comparing the *overall interest rate floor* to the market rate of interest results in economically

identical scenarios being treated consistently as illustrated by the example presented below:

<u>EXAMPLE 2</u>

<u>Relevant facts (same as in Example 1)</u>

- Six-month LIBOR is 4 per cent (on both a spot and forward basis for the life of the loan)
- Market rate of interest (including credit and other spreads) for a similar instrument with no floor is 8 per cent.

<u>Scenario 1 (c)</u>

A five-year loan with a contractual interest rate of six-month LIBOR in the currency of the loan plus a 2.5 per cent a year fixed spread but with the **overall interest rate floored** at 7.5 per cent.

Application of paragraph AG 33(b) of IAS 39:

Compare the overall interest rate floor of 7.5 per cent to the market rate of interest for a similar instrument with no floor of 8 per cent ie 7.5 per cent – 8 per cent = - 0.5 per cent

Conclusion => interest rate floor is out of the money and consequently the embedded derivative is not required to be separated.

<u>Scenario 1 (d)</u>

A five-year loan with a contractual interest rate of six-month LIBOR in the currency of the loan plus a 2 per cent a year fixed spread but with the **overall interest rate floored** at 8.5 per cent.

Application of paragraph AG 33(b) of IAS 39:

Compare the overall interest rate floor of 8.5 per cent to the market rate of interest for a similar instrument with no floor of 8 per cent ie 8.5 per cent – 8 per cent = + 0.5 per cent

Conclusion => interest rate floor is in the money and consequently the embedded derivative must be separated

31. Considering the two scenarios outlined in Example 2 above we note that:

    (a) scenario 1(c) is economically identical to scenario 1(a) in Example 1 (the overall interest rate floor is 7.5 per cent) and in both cases, the embedded interest rate floor is not required to be separated; and

    (b) scenario 1(d) is economically identical to scenario 1(b) in Example 1 (the overall interest rate floor is 8.5 per cent) and in both cases, the embedded interest rate floor is required to be separated.

32. However, we agree that the wording of the tentative agenda decision is not clear on what is meant by the *interest rate floor* in accordance with paragraph AG33(b) of IAS 39 and consequently we are of the view that it should be amended to provide the required clarity.

Market Rate of Interest

33. As noted in paragraph 15 of this agenda paper, respondents raised a number of comments pertaining to the *market rate of interest*.

34. Firstly, as noted in paragraph 15(a) of this agenda paper, two respondents suggested that the wording of the tentative agenda decision should clarify whether when determining the appropriate *market rate of interest* in accordance with paragraph AG33(b) of IAS 39, an entity should consider a similar debt instrument that has an interest rate floor (ie the hybrid instrument) or a similar debt instrument that does not have an interest rate floor (the host).

35. In this regard, we observe that paragraph AG33 of IAS 39 provides application guidance pertaining to hybrid instruments[3] and sets out examples of instances where the economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract. Consequently, we observe that in order to determine whether an embedded derivative is closely related to the host contract, an entity is required to compare the hybrid contract (which contains the

[3] Paragraph 10 of IAS 39 notes that a hybrid instrument contains both an embedded derivative component and a non-derivative host contract.

embedded derivative) to the host contract (which does not contain the embedded derivative).

36. Based on the above, we are of the view that in order to apply the requirements of paragraph AG33(b) of IAS 39, the interest rate floor on the hybrid contract (ie the contract which contains the embedded derivative) should be compared to the *market rate of interest for the host contract* – ie a similar debt instrument that does not contain this embedded derivative feature. We observe that this would be consistent with the comparison required by paragraph AG33(a) of IAS 39 which provides application guidance relating to other types of embedded interest rate derivatives.

37. We agree that the wording of the tentative agenda decision does not make it clear that when determining the *market rate of interest* in accordance with paragraph AG33(b) of IAS 39, an entity is required to consider the host contract (ie a similar debt instrument which does not contain an interest rate floor). Consequently, we are of the view that it should be amended to provide the required clarity.

38. Secondly, as noted in paragraph 15(b) of this agenda paper, one respondent does not consider that the references to IFRS 13 and paragraph AG64 of IAS 39 are relevant when determining the *market rate of interest*. However, as explained in paragraphs 39 – 41 of Agenda Paper 9[4] which was presented at the September 2015 Interpretations Committee meeting, we are of the view that these references are appropriate and consequently we do not propose any amendments to the tentative agenda decision in this regard.

39. Finally, we note that one respondent requested some clarifications to the wording which describes the factors to consider when determining the *market rate of interest* ie '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'.

[4] September 2015 Interpretations Committee meeting - Agenda Paper 9.

40. We propose that the wording of the tentative agenda decision be amended to make it clear that factors such as the counterparty and the market are not part of the specific terms of the contract.

IFRS 9

41. As noted in paragraph 16 of this agenda paper, one respondent commented that because the issue in question is also relevant to financial liabilities under IFRS 9, the final agenda decision should be updated to reflect this.

42. In this regard, we observe that paragraphs B4.3.8(b) and B5.1.1 of IFRS 9 replicate the requirements of paragraphs AG33(b) and AG64 of IAS 39 respectively. Consequently, we are of the view that the conclusions noted in this agenda decision would be equally applicable to financial liabilities accounted for in accordance with IFRS 9 and that the agenda decision should be updated to reflect this.

Staff Recommendation

43. On the basis of the comments received, we propose to the Interpretations Committee that the agenda decision should be finalised with the following changes:

    (a) clarify that the *interest rate floor* referred to in paragraph AG33(b) of IAS 39 should be understood to mean the overall interest rate floor (see paragraphs 22 - 32 of this agenda paper);

    (b) clarify that the *market rate of interest* referred to in paragraph AG33(b) of IAS 39 should be understood to mean the market rate of interest on the host contract (see paragraphs 33- 37 of this agenda paper);

    (c) clarify the description of the factors to take into account when determining the *market rate of interest* (see paragraphs 39- 40 of this agenda paper); and

(d) clarify that the conclusions reached in the tentative agenda decision would also apply to financial liabilities in accordance with IFRS 9 (see paragraphs 41 – 42 of this agenda paper).

44. We have reflected these changes as a mark up to the published tentative agenda decision in Appendix A (A1). We have also included a clean version of the final proposed agenda decision wording in Appendix A (A2).

Questions to the Interpretations Committee

Question to the IFRS Interpretations Committee
1. Does the Interpretations Committee agree with our suggested amendments to the agenda decision? 2. If so, does the Interpretations Committee agree with our recommendation to finalise the agenda decision?

Appendix A—Agenda decision

A1. We propose the following amendments to the original 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 request to clarify the application of the embedded derivative requirements of IAS 39 *Financial Instruments: Recognition and Measurement* in a negative interest rate environment. Specifically, the Interpretations Committee considered:

a) whether paragraph AG33(b) of IAS 39 should apply to an embedded interest rate floor in a floating rate host debt contract in a negative interest rate environment; and

b) how to determine the 'market rate of interest' referred to in that paragraph.

The Interpretations Committee observed that:

a) paragraph AG33(b) of IAS 39 should be applied to an interest rate floor in a negative interest rate environment in the same way that it would be applied in a positive interest rate environment; ~~and~~

b) when applying paragraph AG33(b) of IAS 39, an entity should compare the overall interest rate floor (ie the benchmark interest rate plus appropriate spreads) to the market rate of interest for a similar contract without the interest rate floor (ie the host contract); and

~~b~~c) 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 host contract and the relevant spreads (including credit spreads) appropriate for the transaction. ~~, 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:

a) paragraph AG33(b) of IAS 39 makes no distinction between positive and negative interest rates and, therefore, the requirements of that paragraph should be applied consistently in both cases; ~~and~~

b) paragraph AG33(b) of IAS 39 requires an entity to identify whether an embedded interest rate floor is closely related to a host debt contract and makes no reference to individual components of an embedded interest rate floor (such as the benchmark interest rate); and

~~b~~c) the term market rate of interest is linked to the concept of fair value as defined in IFRS 13 *Fair Value Measurement* 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'.

The Interpretations Committee also observed that paragraphs B4.3.8(b) and B5.1.1 of IFRS 9 replicate the requirements of paragraphs AG33(b) and AG64 of IAS 39 respectively. Consequently, the conclusions noted in this agenda decision would be equally applicable to financial liabilities accounted for in accordance with IFRS 9.

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

A2. We propose the following wording for the final 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 request to clarify the application of the embedded derivative requirements of IAS 39 *Financial Instruments: Recognition and Measurement* in a negative interest rate environment. Specifically, the Interpretations Committee considered:

a) whether paragraph AG33(b) of IAS 39 should apply to an embedded interest rate floor in a floating rate host debt contract in a negative interest rate environment; and

b) how to determine the 'market rate of interest' referred to in that paragraph.

The Interpretations Committee observed that:

a) paragraph AG33(b) of IAS 39 should be applied to an interest rate floor in a negative interest rate environment in the same way that it would be applied in a positive interest rate environment;

b) when applying paragraph AG33(b) of IAS 39, an entity should compare the overall interest rate floor (ie the benchmark interest rate plus appropriate spreads) to the market rate of interest for a similar contract without the interest rate floor (ie the host contract); and

c) 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 host contract and the relevant spreads (including credit spreads) appropriate for the transaction.

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

a) paragraph AG33(b) of IAS 39 makes no distinction between positive and negative interest rates and, therefore, the requirements of that paragraph should be applied consistently in both cases;

b) paragraph AG33(b) of IAS 39 requires an entity to identify whether an embedded interest rate floor is closely related to a host debt contract and makes no reference to individual components of an embedded interest rate floor (such as the benchmark interest rate); and

c) the term market rate of interest is linked to the concept of fair value as defined in IFRS 13 *Fair Value Measurement* 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'.

The Interpretations Committee also observed that paragraphs B4.3.8(b) and B5.1.1 of IFRS 9 replicate the requirements of paragraphs AG33(b) and AG64 of IAS 39 respectively. Consequently, the conclusions noted in this agenda decision would be equally applicable to financial liabilities accounted for in accordance with IFRS 9.

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

Appendix B – Relevant Accounting Guidance

Relevant Extracts from IAS 39 Financial Instruments: Recognition and Measurement

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…

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]*

Relevant Extracts from IFRS 9 Financial Instruments

B4.3.8 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 hybrid contract 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 [.......]

B5.1.1 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph B5.1.2A and IFRS 13). 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.

Appendix C – Comment Letters received

See separate attachment