

STAFF PAPER

16-18 September 2013

REG FASB | IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Contractual Cash Flow Characteristics: Contingent Features		
CONTACT(S)	Rahul Gupta	rgupta@fasb.org	+1 203 956 5317
	Nicholas Milone	nkmilone@fasb.org	+1 203 956 5344
	Yulia Feygina	yfeygina@ifrs.org	+44(0)20 7332 2743
	Alex Debbink	amdebbink@fasb.org	+1 203 956 5296

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB Action Alert or in IASB Update.

Purpose and structure of the paper

1. This is the fourth paper in the series of papers for the September joint board meeting on the **solely principal and interest (“P&I”) condition** in IFRS 9 *Financial Instruments*, and the FASB’s proposed Accounting Standards Update *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* (“the FASB’s proposed ASU”). This paper builds upon the concepts and clarifications to the solely P&I condition discussed in IASB Agenda Papers 6B and 6D/FASB Memos 242 and 244 for this month’s meeting. Specifically, this paper addresses **contingent¹ features** in financial assets and:
 - (a) provides a summary of the relevant guidance in the FASB’s proposed ASU and IFRS 9,

¹ The Oxford Dictionary defines *contingency* as ‘a future event or circumstance which is possible but cannot be predicted with certainty.’

- (b) summarises the feedback received from the IASB and FASB stakeholders on the assessment of contingent features in applying the solely P&I condition,
 - (c) discusses alternative approaches to classifying financial assets with the following types of contingent features:
 - (i) contingent features that result in cash flows that are solely P&I (paragraphs 15-26), and
 - (ii) contingent features that result in cash flows that are not solely P&I (paragraphs 27-50).
2. This paper discusses contingent features **other than** contingent prepayment and extension features (these are the subject of IASB Agenda Paper 6F/FASB Memo 246)—and is relevant only to those contingent features that impact the contractual cash flows of a financial asset by more than a de minimis amount.²

Summary of the guidance in the FASB’s proposed ASU and IFRS 9

3. Consistent with the approach discussed in IASB Agenda Paper 5A/FASB Memo 133 for the February 2012 joint board meeting (‘the February 2012 paper’) and the tentative decisions that the boards made at that meeting, the guidance in the FASB’s proposed ASU required an entity to consider both:
- (a) the nature of the contingent trigger event, and
 - (b) whether the cash flows that result upon the occurrence of that event are solely P&I.

² The Oxford Dictionary defines *de minimis* as ‘too trivial or minor to merit consideration, especially in law.’ All features (including contingent features) that only result in a de minimis impact on cash flows of a financial asset are discussed in Agenda Paper 6D/FASB Memo 244 for this month’s meeting.

4. The FASB's proposed ASU included the following examples, which were originally set out in the February 2012 paper³:
- (i) A privately issued debt instrument contains a contractual term that requires that if the issuing entity does not become a publicly traded entity within a specified time period, the interest rate on the debt instrument would be reset to a market rate for a comparable privately issued debt instrument...The nature of the contingency is to maintain an appropriate rate of return on the instrument that represents compensation for the time value of money and the credit risk. Therefore, the contingent feature results in cash flows that are solely payments of principal and interest on the principal amount outstanding.
 - (ii) In contrast, if the contractual term of the instrument results in the interest rate being reset to a punitive rate if the issuing entity does not become a publicly traded entity, such a contractual term would result in cash flows that are not solely payments of principal and interest on the principal amount outstanding.
5. Consistent with the February 2012 paper, the FASB's proposed ASU also provided specific guidance for contingent prepayment and extension features.⁴ In particular, it specified that such features could⁵ result in cash flows that are solely P&I if those features protect:
- (a) The holder against the credit deterioration of the issuer (for example, defaults, credit downgrades, or loan covenant violations) or a change in control of the issuer; or
 - (b) The holder or issuer against changes in relevant taxation or law.

³ The FASB's proposed ASU paragraph 825-10-55-25

⁴ The FASB's proposed ASU paragraph 825-10-55-21 through 55-22

⁵ There are additional requirements for such features to be consistent with the solely P&I condition. For prepayment features, the prepayment amount should substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract. For extension features, contractual cash flows over the extension period must be solely P&I.

6. IFRS 9 contains the same requirements for contingent prepayment and extension options.⁶ However, IFRS 9 does not provide explicit guidance on the assessment of other types of contingent features and states that a contractual term that changes the timing or amount of payments of principal and interest does not result in solely P&I unless it is a variable rate that is consideration for the time value of money and credit risk.⁷
7. The guidance in the FASB’s proposed ASU and IFRS 9 does not allow an entity to take into account the probability of a contingent feature occurring, except that it requires an entity to ignore any ‘non-genuine’ features (that is, features that are extremely rare, highly abnormal and very unlikely to occur).
8. Although the IASB did not propose any changes to that guidance in its exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) (‘the Limited Amendments ED’), stakeholder feedback on contingent features has been received on both FASB’s proposed ASU and IFRS 9.

Feedback

9. During stakeholder outreach meetings and in the comment letters, both the IASB and the FASB received feedback about the assessment of contingent features in applying the solely P&I condition, although these concerns were most prevalent in the United States. Many stakeholders who commented on contingent features expressed concerns that some of those features that are commonly included in financial assets could result in the instrument not meeting the solely P&I condition—and thus being measured at fair value through profit or loss (FVPL)—even if the contingent feature has an **insignificant fair value**. The contingent

⁶ IFRS 9 paragraph B4.1.10 and paragraph B4.1.11

⁷ IFRS 9 paragraph B4.1.12

feature could have an insignificant fair value on a standalone basis either because (a) it could only have a de minimis impact on cash flows and/or (b) even though it could have a material effect on cash flows if triggered, the probability of it being triggered is remote.

10. FASB's stakeholders also expressed the view that the FASB's proposed ASU is **inconsistent in its consideration of the probability of outcomes**. That is, in assessing a modified economic relationship between principal, time value of money and credit risk (that arises due to leverage or interest rate mismatch features) the FASB's proposed ASU (and the IASB's Limited Amendments ED), requires consideration of only reasonably possible outcomes. In contrast, the FASB's proposed ASU (and IFRS 9) does not allow an entity to take into account the probability that a contingent event will occur (except for non-genuine features) – so implicitly all potential (genuine) scenarios must be considered.
11. Many stakeholders (notably respondents to the FASB's proposed ASU, although a few IASB stakeholders also raised this point) questioned whether (and if so, why) it is necessary or relevant to consider the **nature of the contingent trigger event if the resulting cash flows are solely P&I**. They also requested clarifications as to which particular trigger events would be considered consistent with the solely P&I condition.
12. Furthermore, the stakeholders noted that they did not understand why the application guidance explicitly discusses **the nature of particular contingent trigger events** in the context of contingent prepayment and extension features (that is, noting that those features that protect the holder from credit deterioration of the issuer, or a change in control of the issuer, or protect the holder or the issuer from changes in relevant taxation or law are consistent with the solely P&I condition), but does not provide such guidance for other types of contingent features. FASB's stakeholders raised a concern that the only example in the FASB's proposed ASU of a contingent feature that meets the solely P&I condition (other than a contingent prepayment or extension feature) is a feature that is included in the instrument to maintain an appropriate rate of return. Those respondents considered that example to be narrower than and inconsistent with the

guidance for contingent prepayment and extension features. Generally, FASB's and IASB's respondents who commented on the nature of the contingent trigger event expressed a view that the boards should either align the guidance on permissible triggers for all contingent features (including prepayment and extension features) or clarify why the guidance is different.

13. Finally, respondents provided specific examples of instruments that they believed would not or may not meet the solely P&I condition in the FASB's proposed ASU and IFRS 9, including:

- (a) A lender provides a loan to a start-up company at a below market interest rate. However, if and when the start-up company's EBITDA reaches a specified level, the contractual terms of the loan require that the interest rate is reset to the current market rate for similar loans. Respondents expressed concern that the nature of the trigger event could affect classification even if the resulting cash flows represent appropriate consideration for the time value of money and credit risk.
- (b) A financial asset is issued at a market interest rate that is fixed at origination. However, if the price of gold exceeds a specified level, the contractual terms of the asset require that the interest rate is reset to the then current market rate for an instrument of a comparable credit quality, liquidity, currency and term structure. Respondents expressed the view that the asset would not meet the solely P&I condition due to the nature of the trigger event, even if the resulting cash flows represent appropriate consideration for the time value of money and credit risk.
- (c) A financial asset is issued at a market interest rate that is fixed at origination. However, it contains a contractual term requiring that the interest rate is reset to the current market rate for a comparable asset if there is change in control of the issuer. Respondents expressed concern that the asset may not meet the solely P&I condition even if the resulting cash flows represent appropriate consideration for the time value of money and credit risk. That concern arose because a change in

control event is discussed only in the context of contingent prepayment and extension features.

- (d) A financial asset is issued at a market interest rate that is fixed at origination. The asset contains a contractual term that provides the creditor with yield protection; that is, in the event of a change in relevant laws or regulations the creditor will charge a fee or increase the interest rate on the asset. Respondents expressed concern that the asset may not meet the solely P&I condition even if the resulting cash flows represent appropriate consideration for the time value of money and credit risk. That concern arose because changes in relevant laws or regulations are discussed only in the context of contingent prepayment and extension features.
- (e) A financial asset is issued at a market interest rate but contains a contractual term that requires the interest rate to be increased by 500 basis points if the issuer is not able to maintain a specified credit rating. Respondents expressed the view that the asset would not meet the solely P&I condition because they believe that the resulting interest rate is ‘punitive’ and therefore the contractual cash flows do not represent appropriate consideration for the time value of money and credit risk.
- (f) An auction rate security is issued with a market interest rate but that rate is reset to a punitive rate, until the next auction, if the auction fails. Respondents expressed the view that the asset would not meet the solely P&I condition because they believe that the resulting interest rate is ‘punitive’ and therefore the contractual cash flows do not represent appropriate consideration for the time value of money and credit risk.
- (g) A financial asset is issued with a fixed interest rate which represents the current market rate at origination. The interest rate on the asset is reset to a punitive rate (or a fixed fee is charged) during the period in which the issuer/borrower is not in compliance with the filing requirements of its financial statements with the regulator (for example, the SEC in the

United States). Respondents expressed the view that the asset would not meet the solely P&I condition because the contingent cash flows do not represent appropriate consideration for the time value of money and credit risk.

- (h) A financial asset is issued with a fixed interest rate which represents the current market rate on origination. The instrument may or will automatically convert into the issuer's own equity instruments upon the occurrence of an uncertain future event. The value of the equity instruments that will be delivered upon conversion is different from the amount of principal and interest outstanding (for example, particular convertible—or contingently convertible—debt instruments).

Respondents expressed the view that the asset would not meet the solely P&I condition because the contingent cash flows are not solely P&I and that this would be the case even if the probability of conversion is very low or remote.

- (i) A financial asset is issued with a market interest rate. The outstanding amount of principal and interest may be partially or wholly cancelled or converted into the issuer's own equity instruments at a ratio that does not reflect the value of the outstanding principal and interest if the issuer fails to meet particular regulatory capital requirements (herein called 'bail-in instruments'). Respondents expressed the view that the asset would not meet the solely P&I condition because the contingent cash flows are not solely P&I and that this would be the case even if the probability of these features being triggered is very low or remote.

14. To summarise, respondents raised the following key concerns and questions:

- (a) The impact of the nature of the contingent trigger event on classification
- (i) Whether (and if so, why) a contingent feature will be considered inconsistent with the solely P&I condition

simply due to the nature of the trigger event, even if the resulting cash flows are solely P&I, and

- (ii) Why there is specific guidance set out for the trigger events for contingent prepayment and extension features but not for other types of contingent features—and whether the guidance on trigger events should be aligned,
- (b) The impact on classification of ‘punitive’ interest rates,
- (c) The impact on classification of the probability that a trigger event will occur; that is, whether it is appropriate to exclude only non-genuine features or whether the probability threshold should be set at a lower level.

Contingent features that result in cash flows that are solely P&I

15. This section addresses contingent features that result in cash flows that are solely P&I. In light of the feedback received, the staff believe that the boards should consider and clarify the following points:
- (a) Whether the nature of the trigger event *in itself* should impact the classification of a financial asset,
 - (b) Whether the boards intended a different approach for
 - (i) trigger events related to contingent prepayment and extension features; and
 - (ii) trigger events related to other types of contingent features, and
 - (c) The assessment of ‘punitive’ rates in classifying financial assets.
16. The staff believe there is an important interaction between the nature of the trigger event and the resulting cash flows—and that interaction needs to be considered in assessing a contingent feature. To illustrate, consider the following scenarios:

- (a) A financial asset has an interest rate set at 5% but that rate is reset to 10% if the credit quality of the financial asset deteriorates below a specified level.
- (b) A financial asset has an interest rate set at 5% but that rate is reset to 10% if a particular equity index reaches a specified level.
17. In both scenarios, the interest rate is fixed at origination at 5% but is reset to – and remains fixed at – 10% upon the occurrence of an uncertain future event. That is, the contractual cash flows in both scenarios are the same both before and after the respective trigger events. However, the trigger event in itself could influence the assessment of whether the instrument is consistent with the solely P&I condition.
18. For example, in the first scenario, based on all the relevant facts and circumstances the entity may conclude that the higher rate represents compensation for the increased credit risk of the instrument. That could be the case even if the contractually agreed increased interest rate is above the market rate for instruments of such credit quality and therefore could be described by some as ‘punitive’. That is because, as discussed in Agenda Papers 6B-D / FASB Memos 242-244 for this month’s meeting, the solely P&I condition does not require an assessment of whether the asset’s interest rate is consistent with or above / below market – the appropriateness of the effective return for accounting purposes will always be ensured by initial recognition requirements for financial instruments. Rather, the solely P&I condition is intended to ensure that the interest rate does not include elements that are inconsistent with the notion of interest in a basic lending-type relationship. That is, the solely P&I condition focuses on whether the interest rate introduces volatility that is unrelated to time value of money, credit risk and liquidity risk—and whether amortised cost would be able to effectively allocate the contractual cash flows over time and provide useful information.
19. Besides, some rates that are described as ‘punitive’ (for example, rates that require higher compensation for credit risk than seemingly should be required considering the increased potential credit losses) could in fact represent appropriate

consideration for credit risk for a basic lending-type relationship for particular products or scenarios. A typical example would be a significant increase in the interest rate that is sometimes charged on a credit card balance when the debtor misses a payment; that is, arguably, that increase in the interest rate is not directly commensurate with the increase in expected credit losses on the financial asset however this is how credit risk is commonly priced in those circumstances.

20. In contrast, in the scenario described in paragraph 16(b) in which the interest rate is reset if an equity index reaches a specified level, the reset in the interest rate is unrelated to the credit risk or liquidity risk of the asset itself. Rather, the return on the instrument is driven by an external factor. So for example, even if the credit quality of the instrument has not deteriorated and benchmark interest rates have not increased, the interest rate on the financial asset would increase if the equity index reaches the specified level. Accordingly, even though the resulting rate is predetermined—that is, it does not introduce any more variability than the scenario described in paragraph 16(a)—it is difficult to argue that cash flows on such a financial instrument provide consideration only for the time value of money, credit risk and liquidity risk associated with the instrument. Rather, the link to equity prices means that the return on the instrument is also affected by equity prices. In other words, such a rate could be viewed as analogous to a variable interest rate that is driven by equity prices, which is inconsistent with the solely P&I condition. Accordingly, amortised cost would not provide useful information by allocating that return over time.
21. In both of the examples discussed above, it is critical to consider both *whether* and *how* the trigger event affects the instrument's cash flows in order to determine whether those cash flows are solely P&I. In the example of the interest rate that is reset due to the issuer's credit deterioration—if that feature does not have a meaningful fair value and does not result in a premium on initial recognition of the financial asset, that would indicate the appropriate consideration for credit risk. This would be the case even if one could view the increase in the interest rate as 'punitive'—and such punitive rates do in fact occur.

22. In contrast, in the case of the instrument described in paragraph 16, the equity index is expected to have an effect on the instrument’s cash flows in one of two ways. Depending on the magnitude of the increase in the instrument’s interest rate, the price that someone would pay to invest in the instrument would be expected to vary—or alternatively, depending on the price at which the instrument is issued, the issuer is likely to agree to a rate of 10% or another rate (depending on the equity index that causes the interest rate to be reset). This means that the contractual cash flows and the assessment of whether they are solely P&I is affected by the trigger.
23. Therefore the staff believe that it is appropriate—and indeed necessary—to consider the trigger event and the resulting cash flows *in combination* to determine whether the contractual cash flows on the financial asset are solely P&I. For example, if the occurrence of the trigger event results in updating components of the interest rate such that the revised interest rate provides appropriate consideration that reflects the change in the conditions relevant to a basic lending relationship (such as a change in the issuer’s credit), the financial asset could meet the solely P&I condition. That is, the nature of the trigger event in itself is **not a determinative factor** in assessing whether the contractual cash flows are solely P&I throughout the life of the instrument. However, the nature of the trigger is **a helpful indicator** in assessing whether the contractual cash flows are solely P&I.
24. In other words, the ‘nature of the trigger event’ and ‘the contingent cash flows’ are not two unrelated factors that should – or could – be assessed in isolation. Rather, all contractual provisions should be considered holistically in classifying a financial asset. The staff believe that the guidance should be clarified accordingly.
25. In considering the nature of the contingent trigger events, the staff do not believe that the boards intended the requirements for contingent features in general to be more restrictive than the requirements for contingent prepayment and extension features. Rather, the staff believe that the examples used for prepayment and extension features were examples of triggers that were expected to typically result

in cash flows that are solely P&I. Accordingly, in clarifying the guidance on contingent features, the staff believe that no distinction should be made between contingent prepayment and extension features and other types of contingent features.

26. Finally, the staff acknowledge that the specific example of a punitive rate included in the FASB's proposed ASU may indeed suggest that *any* rate that could be considered 'punitive' in nature does not meet the solely P&I condition because it does not 'appropriately' reflect consideration for the time value of money, credit risk and liquidity risk of the financial asset. Therefore, consistent with the analysis in this paper and IASB Agenda Paper 6D / FASB Memo 244 for this month's meeting, the staff propose that the guidance on punitive rates should be updated to reflect that if a 'punitive' interest rate is consistent with the notion of interest, it should not result in the instrument failing the solely P&I condition.

Question 1 for the boards

Do the boards agree with the staff recommendation that the guidance on the assessment of contingent features that result in cash flows that are solely P&I should be clarified as explained in paragraphs 23-26?

Contingent features that result in cash flows that are not solely P&I

27. This section addresses contingent features that result in cash flows that are inconsistent with the solely P&I condition. For example, if the contingent events could lead to a reset of the interest rate to a rate which is clearly not consistent with the notion of interest (for example, a link to a commodity index is introduced) or could result in a conversion into equity instruments⁸—as set out in

⁸ Generally conversions into equity instruments are done using a predetermined ratio. However if the conversion is done such that the fair value of the equity instruments delivered is equal to the value of the principal and interest outstanding, the staff believe that such a debt instrument will meet the solely P&I condition. This is because the *form* of settlement of the outstanding principal and interest (that is, in cash or other financial assets) is not relevant. This section therefore only discusses those debt instruments that can be converted into equity instruments at an amount **other than** the outstanding principal and interest.

the examples in paragraphs 13(h)-(i) — such contingent cash flows would not be considered consistent with the solely P&I condition. This is because, as discussed in Agenda Paper 6C/FASB Memo 242 for this month’s meeting, amortised cost is a simple measurement mechanism that allocates interest over time and therefore cannot effectively cope with—or provide useful and relevant information about—more complex cash flows.

28. As noted in paragraph 7 of this paper, the FASB’s proposed ASU and IFRS 9 generally do not allow an entity to take into account the probability of a contingent feature occurring; however, they require an entity to ignore any non-genuine features. Thus, any contingent feature that results in cash flows that are not solely P&I would require the instrument to be measured at FVPL regardless of the probability of the event occurring (unless the feature is non-genuine).

Overview of the alternatives

29. The staff has identified for the boards’ consideration the following alternatives for assessing contingent features that result in cash flows that are not solely P&I.⁹
- (a) **Alternative A** – If the contractual cash flows are not solely P&I, the financial asset does not meet the solely P&I condition regardless of how likely it is that the non-P&I cash flows will occur (except if they are non-genuine). This alternative is consistent with the current guidance in the FASB’s proposed ASU and IFRS 9.
- (b) **Alternative B** – The holder would be required to consider the probability of the occurrence of contingent contractual cash flows that are not solely P&I for all types of contingent features.¹⁰ In other words, the current ‘non-genuine’ threshold would be replaced with the lower probability threshold of ‘remote’ (lowering the threshold in that assets

⁹ As a reminder, contingencies that have a de minimis effect are outside the scope of this discussion.

¹⁰ Contingent prepayment and extension features are however discussed in the IASB AP 6F / FASB Memo 246 for this month’s meeting.

that have payments that are genuine but remote would also be eligible for amortised cost). Under this alternative, the probability of the contingent non-P&I cash flows would affect the classification, but the nature of the trigger event would not. If the probability of the non-P&I cash flows occurring is no longer remote, the financial asset would be reclassified to FVPL.

- (c) **Alternative C** – The holder would be required to consider the probability of occurrence of contingent contractual cash flows that are not solely P&I for specific contingent features that result in cash flows that are not solely P&I. In other words, the current ‘non-genuine’ threshold would be replaced with the lower probability threshold of ‘remote’ only for specific contingencies. The financial assets captured by this alternative are the so called bail in instruments discussed in paragraph 13(i). This alternative would provide a remote probability threshold for those specific contingent features while retaining the non-genuine threshold for all other contingent features. Under this alternative, both the probability and the nature of the contingent trigger event would affect the classification of financial assets.

	Nature of contingent trigger event	Probability of occurrence	Classification outcome
Alternative A	Not relevant	Not relevant (except for non-genuine features)	<i>All contingencies that result in non-P&I cash flows ‘fail’ unless non-genuine</i>
Alternative B	Not relevant	Relevant. Need to reassess (for all non-P&I contingent cash flows).	<i>All remote contingencies that result in non-P&I cash flows ‘pass.’ All contingencies that are</i>

			more likely than remote 'fail'. That is, lower the non-genuine threshold for all non-P&I contingent cash flows.
Alternative C	Relevant	Relevant. Need to reassess (for specific contingent cash flows).	Non-P&I contingent cash flows triggered by specific events (ie a failure to meet a specified regulatory capital requirement that results in the cancellation of debt or its conversion into equity instruments) 'pass' if remote. All other contingencies that result in non-P&I cash flows 'fail' (unless non-genuine).

Probability assessment – general observations

30. In essence, all alternatives presented above take into account the probability of the occurrence of contingent non-P&I cash flows. However, the probability threshold is set at either the non-genuine or a lower level—and the lower threshold is applied to either all or specific contingent features that result in cash flows that are not solely P&I.
31. Before discussing those alternatives in detail, the staff would like to discuss the implications of lowering the probability threshold for reclassification

requirements and establish the appropriate level of such a lower probability threshold.

Reclassifications

32. In the staff's view, if the boards decided to pursue an alternative with a probability threshold for some or all non-P&I contingent cash flows that is lower than non-genuine, the boards should **require reclassification** of those instruments into the FVPL category when the probability that the non-P&I cash flows will occur increases beyond that threshold level. This is because, as discussed in Agenda Paper 6B / FASB Memo 242 for this month's meeting, amortised cost only provides useful information about financial assets with simple contractual cash flows by allocating those cash flows over time. The staff do not believe that the same considerations apply to the non-genuine threshold currently used in IFRS 9 and the FASB's proposed ASU due to the very nature of the non-genuine threshold. That is, the extremely low probability of the non-P&I cash flows occurring means that the feature can be disregarded altogether (it is essentially treated as being irrelevant).
33. The staff acknowledge that requiring reclassifications would add complexity to the model and impair comparability of the information provided to users. Nevertheless, the staff believe that these considerations are outweighed by the loss of information content that would occur if non-P&I cash flows were to continue to be measured at amortised cost once their probability of occurrence increases above that acceptable level.
34. In addition, the staff note that the concept of monitoring a feature for changes in circumstances would not be new to the accounting in this area. For example, the staff understand that, in today's practice, embedded derivatives that technically require bifurcation and fair value measurement are deemed to have a de minimis value if they are remote and thus are not recorded and accounted for separately at inception. However, these features are monitored on an ongoing basis to ensure their value remains de minimis. To the extent that circumstances change and the

value of those features becomes other than de minimis, these features are then recorded and accounted for at fair value.

35. However, the staff think that if an entity has (i) reclassified the asset into the FVPL category because the probability of the occurrence of the contingent non-P&I cash flows has increased beyond the threshold level, or (ii) initially classified the asset at FVPL because the probability of the occurrence of the contingent non-P&I cash flows was beyond the threshold level, the boards should require that the asset is measured at FVPL from that point forward (regardless of whether the entity subsequently concludes that the probability of occurrence has decreased below the threshold level). That is, an entity should not be required – or allowed – to reclassify the asset back and forth between FVPL and another measurement category throughout the asset’s life (that is, reclassification out of the FVPL category would be prohibited). The staff acknowledge that such an approach is asymmetrical and note that some may be concerned that this will result in a greater use of fair value. However, if such reclassifications were required – or allowed – the staff believe that would dramatically impair comparability and increase complexity and would ultimately not provide useful information by allocating contractual cash flows over portions of the asset’s life.

Probability threshold

36. The staff believe that for any alternative the probability threshold should **not be lower than remote**.¹¹ This is because as the probability of the non-P&I contingent cash flows increases, the feature acquires a meaningful fair value and the overall return on the instrument ceases to be consistent with the notion of interest in a basic lending-type relationship and thus amortised cost would not provide useful information by allocating such return over time. It would mean that there is a real possibility that cash flows could arise that are not well captured by amortised cost measurement. Accordingly, if the boards decided to require a

¹¹ The Master Glossary of U.S. GAAP defines ‘remote’ as the chance of a future event or events occurring as slight. Remote is not defined in IFRS. The staff are not aware of any differences in interpretation of ‘remote’ between IFRS and US GAAP.

threshold that is lower than remote—such as more-likely-than-not, reasonably possible or probable—the staff believe that this would be inconsistent with the overall conceptual basis for classifying financial assets at amortised cost.

37. Besides, if the boards were to require a probability threshold that is lower than remote, that would result in significantly more instances when reclassification would be required and reclassifications may not happen soon enough to provide timely information to users.
38. Finally, the staff note that the remote threshold is consistent with suggestions received from constituents who believed that the non-genuine threshold should be lowered.

Discussion of the alternatives and classification outcomes

39. **Alternative A** reflects the view that amortised cost is a simple measurement method that can only provide useful information for simple cash flows by allocating those cash flows over time. Accordingly, this alternative applies the non-genuine probability threshold to all contingent features that result in non-P&I cash flows. It is easy to understand and apply and it would not require continuous reassessment of the probability of the occurrence of the contingent feature (or reclassification on that basis) or the assessment of the nature of the contingent trigger event. Under this alternative, information about potential non-P&I cash flows that are genuine is provided to users of financial statements through the fair value measurement. This alternative retains the guidance in IFRS 9 and the FASB's proposed ASU and retains the classification outcomes of that guidance. That is, a financial asset with contingent non-P&I cash flows will be classified at FVPL as long as the feature is genuine even if the probability of the occurrence of the trigger event is remote (and consequently the fair value of the feature on a standalone basis is insignificant).
40. **Alternative B** applies a lower than non-genuine probability threshold to all contingent features that result in non-P&I cash flows. As explained in paragraphs 36-38, the staff believe that a lower probability threshold should be established as

“remote”. A threshold that is lower than remote would, in the staff’s view, be inconsistent with the notion of a basic lending-type return and will create a significant need for reclassifications that will impair comparability and increase the complexity of application.

41. Alternative B does not take into account the nature of the contingent trigger event so it applies to a broad population of instruments. Accordingly, this alternative may allow instruments to be measured at amortised cost even if they indeed have contingent features information about which can only be properly captured through fair value measurement.
42. Some staff think that the remote threshold should still result in many common convertible instruments being measured at FVPL (consistent with the outcome of the guidance proposed under FASB’s proposed ASU and IFRS 9). They take this view because the exercise of the conversion option in those instruments is driven by “economic compulsion” (that is, economic gain to the holder) and the holder’s own behaviour—and therefore it would be difficult for the holder to assert that the probability of conversion is remote. However, based on the facts in some circumstances, some staff are concerned that many will inevitably argue that the probability of conversion will indeed be remote; for example, if the conversion option is deeply out-of-the-money. Thus even some convertible bonds could be measured at amortised cost. Furthermore, some staff note that if the threshold is established as “remote” the concerns raised by stakeholders regarding bail-in instruments may continue to exist under this alternative. For example, some may question whether an entity can assert that the probability of it violating its Tier 1 capital requirement is “remote”, especially in the United States, where many large financial institutions have violated Tier 1 capital requirements during the financial crisis.
43. Therefore, some staff question the benefits of this alternative. They note that this alternative does not necessarily address key concerns raised by constituents and at the same time creates a risk of unintended consequences (ie instruments being measured at amortised cost where amortised cost would not provide useful information), is complex and requires reclassifications.

44. **Alternative C** would only allow particular contingent non-P&I cash flows that are unlikely to occur – so called bail-in instruments discussed in paragraph 13(i) – to be measured at amortised cost. This alternative is similar to Alternative B in that it establishes a lower probability threshold than non-genuine (specifically the remote threshold) however it only applies this threshold to a narrow population of instruments. This alternative effectively proposes an exception to the solely P&I condition in IFRS 9 and FASB’s proposed ASU. Accordingly, the advantage of this alternative compared to Alternative B is that it has a narrow scope and involves a smaller risk of unintended consequences.
45. However, from a conceptual standpoint, the staff are not convinced that the nature of the contingent trigger event is relevant to the classification of a financial asset if the contingent event results in non-P&I cash flows. The staff note that this is different from the assessment of contingent features that result in cash flows that are P&I. That is because in that latter case, as discussed in paragraphs 15-26, the nature of the contingent trigger event, even if not determinative in itself, is a helpful indicator in assessing whether the cash flows are indeed P&I and whether the return is indeed consistent with a basic lending-type return.
46. At the same time, as discussed in paragraph 42, the staff note that this alternative may not necessarily address specific concerns raised by IASB and FASB stakeholders – if the probability threshold is set as remote – because it would be difficult for an entity to assert that, for example, it is remote that the entity will not meet the applicable regulatory capital requirements particularly if the instrument is long dated. If that is the case, the practical impact of this alternative is questionable.

Staff recommendation

47. The staff believe that many of the concerns raised by stakeholders that financial assets that those constituents consider to be plain vanilla would not meet the solely P&I condition are already alleviated by the clarifications to the solely P&I

condition in the IASB Agenda Paper 6D / FASB Memo 244. However some staff members support Alternative A and some support Alternative B.

48. The staff members that support Alternative A believe that classifying financial assets at amortised cost by lowering the probability threshold to remote— or essentially creating an exception for particular types of specified features—would not provide useful information. They believe that the other clarifications made to the solely P&I condition are sufficient. These staff members continue to believe that measuring financial assets at other than FVPL when those assets have contingent non-P&I cash flows that have a remote probability of occurring would be inconsistent with the boards’ objective that only simple financial assets should be measured at other than FVPL. In addition these staff members believe that lowering a probability threshold from non-genuine to remote would create the need for continuous reassessment and reclassifications and thus would increase complexity and impair comparability. Those staff members also note that users are generally not supportive of reclassifications.
49. Staff members that support Alternative B do so because they believe as long as the probability is remote that a contingent feature will occur, such a feature should not determine the classification of the entire financial asset. These staff members believe that if the probability of the occurrence of non-P&I cash flows is remote, there is an expectation of “simple” interest and principal cash flows, in which case amortised cost is capable of providing relevant information to financial statement users about the expected cash flows of the financial asset by allocating those cash flows over time. These staff members acknowledge that requiring reclassifications might add complexity to the proposed guidance. However, they argue that (a) setting the threshold at “remote” would keep the number of potential reclassifications low (as “remote” is still a high threshold for a contingent feature to meet), and (b) as noted in paragraph 34 many preparers and users already monitor (on an on-going basis) those bifurcated embedded derivatives that have a de minimis fair value at inception due to their low probability of occurrence— therefore a requirement to monitor a specific feature on an on-going basis would not be new).

50. In addition, not lowering the probability threshold to remote could lead to situations where a remote but genuine feature (which has a de minimis fair value on a standalone basis but could impact cash flows by more than a de minimis amount if the trigger event occurs) causes the entire financial asset to fail the solely P&I condition, resulting in the entire asset being measured at FVPL. In those circumstances, entities would effectively be classifying at FVPL a financial asset whose cash flows (which would be used to determine its fair value) meet the solely P&I condition in all but the remote scenario.

Question 2 for the boards

Which alternative do the boards prefer for contingent features that result in cash flows that are not solely P&I?

Question 3 for the boards

If the boards prefer Alternative B or C, do the boards agree with the staff recommendation that the probability threshold should be set at remote?

Do the boards agree with the staff recommendation that reclassifications into FVPL should be required under alternative B and C if the contingent non-P&I cash flows become more likely than that probability threshold however reclassifications out of FVPL should not be permitted?

Question 4 for the boards

If the boards prefer Alternative C, do the boards agree that Alternative C should only capture the so called bail in financial assets described in paragraph 13(i)?