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Project	**Financial instruments: classification and measurement**		
Paper topic	Contractual cash flow characteristics of financial assets		
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Purpose of the paper

1. This paper discusses the contractual cash flow characteristics assessment for financial assets. The objectives of this paper are to:

   (a) More closely align the cash flow characteristics assessment in IFRS 9 and in the FASB's tentative model; and

   (b) Address the feedback received by the IASB on the application of the contractual cash flows characteristics assessment in IFRS 9 to particular financial assets.

2. The contractual cash flow characteristics assessment determines which financial assets **could be eligible for a measurement category other than fair value through profit or loss (FVPL)** [1] (ie categories A-C in the AP 5/FASB Memo 132).

[1] Under IFRS 9, an entity may make an election on initial recognition to present fair value gains and losses on an investment in an equity instrument in other comprehensive income. Hence, when this paper refers to measurement at FVPL on the basis of contractual cash flows characteristics of the financial asset, it implies that an entity may still designate an equity investment at fair value through other comprehensive income (FVOCI) under IFRS 9. Such an option is not available under the FASB's tentative model, which requires

3. This paper considers classification of financial assets **in their entirety**. At a future meeting, the staff will ask the boards whether financial assets that are **not** eligible for a measurement category other than FVPL in their entirety due to their characteristics (ie category D in AP 5/FASB Memo 132) should be subject to bifurcation and if so, what the basis for that bifurcation should be.
4. This paper contains a series of questions for the boards. The staff will first ask the boards whether they agree with the overall proposed approach. The staff will then ask a series of questions about specific aspects of the proposed approach.
5. The staff are aware that the boards have different starting points in their respective classification and measurement models. The IASB is undertaking a project to consider limited modifications to IFRS 9. The FASB has developed a tentative classification and measurement model through redeliberations of its May 2010 proposed Accounting Standards Update[2]. Questions to the boards are designed to reflect the boards' different starting points and to get the boards to a more converged position on each issue discussed.
6. The last section of the paper outlines the differences that will remain between the IASB's and FASB's models if the boards agree with all of the staff recommendations in this paper.

Background

IFRS 9 approach

7. Under IFRS 9, a financial asset could be eligible for a measurement category other than FVPL if the contractual terms of the financial asset give rise on specified dates to cash flows that are *solely payments of principal and interest* on the principal amount outstanding (P&I). For the purpose of making that assessment, interest is 'consideration for the time value of money and for the

equity investments to be measured at FVPL (except for nonmarketable securities held by non-public entities).

[2] FASB Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities — Financial Instruments (Topic 825) and Derivatives Hedging (Topic 815).

credit risk associated with the principal amount outstanding during a particular period of time'. Principal is not defined in IFRS 9; however, BC4.23 states that 'cash flows that are interest always have a close relation to the amount advanced to the debtor (the 'funded' amount)'. That is, principal is understood as economic principal.

8. If a financial asset contains features that give rise to contractual cash flows that are not solely P&I, the financial asset must be measured at FVPL. For example, a financial asset with an equity conversion option does not have contractual cash flows that are solely P&I and will be measured at FVPL because the return on the instrument does not only reflect the time value of money and the credit risk of the instrument. Rather, the return is also linked to the value of equity.

9. Paragraphs B4.1.7—B4.1.26 in IFRS 9 provide guidance for determining whether the contractual cash flows are solely P&I. For example, financial assets with variable interest rates, prepayment and extension options can have contractual cash flows that are solely P&I. The relevant application guidance from IFRS 9 is reproduced in Appendix A of this paper.

10. The assessment of the contractual cash flow characteristics of the financial asset is performed by the holder on initial recognition and is not subsequently reconsidered. For example, if a financial asset contains a non-P&I feature on initial recognition but the feature subsequently expires, the financial asset is not reassessed or reclassified. However, if the holder acquires the financial asset after the non-P&I feature has expired, the holder will only consider whether the remaining contractual cash flows are solely P&I.

11. The contractual cash flows characteristics assessment in IFRS 9 has been supported by constituents and the staff understand that generally it has been operable in practice. However since the publication of IFRS 9, the IASB has received questions about how to apply the guidance on P&I to particular instruments, including:

    (a) Interest rate mismatches

(i) Variable interest rates with a reset feature where the frequency of the reset does not match the tenor of the rate (eg interest rate is reset annually to a 5-year rate);

(ii) Variable interest rates that are fixed before the start of the interest period (eg 6-month Euribor rate fixed 2 months before the start of the interest period);

(iii) Variable interest rates that are linked to a market average (eg 3-month Euribor rate determined as an average of 3-month rates during previous 1 month);

(iv) A combination of the above (eg 6-month Euribor rate determined as an average of 6-month rates for the 3-month period ending 3 months before the start of the interest period).

(b) Performance-linked interest payments where performance indicators are intended to serve as a proxy for reflecting the creditworthiness of the borrower (eg net debt/EBITDA).

(c) Discretionary rates where the lender has a conditional right (eg in the event of market disruption) or an unconditional right to determine the rate by reference to a specified formula (eg by reference to the lender's own funding cost).

12. The IASB has also received questions regarding specific paragraphs in the application guidance to IFRS 9, notably the guidance on non-recourse debt and contractually linked instruments. The need for any clarifications to these specific requirements will be considered by the IASB separately at a later date.

FASB's tentative approach

13. The FASB's tentative classification and measurement model also requires an assessment of the characteristics of financial assets. A debt instrument that does not meet all of the following characteristics would be measured at FVPL:

(a) It is not a financial derivative subject to the guidance in Topic 815 on derivatives and hedging.

(b) An amount is transferred to the debtor at inception that will be returned to the creditor at maturity or other settlement, which is the principal amount of the contract adjusted by any discount or premium at acquisition.

(c) The debt instrument cannot be contractually prepaid or otherwise settled in such as a way that the investor would not recover substantially all of its initial investment, other than through its own choice.

14. Under the FASB's tentative model, trade receivables would generally meet the criterion above. Derivatives (except those designated as the hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation) and equity investments (except those subject to the practicability exception for non-public entities) will be measured at FVPL.

15. The FASB's tentative model requires bifurcation of hybrid financial assets under Subtopic 815-15 on embedded derivatives. Bifurcated embedded derivatives will be measured at FVPL. Host contracts will be subject to further assessment, including the assessment of their contractual cash flow characteristics discussed above. An entity will be allowed to measure a hybrid financial asset at FVPL in its entirety after the entity has determined that an embedded derivative feature exists that otherwise requires bifurcation and separate accounting.

16. The assessment of the contractual characteristics of financial assets is performed at initial recognition. No subsequent reclassification is allowed.

Proposed approach

17. The assessment of a financial asset's contractual cash flow characteristics under IFRS 9 and the application of the FASB's tentative model generally result in the same classification and measurement for derivatives and equity investments[3].

18. The FASB's tentative model requires bifurcation whereas the financial assets model in IFRS 9 does not; however, this paper only discusses the classification and measurement of financial assets in their entirety. The need for bifurcation and alternative approaches to bifurcation will be discussed at a future date.

19. The outcome of the assessment of other financial assets (ie debt instruments) under IFRS 9 and the FASB's tentative model may be different; however, the underlying objective of both models is to identify simple debt instruments that could be eligible for a measurement category other than FVPL. On this basis, the staff propose an aligned approach that builds upon the notion of 'solely principal and interest' and takes into account relevant feedback from constituents.

20. Under the proposed approach, a financial asset could be eligible for a measurement category other than FVPL (depending on the business model within which it is held) if the contractual terms of the financial asset give rise on specified dates to cash flows that are **solely payments of principal and interest** on the principal amount outstanding. Interest is consideration for the **time value of money** and for the **credit risk** associated with the principal amount outstanding during a particular period of time[4]. Principal is understood as the amount transferred by the holder on initial recognition. Features other than solely P&I will result in classification at FVPL. The economic relationship between principal and interest must be right—that is, the interest must represent an appropriate economic return for the time value of money and for the credit risk associated with the principal amount outstanding for a particular period of time.

[3] Under IFRS 9, an entity may designate an equity investment at FVOCI at initial recognition. Such an option is not available under the FASB's tentative model, which requires equity investments to be measured at FVPL (except for nonmarketable securities held by non-public entities).

[4] Interest may also include a premium for liquidity risk.

21. An entity shall assess whether contractual cash flows are solely principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

22. Consistent with both IFRS 9 and the FASB's tentative model, it is proposed that the assessment will be performed on initial recognition and will be based on all available information. No subsequent reclassification based on the terms of the instrument will be allowed.

23. A helpful way to think about the effect of the proposed approach is in terms of 'building blocks':

    (a) If the financial asset **contains a feature (ie a 'building block') other than principal, compensation for the time value of money and the credit risk of the instrument**, the instrument must be measured at FVPL. For example, that would be the case if interest payments are indexed to commodity prices or equity prices, **even if the effect of such indexation is not expected to be significant**[5]. This is because such indexation is inconsistent with the economic notion of interest.

    (b) If the financial asset **only contains the relevant 'building blocks'** (ie principal, compensation for the time value of money and for the credit risk), **<u>but</u> the relationship between them is modified** (for example, the interest rate is reset and the frequency of reset does not match the tenor of the rate or the financial asset contains leverage), an entity needs to **consider the effect of the modification** when assessing whether the cash flows on the financial asset are still consistent with the notion of solely P&I. For example, if a financial asset has an interest rate mismatch feature (eg a floating interest rate that is reset monthly to other than a monthly interest rate), an entity would need to assess whether the instrument yields the appropriate economic return.

[5] However, the overall notion of materiality still applies to this condition inasmuch it applies to every item in the financial statements.

(c) If the financial asset **only contains the relevant 'building blocks' and the relationship between them is not modified**, the financial asset could be eligible for a measurement category other than FVPL (depending on the business model within which it is held). An example of such instrument would be a 3-year debt instrument that contains no features other than a floating interest rate that is reset semi-annually to a semi-annual floating rate (time value of money) plus a market margin for that instrument (compensation for the credit risk).

Staff analysis and recommendation

24. Paragraphs 20-23 describe the proposed approach at the principle level. Paragraphs 27-31 provide a staff analysis of the proposed approach at the principle level and a recommendation for each board in the context of the boards' objectives and their respective models.

25. If both boards agree with the proposed approach at the principle level, the staff will ask the boards to jointly discuss how the following items should be assessed under the proposed approach and make decisions in the context of their respective models:

    (a) Contingent cash flows;

    (b) Economic relationship between principal and interest; and

    (c) Prepayment and extension options.

26. These items are discussed in paragraphs 32-74. However, if either board does not agree with the proposed approach at the principle level, the boards will not need to jointly discuss these items.

IASB considerations

27. The staff believe that the approach described in paragraphs 20-23 is broadly consistent with IFRS 9 but provides a minor adjustment to how the notion of P&I is applied in particular circumstances. Specifically, paragraph 23(b) proposes that if the relationship between principal, the time value of money and the credit risk

of the instrument is modified, an entity needs to consider the effect of the modification when assessing whether the cash flows on the financial asset are still consistent with the notion of solely P&I. The staff believe that this would address some of the application questions and concerns that the IASB has received since the publication of IFRS 9.

28. For example, financial assets that contain interest rate mismatches or discretionary rates[6] (refer to paragraph 11) do not automatically result in the financial asset being measured at FVPL. Rather, an entity assesses the effect of the modifying feature and determines whether the cash flows are consistent with the notion of principal and interest.

29. Many of the interpretation issues have arisen from the examples provided in IFRS 9. The staff believe that the most commonly raised issues can be addressed by making a minor amendment to the application guidance in IFRS 9—notably Instrument B in paragraph B.4.1.13 (reproduced in Appendix A). The staff note that the proposed minor amendment is consistent with the IASB's objective to be mindful of those who have already adopted IFRS 9 or dedicated significant resources in preparation for adoption and to keep the change to IFRS 9 to a minimum.

30. The staff does not believe that any amendments are needed to address application questions regarding performance-linked interest payments where performance indicators serve as a proxy for reflecting the creditworthiness of the borrower (discussed in paragraph 11). The staff believe that IFRS 9 is clear that interest payments linked to the debtor's performance, eg those that vary in proportion to revenue or net income, such that the holder effectively participates in the performance of the entity, are not consistent with the notion of solely P&I (refer to IFRS 9 B4.1.13 Instrument A included in Appendix A). In contrast, IFRS 9 is also clear that interest should provide a return commensurate with the time value of money and the credit risk. Therefore a scenario where performance indicators are used as indicators of creditworthiness of the debt with the objective of

[6] The application of the principle to conditional discretionary rates (and other contingent features) is discussed later in this paper in the section 'Further items for discussion'.

maintaining an interest rate that compensates the holder for the credit risk associated with the instrument is consistent with the notion of solely P&I.

FASB considerations

31. The staff believe that the approach based on the notion of solely P&I is consistent with the FASB's intention that only simple debt instruments should qualify for other than FVPL. This approach is also consistent with IFRS 9 and would therefore facilitate greater alignment between the IASB's and the FASB's classification and measurement models. Finally, this approach addresses known questions around how the notion of solely P&I is applied. The staff therefore recommend that the FASB amend the financial instrument characteristics assessment under the tentative model (for financial assets) to the proposed approach described in paragraphs 20-23.

Question 1 for the IASB
In line with the proposed approach described in paragraphs 20-23, does the IASB agree to make a minor amendment to the application guidance in IFRS 9 to require an entity to consider the effect of the modification of the relationship between principal, the time value of money and the credit risk of the instrument when assessing whether the cash flows on the financial asset are still consistent with the notion of solely P&I?

Question 1 for the FASB
Does the FASB agree with the staff recommendation to amend the cash flow characteristics assessment in the tentative classification and measurement model to the proposed approach described in paragraphs 20-23?

Further items for discussion

Contingent cash flows

32. A question may arise how contingent cash flows should be assessed under the proposed approach. A financial asset may contain a 'building block' other than principal, the time value of money or the credit risk on the instrument (eg interest payments linked to an equity index) but the feature only becomes effective if specified conditions are met (for example, a specified index reaches a specified level). Some may raise a question how such contingent cash flows should be assessed under the proposed approach.

33. First of all, it is important to distinguish:

    (a) Variable cash flows; and

    (b) Contingent cash flows.

34. Variable cash flows are consistent with the notion of solely P&I as long as any variability only reflects changes in the time value of money and the credit risk of the instrument[7]. An example of variable cash flows is an instrument that has floating interest payments that are reset semi-annually to a semi-annual benchmark floating rate (time value of money) plus a fixed (market) margin for that instrument (compensation for the credit risk). One may view such cash flows as contingent in a sense that the *amount* of cash flows is based on the benchmark floating rate. However, such cash flows are not considered 'contingent' for the purposes of the following discussion because the *existence o*f these cash flows is not based on the benchmark floating rate.

35. Likewise, contractual cash flows that contain an interest rate mismatch feature (eg an interest rate that is reset semi-annually to a rate other than a semi-annual benchmark rate) are not considered contingent. Even though the effect of the modification in the economic relationship between principal and interest will depend on relative movements in the instrument's interest rate and the semi-

[7] Credit risk may be fixed on initial recognition.

annual rate, the existence of the modification is not contingent. The assessment of financial assets that contain a feature that modifies the economic relationship between principal and interest is discussed in the next section.

36. In contrast, contingent cash flows are those that arise (or cease) as a result of an uncertain future event[8]. The staff believe that there are two different types of contingent cash flows that the boards should consider:

    (a) Contingent cash flows that are **solely P&I**

    (b) Contingent cash flows that are **not solely P&I**

37. Each type is discussed in more detail later in this section[9].

Contingent cash flows that are solely P&I

38. Consider the following example: an entity invests in privately issued debt on the understanding that the debt will be publicly offered within the next twelve months. The terms of the instrument state that if the public offering does not occur, the interest rate will be reset to be aligned with a market rate for comparable private debt[10].

39. This contingency is consistent with the notion of solely P&I. Even though the change in the interest rate is contingent on a public offering, the contingency is introduced to maintain the appropriate return for the instrument (ie the appropriate compensation for the time value of money and the credit risk). In this particular example the adjustment to the interest rate relates to different levels of *credit risk* of private debt compared to public debt[11].

40. Another example of contingent cash flows that are solely P&I is a financial asset with a floating interest rate that is initially based on an appropriate market

[8] The Oxford dictionary of the English language defines *contingency* as 'a future event or circumstance which is possible but cannot be predicted with certainty'.

[9] Common examples of features that introduce cash flow variability and often also involve a contingency attached to them are prepayment and extension options. These are discussed in a separate section later in the paper.

[10] The failed public offering may also result in a reasonable compensation to the lender for the lower interest rate on the instrument during the initial 12-month period.

[11] The adjustment may also include a portion attributable to different liquidity levels of private debt and public debt.

reference rate but that switches to a formula-based rate if the reference rate is no longer available. Assuming that the formula-based rate reflects the *time value* of money and the *credit risk* associated with the instrument, the contingency is consistent with the notion of P&I.

41. To conclude, contingent features that are included to preserve the economic relationship between principal and interest and result in cash flows that are solely P&I are consistent with the notion of solely P&I. Therefore, they do not preclude the financial asset from being measured at other than FVPL.

Contingent cash flows that are not solely P&I

42. Consider the following example: an entity invests in privately issued debt on the understanding that the debt will be publicly offered within the next twelve months. The terms of the instrument state that if the public offering does not occur, the interest rate will be increased to a punitive rate for the remaining life of the instrument.

43. Unlike in the scenario discussed in the previous section, the interest rate adjustment feature is introduced to induce the issuer to execute a public offering. The resulting interest rate does not represent the appropriate return for the instrument—that is, the interest rate is not the appropriate compensation for the time value of money and credit risk. Consequently, this feature is not consistent with the notion of solely P&I.

44. As a second example, consider a financial asset with a floating interest rate that is capped if an equity index reaches a specified level. In this case, the *nature* of that contingency is unrelated to the notion of solely P&I.

45. To conclude: contingencies that are not solely P&I include:

    (a) Contingencies that result in cash flows that are not P&I;

    (b) Contingencies that are incompatible with the notion of P&I by virtue of their nature (ie the nature of the triggering event).

46. A question arises whether the **probability** of contingent cash flows that are not solely P&I should be considered or whether their very existence in the contractual terms requires that the financial asset must be measured at FVPL.

47. An important factor is that the assessment of the contractual cash flow characteristics of financial assets is performed on initial recognition and reclassifications on the basis of those characteristics are prohibited under both IFRS 9 and the FASB's tentative model—and this principle is carried forward to the proposed approach. Hence, if the probabilities of non-P&I features *were* taken into account, financial assets that produce cash flows that are not solely P&I *could be* measured at other than FVPL (ie if the non-P&I feature was ignored on initial recognition because it was improbable but indeed was subsequently triggered). The staff believe that would not provide useful information to users of the financial statements and would be inconsistent with the boards' objective that only simple debt instruments should be measured at other than FVPL.

48. Consequently, the staff propose that **financial assets that contain contingent cash flows that are not solely P&I must be measured at FVPL, regardless of the probability of occurrence of the contingent feature**. Only financial assets with contractual cash flows that are solely P&I in all circumstances could be measured at other than FVPL.

49. However, the staff believe that an exception is appropriate for contingencies that will arise in extremely rare scenarios. Such an exception already exists in IFRS 9 for 'non-genuine' cash flow characteristics. Non-genuine cash flow characteristics are those that affect the instrument's contractual cash flows only on the occurrence of an event that is 'extremely rare, highly abnormal and very unlikely to occur' (IFRS 9 B4.1.18, which is included in Appendix A). This guidance was included in the standard to address questions and concerns received on the IASB exposure draft *Financial Instruments: Classification and Measurement* issued in July 2009.

Staff recommendation

50. The staff believe that application guidance in IFRS 9 (reproduced in Appendix A) is clear and results in outcomes consistent with the analysis in paragraphs 32-49. In particular, IFRS 9 B4.1.12 states:

> A contractual term that changes the timing or amount of payments of principal and interest does not result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding unless it:
>
> > (a) is a variable interest rate that is consideration for the time value of money and the credit risk (which may be determined at initial recognition only, so may be fixed) associated with the principal amount outstanding; and
> >
> > …[12]

51. Hence, any contractual features, including contingencies, that change the timing or amount of the cash flows in a way that is not consistent with solely P&I would cause the financial asset to be measured at FVPL. A change in the timing or amount of cash flows is consistent with solely P&I only if it *relates to* and *results in* the appropriate compensation for the time value of money and the credit risk of the instrument. However, there is an exception for non-genuine features (discussed in paragraph 49).

52. The staff are not aware of any application questions related to the assessment of contingent cash flows under IFRS 9. Consequently, the **staff do not propose any amendments to IFRS 9** and recommend **this guidance be included as part of the FASB's contractual cash flow characteristics assessment**.

Question 2 for the IASB

Does the IASB agree with the staff recommendation in paragraph 52 that it is unnecessary to amend the guidance in IFRS 9 on contractual terms that change the timing or amount of payments of principal and interest, including the guidance on non-genuine features (ie B.4.1.12(a) and IFRS 9 B4.1.18 in IFRS 9)?

Question 2 for the FASB

[12] IFRS 9 B4.1.12 also discusses contingencies related to prepayment and extensions options. These are separately addressed in the next section of this paper.

Does the FASB agree with the staff recommendation in paragraph 52 to incorporate as part of the cash flow characteristics assessment the guidance on contractual terms that change the timing or amount of payments of principal and interest, including the guidance on non-genuine features, provided in IFRS 9 B.4.1.12(a) and IFRS 9 B4.1.18?

Economic relationship between principal and interest

53. Under the proposed approach, if the financial asset **only** contains the relevant 'building blocks' (ie principal, compensation for the time value of money and the credit risk), but the relationship between them is modified, an entity needs to consider the effect of the modification to conclude whether the cash flows on the financial asset are consistent with the notion of solely P&I[13]. Common examples of features that would be subject to this assessment are interest rate mismatches (discussed in paragraph 11) and leverage (eg an instrument that pays interest that is computed as 1.0X x LIBOR). As discussed in paragraph 11, the IASB has received questions about the application of the notion of solely P&I to such features.

54. In order to assess the modification in the economic relationship between principal and interest, an entity needs a benchmark—that is, a comparable 'perfect' instrument that has contractual cash flows that are solely P&I. An appropriate benchmark instrument would be a contract of the same credit quality and with the same terms, except for the contractual term under evaluation. For example, if an entity holds a financial asset that contains an interest rate mismatch feature (eg a floating interest rate that is reset monthly to other than a monthly interest rate), that instrument would be assessed against an instrument of the same credit quality and with the same terms except that the interest rate is reset to a monthly interest rate.

[13] Consistent with the analysis in paragraphs 36-49, if the 'modifying' feature is contingent on future events, the entity assumes that the contingency will happen (that is, the probability is not taken into account unless the feature is non-genuine) and assesses the effect of modification of economic relationship between principal and interest (unless the nature of the contingency itself is inconsistent with solely P&I such that the instrument must be measured at FVPL regardless of the effect of modification).

55. An entity must assess the financial asset under evaluation against the benchmark instrument based on all available information—that is, historical experience, current conditions and future forecasts—and apply judgement. For example, if an entity evaluates a financial asset with an interest rate reset mismatch feature, an entity likely will consider forward yield curves. If forward yield curves have been volatile or the entity is evaluating a long-dated instrument that inherently involves a higher degree of uncertainty, the entity must also consider other factors.

56. It is proposed that if the **difference between the cash flows** of the benchmark instrument and the instrument with a 'modifying feature' is **more than insignificant,** the instrument with the 'modifying feature' must be measured at FVPL because its contractual cash flows are **not solely P&I**. In other words, the instrument being assessed may be eligible for a measurement category other than FVPL only if its contractual cash flows deviate insignificantly from the cash flows of the benchmark instrument.

57. The staff do not believe that the notion of 'insignificant deviation in cash flows' should be quantified in the boards' respective models. Quantitative thresholds have always been criticised because they are rule-based and encourage structuring. Rather, the staff believe that an entity must exercise judgement when assessing whether there is an appropriate economic relationship between the financial asset's principal and interest. The staff note however that the threshold of 'insignificant deviation in cash flows' is considerably lower than the 'double-double' test in Subtopic 815-15 and IAS 39.

58. In practical terms, an entity may compare the effective return on the financial asset being assessed to the rate of return on the benchmark instrument as part of the assessment. This is because the notion of the appropriate economic return is conceptually and mathematically integral to the notion of the cash flows that are solely P&I.

Staff recommendation

59. The staff believe that the analysis in paragraphs 53-58 is broadly consistent with the principle in IFRS 9, that is the contractual cash flows must represent solely P&I, but provides a minor adjustment to how the notion of solely P&I is applied

to financial assets that contain features that modify the relationship between P&I (eg interest rate mismatches). The staff note that the IASB has received questions about application of the notion of solely P&I to such instruments.

60. Consequently, the staff recommend that the IASB make a minor amendment to IFRS 9 to **incorporate the notion of insignificant deviation in cash flows** in the application guidance to IFRS 9 **in the context of contractual provisions that modify the relationship between P&I**. Specifically, the staff believe the analysis of leverage in paragraph B4.1.9 and the analysis of Instrument B in paragraph B.4.1.13 could be clarified.

61. The staff believe that this would address some of the application questions that the IASB has received since the publication of IFRS 9. The staff note that the proposed minor change is consistent with the IASB's objective to be mindful of those who have already adopted IFRS 9 or dedicated significant resources in preparation for adoption and to keep the change to IFRS 9 to the minimum.

62. From the FASB perspective, the staff believe that the notion of insignificant deviations in cash flows is consistent with the overall proposed solely P&I-based approach and represents a principle-based approach to assessing contractual features that introduce cash flow variability rather the current rule-based approach under the 'double-double' test in Subtopic 815-15.

63. Consequently, consistent with the analysis in paragraphs 53-58, the staff recommend that the FASB incorporate in its tentative model **the notion of insignificant deviation in cash flows in the context of contractual provisions that modify the relationship between P&I**.

Question 3 for the IASB
Does the IASB agree with the staff recommendation in paragraph 60 to incorporate the notion of insignificant deviation in cash flows in the application guidance in IFRS 9 in the context of contractual provisions that modify the relationship between P&I (notably in the discussion of interest rate mismatches in the analysis of Instrument B in paragraph B.4.1.13)?

Question 3 for the FASB

Does the FASB agree with the staff recommendation in paragraph 63 to incorporate as part of the cash flow characteristics assessment the notion of insignificant deviation in cash flows in the context of contractual provisions that modify the relationship between P&I?

Prepayment and extension options

64. Prepayment and extension options are common features of financial assets that warrant separate consideration by the boards. Prepayment and extension options, if exercised, change the maturity of the financial asset and can result in both:

    (a) Variability in timing and amount of cash flows (eg a 10-year loan prepays in year 5 and thus the holder does not get interest payments in years 6-10); and

    (b) Variability in return on the instrument (eg if the instrument was acquired at substantial premium or discount and prepays at par).

65. As discussed in paragraphs 34-35, variability in cash flows is not necessarily inconsistent with the notion of solely P&I. Consequently, prepayment and extension options do not preclude a financial asset from a measurement category other than FVPL as long as they result in cash flows that are solely P&I.

66. **Prepayment options** – In the context of prepayment options, that would only be the case if the prepayment amount substantially represents the outstanding amount of principal and interest. If a financial asset can be prepaid at an amount other than the outstanding amount of principal and interest, that may result in an inappropriate economic return and hence cash flows that are not P&I. For example, that would be the case if the financial asset has been acquired at a significant premium or discount and can be prepaid at par.

67. The staff note that both IFRS 9 and the FASB's tentative model contain relevant requirements for prepayment options. IFRS 9 states that prepayment options only result in cash flows that are P&I if 'the prepayment amount substantially

represents unpaid amounts of principal and interest on the principal amount outstanding'[14]. The FASB's model states that a debt instrument must be measured at FVPL if it can 'contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice'. The staff note that these requirements are not identical, however believe that the intention of the boards was broadly similar.

68. **Extension options** – Extension options, in essence, represent the flipside of prepayment options. Consider a 10-year debt instrument that can be prepaid in year 5 at the amount outstanding as opposed to a 5-year debt instrument that can be extended for another 5 years on the same terms. Economically, these two instruments are the same.

69. Consequently, extension options do not preclude a financial asset from a measurement category other than FVPL as long as the terms of the extension option result in contractual cash flows during the extension period that are solely P&I.

70. Both IFRS 9 and the FASB's tentative model provide guidance on extension options. The requirements are not identical however the staff believe that the objectives of these requirements are broadly similar and consistent with the principle in paragraph 69.

71. IFRS 9 addresses extension options in the application guidance. The FASB's tentative model incorporates an analogous requirement via its bifurcation guidance in Subtopic 815-15. Under IFRS 9, the interest rate does not need to be reset at the beginning of the extension period for the instrument to be consistent with the notion of solely P&I. This is because extension options are considered economically the same as prepayment options. This is different to the 'closely related' guidance that forms part of the FASB's tentative model. Under the FASB's model, the interest rate must be concurrently reset upon the exercise of the extension option to the approximate current market rate for the extended term for a hybrid financial asset to qualify in its entirety for a measurement category

[14] The prepayment amount may also include a reasonable compensation for the early termination of the contract.

other than FVPL. The objective of this provision is to prevent the use of term-extension options to circumvent the restriction regarding the investor not recovering substantially all of its initial recorded investment.

72. **Contingencies** – Prepayment and extension options may be contingent (that is, they are exercisable or they are no longer exercisable only if a trigger event occurs). Consistent with the analysis in paragraphs 36-49, contingent prepayment and extension options are solely P&I as long as:

    (a) The resulting cash flows are solely P&I (ie prepayment and extension cash flows are solely P&I, as per analysis in paragraphs 64-69); and

    (b) The nature of the contingency itself is related to the time value of money and the credit risk.

73. The staff note that IFRS 9 contains requirements consistent with the principle in paragraph 72. Under IFRS 9, contingent prepayment or extension options are considered related to the credit risk and hence consistent with the notion of solely P&I if they protect the holder against credit deterioration of the issuer or a change in control of the issuer (as the latter often has a knock-on effect on the issuer's credit risk). A contingency that protects the holder or the issuer against changes in relevant taxation or law is also consistent with the principle in paragraph 72(b). This is because the assessment of the appropriate compensation for the time value of money in the context of lending and borrowing decisions is made in the context of the relevant taxation or law. Other types of contingencies in the context of prepayment or extension options would not be related to the time value of money or the credit risk and hence would result in the financial asset being measured at FVPL.

74. The FASB's tentative model contains similar requirements for contingently exercisable prepayment options. That is, for a financial asset to qualify in its entirety for a measurement category other than FVPL, the contingently exercisable prepayment option 'can be indexed only to interest rates or credit risk, not some extraneous event or factor'. In addition, Subtopic 815-15 provides specific guidance for contingent extensions. Under Subtopic 815-15, a contingent

extension that automatically extends the term significantly would generally require bifurcation because they would not be considered clearly and closely related to the host contract unless the interest rate is concurrently reset to the appropriate current market rate for the extended term and the debt instrument initially involved no significant discount.

Staff recommendation

75. Application guidance to IFRS 9 contains specific requirements with respect to prepayment and extension options, which are consistent with the analysis in paragraphs 64-72 (IFRS 9 B4.1.10-11, IFRS 9 B4.1.12(b-c) included in Appendix A). The staff are not aware of any significant concerns about how these provisions should be applied. Consequently, the staff **do not propose any amendments to IFRS 9** regarding prepayments and extension options, including those that involve contingencies.

76. The staff believe that the analysis of prepayment and extension options, including those that involve contingencies, in paragraphs 64-72 is consistent with the overall proposed approach. The staff note that there are detailed differences between the guidance in IFRS 9 (paragraphs B.4.1.10-B.4.12 reproduced in Appendix A) and the FASB's tentative model, however the staff believe that the two are directionally consistent. The staff also note that the IASB has not received any application questions regarding prepayment and extension options, including those that involve contingencies. Consequently, in the spirit of reducing the differences between IFRS 9 and the FASB's tentative model, the staff **recommend that the FASB align the guidance on prepayment and extension options, including those that involve contingencies, with IFRS 9**, specifically B4.1.10-11, IFRS 9 B4.1.12(b-c). Currently, the guidance for prepayment and extension options are included in various parts of the FASB's tentative model (prepayments are specifically addressed in the financial instrument characteristics criterion and extension options are addressed in bifurcation guidance in Subtopic 815-15). The staff recommend that the guidance in IFRS 9 for prepayment and extension options be included by the FASB as part of the contractual cash flow characteristics assessment developed in this paper.

Question 4 for the IASB
Does the IASB agree with the staff recommendation in paragraph 75 to not amend the guidance on prepayment and extension options, including those that involve contingencies, provided in IFRS 9 B4.1.10-B.4.1.11 and IFRS 9 B4.1.12(b-c)?

Question 4 for the FASB
Does the FASB agree with the staff recommendation in paragraph 76 to align the guidance on prepayment and extension options, including those that involve contingencies, with IFRS 9, specifically B4.1.10-11, IFRS 9 B4.1.12(b-c)?

Alignment of the IASB's and FASB's models

77. Provided that the boards agree with the all the staff recommendations in this paper, the staff believe that the assessment of contractual cash flows characteristics for financial assets when they are classified and measured in their entirety will be largely aligned at the principle level between the two models.

78. Some differences in detail will remain. In particular, IFRS 9 contains specific application guidance for contractually linked instruments and 'non-recourse' financial assets. IFRS 9 also includes examples to illustrate contractual cash flows that are solely P&I and contractual cash flows that are not solely P&I. The FASB may or may not decide to incorporate (some of) this guidance as it continues to re-deliberate its tentative model. For example, the staff believe that the FASB will need to consider developing guidance for contractually linked instruments if bifurcation of hybrid financial assets is eliminated from its tentative model. At this point the staff do not plan to bring these issues to the boards for a joint discussion.

79. Finally, some differences may exist regarding where particular pieces of guidance will be located under each final standard however the staff believe that will not change the outcome of the assessment.

Appendix A – IFRS 9 application guidance: Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

A7. Paragraph 4.1.1 requires an entity (unless paragraph 4.1.5 applies) to classify a financial asset as subsequently measured at amortised cost or fair value on the basis of the contractual cash flow characteristics of the financial asset that is in a group of financial assets managed for the collection of the contractual cash flows.

A8. An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated (see also paragraph B5.7.2).

A9. Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include leverage. Thus such contracts do not meet the condition in paragraph 4.1.2(b) and cannot be subsequently measured at amortised cost.

A10. Contractual provisions that permit the issuer (ie the debtor) to prepay a debt instrument (eg a loan or a bond) or permit the holder (ie the creditor) to put a debt instrument back to the issuer before maturity result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding only if:

a. the provision is not contingent on future events, other than to protect:

    i. the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or

    ii. the holder or issuer against changes in relevant taxation or law; and

b. the prepayment amount 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.

A11. Contractual provisions that permit the issuer or holder to extend the contractual term of a debt instrument (ie an extension option) result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding only if:

a. the provision is not contingent on future events, other than to protect:

i. the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations) or a change in control of the issuer; or

ii. the holder or issuer against changes in relevant taxation or law; and

b. the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.

A12. A contractual term that changes the timing or amount of payments of principal or interest does not result in contractual cash flows that are solely principal and interest on the principal amount outstanding unless it:

a. is a variable interest rate that is consideration for the time value of money and the credit risk (which may be determined at initial recognition only, and so may be fixed) associated with the principal amount outstanding; and

b. if the contractual term is a prepayment option, meets the conditions in paragraph B4.1.10; or

c. if the contractual term is an extension option, meets the conditions in paragraph B4.1.11.

A13. The following examples illustrate contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
Instrument A Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.	The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding. However, if the interest payments were indexed to another variable such as the debtor's performance (eg the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the interest payments are not consideration for the time value of money and for credit risk associated with the principal amount outstanding. There is variability in the contractual interest payments that is inconsistent with market interest rates.
Instrument B Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term.	The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for the time value of money and for the credit risk associated with the instrument. The fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument. However, if the borrower is able to choose to pay one-month LIBOR for three months and that one-month LIBOR is not reset each month, the contractual cash flows are not payments of principal and interest. The same analysis would apply if the borrower is able to choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate.

Instrument	Analysis
	However, if the instrument has a contractual interest rate that is based on a term that exceeds the instrument's remaining life, its contractual cash flows are not payments of principal and interest on the principal amount outstanding. For example, a constant maturity bond with a five-year term that pays a variable rate that is reset periodically but always reflects a five-year maturity does not result in contractual cash flows that are payments of principal and interest on the principal amount outstanding. That is because the interest payable in each period is disconnected from the term of the instrument (except at origination).
Instrument C Instrument C is a bond with a stated maturity date and pays a variable market interest rate. That variable interest rate is capped.	The contractual cash flows of both: (a) an instrument that has a fixed interest rate and (b) an instrument that has a variable interest rate are payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money and for the credit risk associated with the instrument during the term of the instrument. Therefore, an instrument that is a combination of (a) and (b) (eg a bond with an interest rate cap) can have cash flows that are solely payments of principal and interest on the principal amount outstanding. Such a feature may reduce cash flow variability by setting a limit on a variable interest rate (eg an interest rate cap or floor) or increase the cash flow variability because a fixed rate becomes variable.
Instrument D Instrument D is a full recourse loan and is secured by collateral.	The fact that a full recourse loan is collateralised does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

A14. The following examples illustrate contractual cash flows that are not payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	**Analysis**
Instrument E Instrument E is a bond that is convertible into equity instruments of the issuer.	The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because the interest rate does not reflect only consideration for the time value of money and the credit risk. The return is also linked to the value of the equity of the issuer.
Instrument F Instrument F is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates).	The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. The interest amounts are not consideration for the time value of money on the principal amount outstanding.
Instrument G Instrument G is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due. Instrument G pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest.	The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding. If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.
	The fact that Instrument G is perpetual does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.

Instrument	Analysis
	Also, the fact that Instrument G is callable does not mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding unless it is callable at an amount that does not substantially reflect payment of outstanding principal and interest on that principal. Even if the callable amount includes an amount that compensates the holder for the early termination of the instrument, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.

A15. In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.1.2(b) and 4.1.3 of this IFRS.

A16. This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, the contractual cash flows may include payment for factors other than consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. As a result, the instrument would not satisfy the condition in paragraph 4.1.2(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).

A17. However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraph 4.1.2(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not

meet the condition in paragraph 4.1.2(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

A18. If a contractual cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

A19. In almost every lending transaction the creditor's instrument is ranked relative to the instruments of the debtor's other creditors. An instrument that is subordinated to other instruments may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy. For example, a trade receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor issued loans that are collateralised, which in the event of bankruptcy would give that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal and other amounts due.

Contractually linked instruments

A20. In some types of transactions, an entity may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches.

A21. In such transactions, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:

a. the contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (eg the interest rate on the tranche is not linked to a commodity index);

b. the underlying pool of financial instruments has the cash flow characteristics set out in paragraphs B4.1.23 and B4.1.24; and

c. the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, this condition would be met if the underlying pool of instruments were to lose 50 per cent as a result of credit losses and under all circumstances the tranche would lose 50 per cent or less).

A22. An entity must look through until it can identify the underlying pool of instruments that are creating (rather than passing through) the cash flows. This is the underlying pool of financial instruments.

A23. The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

A24. The underlying pool of instruments may also include instruments that:

a. reduce the cash flow variability of the instruments in paragraph B4.1.23 and, when combined with the instruments in paragraph B4.1.23, result in cash flows that are solely payments of principal and interest on the principal amount outstanding (eg an interest rate cap or floor or a contract that reduces the credit risk on some or all of the instruments in paragraph B4.1.23); or

b. align the cash flows of the tranches with the cash flows of the pool of underlying instruments in paragraph B4.1.23 to address differences in and only in:

i. whether the interest rate is fixed or floating;

ii. the currency in which the cash flows are denominated, including inflation in that currency; or

iii. the timing of the cash flows.

A25. If any instrument in the pool does not meet the conditions in either paragraph B4.1.23 or paragraph B4.1.24, the condition in paragraph B4.1.21(b) is not met.

A26. If the holder cannot assess the conditions in paragraph B4.1.21 at initial recognition, the tranche must be measured at fair value. If the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the conditions in paragraphs B4.1.23 and B4.1.24, the tranche does not meet the conditions in paragraph B4.1.21 and must be measured at fair value.