



Appendix I

We welcome the opportunity to comment on the Exposure Draft “Financial Instruments: Classification and Measurement.”

While we support the proposal in the Exposure Draft to allow two measurement bases for financial instruments, we are concerned about the impact of the term “basic loan” as currently defined in paragraphs B1 to B13 on Brazilian companies. We therefore restrict our response to Question 2 in the Invitation to Comment:

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has ‘basic loan features’ and ‘is managed on a contractual yield basis? If not, why? What additional guidance would you propose and why?

The definition of “basic loan features” in the exposure draft is not particularly clear, but it appears from paragraph BC21 of the Basis for Conclusions that any “leverage” would result in financial instruments not being considered to have “basic loan features”. “Leverage” is not defined in the Exposure Draft, but we understand the term to mean that any multiple of a reference interest rate (such as CDI, the reference short term interest rate in Brazil) has leverage.

In Brazil virtually all bank deposits and many commercial loans are priced at an interest rate of CDI multiplied by a percentage (usually between 80% and 120%). In the Brazilian market, loans priced in this way are intended to be basic loans.

We are concerned that a bank deposit paying 110% of CDI would technically meet the definition of “leveraged”, and so would be required to be measured at fair value with changes in the carrying value recognized in profit or loss. This would result in considerable unnecessary and avoidable income statement volatility in the IFRS financial statements of Brazilian companies, both banks and corporates.

We believe that such a requirement does not faithfully represent the substance of financial instruments priced in this way. In the Brazilian market, a multiple of a benchmark interest rate is intended to reflect credit risk – the CDI multiplied by X% mechanism effectively allows for credit risk on both the principal and the accrued interest to be taken into account. Further, there is empirical evidence that banks with a higher credit rating pay lower percentages of CDI than those banks which are lower-rated.

We believe that a general principle as to what is mean by “basic loan” should be included in the final standard rather than detailed rules; judgement should be allowed when determining whether a financial instrument has “basic loan” features. The examples included in paragraph B3 of the Exposure Draft could be read as an exhaustive list of loans with “basic” features – it would be helpful to clarify that other types of financial instrument could also be considered “basic”, within the context of a broader principle.



Paragraph B3 (a) (iii), in particular, as currently written would appear to require Brazilian loans priced in this way to be measured at fair value.

While we can see that a loan priced as LIBOR multiplied by 1.000% would clearly be leveraged and so measurement at amortized cost would not be appropriate, we believe that the application of a principle and reasonable judgement would allow a loan priced at CDI multiplied by 110% to be considered basic.

Appendix II

Extract from Application Guidance to the Exposure Draft re: Basic Loan Features

B3 The following are examples of basic loan features:

(a) returns to the holder that are:

(i) a fixed amount (eg a zero coupon bond);

(ii) a fixed return over the life of the instrument;

(iii) a variable return that, throughout the life of the instrument, is equal to **a single referenced quoted or observable interest rate (such as LIBOR)** and/or an adjustment of the interest rate in accordance with (c) below; or

(iv) some combination of such fixed return and variable return (such as LIBOR plus or minus 50 basis points), including debt instruments issued at a discount or premium and fixed rate debt instruments with one or more interest rate resets at pre-specified rates and pre-specified times. For fixed and variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal amount outstanding during the period.

(b) a contractual feature that is a combination of a fixed interest return and a variable interest return (as described in (a)). Such a feature may reduce the 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 interest rate becomes variable.

(c) contractual provisions that permit the issuer (the debtor) to prepay a debt instrument (eg loans or bonds) or permit the holder (the creditor) to put a debt instrument back to the issuer before maturity and are not contingent on future events. In such a case, the prepayment amount must substantially represent unpaid amounts of principal and interest. For this purpose, terms that protect the lender from credit deterioration of the borrower in cases of defaults, credit downgrades and loan covenant violations, and terms relating to possible future changes in taxation, law and similar factors that protect the lender are not considered to be contingent on future events. Such prepayment provisions may include terms that require the issuer to compensate the holder for the early termination of the instrument.

B4 The following do not violate the conditions for returns in paragraph B3(a):

(a) changes in the return to the holder attributable to changes in the timing of cash flows (including related contractual payments that compensate either party for that change in the timing permitted in accordance with paragraph B3(c)).

(b) pre-specified resets of interest rates in response to changes in the credit quality of the financial asset or financial liability.

B5 Other contractual features that result in cash flows that are not payments of principal and interest on the principal outstanding are not basic loan features. An interest rate swap, or a forward contract or option contract to deliver another financial instrument, does not have basic loan features because the contractual cash flows are not payments of principal and interest on the principal outstanding.

Basis for Conclusions to Exposure Draft

BC21 The Board noted that **leverage is not a basic loan feature**. Indeed, leverage (a common characteristic of many financial options, forward contracts and swap contracts) amplifies the variability of cash flows, with the result that those cash flows do not have the economic characteristics of interest.

Discussion of Leverage in IASB Staff Paper 1 June 2009

No leverage



31. ... Examples of **common types of leverage** are:

(a) **Interest formulas that use multiples of** notional amounts or **reference interest rates**. (Derivatives are an example of the leverage created by using a notional amount that does not reflect a funding volume; this is in substance the same as using a multiple of a financial instrument's notional amount).