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In Depth

Corporate banking: practical implications of IFRS 9 classification and measurement

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Introduction

As corporate banks apply the classification and measurement ('C&M') requirements in IFRS 9, a question that we are commonly asked is, 'What issues are you seeing in practice?'.

This publication answers that question. It looks at the practical implications of implementing the new standard. The topics covered in this publication are not exhaustive and will continue to evolve, but we have included some of the most common issues/considerations currently facing corporate banks. Where applicable, we have also included references to our published 'Frequently Asked Questions' which provide further guidance on these areas and which are also included in the Appendix. For all areas covered, when finalising the appropriate accounting treatment, consideration will need to be given to individual facts and circumstances.

For a more detailed understanding of the C&M requirements in IFRS 9, please refer to *IFRS 9: Classification and measurement: PwC In depth INT2014-05.*

Contents

Determining the business model

1. Loan syndications

At the outset of a loan syndication (where, for example, a bank intends to sell 50% of the loan and keep the remainder), it is normally clear, for the portion of the loan that the bank intends to sell, that this will be a 'hold to sell' business model.

It might be assumed that, for the portion of the loan that the bank has retained (the 'hold' position), its business model would be 'hold to collect'. However, it is not uncommon for some banks to decide, in view of the price obtained for the 50% sold, to sell some more. As a result, the business model for the 'hold' position might not always be 'hold to collect'. Some, or possibly all, might be 'hold to collect and sell' or 'hold to sell'.

Given that measuring loans at FVOCI or FVTPL can have a negative capital impact at the business level, this is an example of how C&M could really impact and constrain how banks do business, and why C&M is not an area for the finance team alone to deal with.

Related FAQ:

*FAQ 1 – **Business model assessment: different components of syndicated loans***

2. Troubled loans and 'workout units'

IFRS 9 requires the business model assessment to be made at the date of initial application (1 January 2018 for a calendar year reporter adopting in 2018). So, if troubled loans that started out in the 'normal' lending department are now managed within a 'workout' unit (that is, a separate business unit tasked with managing and recovering troubled loans), the workout unit might need to be assessed at transition as a separate business model.

A similar issue arises where a bank holds non-core portfolios that it is looking to exit for strategic reasons.

In these situations, consideration needs to be given to how any planned sales affect the business model assessment and, in particular, whether such sales are consistent with a 'hold to collect' business model (see 'Sales due to credit concentration and deterioration' below for further discussion).

In addition, management reporting and remuneration should be understood when considering the business model – for example, if this is based on fair value or other similar information that could indicate that the business model is not 'hold to collect'.

Related FAQs:

*FAQ 2 – **Sales that are insignificant in value***

*FAQ 3 – **Impact of internal transfers on the business model***

*FAQ 4 – **What examples of sales before maturity would not be inconsistent with a business model of holding financial assets to collect contractual cash flows?***

*FAQ 5 – **Reclassification of the business model when loans are transferred to a run-off portfolio***

3. Broader influences on business models

When performing the business model assessment, broader factors should also be considered. For example, if the loan sales team only receive bonuses for selling recently originated loans, and the reporting entity has little excess regulatory capital to support the writing of new business, this might suggest that the entity's sales team might start to sell existing loans. This might well indicate a 'hold to collect and sell' business model, rather than a 'hold to collect' business model.

Another example of this is considerations in respect of the liquidity risk of the business model. If assets might need to be sold to manage this, this might again indicate a 'hold to collect and sell' business model rather than a 'hold to collect' business model.

Related FAQ:
*FAQ 6 – **Business model assessment: useful indicators***

4. Legal entity versus consolidated group

Differences in business models can arise between the legal entity and the consolidated group. As an example, if a particular legal entity sometimes has to sell loans to a fellow subsidiary to manage its regulatory capital position, the selling subsidiary could have a 'hold to collect and sell' or 'hold to sell' business model. However, at the consolidated level the business model might be 'hold to collect', because the loans have not been sold outside the group. If this happens, two different sets of books and records will need to be maintained, one at the entity level and one at the consolidated group level.

This case illustrates a broader point, namely that banks need to understand plans elsewhere in the group which could impact a particular business model, to ensure that nothing is missed.

Related FAQ:
*FAQ 3 – **Impact of internal transfers on the business model***

5. Sales due to credit concentration and deterioration

Sales due to credit concentration (for example, where strategically a bank wants to reduce its exposure in a particular country, because the risk/reward profile is now less commercially attractive) are generally not consistent with a 'hold to collect' business model.

However, sales are consistent with a 'hold to collect' business model where they are due to credit deterioration of an asset, because the credit quality of financial assets is relevant to the banks' ability to collect contractual cash flows.

Further, the basis of conclusions in IFRS 9 is clear that there does not need to have been a *significant* increase in credit risk to justify this – that is, the loan does not need to be in 'stage 2' for expected credit loss ('ECL') impairment purposes – but there should be evidence to demonstrate that credit deterioration was the reason for the sale.

It is generally expected that, in order to demonstrate that the reason for the sale was credit deterioration, the sale will need to take place soon after the increase in credit risk. This might be relatively easy to demonstrate in some cases (for example, if a loan is sold shortly after it is moved to a 'workout' unit, as discussed above), but in other cases it will be more judgemental. Banks will need to be clear as to how they will demonstrate whether a sale of an asset is due to credit deterioration.

In determining whether the sale of non-performing loans is due to the credit deterioration of an asset, it is permissible to 'look back' beyond the date of initial application – that is, the previous decline in credit quality is a 'fact and circumstance' that exists at the date of initial application, and it can therefore be considered when making the business model assessment. This would mean that a sale of a loan after the date of initial application, as a result of a decline in credit quality prior to the date of initial application, would be permissible in a 'hold to collect' business model.

Related FAQs:

*FAQ 4 – **What examples of sales before maturity would not be inconsistent with a business model of holding financial assets to collect contractual cash flows?***

*FAQ 7 – **Business model assessment: banks that sell down loans to manage single counterparty credit risk limits***

*FAQ 8 – **Is alignment required between 'increase in credit risk' for business model purposes and 'significant increase in credit risk' for ECL purposes?***

6. *Project finance*

Project finance lending businesses might issue a loan to fund the build of an infrastructure project, which will only start being repaid after the development phase is complete and the project starts to generate cashflows.

The build phase is the riskiest period, with the highest returns; once that phase is complete, the bank's business model might then be to sell the loan on. That could be a 'hold to collect and sell' or 'hold to sell' business model, rather than a 'hold to collect' business model. This could result in a transition impact, assuming that these loans are currently measured at amortised cost.

Solely payments of principal and interest ('SPPI') criterion

1. Prepayment/put/call options

These types of clause often involve additional payments on exercise. Whilst such features do not automatically preclude a loan from meeting the SPPI criterion, they can do so. It will be crucial to understand the amount at which the loan is prepayable. If a prepayment amount includes (as well as principal and interest) 'reasonable compensation' for early termination, this will not preclude classification as SPPI. However, there can be a lot of judgement involved in assessing what is 'reasonable compensation', because the standard gives only very limited guidance.

From a qualitative perspective, a prepayment amount on a EUR loan that includes something like a US bank's USD/EUR FX hedge breakage costs, which have nothing to do with the EUR loan, or any other factors alien to a basic lending arrangement, will cause a problem.

If a prepayable instrument was acquired or issued at a premium or a discount (for example, as part of a business combination), further requirements apply. These include assessing whether or not the fair value of the prepayment feature was 'insignificant' when the instrument was first recognised.

Matters are further complicated for symmetric or 'two-way' break clauses. These are clauses under which the party that prepays (which is typically the borrower) might receive, rather than pay, additional compensation (for example, if rates have moved in the borrower's favour). These types of break clause occur, for example, in some Swiss mortgages, as well as in aviation financing and UK Housing Association loans. The IASB amended IFRS 9 in late 2017 to enable some such clauses to still meet SPPI. However, this amendment is not mandatory until 2019, so banks wishing to apply it when they first adopt IFRS 9 will need to early adopt the amendment. For banks in the EU, this requires the amendment to have been endorsed.

Related FAQ:

*FAQ 9 – **What is reasonable compensation in a prepayment clause?***

2. Increased cost clauses

Some loans have clauses that allow certain increases in costs of the bank to be passed on to the borrower via higher interest. If the elements included are themselves consistent with SPPI, this would not preclude a loan from meeting SPPI criterion; however, if they are entity-specific (for example, reflecting the credit risk of the lender, and not of the loan advanced to the borrower), these could pose a problem.

These types of clause can also be drafted very broadly, which can exacerbate the issue. Therefore, it is important to understand what are the costs in practice rather than in theory – for example, whether the clause could actually be used to pass on certain increases in costs, because this might help to narrow down the possible scenarios that need to be considered.

3. Non-recourse

If a non-recourse provision exists in a loan, so a creditor's claim is limited to specified assets, the bank is required to assess (that is, to 'look through to') the particular underlying assets or cash flows to determine whether the loan's contractual cash flows are SPPI. If the loan's terms give rise to any other cash flows, or if they limit the cash flows in a manner inconsistent with the SPPI criterion, the instrument will be measured in its entirety at FVTPL.

If, for instance, a non-recourse loan of 100 is made to an SPV that only has equity shares initially worth 100 with which to repay the loan, as soon as the share price goes down, the loan will make a loss; therefore, in substance, the instrument is a put option on the shares, and not a loan, so it would fail SPPI. The key judgement is where the 'tipping point' is and how much risk is needed for an instrument to fail SPPI.

Related FAQs:

*FAQ 10 – **Non-recourse loans which might be inconsistent with SPPI***

*FAQ 11 – **Non-recourse real estate financing***

*FAQ 12 – **Non-recourse to portfolio of equity instruments***

4. Equity 'kickers'

Equity 'kickers' are a feature in a loan whereby the lender will receive extra cash linked to the price of the borrower's equity (for example, a payout in the event of an IPO or change of control). This feature is not consistent with a 'basic lending arrangement' and would fail SPPI. These types of clause can be found in restructured distressed loans, where they are included to avoid embarrassment if the bank writes off a portion of the loan, and then the company's fortunes revive so that the bank misses out on being repaid cash that it could otherwise have recovered.

Other matters

1. Modification gains/losses

If a financial asset is renegotiated or otherwise modified and this does not result in derecognition, then IFRS 9 is clear that any resulting modification gain or loss is recognised in the income statement immediately (see para 5.4.3 of IFRS 9). The modification gain or loss is calculated as the difference between the new expected cashflows discounted using the original effective interest rate ('EIR') and the current carrying value.

An example to illustrate this would be where a bank has advanced a 4% fixed-interest loan to a corporate with two years left to run but where market rates are now 3%. For relationship reasons, even though the borrower has no contractual right to it, the bank agrees to modify the contract and reduce the interest rate from 4% to 3% for the remaining period. It is concluded that the modification does not result in derecognition.

Under IAS 39, the bank would often accrue interest at the new rate of 3% from the date of the renegotiation, with no immediate income statement impact. Under IFRS 9, the bank would need to re-discount the new cashflows with the 3% interest at the original EIR of 4%, taking an immediate income statement loss of approximately 2%. In the remaining two years of the loan, the bank would continue to recognise interest income at the original EIR of 4% (rather than 3%), comprising 3% of cash interest received plus 1% from the unwind over the two remaining years of the 2% modification loss.

Identifying such modifications in systems, and calculating the immediate gain or loss and the unwind, can be challenging and, unfortunately, this change is fully retrospective (that is, it is not just for new loans going forward). As a result, it will therefore impact any live loan at initial application that has had a renegotiation or modification during its life – although various factors, such as remaining life, will affect the size of any impact.

Related FAQ:

*FAQ 13 – **Impact on transition to IFRS 9 when the modification of financial asset guidance is applied***

2. Ongoing controls

Prior to initial application of IFRS 9, the main SPPI focus is naturally on assessing the existing stock or 'back book' of financial assets. However, banks will also need to put in place a process to assess whether new instruments originated or acquired after the date of that 'back book' assessment meet SPPI. Further, for their business models, banks will need controls in place to prevent unexpected sales or other changes that might jeopardise a 'hold to collect' business model.

Therefore, banks should consider:

- What are the controls in place that will do this?
- When will they begin operating? (If the 'back book' review is done as at 30 June 2017, the new controls will need to start then, and not at 1 January 2018.)
- Do the staff operating these controls have sufficient IFRS 9 knowledge?
- How will the controls be embedded into the front office, to catch and resolve potential issues?

3. Getting the evidence

Banks face challenges in obtaining the evidence necessary to support their business model and SPPI assessments. Particular challenges arise where a bank has acquired a portfolio of loans from a third party, because the bank will not be able to rely on its own established loan origination controls to be satisfied that the loan terms are homogenous when assessing SPPI.

The level of evidence that banks are providing (for example, to auditors and implementation advisors) can vary considerably. These parties should engage to ensure that the documentation being provided meets the necessary requirements.

Appendix

Relevant Frequently Asked Questions

1. Business model assessment: different components of syndicated loans

Question

A bank acts as the lead arranger of a syndicated loan facility. The client's demand for credit exceeds the lead arranger bank's risk appetite. The bank's credit risk committee approves such a deal on the basis that the excess credit risk will be 'sold down' within a defined time frame, which would typically be less than a year.

In classifying syndicated loans, can a bank have different business models for the portion of the loan within the credit limit and the portion exceeding the risk appetite credit limit?

Solution

Yes. The unit of account can be determined to be at a level lower than the facility/loan. Therefore, IFRS 9's classification model could be applied separately to the different components of the facility identified by the bank, resulting in more than one business model for a single facility/loan. In this situation, the bank needs to assess the business model for its loan within the credit limits separately from the business model for the excess funded loan which is to be sold down.

Assuming that the bank's objective is to hold the portion of the loan that is within the specified risk limits in order to collect contractual cash flows, these would be measured at amortised cost (provide that they meet the SPPI criterion). The excess would be viewed as part of a business model whose objective is to realise cash flows through the sale of the assets, and it should be measured at FVTPL. It should be clearly demonstrated internally that two different business models exist for the loan. However, the bank's objective might not always be to hold all of the portion of the loan within the specified risk limits to collect contractual cash flows. For example, the bank might originate a facility/loan with a clear intention to hold 50%, and to sell 30%, but for which the purpose of the remaining 20% is unclear (that is, this portion might be held or sold). While judgement is needed in determining the business model for the remaining 20%, a lack of clear intention to hold this portion of the facility/loan means that it cannot be classified as 'hold to collect'.

Relevant Frequently Asked Questions

2. Sales that are insignificant in value

Question 1

Paragraph B4.1.3B of IFRS 9 states that sales of financial assets could be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows if those sales are infrequent (even if significant in value) or insignificant in value, both individually and in aggregate (even if frequent).

What is the reference point for 'insignificant in value'?

Solution 1

Whether or not sales are 'insignificant in value' requires assessment of the value of those sales (that is, the sale price). The appropriate reference point for comparison of this amount should be the value of the portfolio subject to the business model.

An inappropriate reference point is the entity's total assets, because this does not relate to the portfolio that is subject to the business model assessment.

An entity might also choose to internally monitor gains/losses arising from sales, given that this is required to be presented as a separate line item in the statement of profit or loss. [IAS 1 para 82(aa)]. However, using gains/losses as the only reference point for assessing whether or not sales are insignificant in value would not be appropriate. Such an approach could result in a business model still being considered 'hold to collect', even where a substantial percentage of the loans are sold at book value so that no gains or losses result.

Question 2

How should the term 'in aggregate' be interpreted? Does this relate to the reporting period or to the average life of the portfolio?

Solution 2

Sales should be considered over the average life of the portfolio when assessing whether they are insignificant in value. The average life of the portfolio takes into consideration those portfolios with long-dated average maturities which might be completely turned over during a particular period. As such, consideration of sales only during a particular reporting period is not considered sufficient.

Relevant Frequently Asked Questions

3. Impact of internal transfers on the business model

Question

Bank A has previously concluded, having considered all relevant information available at the time, that it comprises four separate business models: Unit A (hold to collect); Unit B (other – that is, FVTPL); Unit C (hold to collect and sell); and Unit D (hold to collect).

Unit A has originated specific assets, but it now plans to transfer these assets internally. No internal transfers have occurred previously. The transfer will be in exchange for cash, and no arrangements will be put in place that will cause Unit A to retain any of the risks and rewards of the transferred assets, so the transfer is considered to be a sale. The assets to be sold are significant in size, and the transfers will be frequent.

How should the following internal transfers by Unit A be analysed for the purposes of the IFRS 9 business model at the group level:

a. Transfer from Unit A to Unit B (other – that is, FVTPL);

b. Transfer from Unit A to Unit C (hold to collect and sell); and

c. Transfer from Unit A to Unit D (hold to collect)?

Solution

a. Transfer from Unit A to Unit B

The assets are no longer held within a business model whose objective is solely hold to collect, so the stated intention at origination (that is, to hold the assets only to collect their contractual cash flows) is no longer true. Therefore, the business model for Unit A, for newly originated or newly purchased assets, is no longer 'hold to collect'.

b. Transfer from Unit A to Unit C

The assets are no longer held within a business model whose objective is solely hold to collect, so the stated intention at origination (that is, to hold the assets only to collect their contractual cash flows) is no longer true. Therefore, the business model for Unit A, for newly originated or newly purchased assets, is no longer 'hold to collect'.

c. Transfer from Unit A to Unit D

The assets are still held within a business model that is hold to collect, so the initially stated intention (that is, to hold the assets to collect their contractual cash flows) remains true. Since both Unit A and Unit D operate a 'hold to collect' business model, they could potentially have been initially defined as one single 'hold to collect' business model, assuming that the assets were managed collectively, in which case there would be no sale outside the business model to even consider.

It must be noted that, in all of the above circumstances where the business model is considered to have changed, the assets themselves are not reclassified, as the requirements of paragraph B4.4.3 of IFRS 9 regarding reclassification are unlikely to be triggered. Changes in the business model for managing financial assets that trigger reclassifications of financial assets must be significant to the entity's operations and demonstrable to third parties. However, while there is no reclassification, the entity should consider whether, for newly originated or newly purchased financial assets, they will be realised in a similar way to those that the business model previously held, and, if not, a new business model would apply. This change in model only impacts future asset acquisitions after the change in model. This analysis is also from the perspective of the consolidated accounts and not from the separate financial statements of Unit A. However, similar principles would apply if the business models above existed within the same legal entity.

Relevant Frequently Asked Questions

4. What examples of sales before maturity would not be inconsistent with a business model of holding financial assets to collect contractual cash flows?

Question

What examples of sales before maturity would not be inconsistent, according to IFRS 9, with a business model of holding financial assets to collect contractual cash flows?

Solution

Some examples would include:

- The sale of a financial asset if it no longer meets the entity's investment policy, because its credit rating has declined below that required by that policy (see FAQ 8 for guidance on whether alignment is required between 'increase in credit risk' for business model purposes and 'significant increase in credit risk' for ECL purposes);
- sales so close to maturity or the financial asset's call date that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
- sales to execute a liquidity crisis plan when the crisis event is not reasonably expected; and
- other than the above, sales due to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity, such as:
  - sales in response to a change in tax law that significantly affects the tax status of the financial asset, or a significant change in regulations (such as a requirement to maintain regulatory capital) that directly affects the asset; or
  - sales in response to a significant internal restructuring or business combination.

Relevant Frequently Asked Questions

5. Reclassification of the business model when loans are transferred to a run-off portfolio

Question

An entity has a portfolio of loans that are classified as amortised cost. After a period of time, a small number of the loans become non-performing and are transferred into a run-off portfolio, where the entity's intention is to maximise the recovery of the loans (which could be by selling the loans, if a good price can be obtained in the market).

Does such an event require reclassification of the business model?

Solution

Such a transfer does not constitute a reclassification event, because IFRS 9 is clear that a change of intention or a transfer of financial assets between different portfolios is not a reclassification event.

IFRS 9 establishes that, if cash flows are realised in a way that is different from the entity's expectations at the date when management assessed the business model, this fact does not give rise to a prior period error in the entity's financial statements (in accordance with IAS 8) – for example, if the entity sells more or fewer financial assets than it expected when it classified the assets. It also does not change the classification of the remaining financial assets held in that business model (that is, those assets that the entity recognised in prior periods and still holds), provided that the entity considered all relevant and objective information that was reasonably available at the time when it made the business model assessment.

Relevant Frequently Asked Questions

6. Business model assessment: useful indicators

Question

What are some of the indicators that management might find helpful to consider in assessing the business model for each portfolio that it has identified?

Solution

Some useful indicators would include:

- The purpose of the portfolio, as assessed by management (for example, whether the portfolio is held to collect cash flows, to maximise investment return or to meet liquidity requirements);
- The composition of the portfolio, and its alignment with the declared objectives of the portfolio;
- The mandates granted to the manager of the portfolio (for example, the breadth of the investments that can be made, and the limitations on disposals);
- The metrics used to measure and report on portfolio performance (for example, whether fair values are an important KPI);
- The methodology for the portfolio manager's remuneration (for example, whether the manager is remunerated based on realised profits or unrealised gains and losses); and
- Levels of, and reasons for, any sales of assets in the portfolio.

Relevant Frequently Asked Questions

7. Business model assessment: banks that sell down loans to manage single counterparty credit risk limits

Question

Bank credit risk management frameworks and regulatory regimes often require banks to consider their credit risk exposure to a single counterparty (that is, concentrations of credit risk). Due to such credit concentration risk, banks might regularly and actively sell down loans when they would be close to breaching or exceeding the credit risk limits.

Do such sales, in response to credit concentration risk, result in the relevant portfolios having a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets?

Solution

It depends. Banks that regularly and actively sell down portions of their loan portfolio in response to credit concentration risk have a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. This is on the assumption that banks collect the contractual cash flows until they reach or exceed the credit risk limits. However, the facts and circumstances of each particular situation should be analysed.

Relevant Frequently Asked Questions

8. Is alignment required between 'increase in credit risk' for business model purposes and 'significant increase in credit risk' for ECL purposes?

Question

When assessing the business model requirements of IFRS 9, the standard states that sales due to 'an increase in the assets' credit risk' are not inconsistent with a 'hold to collect' business model. This is because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. [IFRS 9 para B4.1.3A].

This might appear similar to the concept of a 'significant increase in credit risk' (SICR) in the IFRS 9 expected credit loss (ECL) impairment model, after which lifetime expected credit losses are recognised on financial instruments (sometimes referred to as 'stage 2').

Is alignment required between an SICR for ECL purposes and an 'increase in credit risk' for business model purposes, so that a sale from a 'hold to collect' business model is only justified on the basis of increased credit risk if the asset has also moved to 'stage 2' for impairment purposes?

Solution

No. Paragraph BC 4.146 of IFRS 9 states that a 'hold to collect' business model does not require an entity to wait to sell the financial asset until it has incurred a credit loss or until there has been a significant increase in credit risk (and lifetime expected credit losses are recognised on the asset). However, a substantive increase in credit risk nevertheless needs to have occurred based on reasonable and supportable information – A sale cannot be justified just because some future adverse event might happen. Furthermore, the information used to demonstrate that a sale is due to an increase in credit risk for business model purposes would be expected to be consistent with the information used to assess SICR. If it is not, there should be appropriate justification for this.

In order for a sale to be justified due to an asset's increase in credit risk, the sale would generally be expected to take place shortly after the entity becomes aware of the increase in credit risk and not left until a later date. The longer the period between the increase in credit risk and the sale, the more evidence that is required to justify the delay and that the sale was due to the increase in credit risk, rather than due to some other reason. The delay, for example, could be due to a lack of buyers in the market.

In contrast to the requirements of SICR, the IFRS 9 business model requirements also include no explicit statement that an 'increase in credit risk' should be assessed by reference to the credit risk of the asset at initial recognition. However, the requirement for the sale to be in response to an increase in credit risk will generally mean that this is required. Consider an example where an entity acquires a financial asset when the asset has a BB credit rating, following which the credit rating improves to AA but then declines to A, at which point the entity sells the asset. It would be rare that such a sale would be justified for business model purposes on the basis of an increase in credit risk: if, when acquired, the credit risk at BB was considered acceptable in the context of the entity holding the asset to collect its contractual cash flows, the same would be expected to be true when the credit rating had improved to A. In rare circumstances, an entity might change its credit criteria for holding financial assets, but such changes are expected to be infrequent and would need to be supported by sufficient evidence.

Relevant Frequently Asked Questions

9. What is reasonable compensation in a prepayment clause?

? Question

In paragraph B4.1.11(b) of IFRS 9, one of the examples provided of instruments whose cash flows are 'solely payments of principal and interest' or 'SPPI', is an instrument with a contractual term that permits the issuer (that is, the debtor) to prepay or permits the holder (that is, the creditor) to put the instrument back to the issuer before maturity. The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable compensation for the early termination of the contract.

What is reasonable compensation?

The IASB issued an amendment to IFRS 9 in October 2017 addressing prepayment features with negative compensation. The amendment is mandatory for annual periods beginning on or after 1 January 2019, though earlier application is permitted where applicable. However, the amendment added paragraphs to the Basis for Conclusions on what is reasonable compensation and these are also considered relevant in interpreting 'reasonable additional compensation' in the pre-amendment version of IFRS 9 issued in July 2014. The guidance set out below, which incorporates the additional guidance contained in the amendment, is therefore considered relevant to both annual periods beginning on or after 1 January 2019 and earlier periods to which IFRS 9 is applied.

Solution

IFRS 9 does not provide detailed guidance on what is considered 'reasonable compensation'. An entity therefore needs to apply judgement in developing its own accounting policy and in determining whether specific compensation clauses provide for only reasonable compensation. That policy should be consistently applied. In making this judgement, the following factors are relevant.

Overall considerations

In order to assess whether or not a compensation clause provides for only reasonable compensation, the first step is to understand the economic rationale of the clause, what it is designed to achieve and in what circumstances it may in practice be exercised. The assessment of whether a clause contains 'reasonable compensation' is complicated by the fact that a wide variety of clauses exist in practice, and their meaning and application can be unclear. For this reason an entity may consider it appropriate in some circumstances to seek legal advice in order to assess the enforceability of a clause and its contractual effect. A clause should not automatically be considered to result in 'reasonable compensation' just because it occurs more commonly or is a 'market standard' clause, so analysis of the specific details will still be needed where this is the case.

In some situations the compensation for early termination may not affect whether the instrument meets the SPPI criterion. This will be the case where:

- The reasonable compensation could only ever be de minimis (both in a single reporting period and cumulatively) or is non-genuine (that is, 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) as stated in paragraph B4.1.18 of IFRS 9. However, such cases are expected to be rare, and it should be questioned why the compensation clause has been included in the contract if it appears it may be either de minimis or non-genuine; or
- The compensation feature arises solely as a matter of law rather than contract.

Further analysis will be necessary where the above do not apply.

Qualitative considerations

Paragraph B4.1.7A of IFRS 9 states that the following elements of interest are consistent with a basic lending arrangement that is SPPI:

- Time value of money;
- Credit risk associated with the principal amount outstanding;
- Other basic lending risks (for example, liquidity risk);
- Costs (for example, administrative costs) associated with holding the financial asset for a particular period of time; and
- A profit margin.

Therefore, where the additional compensation for early termination compensates only for some or all of these elements, the additional compensation may be considered reasonable on a qualitative basis, subject to the other considerations discussed below. Where additional compensation includes compensation for other factors it would not be considered reasonable on a qualitative basis. For example, a loan whose prepayment amount varies with the proceeds received on IPO by the borrower would introduce equity price risk into the loan, which is inconsistent with a basic lending arrangement and would fail SPPI.

Particular judgement may be required when a financial instrument is prepayable at its current fair value or at an amount that includes the fair value cost to terminate an associated hedging instrument (which may or may not be designated in an accounting hedge of the prepayable instrument). Paragraph BC4.232 of IFRS 9 states that whilst there may be some circumstances in which such contractual prepayment features meet SPPI as the compensation is reasonable for the early termination of the contract, that will not always be the case.

In the case of prepayment that includes the fair value cost to terminate an associated hedging instrument, paragraph BC4.232 includes an example where compensation may be considered reasonable. This is when the calculation of the prepayment amount is intended to approximate unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate. The cost to terminate a collateralised fixed/floating interest rate swap hedge whose critical terms (such as currency, maturity) match those of the instrument, would generally be expected to reflect the effect of the change in the relevant benchmark interest rate over the remaining term and so be consistent with SPPI. Conversely, a EUR denominated instrument prepayable at an amount that includes the lenders' cost to terminate an associated EUR/USD cross-currency swap hedging instrument would introduce EUR/USD currency risk into the EUR denominated loan, which would not be consistent with a basic lending arrangement and would fail SPPI.

In contrast to compensation that reflects the effect of changes in the benchmark interest rate, IFRS 9 contains no explicit guidance regarding circumstances in which the terms of a financial instrument provide for prepayment at the instrument's current fair value. This will therefore be a particularly judgemental area. It can be argued that prepayment at fair value compensates the holder for all of the components of SPPI and so can be considered reasonable compensation. Furthermore if the instrument contained no prepayment clause, fair value is the amount at which the two parties would often be expected to agree to terminate. However, if there is a high likelihood of prepayment at fair value it could be questioned whether amortised cost is the most appropriate measurement basis. The considerations in this paragraph would also apply where, rather than being prepaid at current fair value, prepayment is instead at a formulaic amount designed to approximate current fair value.

Quantitative considerations

IFRS 9 does not contain guidance on how to quantitatively assess what is reasonable and therefore this aspect of the assessment may be particularly judgemental. However, relevant factors to consider in making this assessment include:

- The mechanics of the compensation calculation - a formula used to determine compensation for lost interest that references a time period longer than the period remaining from prepayment up to contractual maturity, for example double that period with the result that the compensation paid is twice the present value of lost interest, would not be reasonable.
- Whether the clause is common in the relevant market - if the compensation to be paid is significantly more than the ‘market standard’ amount payable by other similar instruments that would call into question whether the compensation was reasonable. It would then be necessary to understand the specific facts and circumstances of the instrument, the customer etc. before concluding. Conversely, a compensation clause that is ‘market standard’ may indicate that the resulting compensation is reasonable, however as noted above, a clause should not automatically be considered to result in ‘reasonable compensation’ just because it is a ‘market standard’ amount.

Disclosure

Where judgements as to whether compensation features provide only for reasonable compensation have a significant effect, the disclosures on significant accounting judgements required by paragraph 122 of IAS 1 should be provided.

Relevant Frequently Asked Questions

10. Non-recourse loans which might be inconsistent with SPPI

Question

What examples of non-recourse loans might be inconsistent with the SPPI criterion?

Solution

Examples of non-recourse loans that might be inconsistent with the SPPI criterion are:

- A non-recourse loan made to fund the construction of a toll road, where the amount of the cash flows that are contractually due varies with the asset's performance (such as where the number of cars that drive down the toll road determines the amounts to be paid); or
- A non-recourse loan that can be pre-paid at an amount that varies with the value of an underlying asset.

There is limited guidance in IFRS 9 as to how the existence of a non-recourse feature might impact the SPPI criterion. Judgement will be needed to assess these types of lending relationship.

Relevant Frequently Asked Questions

11. Non-recourse real estate financing

Question

A bank has a real estate financing business, where its business model is to provide non-recourse financing to customers so as to generate interest income on the resulting loans. The bank's business model is not to participate in the economic performance of the underlying real estate (upside or downside). The bank limits its exposure to the real estate in several ways, including:

- By limiting the amount lent to between 60% and 75% of the value of the real estate at the inception of the loan (depending on the term of the loan and the nature of the real estate);
- By ensuring that the cash flows expected to be generated by the customer are more than sufficient to repay the loan (both principal and interest); and
- By ensuring that another party has contributed sufficient equity or subordinated financing to absorb all expected losses.

Interest received is determined upfront as floating rate plus a fixed margin (determined primarily based on the credit quality of the borrower), with no reference to the performance of the underlying asset.

Would the loans provided by the bank meet the SPPI criterion?

Solution

Yes. Such a loan will meet the SPPI criterion, because the amount of cash flows due is not expected to vary with the asset's performance, nor is the payment linked to asset risk.

Relevant Frequently Asked Questions

12. Non-recourse to portfolio of equity instruments

Question

A bank has provided a loan to a borrower with a fixed rate of interest and fixed maturity date. The loan is secured, on a non-recourse basis, on a portfolio of equity instruments (shares). The value of the shares approximates to the principal of the loan at inception. As such, at maturity of the loan, the borrower intends to sell the shares and to use the proceeds to repay the loan. The borrower would keep any upside in the share price, but the bank would suffer any loss. The pricing in this case is the same as a written put option on the shares.

Would such a loan meet the SPPI criterion?

Solution

No. This loan is likely to fail the SPPI criterion, because the amount of cash to be repaid varies with the performance of the equity instruments. Economically, the non-recourse feature in the loan behaves like a written put option on the equity instrument.

Relevant Frequently Asked Questions

13. Impact on transition to IFRS 9 when the modification of financial asset guidance is applied

Question

Bank A has a fixed-rate mortgage portfolio measured at amortised cost. Prior to the adoption of IFRS 9, some of these mortgages were renegotiated. Bank A assessed the renegotiation under IAS 39, and it concluded that the resulting change in terms should be treated as a modification which does not lead to de-recognition Given that there is no clear guidance on the treatment of gains or losses as a result of financial assets that have been modified under IAS 39, bank A's accounting policy under IAS 39 is to account for any resulting change in the expected future cash flows by adjusting the effective interest rate prospectively, rather than by adjusting the carrying amount of the loan.

IFRS 9 introduces new guidance on measuring financial assets that have been modified. Under IFRS 9, the carrying amount is recalculated by discounting the modified contractual cash flows using the original effective interest rates. Any difference between this recalculated amount and the existing gross carrying amount is recognised in profit or loss as a modification gain or loss.

Since IFRS 9 requires retrospective application, what is the impact on the date when bank A transitions to IFRS 9?

Solution

Because bank A currently treats modification gains and losses by adjusting the effective interest rate prospectively, at transition date, there will be a one-off 'catch up' impact. Bank A will need to re-assess, at the time of modification, the change in carrying value of the asset using the original effective interest rate. This change will be partially offset by an offsetting change in amortisation, between the period of modification up to the transition date, because the original effective interest rate will be used to amortise the modified loans during this period. The difference in the carrying amounts, after taking into account this amortisation, is recognised in retained earnings.

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