www.pwc.co.uk

In Depth

Retail banking: practical implications of IFRS 9 classification and measurement

December 2017

pwc

Introduction

As retail 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 retail 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. Legal entity versus consolidated group, including securitisations

Differences in business model, between the legal entity and the consolidated group, can arise where an entity originates loans and then sells them to a securitisation vehicle that is consolidated within the same group. Where the entity achieves derecognition on the sale to the securitisation vehicle, but the loans are not derecognised by the securitisation vehicle, the business model at the legal entity and at the consolidated level will differ. 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.

In many cases, if the securitisation vehicle is consolidated, the selling entity fails to qualify for derecognition on the sale of loans to the securitisation vehicle (so there would be no sale for accounting purposes). In this case, there would generally be a 'hold to collect' business model at both the legal entity and consolidated group levels, and this complexity would be avoided. But this will not always be the case.

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

Related FAQ:

*FAQ 1 – **Business model assessment: securitised loans***

*FAQ 3 – **The impact of sales to a fellow group entity due to regulatory capital constraints***

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 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 the business model is not 'hold to collect'.

Related FAQs:

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

*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. Sales due to credit deterioration

Sales can be consistent with a 'hold to collect' business model where they are due to the credit deterioration of an asset; this is 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 6 – ***Is alignment required between 'increase in credit risk' for business model purposes and 'significant increase in credit risk' for ECL purposes?***

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

Banks need to assess whether the contractual cash flows of financial assets represent SPPI. Contractual features that introduce exposure to risks or volatility in the contractual cash flows that are unrelated to a basic lending arrangement might result in a financial asset not meeting the SPPI criterion. Set out below are some examples of features that might prohibit SPPI classification:

1. Government regulation

In some jurisdictions, the government or a regulator sets out or restricts the terms and conditions allowed in loans, particularly loans to retail customers. Examples include loans in:

- China, where interest rates set by the government might include a modified time value of money (see also 'Tenor mismatch' below);
- Poland, where some loans contain a leveraged interest rate cap set at a multiple (such as 2x or 4x) of a specified floating interest rate; and
- the USA, where the terms of bank-issued student loans eligible for certain government compensation (for example, if a student becomes a public employee and their loan is waived) are predefined in legislation that specifies an interest rate with a tenor mismatch (see also 'Tenor mismatch' below).

These types of loan require careful analysis. An interest rate or clause that is set by the government or a regulator might not necessarily fail SPPI, even if it would in other circumstances. This is because paragraph B4.1.9E of IFRS 9 has specific guidance for such arrangements that allows some additional flexibility.

However, it is important to be clear which of the features of the loan arise from the regulation and which do not. If a feature does not arise from the regulation, paragraph B4.1.9E of IFRS 9 will not apply.

Related FAQs:

*FAQ 7 – **Determining SPPI for loans in highly regulated countries***

*FAQ 8 – **Assessing SPPI for a five-year constant maturity interest rate loan***

2. Tenor mismatch

Some instruments have a so-called 'tenor mismatch', where the time period or 'tenor' in the variable interest rate paid (for example, 3 months in the case of 3-month Libor) does not match the frequency at which the variable interest rate is reset on the instrument (for example, monthly in the case where the rate resets each month). This is an example of what IFRS 9 calls a 'modified time value of money'. Such features have been seen in parts of the Eurozone and elsewhere.

One reason for this type of feature is that longer-term interest rates are generally more stable, and so they can protect retail customers from the volatility that a shorter-term interest rate might create.

If the time value of money element is modified, the bank will need to compare the contractual cash flows of the instrument to the cash flows of a 'perfect' ('benchmark') instrument that does not have the tenor mismatch. If the cash flows could be significantly different, the contractual cash flows of the instrument are not considered to be SPPI. In some circumstances, the bank might be able to make this determination by performing a qualitative assessment; in other cases, a quantitative assessment is needed.

Related FAQs:

*FAQ 9 – **Interpreting 'significantly different' when performing the modified time value of money test***

*FAQ 10 – **Determining when a qualitative assessment of the SPPI criterion is required if the time value of money element is modified under a range of different scenarios***

*FAQ 11 – **Applying the modified time value test to a 10-year bond whose interest rate resets annually to a 10-year rate***

*FAQ 12 – **How should the 'benchmark test' be applied when assessing SPPI?***

3. Early repayment features

Many retail loans include clauses that provide for prepayment. 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 (in addition to 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', since IFRS 9 gives only very limited guidance.

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 13 – **What is reasonable compensation in a prepayment clause?***

4. Leveraged interest rates

The variable interest rate charged on a loan can be 'leveraged' (that is, more than 1x the floating reference rate, such as 120% of the reference rate). If the interest rate is 'leveraged', this is very likely to result in the loan failing SPPI. The reason is that if, for example, 100% of LIBOR appropriately compensates the holder for time value of money, a rate of 120% of LIBOR would over-compensate, which suggests that the extra 20% is for something other than the time value of money and so breaches SPPI.

Leveraged interest rates have been identified in some Chinese and Polish loans (the guidance on government-regulated rates is also relevant here – see 'Government regulation' above) and some Brazilian loans, where the interest rate is not required by regulation or law but reflects how the market operates.

Although loans with leveraged interest rates will generally fail SPPI, there might be rare instances where this is not the case. In particular, if it can be determined that the leverage (that is, the 'extra' 20% in the example above) does not result in cash flows that do not have the economic characteristics of interest, the SPPI criterion might still be met.

Related FAQ:
*FAQ 14 – **Assessing SPPI for loans that have leverage-type features in relation to interest***

5. Discretion in setting interest rates

There are various types of variable rate loan that permit the bank to adjust the rate. Examples include loans whose interest is a bank-determined 'base rate', credit cards and loans where the rate can only be varied for specified reasons (for example, to pass on costs associated with regulatory changes).

This is a judgemental area. In determining whether or not these loans pass SPPI, it is important to understand where this discretion exists and to make sure that it has been appropriately assessed.

Related FAQ:
*FAQ 15 – **Assessing SPPI when banks can adjust interest rates***

6. 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 fair value through profit or loss ('FVTPL').

Non-recourse loans might arise in private banking – for example, a 'margin loan' provided to a wealthy customer who uses the funds as collateral for trading investments where, in an event of default, the lender's only claim is on the underlying trading investments.

Related FAQs:
*FAQ 16 – **Non-recourse loans which might be inconsistent with SPPI***
*FAQ 17 – **Non-recourse real estate financing***
*FAQ 18 – **Non-recourse to portfolio of equity instruments***

Other matters

1. Effective interest rate ('EIR')

The IFRS 9 requirements on EIR for assets are unchanged from IAS 39. Under IAS 39, often the only material consideration was interest income recognition at the entity level, so calculating EIR at a high level was justifiable. However, there is more to think about under IFRS 9. In particular, calculating an EIR for different segments of a portfolio could make a big difference to the ECL on high-interest products such as retail credit cards, given that the ECL must be discounted at the loan's EIR.

Therefore, it is recommended that banks review their current EIR approach to assess if current simplifications could have a material impact on the measurement of ECL. Further, given the renewed focus on the expected lives of assets under IFRS 9 ECL, banks should also revisit expected lives used, for example, in fee amortisation, to make sure that they are materially consistent with estimated lives used elsewhere in IFRS 9.

Related FAQ:
*FAQ 19 – **What discount rate should be used when measuring ECL for credit cards and other similar products?***

2. Derecognition and write-offs

As with EIR, the principles of derecognition in IFRS 9 are also unchanged from IAS 39. However, an additional sentence has been included in IFRS 9 which states that a loan should be written off, wholly or partially, when there is no reasonable prospect of recovery. [IFRS 9 para 5.4.4].

For many banks, this might reflect what they were already doing under IAS 39. However, under IAS 39 some banks wrote off loans very quickly after default, often to align with local regulatory rules, and then experienced large subsequent recoveries. Those banks might need to reassess their write-off policies when moving to IFRS 9, since a change will be needed if existing practice is materially inconsistent with the new guidance.

More broadly, given the impact that derecognition has on the date of initial recognition used by IFRS 9 ECL to assess significant increases in credit risk, many banks have reviewed their derecognition policy. Banks might need to fill in any gaps in the documented policy (for example, to cover a broader range of events that might occur during the life of a loan).

3. 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?

4. 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: securitised loans

Question

An entity originates loans with a view to later selling them to a securitisation vehicle. On the sale to the vehicle, the loans continue to be recognised in the consolidated financial statements, but they are de-recognised in the separate financial statements of the originating entity. Assuming that the loans are held by the securitisation vehicle to collect their contractual cash flows, will the business model for the loans be 'held to collect' in both the consolidated and the separate financial statements?

Solution

In the consolidated financial statements, the loans are part of a portfolio managed to collect the contractual cash flows, since they are not de-recognised (that is, they are not considered 'sold' for accounting purposes). Therefore, they are a part of a 'held to collect' business model in the consolidated entity. Similarly, in the separate financial statements of the securitisation vehicle, they are considered part of a 'held to collect' business model. However, in the separate financial statements of the originating entity, where they are de-recognised, they cannot be considered part of a portfolio that is 'held 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. The impact of sales to a fellow group entity due to regulatory capital constraints

Question

Some groups have business models which operate across multiple legal entities. Sales might occur between legal entities (for example, due to regulatory capital constraints in an individual legal entity). Consider the following example:

- Bank XYZ has multiple legal entities and business models within the consolidated Group. Two 100% owned entities, Subsidiary A and Subsidiary B, each originate loans that meet SPPI and are part of the same 'hold to collect' business model at the consolidated group level.
- Due to regulatory capital constraints at the legal entity level, Subsidiary A sometimes sells loans to Subsidiary B to avoid breaching its regulatory capital requirements, resulting in de-recognition of these loans in Subsidiary A's separate financial statements. It is not known, at the time when a loan is originated, whether the loan will subsequently be sold.
- Such sales are more than infrequent, more than insignificant in value, and there are no other circumstances that indicate that they are consistent with a 'hold to collect' business model (such as an increase in the assets' credit risk).
- No accounting gain or loss is recognised by Subsidiary A from the intra-group sales to Subsidiary B, because the loans are sold at book carrying amount.
- On a stand-alone legal entity reporting basis, no fair value information is reviewed by Subsidiary A in assessing performance, remuneration or risk management; only amortised cost information is used.

In assessing the business model of Subsidiary A at an individual legal entity level, are such sales inconsistent with an objective of holding assets to collect the contractual cash flows?

Solution

Yes. As illustrated by Example 3 in paragraph B4.1.4 of IFRS 9, a group can have a 'hold to collect' business model at the consolidated group level, but have a business model other than 'hold to collect' at the legal entity level where sales occur between different legal entities. Further, paragraph B4.1.3B of IFRS 9 states that 'Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to this assessment'. Therefore, the fact that the sales by an entity might arise from regulatory capital requirements imposed by a third party does not alter the business model analysis (that is, these sales cannot be disregarded). The need to sell existing loans can also be viewed as resulting from the entity's own free choice; this is because, if it did not originate new loans in Subsidiary A, then these sales would not be necessary.

Therefore, in assessing the business model of Subsidiary A at the individual legal entity level, such sales cannot be disregarded. Since such sales are more than infrequent, more than insignificant in value and there are no other circumstances that indicate that they are consistent with a 'hold to collect' business model, they are not consistent with a business model whose objective is to hold assets to collect contractual cash flows. This is consistent with the fact that sales are an integral part of the business model of Subsidiary A at the individual legal entity in order for it to manage its regulatory capital risk. [IFRS 9 para B4.1.2B(b)]. As a result, the business model of Subsidiary A at the individual legal entity level cannot be 'hold to collect'.

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 6 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 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

7. Determining SPPI for loans in highly regulated countries

Question

Certain loans in highly regulated countries are regulated by the government, and they are reset according to the original maturity of the loan rather than according to the remaining maturity or the period until the next reset date (for example, where the interest rate is reset to a three-year rate because the instrument has an original maturity of three years).

Do such loans meet the SPPI criterion?

Solution

Under the exception, this type of feature would not cause the instrument to fail the SPPI criterion, provided that the regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.

Relevant Frequently Asked Questions

8. Assessing SPPI for a five-year constant maturity interest rate loan

Question

An entity has a loan whose interest rate is reset periodically to equal the prevailing rate applied to new loans with an initial term of five years, regardless of the remaining time to maturity of the existing loan.

Would such a feature cause the loan to fail the SPPI criterion?

Solution

If such a reset represents the only legal pricing basis available in a particular jurisdiction, it does not preclude the loan from having contractual cash flows that are SPPI. This might be the case in jurisdictions where interest rates on loans are extensively regulated by the government and are reset based on their original maturity, regardless of the remaining time to maturity. But, if, in the jurisdiction concerned, similar loans are available on other pricing bases (for example, a periodic reset to a rate that reflects the remaining time to maturity of the loan), the constant maturity interest rate will not represent SPPI.

Relevant Frequently Asked Questions

9. Interpreting 'significantly different' when performing the modified time value of money test

Question

An entity issues a bond with a structured coupon that varies with an underlying interest rate – for example, a constant maturity swap ('CMS') bond.

Under IFRS 9, such bonds will fall within the modified time value of money guidance. Paragraph B4.1.9C states that, if the modified time value of money element could result in contractual cash flows that are 'significantly different' from the un-discounted benchmark cash flows, the financial asset does not give rise to cash flows that are solely payments of principal and interest, and so the whole asset should be classified as FVTPL.

Can the 'double-double test' for embedded derivatives in paragraph B4.3.8 of IFRS 9 be used to determine 'significantly different'?

Solution

No. 'Significantly different' is a matter of judgement for management to determine, and it should be assessed on an individual instrument-by-instrument basis. Whether this test is met for instruments such as CMS bonds will depend on a range of factors, including the life of the bond, yield curves and reasonably possible changes in yield curves over the bond's life. There are no bright-line tests that should be applied, such as the 'double-double test' for embedded derivatives in paragraph B4.3.8 of IFRS 9.

Relevant Frequently Asked Questions

10. Determining when a qualitative assessment of the SPPI criterion is required if the time value of money element is modified under a range of different scenarios

? Question

If the time value of money element is modified, an entity should perform a benchmark test to assess the modification, to determine whether the SPPI criterion is still met. In some circumstances, the entity might be able to make that determination by performing a qualitative assessment; in other cases, a quantitative assessment is needed.

When would a qualitative assessment be sufficient to determine whether the SPPI criterion is met?

Solution

IFRS 9 does not define the terms ‘modified’ and ‘imperfect’. However, the underlying principle of IFRS 9 is that, if the financial asset contains contractual terms that introduce exposure to risks or volatility unrelated to a basic lending arrangement (for example, equity prices or commodity prices), the SPPI criterion is failed without performing a benchmark test.

The following table contains examples of contractual features that are considered modified (that is, imperfect) under the IFRS 9 guidance. The guidance suggests situations in which a qualitative assessment is sufficient. The list is not exhaustive, and the assessment is only provided as guidance. As such, the terms of the instrument must be examined on a case-by-case basis, to determine the kind of assessment required.

Description/Example	Qualitative assessment sufficient?
Inverse floater where the coupon rate has an inverse relationship to a benchmark rate *(6% – 2 × 3m EURIBOR)*	Due to guidance in paragraph B4.1.14, Instrument G, of IFRS 9, the SPPI criterion is not passed. This can be demonstrated based on a qualitative assessment.
The currency of the reference interest rate differs from the currency of the instrument *($–Bond with $ interest payments but EURIBOR reference rate)*	If the currencies are not clearly linked, a qualitative assessment is sufficient, and the SPPI criterion is likely to fail. If the currencies are clearly linked (as, for example, where one currency is pegged to the other), a quantitative assessment would be required, to demonstrate whether the SPPI criterion is met.
Instrument’s interest rate is only adjusted if the reference rate exceeds a pre-defined threshold *(reference rate = 1-month EURIBOR; interest rate of the instrument is only adjusted if the 1-month EURIBOR exceeds a cap of 6%)*	The benchmark test is not relevant here. This is because the instrument is seen as a variable-rate instrument with a cap and, as such, there is no modified time value of money. The instrument in question should meet the SPPI criterion.
Interest rates are calculated as an average of different reference (benchmark) rates *(coupon is fixed by using the average of 3/6 and 12-month EURIBOR)*	A quantitative assessment is likely to be required, to determine if the SPPI criterion would be met.

Description/Example	Qualitative assessment sufficient?
Interest rates are calculated as the average of a reference (benchmark) rate *(interest rate is calculated as the average of 3-month EURIBOR from the last month)*	A qualitative assessment would be sufficient, provided that the benchmark used is the average over a short time frame (for example, three months), and a period of low volatility in that benchmark interest rate, because it is unlikely to fluctuate significantly. If so, the SPPI criterion would be met. If the average of the benchmark rate is over a longer or highly volatile period, a quantitative assessment is likely to be needed.
Interest rates are calculated on the basis of a reference (benchmark) rate multiplied by a factor other than 1 *(interest rate is calculated by 1-month EURIBOR * 1.5)*	A factor of more than 1 would normally indicate that the cash flows do not have the economic characteristics of interest and hence fail the SPPI criterion. Any factor less than 1 should not fail the modification test and the SPPI criterion.
Interest is linked to the inflation of a different currency *(interest rate of a EUR bond is linked to the US consumer price index ('CPI'))*	If the currencies are not clearly linked, based on a qualitative test, the SPPI criterion would be failed. If the currencies are clearly linked, a quantitative assessment is likely to be required, to demonstrate whether the SPPI criterion is met.
Interest rates are reset, based on a lagged reference (benchmark) rate *(interest rates are reset every 3 months using the 3-month EURIBOR reference rate from the last day of the previous month)*	Based on a qualitative assessment, if the lag reference is not too long and the rate is not that of a highly volatile economic environment, the SPPI criterion should be met.

Relevant Frequently Asked Questions

11. Applying the modified time value test to a 10-year bond whose interest rate resets annually to a 10-year rate

Question

Consider a bond that is issued in June 2015, matures in 10 years (in June 2025), and contains a constant maturity reset feature where the interest rate resets annually to a 10-year rate of interest. The interest is linked to the bond's original maturity, which means that, if the interest rate is reset in June 2016, it will be reset to the 10-year interest rate until June 2026.

How should the modified time value of money test be applied to the bond, in order to assess whether it meets the SPPI criterion, and how many scenarios should be taken into consideration?

Solution

The test should compare the contractual un-discounted cash flows on this bond to those on a bond that resets annually to a one-year rate, in order to assess whether the cash flows of the two bonds could be significantly different. A number of different interest rate scenarios should be considered, in order to determine how the relationship between the one-year rate and a 10-year rate could change over the life of the instrument. However, it is only necessary to consider reasonably possible scenarios rather than every possible scenario. If, in any reasonably possible scenario, the cash flows are significantly different from the benchmark cash flows (that is, based on a one-year rate), the bond will not meet the SPPI condition (and must be measured at FVTPL).

In jurisdictions where interest rates on loans are extensively regulated by the government, the quantitative test might not be applicable, and a qualitative assessment would be sufficient to assess that the financial asset meets the SPPI criterion.

Relevant Frequently Asked Questions

12.How should the 'benchmark test' be applied when assessing SPPI?

? Question

For debt instruments with a modified time value of money element, a quantitative assessment might be required to determine whether or not the instrument's contractual cash flows represent solely payments of principal and interest ('SPPI') on the principal amount outstanding. The time value of money element is that which provides consideration for only the passage of time.

To perform this quantitative assessment, paragraph B4.1.9C of IFRS 9 requires an entity to compare the contractual cash flows of the financial asset under assessment to the cash flows of a 'benchmark' instrument whose time value of money element is not modified (known as the 'benchmark test'). As an example, if a loan contains a variable interest rate that is reset every month to a one-year interest rate, the assessment would compare the cash flows of the loan to those on a 'benchmark' loan with identical contractual terms and the identical credit risk, except that the variable interest rate resets monthly to a one-month interest rate. Where the modified time value of money element could result in contractual cash flows that are significantly different from the benchmark cash flows, the financial asset fails SPPI.

How should the 'benchmark test' be applied?

Solution

IFRS 9 does not prescribe a single way of performing the 'benchmark test', so different methods might be appropriate. Judgement will therefore be required and the approach adopted should be applied consistently. However, factors to consider in developing an approach to applying the 'benchmark test' include:

- Instrument-by-instrument test: The objective of the 'benchmark test' is to determine how different the contractual (un-discounted) cash flows of a financial asset are from those that would arise if the time value of money element of that asset were not modified. The test is therefore an instrument-by-instrument test applied to the un-discounted cash flows of the financial asset.
- Two tests: IFRS 9 requires differences between the cash flows on the actual and benchmark instruments to be considered, both in each reporting period and cumulatively over the life of the financial instrument. It would not be appropriate to perform only a single cumulative test over the total life of the instrument. Nor would it be appropriate to include the impact of other periods within a test of a single reporting period, since this could hide the impact of significant positive and negative differences arising in individual reporting periods by offsetting them. Similarly, performing only a regression-type analysis that focuses on the overall relationship between the actual and benchmark instrument risks overlooking the impact of significant differences in a single reporting period as well as potentially over the total life, and so would not be appropriate in isolation.
- Reporting period: The 'benchmark test' must be performed at the initial recognition of a debt investment, considering the effect of the modified time value of money element in each 'reporting period' and cumulatively over the whole life. Given that paragraph B4.1.9C of IFRS 9 does not refer to the 'annual reporting period', the 'reporting period' required to be considered will be three months if an entity issues quarterly interim financial reporting and six months if an entity issues semi-annual interim financial reporting. However, given that it would be anomalous for two entities to reach different conclusions on SPPI solely because of their different reporting periods, when determining what is a 'significant' difference for the purposes of a reporting period of less than 12 months (see also Definition of 'significant' below), it

would be acceptable to use a threshold that is greater than a simple pro rata split of the threshold that would be used for a 12-month reporting period.

- Number of scenarios to be considered: Paragraph B4.1.9D of IFRS 9 requires an entity to consider 'only reasonably possible scenarios instead of every possible scenario'. If no significant differences arise when applying historically observed scenarios that include a financial crisis or other period with significant volatility, then an instrument might appear to pass the 'benchmark test'. However, entities should also ensure that the scenarios used appropriately incorporate previously unobserved outcomes that are nevertheless reasonably possible in the future (for example, due to changes in the geo-political environment). Nevertheless, an entity could use only the most extreme of the scenarios considered reasonably possible (that is, those reasonably possible scenarios that give rise to the greatest positive and negative differences between the actual and benchmark cash flows) since, if these pass the benchmark test, then all other less extreme scenarios will similarly pass, so that these other less extreme scenarios do not need to be considered separately.
- Exclusion of principal amounts: The objective of the 'benchmark test' is to consider adjustments made only to the time value of money element, which is generally a component of the interest receipts. Hence, inclusion of the principal payments in the 'benchmark test' risks diluting the impact of differences in the time value of money element, and therefore principal payments should be excluded. However, if cash flows are a combination of principal and interest (for example, an amortising mortgage loan where monthly payments include elements of both principal and interest) then, unless the cash flows are separated between principal and interest, thresholds should be appropriately lowered to mitigate the risk of obscuring the modified time value of money element due to the principal's inclusion.
- Absolute versus relative: In determining appropriate thresholds for what is considered 'significant', entities might use (i) a specified percentage of the benchmark cash flows, or (ii) a combination of a specified percentage of the benchmark cash flows and an absolute numerical threshold, used to avoid absolute small differences causing an instrument to fail SPPI. For example, to take account of very low interest rate environments, it might be judged appropriate to use a relative test assessing whether differences between the instruments' cash flows expressed as a percentage of the benchmark instrument's cash flows exceed X% and then also apply an absolute test assessing whether the difference between these cash flows also exceed CU Y. The absolute threshold itself should take account of the size of the instrument being assessed, because it would not be appropriate to apply the same absolute numerical threshold to all instruments under the benchmark test.
- Definition of 'significant': IFRS 9 does not define 'significant' in the context of the benchmark test. Entities will therefore need to exercise judgement in determining this. For example, it might be appropriate to establish a 'lower' boundary for differences below which an instrument will always be SPPI, and an 'upper' boundary for differences above which an instrument will always fail SPPI. Instruments with differences falling between these ranges would require further analysis, including consideration of how often and in what circumstances the lower boundary is exceeded, qualitative factors etc.

Disclosure:

Where the approach taken to applying the benchmark test is a significant accounting judgement (for example, because an alternative approach could result in a material amount of financial instruments changing classification between FVTPL and amortised cost), the disclosures in paragraph 122 of IAS 1 should be provided.

Relevant Frequently Asked Questions

13. 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

14. Assessing SPPI for loans that have leverage-type features in relation to interest

Question

Some loans and other debt instruments include leverage-type features in relation to interest. In some jurisdictions such features are introduced into financial assets by the government or a regulatory authority; in other cases they reflect local market practice. What factors should be considered in assessing whether or not such financial assets meet the SPPI criterion?

Solution

Paragraph B4.1.9 of IFRS 9 states that the existence of leverage will affect whether the SPPI criterion is met since 'leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest.' It follows that in most cases, the inclusion of leverage-type features in a financial asset will cause the SPPI criterion to be failed. However in rare cases this might not be the case. This can be a complex area and in applying this guidance, judgement will be required to determine if a specific leverage-type feature causes the SPPI criterion to be failed. The following considerations are relevant:

Government or regulatory authority–set interest rates

If interest rate leverage is due to a government or regulatory authority setting the interest rate (or framework within which interest rates must be determined) then the more specific guidance in IFRS 9 B4.1.9E on government regulated rates should be applied rather than IFRS 9 B4.1.9. IFRS 9 B4.1.9E refers to a 'regulated interest rate [that] provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement'. This therefore provides for some flexibility, so that a suitably low level of leverage is still considered compatible with SPPI.

Cash flows that have the economic characteristics of interest

The principle in IFRS 9 B4.1.9 is that the SPPI criterion is failed where leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Therefore, if it can be demonstrated that, despite the leverage-type feature, a financial instrument's contractual cash flows nonetheless 'have the economic characteristics of interest' (i.e. the cash flows are still compensation for only time value of money, credit risk and other basic lending risks) the leverage-type feature does not cause the instrument to fail SPPI.

For example, consider a loan whose interest rate is contractually specified as 115% x a benchmark floating rate. This might be judged to have the economic characteristics of interest and so meet SPPI in very specific circumstances, for example in an economic environment with high inflation and high and very volatile interest rates where, as a result, it is common market practice to have this feature at the time the loan is issued. In such a situation, the 15% x the benchmark floating rate component might represent a dynamic credit spread and profit margin that changes as the level of interest rates changes. However, such a feature would not have the economic characteristics of interest and hence would cause the loan to fail the SPPI criterion in other less volatile markets that do not exhibit these characteristics.

Disclosures

Where judgements as to whether or not leverage-type features meet SPPI have a significant effect, the disclosures on significant accounting judgements required by paragraph 122 of IAS 1 should be provided.

Relevant Frequently Asked Questions

15. Assessing SPPI when banks can adjust interest rates

Banks in many jurisdictions use 'base rates' as a reference rate for issuing variable-rate loans. Although banks are able to set their own base rate, they generally follow market convention. These base rates are typically based on a central bank rate, such as LIBOR or other market rate. Banks monitor the movements in their funding rates, and a correlation exists between changes in their funding rate and changes in their base rate. If a bank changes a base rate, the respective interest rates on its loans, whose interest rate is set as base rate plus a margin, are also adjusted.

Question 1

Are 'base rates' consistent with the basic lending arrangement of banks for the purpose of assessing the SPPI criterion under IFRS 9 for their loans, without performing a more detailed analysis?

Solution 1

Yes, it is generally the case that banks' base rates are consistent with the basic lending arrangement, providing compensation for credit risk and time value of money. Therefore, base rates would meet the SPPI criterion without a more detailed analysis. This is further supported by Instrument B in paragraph B4.1.13, which acknowledges that a 'lender's various published interest rates' might be consistent with the SPPI criterion.

Question 2

Does the instrument still meet the SPPI criterion if the bank has a contractual right to adjust the interest rates in cases of financial market, macro-economic or regulatory changes (that is, events outside the bank's control)?

Solution 2

It depends and requires the application of judgement. If the contractual agreement to change the rate is simply passing on, for example, costs related to a basic lending arrangement or costs associated with regulatory changes, this might still meet the SPPI criterion. However, if the adjustment is to pass on other costs or losses borne by the bank, which are not reflective of credit risk and consideration for time value of money specific to the instrument in question, this would not meet the SPPI criterion.

Question 3

Could the instrument meet the SPPI criterion if the bank has discretion to adjust the interest rate, irrespective of the market situation and the regulatory environment?

Solution 3

It depends. Where banks have an unfettered ability to change rates, an assessment of the facts and circumstances is required on a case-by-case basis, to assess whether any change would reflect consideration for the time value of money and credit risk of the instrument in question.

Take, for example, country X, where banks have historically issued variable-rate mortgage loans, with contractual clauses providing them with an unfettered ability to change the rates at their discretion. However, the natural competition in the banking sector in country X allows customers to easily refinance loans if their bank increases rates above standard market rates. As such, historically, the banks have not been able to exercise their unfettered ability to change rates to one above compensation of time value of money and credit risk. In this case, the loans issued by the banks in country X are likely to satisfy the SPPI criterion.

In contrast, a bank could potentially link changes in interest rates on issued loans to other variables completely outside credit risk and the time value of money, such as equity prices. These loans would not meet the SPPI criterion.

Relevant Frequently Asked Questions

16. 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

17. 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

18. 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

19 What discount rate should be used when measuring ECL for credit cards and other similar products?

Question

The contractual interest rate on credit cards and other similar products can be significant, and the discount rate used can have a significant impact on the expected credit loss (ECL) impairment provision recognised under IFRS 9.

What discount rate should be used when measuring ECL for credit cards and other similar products?

Solution

The definition of credit loss in Appendix A to IFRS 9 states that cash flows should be discounted at the original effective interest rate (EIR), other than for purchased or credit-impaired financial assets.

In practice, determining the original EIR for credit cards and other similar products can be complex and judgemental, particularly since the contractual interest rate can vary significantly from period to period for the same credit card customer. This can occur if, for example, the contractual terms specify that customers (sometimes referred to as 'transactors') will incur 0% interest if amounts spent on the card are paid off within a specified period such as one month, but customers (sometimes referred to as 'revolvers') will incur a much higher rate of interest, say 20%, if the amount is not paid off within the specified period.

In assessing whether an entity's approach to calculating the original EIR under IFRS 9 is appropriate, relevant factors to consider include:

- **Internal consistency** – The IFRS 9 definition of ECL states that the relevant cash flows should be discounted using the original effective interest rate. Hence, the same EIR should be used for discounting ECL as is used in measuring interest income, in calculating modification gains/losses under paragraph 5.4.3 of IFRS 9, and in any other calculation where the use of original EIR is required.
- **Segmentation** – As discussed in the December 2015 meeting of the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG') in the context of determining the period over which to measure ECL for revolving credit facilities[1], portfolios should be appropriately segmented, or grouped on the basis of shared characteristics, when calculating ECL. The segmentation of portfolios should ensure that ECL is measured in a way that is unbiased and does not combine different facilities that do not have suitably similar characteristics. The importance of appropriate segmentation applies equally to EIR as it does to other aspects of the ECL calculation. An entity should therefore assess whether, on the basis of reasonable and supportable information that is available without undue cost or effort, the level of disaggregation and segmentation applied (including differentiation between 'transactors' and 'revolvers') is appropriate.

[1] Refer to paragraph 44 of the IASB summary of the December 2015 ITG meeting

- **Monitoring segmentation** – An individual customer facility might change from being a transactor incurring 0% interest to a revolver incurring 20% interest, and vice versa, over the life of the facility. If this is the case, and if the credit card is considered to be a floating rate instrument, segmentation should therefore be considered on an ongoing basis and might need to change from one period to another.
- **Stage 2** –Where a facility has had a significant increase in credit risk at the reporting date (so is in 'stage 2') the ECL must be modelled on the basis that the customer fails to pay off their future balance in some instances (para 5.5.18 of IFRS 9). It follows that, in those instances, there will be an unpaid balance at default on which to incur a credit loss. Since the customer will, at that stage, be incurring 20% interest, use of a 0% EIR is not appropriate for stage 2 facilities.

Additional considerations might arise when an entity transitions from IAS 39 to IFRS 9. The definition of EIR in IFRS 9 is identical to the definition in IAS 39; so, from a technical perspective, no change is required. However, there might nonetheless be a need to make changes from an implementation perspective. One reason is that EIR calculations might have validly been performed at very aggregated levels under IAS 39, where appropriate interest income recognition was the only material consideration. However, such a level of aggregation might no longer be appropriate under IFRS 9, where the original EIR will also be used to discount ECL on specific facilities over potentially long time periods.

171207-101843-LD-OS

Ihre Ansprechpartner aus dem National Office

Guido Fladt
Leiter des National Office (Grundsatzabteilung HGB und IFRS)
Frankfurt am Main
Tel.: +49 69 9585-1455
g.fladt@pwc.com

Andreas Bödecker
Unternehmenszusammenschlüsse, Joint Arrangements, assoziierte Unternehmen und Impairmenttest nach IFRS
Hannover
Tel.: +49 511 5357-3230
andreas.boedecker@pwc.com

Peter Flick
Bankspezifische Fragestellungen nach HGB und IFRS (Finanzinstrumente)
Frankfurt am Main
Tel.: +49 69 9585-2004
peter.flick@pwc.com

Karsten Ganssauge
Bilanzierung von Finanz-instrumenten und Leasing nach IFRS
Hamburg
Tel.: +49 40 6378-8164
karsten.ganssauge@pwc.com

Dr. Sebastian Heintges
Umsatzrealisierung, Mitarbeiter-vergütungen und latente Steuern nach IFRS
Düsseldorf
Tel.: - 49 69 9585-3220
sebastian.heintges@pwc.com

Alexander Hofmann
Bilanzierung von Versicherungs-verträgen nach HGB und IFRS
Düsseldorf
Tel.:+49 221 2084-340
alexander.hofmann@pwc.com

Dr. Bernd Kliem
Handelsbilanzielle Fragestellungen
München
Tel.: +49 89 5790-5549
bernd.kliem@pwc.com