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In Depth

Treasury and securities portfolios: practical implications of IFRS 9 classification and measurement

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Introduction

As treasury and securities portfolios 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 treasury and securities portfolios. 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. Whilst primarily written from the perspectives of banks, many of the aspects discussed will also be relevant to other entities that hold portfolios of securities.

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.*

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Determining the business model

1. Liquidity portfolios

Most banks hold a portfolio of high-quality, liquid securities to provide a source of cash in the event of normal funding sources freezing up, as seen by some territories in the 2008 global financial crisis. However, liquidity portfolios might be managed in different ways. IFRS 9 is not prescriptive about the level within an organisation (such as portfolio, desk or division) at which an entity should define its business models. Management will need to apply judgement to determine the most appropriate level(s) at which the business model assessment is applied.

Consequently, we are seeing differences in business model determinations in practice. Some banks are classifying their whole liquidity portfolio as a 'hold to collect and sell' business model. Other banks are looking at a 'layered' approach. With this approach a 'bottom layer' of securities is identified; these securities are only sold in very 'extreme scenarios' (see below), and they are therefore determined to be a 'hold to collect' business model, with the remaining securities in a 'hold to collect and sell' business model. This is very similar to the position of some banks today under IAS 39, where some securities are able to be classified as held to maturity', with the remainder as 'available for sale'.

To work out the most appropriate classification, IFRS 9 is clear that an entity should not just look at past/expected sales, but it should also look at indicators such as how performance is evaluated and how risks are managed.

Related FAQs:

*FAQ 1 – **Business model assessment: financial assets held to manage liquidity needs***

*FAQ 2 – **Business model assessment: useful indicators***

2. Extreme scenarios

Whilst liquidity portfolios are clearly held for use in extreme scenarios, it is clear (from para B4.1.2A and Example 4 in para B4.1.4 of IFRS 9) that worst case or 'stress' scenarios do not need to be considered in determining business model. Therefore, the expectation that a particular portfolio would be sold in a liquidity stress does not, by itself, prevent the business model from being 'hold to collect'.

Related FAQ:

*FAQ 3 – **Business model assessment: stress case scenarios***

3. Regulatory-driven sales

In some jurisdictions, the banking regulator will tell a bank to periodically sell some of the securities in its liquidity portfolio, to demonstrate that they are suitably liquid. IFRS 9 is clear that such sales imposed by a third party cannot be ignored for the purpose of the business model assessment; so, unless the sales are infrequent or insignificant, it is expected that this would prevent a 'hold to collect' business model.

Whilst it is likely that a 'hold to collect and sell' business model would result, a 'hold to sell' business model should not be ruled out. It should also be considered whether the sale results in a sale for accounting purposes. In some territories, performing a repo transaction (which does not result in a sale for accounting purposes) is sufficient to demonstrate liquidity, in which case a 'hold to collect' business model might be possible.

Related FAQs:

*FAQ 4 – **Sales that are insignificant in value***

*FAQ 7 – **What examples of sales before maturity would not be inconsistent with a business model of holding financial assets to collect contractual cash flows?***

4. Legacy portfolios

Some banks might hold old, or so-called 'legacy', portfolios within the treasury function, which were previously managed by another part of the bank that was then shut down or restructured, so that the portfolio was moved into treasury. Since the management of these portfolios might be very different from other more 'mainstream' portfolios managed by treasury, in many cases a separate business model assessment will be appropriate.

5. Bank-wide involvement

As well as managing business models directly within their control, treasury can often have a wider involvement in the bank's other business models. For example, retail mortgages might be predominantly managed by retail banking management, but the group treasurer might sometimes tell the retail bank that it needs to package up certain mortgages for securitisation, which could result in derecognition of the mortgages (that is, a 'sale' for business model purposes). Where this is or might in future be the case, the actions of the treasury function should be appropriately considered as part of the retail mortgages business model assessment(s).

6. 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 from a 'hold to collect' business model are consistent 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), 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 5 – **Business model assessment: banks that sell down loans to manage single counterparty credit risk limits***

*FAQ 6 – **Is alignment required between 'increase in credit risk' for business model purposes and 'significant increase in credit risk' for ECL purposes?***

*FAQ 7 – **What examples of sales before maturity would not be inconsistent with a business model of holding financial assets to collect contractual cash flows?***

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

1. Contractually linked instruments

IFRS 9 contains a special set of SPPI rules for what it calls 'contractually linked instruments' (CLI). These apply, for example, in a 'tranched' structure such as a securitisation or an asset-backed security, where there are predefined rules specifying how payout of the cash flows from the underlying assets is prioritised between the different classes or 'tranches' of instruments, creating concentrations of credit risk.

The detailed requirements are in paragraphs B4.1.21 to B4.1.26 of IFRS 9, but they are complex and set a high hurdle to demonstrate that an instrument meets SPPI. In particular, they require the entity to 'look through' the instrument to the underlying asset pool, which needs to comprise only instruments that meet SPPI or instruments that align specified cash flow mismatches or reduce cash flow variability (such as an interest rate cap).

It can be difficult enough to assess SPPI where an asset is on a entity's own balance sheet and the entity has all of the contractual terms, so it is even more challenging where the assets are owned and structured by another party.

Related FAQs:

FAQ 8 – ***Derivatives in underlying pool of assets***

FAQ 9 – ***Derivative with optionality in underlying pool of asset***

FAQ 10 – ***Investments in collateralised debt obligations (CDOs)***

FAQ 11 – ***What constitutes a tranche when assessing SPPI for a contractually linked instrument?***

2. 'Bail in' clauses

As a result of the regulatory response to the 2008 global financial crisis, bank-issued securities are often subject to 'bail in' features. These features are designed to pre-empt the bank breaching its regulatory capital requirement by allowing for the security to be written down to nil or converted into ordinary shares, boosting capital when it is needed most.

These 'bail in' features can be complex. When assessing SPPI for the holder of a security, the key principle is that the feature can be ignored for SPPI purposes if it only arises as a result of a regulator's power to impose losses on the holder (see Instrument E in para B4.1.13 of IFRS 9). This is because IFRS 9 is a contract-based standard; so, if the resulting payments do not arise from a contractual term, but instead from regulation/legislation, they are not relevant to the IFRS 9 assessment.

However, if the feature is a contractual term (for example, because a security's terms state a specific capital ratio threshold that will trigger 'bail in' when breached that is not prescribed by regulation/legislation), that would be considered a contractual term and be expected to cause the security to fail SPPI. This is even if the probability of loss is considered remote, which is normally the case. So, understanding the detail of any relevant clauses will be key.

The above assumes that the security is a liability under IAS 32 from the issuer's perspective (that is, a debt instrument). An increasingly common instrument with a 'bail in' feature is an 'AT1' or 'Additional Tier 1' bond issued by a bank (sometimes also referred to as a 'contingent convertible bond'). These are complex instruments and terms vary, but (in some territories, such as the UK) they can be wholly equity under IAS 32, which would mean that the holder has to classify the instrument as FVTPL unless it takes the instrument-by-instrument election to measure it at FVOCI without P&L recycling.

Related FAQ:

*FAQ 12 – **Interaction of contractual and legal terms in loan contracts when assessing the SPPI criterion***

3. 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 13 – **Interpreting 'significantly different' when performing the modified time value of money test***

*FAQ 14 – **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 15 – **Applying the modified time value test to a 10-year bond whose interest rate resets annually to a 10-year rate***

*FAQ 16 – **How should the 'benchmark test' be applied when assessing SPPI?***

4. Money market funds

Amongst their mix of investments, treasury functions might hold investments in money market funds. Whilst it might make little difference to the carrying amount, given that fair value typically approximates to amortised cost, the classification will matter from a disclosure point of view, and it is not always straightforward. For example, if the fund investment meets the definition of equity under IAS 32 in the issuing fund (which is not the same as being classified as equity under IAS 32, because some puttable investments in a fund might be eligible to be classified as equity, even though they do not meet the IAS 32 definition of equity), the only options for the holder are FVTPL or to take the instrument-by-instrument election to measure at FVOCI without P&L recycling. In this case, amortised cost is not an option.

If, instead, the fund investment is a debt instrument rather than equity, the next key consideration is whether the return paid by the fund meets SPPI. This can be complicated if there is no stated return, but rather the investor gets their share of the return generated by the underlying investments. However, depending on the nature of the underlying investments, there might be grounds to say that, qualitatively, the returns meet SPPI, without the need to do the detailed analysis required by the 'benchmark' test – for example, if all of the underlying instruments held by the fund are themselves SPPI and the fund does not sell instruments (see paras B4.1.9B to B4.1.9D of IFRS 9).

A similar analysis can also be applicable to some central counterparty (or ‘CCP’) default funds, where the cash placed by a clearing member with the CCP is invested in a fund-type arrangement.

5. 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 (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’, 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 17 – ***What is reasonable compensation in a prepayment clause?***

6. Non-recourse

If a non-recourse provision exists in a security, so a creditor’s claim is limited to specified assets, the bank is required to assess (that is, to ‘look through to’) the underlying assets or cash flows to determine whether the security’s contractual cash flows are SPPI. If the security’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. This applies if the security is not a ‘tranched’ instrument (if it is tranched, the CLI rules discussed above would apply instead).

For example, if an instrument’s cash flows came from toll road revenues and the cash flows paid would increase as more cars used the toll road, the instrument would not be a basic lending arrangement and so would fail SPPI.

Related FAQs:

FAQ 18 – ***Non-recourse loans which might be inconsistent with SPPI***

FAQ 19 – ***Non-recourse real estate financing***

FAQ 20 – ***Non-recourse to portfolio of equity instruments***

Other matters

1. Investor point of view

As well as assessing the balance sheet classification of the bank's own assets, the treasury function might also want to consider whether the bank's own issued instruments meet SPPI for the holder before they are marketed and issued. This will be relevant where the investors of these instruments are IFRS reporters who want to achieve amortised cost or FVOCI accounting.

2. Automated tools

Assessing SPPI across hundreds or thousands of securities can be very time-consuming, so banks are using automated tools that help to do the assessment. The challenge, with these types of tool, is to get beyond concluding 'Pass' for instruments that obviously pass SPPI and an unhelpful 'Maybe' for all the rest. Therefore, if a bank is relying on such a tool, it is important to understand 'what audit trail does the tool provide to explain why the instrument passed or failed SPPI?' and 'how does the tool conclude on judgemental issues, such as what is "reasonable compensation" in a prepayment clause?'.

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.

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Relevant Frequently Asked Questions

1. Business model assessment: financial assets held to manage liquidity needs

Question

A financial institution holds financial assets to meet its everyday liquidity needs. The entity holds financial assets to collect contractual cash flows, and it sells financial assets to re-invest in higher-yielding financial assets or to better match the duration of its liabilities. In the past, this strategy has resulted in frequent sales activity, and such sales have been significant in value. This activity is expected to continue in the future. What is the business model for the financial assets?

Solution

In this scenario, the objective of the business model is to maximise the return on the portfolio to meet everyday liquidity needs, and the entity achieves that objective by both collecting contractual cash flows and selling financial assets. Therefore, the business model is ‘held to collect and sell’.

Relevant Frequently Asked Questions

2. 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

3. Business model assessment: stress case scenarios

Question

Should an entity take stress case scenarios into account in its business model assessment?

Solution

No. If an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur.

Relevant Frequently Asked Questions

4. 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

5. 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

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. 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

8. Derivatives in underlying pool of assets

Question

A special purpose entity (SPE) holds floating-rate EUR assets, and it issues fixed-rate GBP notes contractually linked to the assets. The SPE has entered into one swap that is a pay EUR floating and receive GBP floating, and a second swap that is a pay GBP floating and receive GBP fixed. Both of these swaps would meet the requirements, in paragraph B4.1.24(b) of IFRS 9, of aligning the cash flows of the tranches with the cash flows of the pool of underlying instruments.

Assuming that the other features of contractually linked instruments have been met (according to para B4.1.21 of IFRS 9), would such a note in a tranche issued by an SPE meet the SPPI criteria?

Solution

Yes. However, if the SPE had a derivative that introduced a third currency (say, USD), this would not align the cash flows, and the tranche would have to be measured at FVTPL. [IFRS 9 para B4.1.24].

Relevant Frequently Asked Questions

9. Derivative with optionality in underlying pool of asset

Question

An SPE holds a fixed-for-floating swap that also hedges pre-payment risk such that, if the underlying pool of fixed-rate assets pays down early, the derivative is cancelled, with no further amounts to pay. This is to ensure that there are no excess derivatives and no fair value gains or losses on settlement; this is because, when the assets pre-pay, the notes pre-pay.

Assuming that the other features of contractually linked instruments have been met (according to para B4.1.21 of IFRS 9), would such a note in a tranche issued by an SPE meet the SPPI criteria?

Solution

Yes. This feature would not fail the SPPI criterion, so the holder might be able to measure its investment at amortised cost. This could also be achieved by other mechanisms (for example, the SPE could be required to enter into an offsetting derivative as soon as practicable), to make sure that there are no excess derivative positions after the pre-payment of the notes.

Relevant Frequently Asked Questions

10. Investments in collateralised debt obligations (CDOs)

Question

An entity has an investment in a cash CDO, where the issuing SPE holds the underlying referenced assets.

Would such a note in a tranche issued by an SPE meet the SPPI criteria?

Solution

The investment might qualify for amortised cost accounting, provided that the underlying assets qualify for amortised cost accounting, and the other requirements of IFRS 9 are met for contractually linked instruments. But investments in synthetic CDOs (where the SPE has a credit derivative that references particular exposures) would not qualify, because the derivatives on the reference exposures do not have cash flows that are SPPI, nor do they align the cash flows permitted by IFRS 9.

Relevant Frequently Asked Questions

11. What constitutes a tranche when assessing SPPI for a contractually linked instrument?

Question

A special purpose vehicle ('SPV') holds a financial asset and issues only one type of note. Any cash flow collected on the transferred asset is then passed to the note holder, and to the party that transferred the financial asset to the SPV, using a waterfall. The waterfall structure contains a credit enhancement whereby the excess of the return on the financial asset over the rate paid on the issued note (also known as the 'excess spread') is retained by the SPV to absorb the first losses on the financial assets held by the SPV. This credit enhancement is paid back to the transferor using a predefined schedule defined in the waterfall.

Does the 'excess spread' credit enhancement constitute a tranche when assessing whether the contractually linked instruments guidance should be applied to the structure?

Solution

Yes. Paragraph B4.1.20 of IFRS 9 defines a contractually linked instrument as 'transactions in which an issuer may prioritise payments to the holders of financial assets using contractually linked instruments that create concentration of credit risk. Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche'.

This definition does not restrict the form of a 'tranche' to only notes or securities. Since the structure contains the key feature of a contractually linked instrument (that is, it passes any cash flows that it collects using a waterfall in a manner that creates concentrations of credit risk), the 'excess spread' credit enhancement should be considered a tranche for the purposes of applying the contractually linked instruments guidance.

Relevant Frequently Asked Questions

12. Interaction of contractual and legal terms in loan contracts when assessing the SPPI criterion

Question

Paragraph B4.1.13 of IFRS 9 clarifies that, where payments arise only as a result of legislation that gives the regulatory authority power to impose changes to an instrument, they should be disregarded when assessing the SPPI criterion, because that power is not part of the contractual terms of a financial instrument. Instrument E in the guidance specifically refers to bail-in instruments as an example that might meet the SPPI criterion.

When should the contractual terms of an instrument which includes references to the legislation, such as a bail-in clause, be taken into account when assessing the SPPI criterion?

Solution

The bail-in clause should not be taken into account, when assessing the SPPI criterion, where the clause merely acknowledges the existence of the bail-in legislation (that is, the clause does not create additional rights or obligations that would not have existed in the absence of such a clause). For this to be the case, it is necessary that:

- The bail-in regulations themselves specify all of the key terms, including what the bail-in trigger is and the effects of the bail-in trigger being met;
- The effects of the bail-in trigger are at the discretion of the regulator, and the contract does not add to this by allowing discretion of the entity or imposing an earlier trigger; and
- The contract terms are drafted such that, if the regulations change, the bail-in terms of the instrument change in exactly the same way.

However, some contract terms include non-viability trigger event clauses. These are clauses in debt agreements in certain jurisdictions that allow regulatory authorities to instruct an entity to modify the debt instrument on issue if it determines that, without the amendment, the entity would become non-viable. Such a contractual reference creates additional rights or obligations, with respect to the treatment of the instrument that would not have existed in the absence of such a clause, that extend beyond mere bail-in clauses. As such, the effects of such a clause should be taken into account when assessing the SPPI criterion, and they might cause it to fail.

Relevant Frequently Asked Questions

13. 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

14. 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.

Description/Example	Qualitative assessment sufficient?
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.
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

15. 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

16. 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

17. 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 (refer to FAQ 12).

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

18. 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

19. 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

20. 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.

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