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In depth

A look at current financial reporting issues

IFRS 9: Classification, measurement & modifications– Questions and answers

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At a glance

On 24 July 2014, the IASB published the complete version of IFRS 9, 'Financial instruments', which replaces most of the guidance in IAS 39. The final standard includes amended guidance on classification and measurement of financial assets from the previous versions of IFRS 9. For further guidance on the new standard please see 'In depth: IFRS 9 – Classification and Measurement'

This publication sets out our views on some of the most common issues that have been raised by preparers and reviewers of financial statements as part of implementation of the new standard. Issues related to impairment of financial asset requirements and hedging requirements under IFRS 9 have been considered in separate documents.

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Treatment of ratchet loans

Question:

Some loans include price-ratcheting clauses. Under these clauses, the contractual interest rate is reset in accordance with a scale of pre-defined rates on the occurrence of one or more pre-defined events that are linked to a deterioration in the borrower's credit risk (such as a specified gearing ratio of the borrower). These clauses are included to avoid the need to renegotiate the loan when the credit risk of the borrower changes.

Does a loan with a ratchet clause meet the solely payments of principal and interest ('SPPI') criterion?

Solution:

The SPPI criterion will be met provided that:

- The pre-defined trigger reflects an increase in the credit risk of the loan; and
- The new rate is established at inception of the contract so as to compensate the holder for the increased credit risk.

Paragraph B4.1.10 of IFRS 9 gives an example of a financial instrument whose interest rate is reset to a higher rate if the borrower misses a particular number of payments. This example indicates that such a reset feature could meet the SPPI criterion. The ratchet clause is similar in nature to this example.

Interpretation of 'significantly different'

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 results in contractual cash flows that are 'significantly different' from the undiscounted 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 fair value through profit or loss ('FVTPL').

Should the 'double-double test' for embedded derivatives in paragraph AG 33(a) of IAS 39 be used to determine 'significantly different' under IFRS 9?

Solution:

No. 'Significantly different' is a matter of judgement for management to determine and should be assessed on an individual product-by-product 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 IAS 39.

Interaction of contractual and legal terms

Question:

Paragraph B4.1.13 of IFRS 9 clarifies that payments that arise only as a result of legislation that gives the regulatory authority power to impose changes to an instrument should be disregarded when assessing the 'SPPI' criterion, as 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 might be 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 as it determines, because, 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 might cause it to fail.

Assessing SPPI when banks can adjust interest rates

Question:

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.

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

Solution:

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:

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, macroeconomic or regulatory changes (that is, events outside the bank's control)?

Solution:

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:

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:

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. In this situation, these loans would not meet the SPPI criterion.

Benchmark test

Question:

If the time value of money element is modified, entities 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 a list of examples of contractual features that are considered modified (that is, imperfect) under the IFRS 9 guidance. The guidance suggests whether 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 x 3M EURIBOR)*	Due to guidance in IFRS 9 paragraph B4.1.14 Instrument G, the SPPI criterion is not passed. This can be done based on a qualitative assessment.
The currency of reference interest rate differs from 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 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*	The benchmark test is not relevant here. This is because this 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?
instrument is only adjusted if the 1-month EURIBOR changes by more than 25bp compared to previous fixed interest rate)	
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 the benchmark used is the average over a short time frame (for example, 3 months), as 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 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)*	Any factor exceeding 1 would lead to failure of the modification test and the SPPI criterion, as this is considered leveraged. 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 'CPI' (consumer price index))*	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 based on a lagged reference (benchmark) rate *(interest rates are calculated using the 3-month EURIBOR reference rate from previous last day of the 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.

Business model assessment

Sales due to single counterparty credit risk limits

Question:

Bank credit risk management frameworks and regulatory regimes often require that banks consider their credit risk exposure to a single counterparty (that is, concentrations of credit risk). Due to such credit concentration risk, banks might 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 and thereby achieve fair value through other comprehensive income ('FVOCI') classification, assuming the SPPI criterion is met?

Solution:

It is likely that banks that 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.

Syndicated loans

Question:

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

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

Solution:

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

Assuming the bank's objective is to hold the portion of the loan that is within the specified risk limits in order to collect contractual cash flows, these would be measured at amortised cost, assuming they meet the SPPI criterion. The excess would be viewed as part of a business model whose objective is to realise cash flows through the sale of the assets, and should be measured at FVTPL. It should be clearly demonstrated internally that two different business models exist for the loan.

Impact of fair value information on business model classification for repo transactions

Question:

Bank X undertakes repo and reverse repo transactions. All reverse repo assets are held to maturity to collect the contractual cash flows. However, the bank's traders manage their cash flow exposures by layering on new trades or ceasing to roll overnight repos, based on fair value information. This is done with the objective of creating or eliminating exposures to different parts of the interest rate yield curve, and achieving the same economic outcome as if they were buying and selling financial instruments. Fair value information is used for management reporting and compensation purposes.

Is this business model 'hold to collect'?

Solution:

No. Reverse repo assets which are held to maturity would normally meet the requirement in paragraph 4.1.2 of IFRS 9, which states that a 'hold to collect' business model is one 'whose objective is to hold financial assets in order to collect contractual cash flows'. However, paragraph B4.1.6 of IFRS 9 states that 'a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets'.

In this case, the use of fair value-based management information is associated with a business model involving trading out of positions by layering on offsetting positions to realise fair value gains and losses. Furthermore, classifying these assets as FVTPL will present users of the accounts with the fair value information that management itself deems the most relevant in understanding and managing the business. Therefore, in such a situation, even though assets are held to maturity to collect contractual cash flows, the layering of transactions and the management of the exposure on a fair value basis should result in FVTPL classification. This is supported by paragraph BC4.78 of IFRS 9.

Equity instruments

Classification of investment in puttable shares

Question:

An entity invests in a fund that has puttable shares on issue – that is, the holder has the right to put the shares back to the fund in exchange for its pro rata share of the fund's net assets. The puttable shares meet the requirements to be classified as equity from the issuer's perspective, but this is an exception within IAS 32 as they do not meet the definition of equity in the standard.

Are puttable shares eligible for the irrevocable option to take fair value changes on equity instruments through OCI, included in paragraph 5.7.5 of IFRS 9?

Solution:

No. paragraph BC5.21 of IFRS 9 clarifies that the option is only available for equity instruments that comply with the definition of equity instruments in accordance with IAS 32. Whilst puttable instruments are classified as equity for accounting purposes, they do not meet the definition of equity under IAS 32. Therefore, an entity cannot apply the FVOCI option for equity instruments, and the puttable shares should be measured at FVTPL.

Modifications

Accounting for modified loans due to commercial reasons

Question:

Sometimes, banks modify loans for commercial reasons (for example, because a creditworthy borrower wishes to extend the term of a loan). In many cases, the new terms will be reset to market rates for the new cash flows.

Can the fact that a loan is modified for commercial reasons automatically result in the modification being regarded as a new loan under IFRS 9 where the new terms are at current market rates?

Solution:

No. The derecognition requirements in IFRS 9 are broadly the same as those in IAS 39. Therefore, if the terms are not substantially modified, the loan does not constitute a new loan under IFRS 9. In this case, a modification gain or loss should be recognised under paragraph 5.4.3 of IFRS 9. However, if the terms are substantially modified, the transaction should be treated as resulting in a new loan. Additionally, other factors might be considered; for example, if the original loan had an early repayment option at par plus accrued interest, this would point to the substance being repayment (and extinguishment) of the old loan, followed by the issue of a new market rate loan.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner.

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