



Implementing Phase 1 of IFRS 9 (Second edition)

ERNST & YOUNG
Quality In Everything We Do



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Background

On 12 November 2009, the International Accounting Standards Board (the IASB or the Board) published the first part of Phase 1 of IFRS 9 *Financial Instruments*, the accounting standard that will eventually replace IAS 39 *Financial Instruments: Recognition and Measurement*. The first part of Phase 1 of IFRS 9 (or the standard) dealt with the classification and measurement of all financial assets within the scope of IAS 39. On 28 October 2010, the Board issued amendments to IFRS 9 to address financial liabilities. The Amendments also incorporated into IFRS 9 the current derecognition principles of IAS 39. The Amendments completed Phase 1 of IFRS 9 *Classification and Measurement of Financial Instruments*.

Whilst IFRS 9 is not mandatory until 1 January 2013, entities may adopt it earlier, subject to the approvals necessary within each jurisdiction. Having said that, it is possible that the mandatory effective date for IFRS 9 maybe deferred to 1 January 2015, in response to constituent feedback during the IASB's recently concluded Effective Dates project. We highlighted the main changes to the accounting requirements for financial instruments that came into effect with Phase 1 of IFRS 9, and provided a brief commentary on the possible business impact, in our *Supplements to IFRS Outlook*, issues 60 and 89¹. The new standard is more principles-based, with less extensive rules and application guidance than IAS 39. As a result, application of the new standard will require the careful use of judgment. This is the second edition of a publication in which we address some of the key questions that are being asked about implementing IFRS 9, recognising that some aspects of the standard are still unclear.

IFRS 9 is very much in its infancy, with limited adoption anywhere in the world so far. A number of important issues are still being debated and, like other constituents, we as a firm have observed the practical difficulties of adopting the standard while engaging with our clients. As you will observe throughout this publication, some of the questions have no "right" answer and we highlight the factors that need to be considered in arriving at a conclusion.

Further issues and questions are likely to be raised during the course of application and we expect that a degree of consensus and best practices will emerge over time.

¹ Available at www.ey.com/ifrs.

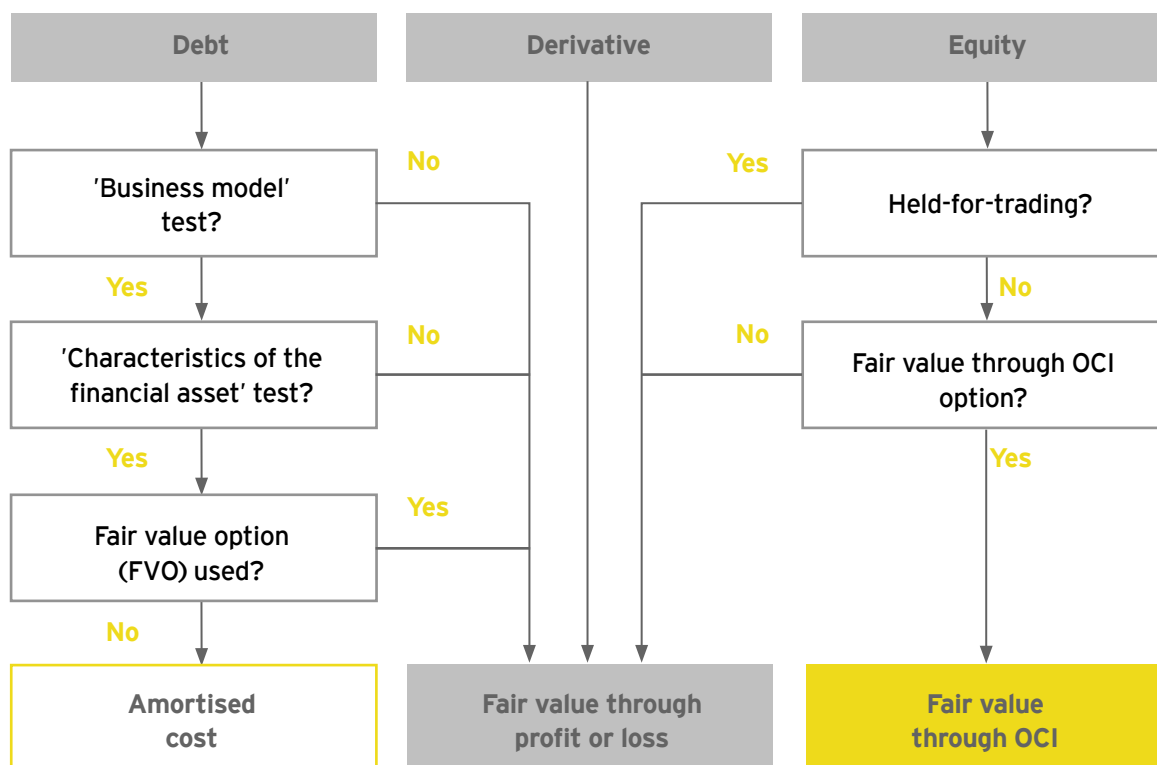


Financial assets

Under IFRS 9, the classification and measurement of financial assets depends upon whether the asset is a derivative, a debt instrument or an equity investment. All derivatives are measured at fair value through profit or loss (FVTPL), unless they qualify and are designated for hedge accounting. Debt instruments are measured at amortised cost if they meet certain tests. Otherwise they are measured at FVTPL. Even if they satisfy the amortised cost tests, they may also be measured at FVTPL by using the fair value option (FVO) to avoid a measurement mismatch.

Equity investments that are held for trading must be measured at FVTPL. Other equity investments may be measured at FVTPL or at fair value through other comprehensive income, with no recycling of the change in fair value to profit or loss if the investment is subsequently derecognised. However, dividends are recognised in profit or loss unless the dividend clearly represents a recovery of part of the cost of the investment.

Synopsis: Classification and measurement of financial assets





Debt instruments

All financial assets that are non-derivative debt instruments are subject to two tests to determine whether they can be measured at amortised cost subsequent to initial recognition:

- ▶ The asset is held within a business model, the objective of which is to hold the assets to collect the contractual cash flows (the 'business model' test)

And

- ▶ The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding (the 'characteristics of the financial asset' test)

The 'Business model' test

IFRS 9 is clear that an entity may have more than one business model for managing its financial assets. This means that the assessment of the business model need not be made at the reporting entity level, nor is it an instrument-by-instrument approach. The assessment would therefore be made at an intermediate level. In addition, the assessment must be based on the objectives of the business model as determined by key management personnel², rather than management's intent for specific financial assets.

The standard also states that the objective of an entity's business model may continue to be the holding of financial assets to collect contractual cash flows, even when some investments from the portfolio are sold. That is, the entity need not hold all of those financial assets until maturity. Whilst the standard illustrates some situations where such sales may or may not be consistent with the objective of holding the assets to collect contractual cash flows, the assessment clearly requires judgment, as we explore in the questions that follow (see Table 1 below for highlights).

Entities also need to bear in mind the disclosure requirements for financial assets held at amortised cost: (1) to show separately on the face of the statement of comprehensive income any gains or losses on derecognition; and (2) qualitative disclosure of the reasons for derecognising those assets. Significant amounts of gains or losses on derecognition and/or an unconvincing explanation of the reasons for the sale may imply that the entity's original assessment of its business model is no longer appropriate. If so, the consequence is that any new assets acquired by the affected business will need to be classified at FVTPL while existing assets will remain at amortised cost.

Table 1: Business model test – highlights

The objective of the entity's business model must be to hold instruments to collect contractual cash flows.

A business model may still qualify for amortised cost, for example, if a sale is made because:

- ▶ The asset no longer meets the investment policy (e.g., a decline in credit rating)
- ▶ The entity adjusts the investment portfolio to match the maturity of liabilities
- ▶ The asset is sold to fund unexpected capital expenditure or losses

Amortised cost *may not* be appropriate if 'more than infrequent' sales occur.

Use judgment based on facts and circumstances. Consider:

Quantitative indicators

The frequency, volume and value of sales

and

Qualitative factors

The purpose for which financial assets are acquired, the reasons for any sales, how performance is managed, how employees are remunerated, etc.

² IAS 24 *Related Party Disclosures* defines key management personnel as 'those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.'



Level for applying the business model test

Q1: An entity holds financial assets with the objective of collecting the contractual cash flows. However, the entity may sell an investment when there is an opportunity to do so. Would such sales prevent amortised cost accounting?

Analysis

It depends. There are business models within which financial assets are neither managed solely to realise fair value changes from movements in market rates nor are they held only to collect contractual cash flows. As such, these business models are a hybrid of the two contemplated by the standard. Prior to IFRS 9, entities generally classified financial assets held within such business models as available for sale (AFS). It may be a challenge to apply the new approach under IFRS 9 to businesses that may not be managed on a fair value basis, but where a significant number of assets are sold before maturity.

For example, the entity might sell an asset in order to buy another asset with a similar maturity and risk, but a higher yield (a process known as 'switching'), and the entity may be prepared to incur losses in the process of switching, so as to lock in a higher long-term yield rather than 'to realise fair value gains' (paragraph B4.1.5 of IFRS 9).

The application guidance in paragraphs B4.1.3 and B4.1.4 of IFRS 9 states that 'if more than an infrequent number of sales are made out of a portfolio, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows' and that 'some sales would not contradict that objective'. Whilst some changes or 'turnover' within the portfolio may be consistent with the measurement at amortised cost (see example below), 'more than infrequent' or 'more than some' sales would call that assessment into question.

If the objective of the entity's business model is to periodically buy and sell assets in order to make gains through arbitrage, or if it measures performance on a fair value basis for internal management information purposes, especially if it rewards staff based on this performance, it would generally not be appropriate to record these assets at amortised cost. In addition to these factors and the indicators set out in the examples within the standard, it is important to consider the reasons for the sales and whether the sales were expected to occur at the time the investments were purchased.

Business model test – example


Entity A has debt investments worth CU 100, comprising notes with maturities of 3 to 5 years. Until the adoption of IFRS 9, all of these debt investments were classified as AFS under IAS 39. In practice, CU 10 of the portfolio is sold and reinvested at least once a year while the remaining CU 90 investments are typically held to near their maturity. First, the entity needs to use judgment to determine whether it has:

- (a) Two business models: (i) CU 90 debt instruments held to near their maturity; and (ii) CU 10 debt instruments which are actively bought and sold, provided those assets can be separately identified

Or

- (b) One business model applied to the overall portfolio of CU 100 debt investments.

If scenario (a) above is considered more appropriate, the entity could achieve amortised cost classification for a majority of the debt instruments and would probably need to account for the remaining debt instruments at FVTPL. Alternatively, if scenario (b) is considered more appropriate, the entity needs to determine whether the level of expected sales and repurchases is significant enough to require the whole portfolio to be measured at FVTPL. The sale and reinvestment of 10% of the portfolio at least once a year would potentially be 'more than infrequent' and/or 'more than some'. However, the standard cites infrequent/some sales as indicators (rather than as criteria) to determine whether the business model is to hold instruments to collect contractual cash flows. Other factors to consider include the reasons for the sales and how the performance of the business is reported to and assessed by management. It is possible that consensus will emerge around factors to be considered and circumstances in which disposals are considered consistent with amortised cost accounting for a business model which is not managed on a fair value basis.



To further illustrate some of the practical difficulties with interpreting the reference to 'more than infrequent' and 'more than some' sales in the application guidance, consider the following additional scenarios:

Q2: Switching of assets

Additional information

An entity has a portfolio of CU 100 of debt instruments. The employee responsible for managing the portfolio has been mandated to optimise the long- term yield on the portfolio. Accordingly, he/she regularly sells the assets and reinvests the proceeds from the sales in new assets that have a similar maturity and risk profile, but generally with a higher yield.

Insignificant gains/losses are generated in the process of switching the assets in order to lock in a higher yield. This happens on a fairly regular basis and, over a period of six months, approximately 10% of the portfolio is turned over. Despite the 10% turnover, the overall size and composition of the portfolio is relatively unchanged. The employee is remunerated based on the overall yield of the portfolio (i.e., maximising the portfolio's yield); fair value gains/losses are not considered in his/her remuneration. Management's documented strategy and defined key performance indicators (KPI) emphasise optimising long- term yield rather than fair value gains and accordingly, the entity's management reporting focuses on yield rather than fair value of the debt instruments within the portfolio. At initial recognition, and upon subsequent sales (and reinvestment), the entity is not able to clearly identify the assets that would be switched.

Analysis

The key consideration is whether the underlying objective of the entity is to hold the assets to collect their contractual cash flows. Based on the factors mentioned above, it could be argued that the objective of the entity is not to realise fair value gains/losses because:

- ▶ Insignificant gains/losses (relative to the interest earned from the portfolio) are earned/incurred in the 'switching' process
- ▶ The overall size and composition of the portfolio is relatively unchanged from the 'switching'
- ▶ The employee is remunerated based on the overall yield of the portfolio, and fair value gains/losses are not considered in his/her remuneration
- ▶ Management's documented strategy and defined KPIs emphasise long- term yield rather than fair value gains
- ▶ Management reporting is focused on yield rather than the fair value of the debt instruments within the portfolio

However, in our view, the fact that it is not the entity's objective to realise fair value gains/losses is not sufficient in itself to be able to conclude that measurement at amortised cost is appropriate. Such an objective is not necessarily the same as holding a portfolio of financial assets to collect their contractual cash flows. While the standard states that an infrequent number of sales and "some" sales would not contradict that objective, it does not provide any further guidance. A common interpretation of these various terms may arise as the standard is adopted. Until then, each entity will need to exercise its own judgment and consider other available information before concluding that amortised cost classification is consistent with the business model in these circumstances.



Q3: Sales of securities that are held for liquidity purposes

Additional information

A bank holds a liquidity 'buffer' portfolio of high grade plain vanilla securities. These are assets that are held by the bank to fund unexpected cash outflows arising from stressed scenarios. The bank's strategy is to always have a buffer, hence the overall portfolio size remains stable within pre-defined currency and maturity bands. The employees of the bank responsible for managing the portfolio are assessed based on the yield that they achieve from a buffer that meets pre-defined credit, currency and maturity criteria. The fair value performance of the portfolio is not considered in determining the employees' remuneration. The employees are aware of the portfolio's fair value such that they know how much cash can be raised if the assets ever need to be sold, but the portfolio is not managed to maximise fair value.

However, the employees churn the portfolio regularly buying and selling, for the following reasons:

- (i) The regulators require regular sales to prove that the assets are liquid

And

- (ii) The bank wants to maintain a presence in the market so that, in the event of liquidity difficulties, it would not be obvious that they have been forced to sell

The churn rate is about 10% per month. The duration of the portfolio is roughly one year and it is anticipated that the gains/losses earned/incurred as the portfolio is churned will be significant.

Analysis

Even though the bank's strategy, and the basis for the employees' performance assessment, is non-trading in nature, a portion of the portfolio is sold frequently and substantial fair value gains/losses are expected to be earned/incurred in churning the portfolio.

Whilst not explicit in IFRS 9, we would presume that if a portfolio of financial assets is to qualify for amortised cost classification, then the bank should not expect to report significant fair value gains/losses from sales. In this scenario, the fair value gains/losses were already anticipated at inception, hence the assessment of the business model of being to hold the assets to collect their contractual cash flows may be inappropriate.

In addition, the churn rate of 10% per month would mean that only a small proportion of the original portfolio would still be held after 11 months, which would seem inconsistent with the portfolio's objective to hold the assets to collect the contractual cash flows. Hence, the sale of 10% of the portfolio every month may be considered more than 'some sales' and the business model may not qualify for amortised cost classification.

The debate around liquidity portfolios and whether they meet the IFRS 9 business model test is one of those areas where no consensus has yet emerged. In addition, facts and circumstances differ from one bank to another, hence, it is a challenge to draw parallels, and as a result, diversity of application is likely to arise.

Overall, the assessment will need to make use of appropriate judgment, considering the facts and circumstances specific to the entity, in order to determine whether amortised cost represents the most appropriate method of accounting for a particular business model.



Loans that are to be sold or sub-participated

Q4: How should an entity account for originated loans, when some are intended to be sold or sub-participated?

Analysis

An entity may originate loans so that it holds part of the portfolio to maturity, but sells a portion in the near term or sub-participates a part of the loans to other banks. The question arises whether, for the purposes of application of IFRS 9, the entity has one business model or two.

The entity could consider the activities of lending to hold and lending to sell or sub-participate as two separate business models requiring different skills and processes. Whilst the financial assets

resulting from the former would typically qualify for amortised cost measurement, those from the latter would probably not and would, therefore, need to be measured at FVTPL.

If a loan is assessed, in part, to be sold or sub-participated, this raises the additional issue of whether a single financial asset can be classified into two separate business models. As it is already common under IAS 39 for loans to be classified in part as held for trading and in part at amortised cost, it is likely that this practice will continue under IFRS 9.

Q5: What happens if the sale or sub-participation referred to in Q4 fails?

Analysis

In some cases, an entity may fail to achieve the intended disposal, having previously classified a portion of a loan at FVTPL because of the intention to sell.

The standard requires classification to be determined in accordance with the business model applicable at the point of initial recognition of the asset. In this example, the fact that the entity fails to achieve an intended disposal does not trigger a reclassification in accordance with the standard. Therefore, loans or portions of loans that the entity fails to dispose of would continue to be recorded at FVTPL.

Sales due to infrequent events

Q6: Would a business model still satisfy the amortised cost criteria if financial assets are sold due to an infrequent event?

Analysis

The question arises because the incidence may be 'infrequent', but the proportion of assets sold may be considered more than 'some'. For example, an entity may need to sell financial assets if there is a major loss, or if it needs to fund major unexpected capital expenditure or a business acquisition. The entity needs to consider, amongst other facts and circumstances, the factors described in response to Q1 and, in particular, the purpose for which the assets were originally acquired.

- ▶ If a business model is initially assessed as qualifying for amortised cost measurement and if assets are subsequently sold infrequently for reasons that were not previously anticipated, we believe that the business model may possibly still qualify for amortised cost accounting.
- ▶ However, if assets are held to fund capital expenditure or an acquisition that is expected to take place, it would presumably be necessary for the maturities of the financial assets to reflect the expected holding period, if they are to be recorded at amortised cost. For example, if an acquisition is expected to take place in six months' time, then the assets that will be used to fund the acquisition should normally have a maturity of approximately six months, not several years, if they are to be recorded at amortised cost.



Changes subsequent to initial recognition

Q7: An entity's objective for a portfolio meets the business model test to be recorded at amortised cost but, subsequently, the entity changes the way it manages the assets. How should the entity measure: (i) the existing assets; and (ii) any newly acquired assets?

Analysis

Having determined that the objective for a portfolio originally met the business model test to be classified at amortised cost, if the entity subsequently changes the way it manages the assets (for instance, by making more than an infrequent number of sales), so that the business model would no longer qualify for amortised cost accounting, the question of how the entity should measure the existing assets and any newly acquired assets then arises.

Although more than an infrequent number of sales has occurred, unless there has been a fundamental change in the entity's business model, the requirements of the standard regarding

reclassification are unlikely to be triggered. The standard requires assets to be reclassified if the objective of the business model changes due to sudden and significant changes of circumstances, but neither requires nor permits a reclassification if the change is gradual or progressive.

Assuming that the assets are not reclassified, it is likely that the entity will have to treat the portfolio as if it comprises two business models going forward – one for the old assets and one for any new assets acquired.

Financial assets previously held will remain at amortised cost. New financial assets acquired will be recorded at FVTPL.

Financial assets that are legally sold, but not derecognised

Q8: When assessing the business model, should an entity consider whether it legally 'sells' assets or whether it derecognises them for accounting purposes?

Analysis

Take an example where an entity enters into sale and repurchase (repo) transactions. Whilst the entity legally sells the assets and repurchases them under the arrangement, the repo'd assets continue to be recognised in the balance sheet, although interest is physically collected by the counterparty.

Consider a further example of trade receivables that are originated and then sold as part of a factoring programme. Whilst the contractual rights to the cash flows are transferred, the seller retains the credit risk (by way of a guarantee) and is not permitted to derecognise the assets.

The question arises whether, in order to qualify for amortised cost measurement, the entity should physically collect the contractual cash flows, or whether it is sufficient that the entity has not derecognised the asset for accounting purposes.

The standard does not contain any specific guidance on this issue. In our view, accounting derecognition is critical to determining whether the entity has ceased to hold the assets to collect contractual cash flows for the purpose of the business model test. Application of this approach would give an intuitively correct answer for both examples above – repo transactions and the factoring arrangement, both of which are, in substance, financing transactions, as the assets will qualify for amortised cost accounting.



Business models based on maturity bands

Q9: Is amortised cost appropriate for a portfolio of instruments held to match the duration of a bank's liabilities?

Additional information

A bank allocates investments into maturity bands to match the expected duration of its time deposit accounts. The invested assets have a similar maturity profile and amount to the corresponding deposits. The ratio of assets to deposits for each maturity band has pre-determined minimum and maximum levels. For example, if the ratio exceeds the maximum level because of an unexpected withdrawal of deposits, the bank will sell some assets to reduce the ratio. The choice of assets to be sold would be based on those that would generate the highest profit or incur the lowest loss.

Meanwhile, new assets will be acquired when necessary (i.e., when the ratio of assets to deposits falls below the pre-determined minimum level). The expected repayment profile of the deposits would be updated on a quarterly basis, based on changes in customer behaviour. Under IAS 39, these assets were classified as AFS and there has been no history of active trading.

Analysis

The question is whether adjusting the assets/deposits ratio by selling assets to correspond with a change in the expected repayment profile of the deposits would mean that the business model is inconsistent with the objective of holding to collect the contractual cash flows. In these circumstances, an analogy can be drawn to paragraph B4.1.3 (b) of the standard which states that an insurer may adjust its investment portfolio by selling a financial asset to reflect a change in the expected duration (i.e., expected timing of payouts) of its liabilities. However, the guidance clarifies that if more than an infrequent number of sales are made out of the portfolio, the entity would need to assess how such sales are consistent with an objective of holding to collect the contractual cash flows.

If the bank had a good track record of forecasting its deposit repayments, we would expect such sales to be infrequent. If numerous sales happen every year, it might be difficult to rationalise such practice with an objective of holding to collect the contractual cash flows. Due consideration will also need to be given to the magnitude of sales and more than 'some' sales will require further analysis in terms of the reasons for the sales before an appropriate conclusion could be reached.



Business model assessment for large, multinational organisations

Q10: How do you determine the granularity of business models in a large, multinational organisation? For example, in the following scenario, for the purpose of its consolidated financial statements, how many business models does the banking group have?

Additional information

A global banking group operates two business lines, retail banking and investment banking. These businesses both operate in the same five locations by means of separate subsidiaries. Each subsidiary has its own Board of Directors that is responsible for carrying out the strategic objectives as set by the group's Board of Directors.

The financial assets held by the investment banking business are measured at FVTPL as the group's strategy is to actively trade these financial assets. Financial assets held by four of the five retail banking subsidiaries are considered to be held to collect their contractual cash flows. However, the fifth retail banking subsidiary has a large portion of assets that it expects to sell before maturity. These assets are not held for trading, but are instead held to maximise their yield. As a result, more than infrequent sales and more than some sales are anticipated for this one location and it is unlikely that this subsidiary would meet the amortised cost criteria if it was assessed on a stand-alone basis. This particular subsidiary comprises 10% of the group's retail banking business.

Analysis

It depends. The bank will need to exercise judgement to determine the appropriate level at which to assess its business model(s). Hence, different conclusions are possible depending on the facts and circumstances.

This does not mean that the bank has an accounting policy choice but it is, rather, a matter of fact that can be observed by the way the organisation is structured and managed. In many organisations, key management personnel may determine the overall strategy and then delegate their authority for executing that strategy to others. The combination of the overall strategy and the effect of the delegated authority are among the factors that can be considered in the determination of 'business models'. As a result, the number of business models could vary from two (i.e., retail banking and investment banking) to three (i.e., investment banking, one retail banking business for the first four subsidiaries and a second retail banking business for the fifth subsidiary) or even more, depending at which level the business model assessment is carried out.

Business model for loans purchased at a discount

Q11: Can a portfolio of loans that is acquired at a discount be considered to be held within an amortised cost business model?

Additional information

An entity purchases a large portfolio of non-performing loans at a significant discount from their face value. However, the contractual terms of the loans are such that they only give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. Notwithstanding the fact that the loans are non-performing, the purchaser intends to hold them to collect their contractual cash flows as far as possible.

Analysis

The purchaser's business model is to hold the acquired loans to collect the contractual cash flows, and not to trade them in the

market. Hence, in these circumstances, the purchaser can subsequently measure the acquired portfolio at amortised cost. The fact that the portfolio was purchased at a significant discount is not relevant to the assessment as the contractual cash flows meet the 'characteristics of the financial asset' test (see next section).

This view is further supported by Example 2 in B4.1.4 of the standard which considers an entity whose "*business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets with incurred credit losses*". The analysis concludes that the entity's business model is to collect contractual cash flows, even though it may not expect to collect all of the contractual cash flows.



'Characteristics of the financial asset' test

Once an entity determines that its business model is to hold the assets to collect the contractual cash flows, it must assess whether the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding. Interest is defined as

the consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time.

Table 2 gives examples of features that will result in the asset either qualifying or not for amortised cost accounting.

Table 2: Characteristics of the financial asset test

Contractual terms of the financial asset give rise, on specified dates, to cash flows that solely represent principal and interest payments.

Features that would typically not be inconsistent with amortised cost accounting:

- Prepayment options, extension options
- Fixed/variable interest rate
- Caps, floors, collars
- Unleveraged inflation index linked

Features that would be inconsistent:

- Leverage (e.g., options, forwards and swaps)
- Conversion options (e.g., convertible bonds)
- Coupons paying a fixed rate minus LIBOR (e.g., inverse floaters)
- Variable rate coupons that reset periodically but reflect a constant maturity
- Triggers that result in a significant reduction of principal, interest or both (e.g., catastrophe bonds)

Inflation linked bonds

Q12: Would an inflation-linked bond qualify for measurement at amortised cost if payments of both the principal and interest are linked to the inflation index, but the principal is not protected?

Analysis

Paragraph B4.1.13 of the standard deals with an inflation-linked bond where the principal is protected. The guidance concludes that such a bond would qualify for measurement at amortised cost provided that the inflation link is not leveraged. The question has since been asked as to whether the principal protection is critical to the assessment.

We believe measurement at amortised cost is possible even if the principal of an inflation-indexed bond is not protected, provided the inflation link is not leveraged. Payments on both the principal and interest will be inflation-adjusted and, as with the principal-protected inflation-linked bond, the payments are representative of 'real' interest, which is consideration for the time value of money on the principal amount outstanding.



Q13: Further to Question 12, consider Entity A which invests in euro- denominated bonds with a fixed maturity issued by Entity B. Interest on the bond is linked directly to the inflation index of Eurozone Country C, which is Entity B's principal place of business. Can Entity A measure the euro bonds at amortised cost given that interest is not linked to the inflation index of the entire Eurozone area?

Analysis

Yes. The bond is denominated in euros and Eurozone Country C is part of the Eurozone, therefore, we consider the inflation link to be acceptable. The inflation index reflects the inflation rate of the currency in which the bond is issued since it is the inflation index of Entity B's economic environment, and the euro is the currency

for that economic environment. By linking the inflation index to the inflation rate of Eurozone Country C, Entity B is reflecting 'real' interest for the economic environment in which it operates. Hence, in these circumstances, Entity A could regard the interest as consideration for the time of value of money and credit risk associated with the principal amount outstanding on the bond.

Constant maturity bonds

Q14: An entity invests in 15-year floating rate government bonds and the coupons are reset every six months by referencing to the 10-year rate. Would the instrument qualify for amortised cost measurement?

Analysis

No. As worded, the Example B in paragraph B4.1.13 of the standard makes it clear that if the interest payable in each period is disconnected from the term of the instrument, the contractual cash flows do not reflect only the time value of money and compensation

for credit risk. There are a number of instruments (across various jurisdictions), where the coupon rate is periodically reset to a reference rate that is not connected to the period to which it is applied. Hence, based on the example in the standard, such instruments may not qualify for amortised cost classification.

Dual currency bonds

Q15: If the interest payments on a financial asset are denominated in a currency that is different from the principal of the financial asset, is the financial asset considered to have contractual cash flows that are solely payments of principal and interest?

Analysis

It depends. Paragraph B4.1.8 of IFRS 9 requires the assessment of "whether contractual cash flows are solely payments of principal and interest on the principal outstanding for the currency in which the financial asset is denominated". This implies that any instrument in which interest is calculated based on a principal amount other than that payable on maturity will not qualify for amortised cost accounting. For instance, if variable interest

payments are computed based on a fixed principal amount in another currency, e.g., US dollars, although repayment of the principal is in sterling, the financial asset is not considered to have payments that are solely principal and interest. However, there may be instances where interest is denominated in a currency that is different from the principal currency, but the contractual cash flows could possibly constitute solely payments of principal and interest. One such example is described in Question 16.

Q16: Can an investment in a dual currency bond with the following features give rise to contractual cash flows that are solely payments of principal and interest?

Additional information

- ▶ The principal amount of the bond is denominated in Canadian dollars (CAD) and fixed interest payments are in Indian Rupees (INR)
- ▶ The interest is fixed in INR at inception based on the market interest rates and foreign exchange spot and forward rates at that time

And

- ▶ The bond is redeemed in CAD at a fixed maturity

Analysis

While not explicit in the standard, in our view, if the bond can be separated into two components that, on their own, would meet the characteristics test, then the combined instrument would do so. That is, if the bond can be viewed as the combination of a zero-coupon bond denominated in CAD and a stream of fixed payments denominated in INR, and if both instruments can be analysed as a stream of cash flows that are solely payments of principal and interest, then the sum of the two would do so as well.

An analogy can be drawn to Instrument C in paragraph B4.1.13 that deals with a bond that pays a variable interest rate that is capped. The application guidance states that such an instrument can be viewed as a combination of an instrument that has a fixed rate and another instrument that has a variable rate, and concludes that if both instruments meet the characteristics test, a combination of them would do so too.

Note that this conclusion is premised on the fact that the individual components arising from the decomposition of the instrument each meet the characteristics test and an analogy cannot be drawn to other instruments (e.g., convertible bonds) where the individual components following decomposition do not meet the characteristics test.

In this particular example, the distinguishing feature relative to Question 15 is the fact that the interest payments have been fixed at inception and there is no exposure to changes in cash flows.

Financial assets where the interest rate steps up

Q17: Would a financial asset that bears interest at a stepped-up rate be considered to have cash flows that are solely payments of principal and interest?

Analysis

Yes, if the step-up rates throughout the life of the asset are contractually set at inception, and the net present value at

inception is the same as if the instrument had been issued at a fixed market rate. However, if the step-up rates compensate the lender for more than just the time value of money and credit risk, amortised cost measurement may not be appropriate.



Q18: As a variation of question 17, consider an investment in a note issued by a securitisation vehicle in which the floating interest rate on the note steps-up after an initial period (P1). This step-up coincides with the start of the period (P2) in which the issuer has the option to redeem the note. Will an investment in such a note give rise to contractual cash flows that are solely payments of principal and interest?

Analysis

It depends. The combination of a non-contingent, issuer call option (exercisable at par, i.e., principal and unpaid contractual interest) and a step-up in the interest rate at the start of the period in which the option takes effect does not affect the classification at amortised cost provided that the rate paid during the entire period (P1 + P2 combined) is contractually determined at inception and is a market rate for the corresponding term.

In this fact pattern, there are 2 possible scenarios:

Scenario 1:

- ▶ The interest margin during P1 incorporates a credit spread that is equal to the market's credit spread for an equivalent, non-prepayable instrument maturing at the end of P1

And

- ▶ The step-up represents a "reset" to market of the credit spread, pre-determined at inception for an instrument maturing at the end of P2

In these circumstances, the contractual cash flows would probably give rise to payments of solely principal and interest on the principal outstanding as the interest rate reflects the market rate for a similar instrument.

Scenario 2:

This is similar to scenario 1, however, there is a higher step up in P2 than in scenario 1. The reason for this is to economically compel the issuer to exercise the call and redeem the notes. If the call is not exercised, it could indicate that market conditions have changed since the initial issue of the notes (e.g., the issuer may have experienced a credit downgrade, hence the step-up could be construed as compensating the holder for the time value of money and associated credit risk in line with B4.1.11 of IFRS 9).

While the step-up rate might give rise to compensation for the time value of money and credit risk, the holder will not be able to make this assessment at initial recognition of the investment. The standard is clear that an entity classifies a financial asset at initial recognition based on the contractual terms over the life of the instrument (BC4.117 of IFRS 9). As a result, in this scenario, the investment may not qualify for measurement at amortised cost.



Q19: A loan agreement contains a covenant whereby the contractual spread above the benchmark rate will increase if the borrower's earnings before interest, tax, depreciation and amortisation (EBITDA) or its debt-to-equity ratio deteriorates by a specified amount by a specified date. Does this feature result in cash flows that are solely payments of principal and interest on the principal amount outstanding?

Analysis

It depends on the specific terms. Interest is defined in IFRS 9 as consideration for credit risk and the time value of money. The loan would qualify for amortised cost accounting if the covenant serves to compensate the lender for taking on a higher credit risk.

However, if the covenant results in more than just credit protection or provides for an increase in the rate of return which is not solely related to a deemed increase in credit risk (e.g., by allowing the lender a share of the borrower's results), the loan would not qualify for amortised cost treatment.

Interest rates that are quoted as a multiple of a benchmark interest rate

Q20: Would debt instruments for which the interest rate is quoted as a multiple of a benchmark interest rate (e.g., 2 times 3-month EURIBOR for a 3-month term) be considered to have contractual cash flows that are solely payments of principal and interest?

Analysis

No. Such features introduce leverage and paragraph B4.1.9 of the standard is explicit that leverage increases the variability of the

contractual cash flows, resulting in them not having the economic characteristics of interest. As a result, such instruments would need to be measured at FVTPL.

Interest rates that are set at an auction

Q21: Would the contractual cash flows of an instrument whose interest rate is set during an auction be eligible for measurement at amortised cost?

Additional information

Auction Rate Securities have long-term maturity dates, but their interest rate resets more frequently based on an auction. Due to the auction process, the interest rates are short-term and the instruments are treated like short-term investments.

In the event that an auction fails (i.e., there are no buyers to establish a new rate), the rate resets to a penalty rate. The penalty rate is established at inception and does not necessarily reflect the market rate when the auction fails. In substance, the penalty rate is intended to compensate the holder for the instrument's lack of liquidity as the reference rate for the instrument has disappeared due to the auction failure.

Analysis

It depends. An entity classifies a financial asset at initial recognition based on the contractual terms over the life of the instrument (BC4.117 of IFRS 9). Even though the presumption may have been that the auctions were not expected to fail, the potential penalty rate should be taken into account in the characteristics assessment at initial recognition. If the penalty rate could be considered to compensate the holder for the longer-term credit risk of the instrument following the auction failure as a result of a reduction in market liquidity, it may be possible that the penalty rate meets the IFRS 9 definition of interest. However, such instruments usually have multiple issues and the penalty rates for the individual issues would need to be carefully evaluated before a conclusion could be reached.



Investments in open-ended money market or debt funds

Q22: Would an entity that invests in units issued by an open-ended money market or debt fund be able to measure such investments at amortised cost?

Analysis

It is unlikely.

In an open-ended fund, new investors are accepted by the fund after inception and existing investors have the option of leaving the fund at any time. The price at which new entrants invest in the fund or leavers exit the fund is normally based on the fair value of the fund's assets. Given that investors enter and exit the fund based on fair value, the return on such an investment would not represent payments of principal and interest.

In addition, such investments would not qualify for measurement at fair value through OCI as they do not meet the definition of an equity instrument from the perspective of the fund (i.e., the issuer) and thus will be required to be measured at FVTPL. See Question 40 regarding equity investments that can be classified at fair value through OCI.

Extendible deposits

Q23: From the holder's perspective, would an investment in an extendible deposit (see the fact pattern below) constitute contractual cash flows that are solely payments of principal and interest?

Additional information

A retail bank offers a fixed term deposit product whose term can be extended at the discretion of the bank. For example, the extendible deposit may have a fixed term of five years and pay a fixed interest rate of 5%. However, at the end of five years, the bank has the option to extend the deposit at the same rate for an additional five years. Therefore, if the market rate increases to 6% at the end of 5 years, the bank would more likely extend the term for another five years because the initial fixed rate (i.e., 5%) is lower than the current market rate.

Analysis

An extension option will not normally result in a financial asset failing the characteristics criteria provided that the option is not contingent on future events. If the option is contingent on future events, the guidance (paragraph B4.1.11 of IFRS 9) states that provisions that are included to protect the holder against the credit deterioration of the issuer, or a change in control of the issuer, or either parties against changes in applicable taxation or law, are permitted as long as the terms of the extension option give rise to contractual cash flows during the extension period that would meet the characteristics criteria. But in all other cases where there is a contingent option, the asset will need to be recorded at FVTPL.

In this fact pattern, the extension option embedded in the deposit is not contingent on any future events other than the passage of time. We believe that the asset will, therefore, qualify for amortised cost accounting.



Bonds that are pre-payable at fair value

Q24: Would a plain vanilla bond that is pre-payable at fair value (i.e., the issuer has a call option that is exercisable at fair value) give rise to contractual cash flows that are solely payments of principal and interest?

Additional information

The call option allows the issuer to buy back the bond from the holder before maturity. The exercise price of the option is the fair value of the bond (i.e., the exercise price of the call reflects the fair value of the contractual interest and principal payments that remain outstanding at the point of exercise). For example, if the bond has a term of five years and the call option was exercised at the end of the second year, the fair value would be calculated by discounting the principal and interest payments due over the remaining three years by the current market interest rate for a 3-year bond with similar characteristics. The call is not contingent on future events.

Analysis

The fair value exercise price represents unpaid amounts of principal and interest on the principal amount outstanding at the date of exercise, albeit discounted at the current appropriate market interest rate rather than the original market interest rate.

On the one hand, the fact that the exercise price is the fair value could be interpreted as providing reasonable additional compensation (paragraph B.4.1.10 (b) of IFRS 9) to the holder for early termination in a scenario where the market rate has fallen since the issue of the bond.

On the other hand, where interest rates have risen, the holder will not receive additional compensation for early termination and will only receive the fair value of the unpaid amounts of principal and interest, which will be less than the par amount. In these circumstances, due to the negative compensation, the bond will need to be classified at FVTPL by the holder.

In our view, in cases where the prepayment amount is set so that there is 'a floor' equal to the par amount (i.e., the terms of the option stipulate that the prepayment amount received by the lender cannot be less than the par amount of the bond), then the prepayment amount could possibly constitute unpaid amounts of principal and interest.



Renegotiation of a hybrid instrument prior to transitioning to IFRS 9

Q25: Before transition to IFRS 9, is it possible to re-negotiate a hybrid instrument as two separate instruments in order to enable the host instrument to be measured at amortised cost?

Analysis

In principle, yes. Consider the example where an entity extends a loan that includes a profit participation feature. The entity expects to hold that instrument to maturity. The instrument provides not only a return of principal and interest, but also an additional return based on a share of the profit of the entity being financed.

IFRS 9 abolishes the separation of embedded derivatives from financial assets required by IAS 39. Under IFRS 9, most instruments with separable embedded derivatives would be required to be classified in its entirety as at FVTPL. However, in some cases, it might be possible to renegotiate the transaction as two separate instruments (and re-document them accordingly) before transition to IFRS 9 – one instrument being a loan, the host instrument (which could be recorded at amortised cost) and the other being the profit-sharing derivative (to be recorded at FVTPL).

This would only be possible, we believe, if the two instruments after the re-restructuring are in substance, separate financial instruments. Indicators that this is the case would include:

- i) Each instrument can be closed out or transferred separately from the other, which will be a test of commercial practicality as well as legal possibility.
- ii) There are no clauses that have the effect that the cash flows on one instrument will affect those on the other, except for typical master netting arrangements.

The case for recognising the instrument as two separate instruments would be strengthened if the two new contracts are entered into at prevailing market prices – so that the old hybrid instrument is derecognised under IAS 39 and a profit or loss is recognised when the two new instruments are first recorded at their fair values.



Application of cash flow hedge accounting to FVTPL assets

Q26: Can an entity continue to apply cash flow hedge accounting to its interest rate risk in respect of a financial asset that is required to be measured at FVTPL under IFRS 9?

Additional information

Upon transition to IFRS 9, a floating rate financial asset that was classified as a loan and receivable under IAS 39, is required to be measured at FVTPL under IFRS 9 as it fails the 'characteristics of the financial asset' test. For example, the return on the asset consists of a benchmark interest rate plus a performance fee that is calculated based on the underlying profits of the borrower. Hence, the contractual cash flows do not constitute solely payments of principal and interest under IFRS 9. Under IAS 39, the performance fee element would have been accounted for as a separable embedded derivative and recorded at FVTPL while the host asset would have been classified as a loan and receivable. The asset is not managed on a fair value basis, but is held within a business model, the objective of which is to collect the contractual cash flows.

Analysis

In principle, yes. This conclusion is appropriate provided that the financial asset is not managed on a fair value basis or held for trading, and the future cash flows arising from the hedged forecast transaction are expected to be highly probable.

Under IAS 39, it is generally acknowledged that instruments measured at FVTPL do not qualify as hedged items. This is often inferred based on the Implementation Guidance F2.1 which states that a derivative cannot be designated as a hedged item as they are always deemed held for trading and measured at FVTPL unless they are designated as hedging instruments. By analogy to this guidance, hedge accounting cannot be applied to a non-derivative item measured at FVTPL. However, IFRS 9 has made it mandatory for certain financial assets to be measured at FVTPL if they fail the characteristics test, even though they may be held within an amortised cost business model. Hence, in circumstances where assets are not managed on a fair value basis or held for trading, we believe that cash flow hedge accounting ought to be appropriate.

The IASB is in the midst of changing the IAS 39 hedge accounting requirements and the finalised requirements are expected to be issued in the second half of 2011. The Exposure Draft, *Hedge Accounting*, that was issued in December 2010 did not specifically address this issue, but we have recommended that the final standard be more explicit.



Non-recourse loans

The guidance in IFRS 9 notes that some financial assets may have cash flows that are described as principal and interest, but which do not, in substance, represent such payments. The example is given of non-recourse debt where the creditor's claim is limited to certain assets or cash flows and where the contractual cash flows arising from the debt may not exclusively represent the payment of principal and interest – for example, they may include payment for factors other than the time value of money and the credit risk involved in the debt.

However, the fact that a debt is non-recourse does not necessarily mean that it cannot be classified at amortised cost. A holder of a non-recourse instrument in which the lender is entitled only to repayment from specific assets or cash flows, must look through to the ring-fenced assets or cash flows to determine whether payments arising from the contract meet the 'characteristics of the financial asset' test. If the terms of the debt give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments of principal and interest, it does not meet the test. The responses to the following questions indicate the need for greater clarity in this area of the standard.

Project finance loans

Q27: Would project finance loans qualify for amortised cost accounting?

Analysis

It depends. The lender should apply the non-recourse provisions of IFRS 9 and 'look-through' to the underlying assets or cash flows. Loans provided for project finance may be linked to the performance of the project. An example would be where a loan is given for the construction and maintenance of a toll road and the payments of cash flows to the lender are reduced or cancelled if

less than a certain number of vehicles travel on that road. Such loans are not likely to qualify for amortised cost measurement by the lender. Similarly, loans where the cash flows are specifically referenced to the performance of an underlying business will not qualify. In other cases, where there is no such reference and there is adequate loss-absorbing equity in the project, we believe that amortised cost accounting may well be appropriate.

Loans to a Special Purpose Entity (SPE)

Q28: Would a loan to an SPE that funds the acquisition of another asset qualify for amortised cost accounting?

Analysis

It depends. If the SPE uses the loan from the entity to fund investments in assets which will not themselves qualify for amortised cost accounting, such as equity securities or non-

financial assets, and the loan is the only source of finance to the SPE so that it absorbs any losses on the underlying assets in the SPE, then it would probably not be eligible for amortised cost accounting.

Mortgage loans

Q29: Can a mortgage loan be measured at amortised cost by the lender?

Analysis

There are many different types of mortgage loans – whilst some are structured so that the lender has no legal recourse to the borrower and only to the property collateral in the event of default, others may allow full recourse but, in substance, be non-recourse if the borrower has limited other assets. In general, we do not believe that normal collateralised loans such as

mortgages were intended to be caught by the non-recourse provisions of IFRS 9. Therefore, a loan may be eligible for amortised cost accounting, whether or not it is legally non-recourse. However, at inception, if the expected repayment of a loan is primarily driven by future movements in the value of the collateral so that the loan is, in substance, an investment in the real estate market, then this would call into question whether an amortised cost classification is appropriate.

Classification - contractually linked instruments

A structured investment vehicle (e.g., securitisation) will borrow to fund the acquisition of assets by issuing notes that consist of multiple tranches. The tranches create a 'waterfall' structure that prioritises the payments by the issuer to the holders of the different tranches. As a result of such prioritisation, each tranche is either more senior or more subordinate to other tranches. Such tranches are considered contractually linked instruments.

IFRS 9 requires the holder of contractually linked financial instruments to 'look through' the structure until the underlying pool of instruments that are creating (rather than passing through) the cash flows are identified. To qualify for measurement at amortised cost, a three-part test is applied (also see Table 3 below):

1. The contractual terms of the tranche being assessed have cash flow characteristics that are solely payments of principal and interest on the principal amount outstanding.
2. The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding ("Loan Type Instruments").

Any other instruments such as interest rate swaps in the underlying pool either:

- a) Reduce the cash flow variability of the Loan Type Instruments in the pool and, when combined with the Loan Type Instruments in the pool, result in cash flows that are solely payments of principal and interest on the principal amount outstanding

Or

- b) Align the cash flows of the tranches with the cash flows of the underlying Loan Type instruments in the pool to address differences in and only in:

- i) Whether the interest rate is fixed or floating
- ii) The currency in which the cash flows are denominated, including inflation in that currency

Or

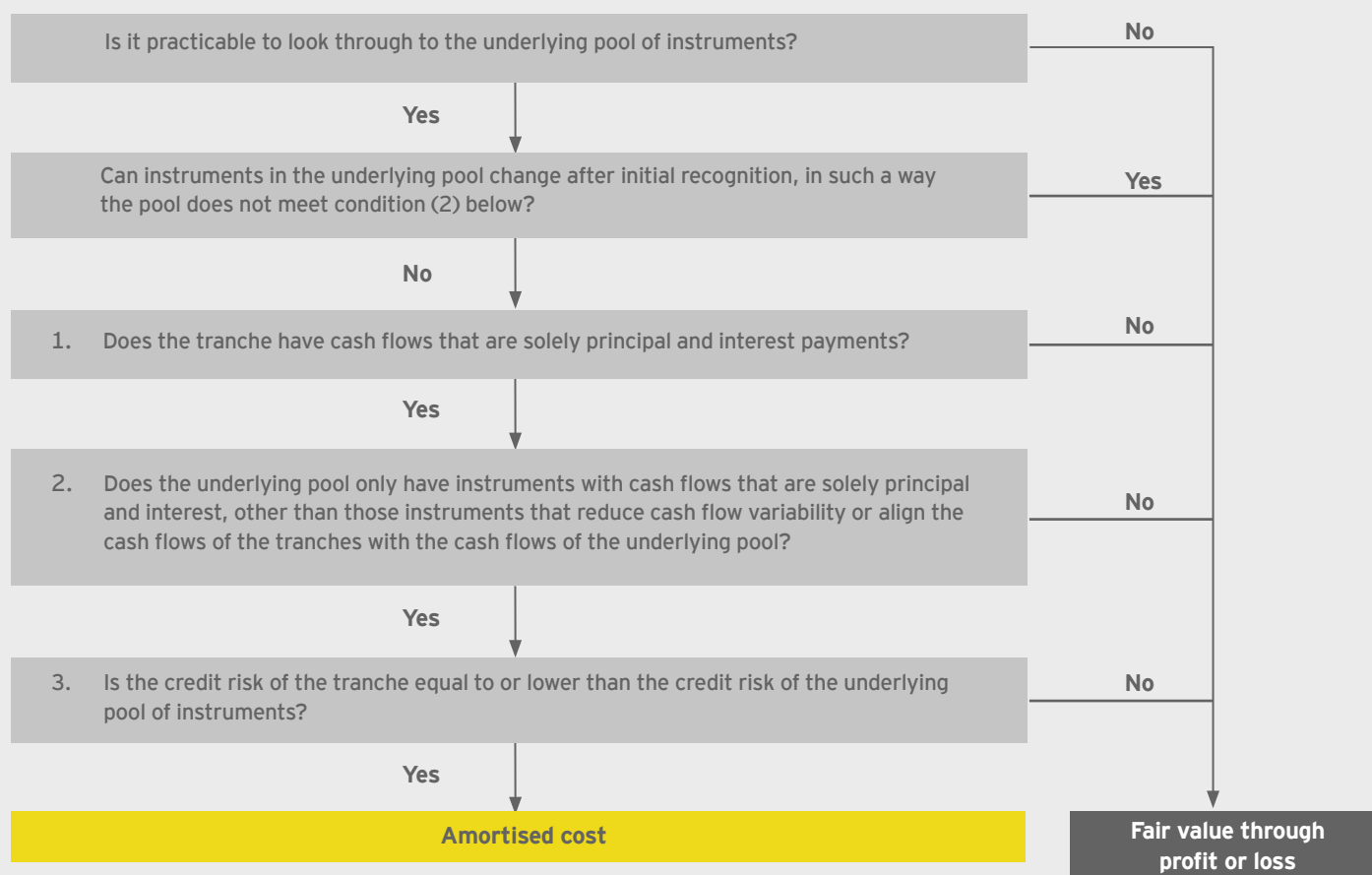
- iii) The timing of the cash flows

3. The exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to, or lower than, the exposure to credit risk of all of the underlying pool of instruments, (i.e., the Loan Type Instruments in the pool as well as the other instruments).

If it is not practicable to look through to the underlying pool of instruments, then the tranche must be measured at fair value. If the underlying pool of instruments can change after initial recognition in a way that does not meet conditions (1) and (2) above, the tranche must be measured at fair value.



Table 3: Look-through test for contractually linked instruments





Application of the contractually linked instruments test

Q30: The second and third parts of the contractually linked instruments test refer to the underlying pool of financial instruments rather than that of financial assets. Why is such a distinction made?

Analysis

For the purpose of the look through assessment, the entity is required to consider the underlying pool of all financial instruments. Therefore, the existence of derivatives (such as interest rate swaps) in the underlying pool, which may be liabilities, would not preclude an amortised cost measurement for the tranche, as long as those derivatives reduce the cash flow variability of the underlying pool of financial instruments or align the cash flows of issued financial assets with that of the underlying pool of financial instruments.

Conversely, if the underlying pool contains government bonds and an instrument that swaps government credit risk for (riskier) corporate credit risk, the pool would not be construed as generating cash flows that solely represent payments of principal and interest. Therefore, amortised cost measurement would be precluded for the tranche (IFRS 9 paragraph BC 4.35(d)). Also see Q32 and Q33.

Determination of the tranche's credit risk

Q31: How should entities determine whether or not the 'exposure to credit risk' in the tranche is less than that of the underlying pool of financial instruments?

Analysis

IFRS 9 does not prescribe a method for comparing the exposure to credit risk in the tranche held by the entity to that of the underlying pool of financial instruments. In some cases, it may be possible to compare the credit rating allocated to the tranche with that (or the average of those) for the underlying pool of financial instruments, if they are all rated. Also, for the more senior and junior tranches, it may be obvious, with relatively little analysis, whether the tranche is less risky or more risky than the underlying assets. However, in other circumstances involving complex

securitisation structures, a detailed assessment may be required, for instance, using a method similar to that prescribed by US GAAP ASC 810-102³, formerly FIN 46(R)⁴. An example is given in Table 4 below. The analysis would involve developing various credit loss scenarios for the underlying pool of financial instruments, computing the probability-weighted outcomes of those scenarios, determining the probability-weighted effect on the tranche held, and comparing the relative variability of the tranche held with that of the underlying assets.

³ FASB Accounting Standards Codification 810, Consolidation.

⁴ FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities.



Table 4: Example: application of the look-through test

Bank A is the sponsor of a securitisation vehicle (the SPE) and holds the junior notes issued by the SPE. The SPE's assets consist of a portfolio of residential mortgages that were originated by and transferred to the SPE by Bank A. The SPE does not hold any derivatives. A number of other banks invest in the mezzanine, senior two, senior one and super senior tranches of notes issued by the SPE. None of the banks has any further involvement with the SPE and all banks have assessed that the SPE is not required to be consolidated in their respective financial statements. The total notional amount of mortgage assets and notes issued is CU 1000.

The following table shows a range of expected credit losses for the portfolio of mortgages as at inception and the estimated probability that scenarios will occur.

	Loss CU	Estimated probability of loss %	Estimated weighted average loss CU
Scenario I	40	10%	4
Scenario II	70	25%	18
Scenario III	110	30%	33
Scenario IV	180	25%	45
Scenario V	230	10%	23
Weighted average loss expectancy			123

The probability weighted expected losses of the underlying assets is therefore 12.3%.

The following table illustrates how an entity may compare the credit risk of the tranche with that of the underlying pool of financial instruments:

Tranche		Super senior	Senior one	Senior two	Mezzanine	Junior	Total
Notional amount in CU (A)		630	150	100	40	80	1000
	Probability	Probability weighted expected losses of the tranches*					
Scenario I	10%	–	–	–	–	4	4
Scenario II	25%	–	–	–	–	18	18
Scenario III	30%	–	–	–	9	24	33
Scenario IV	25%	–	–	15	10	20	45
Scenario V	10%	–	1	10	4	8	23
Expected loss by tranche (B)		–	1	25	23	74	123
Expected loss % by tranche (B)/(A)		0%	0.6%	25%	57%	94%	12.3%
Credit risk of tranche is less than the credit risk of the underlying assets?		Yes	Yes	No	No	No	
Possible classification by the holder of tranches		Amortised cost	Amortised cost	Fair value	Fair value	Fair value	

* For each scenario, expected losses are first allocated to the junior tranches and progressively to the more senior tranches until all expected losses are absorbed. For example, in Scenario IV, the loss of CU180 would be absorbed by the Junior tranche (CU 80), mezzanine tranche (CU 40) and senior two tranche (CU 60). The probability weight of 25% for Scenario IV is then applied to the expected losses allocated to each tranche.

The junior notes held by Bank A have an expected loss which is, in percentage terms, greater than the overall expected loss on the underlying portfolio. Therefore, these notes must be accounted for at FVTPL. Similarly, the mezzanine notes and senior two notes have a greater expected loss than the underlying pool and would not qualify for amortised cost by the holder.

The expected losses on the senior one notes and the super senior notes are lower than the overall expected loss on the underlying pool of instruments and may qualify for amortised cost treatment, provided all other IFRS 9 requirements are met and the instruments are not held for trading.

In this example, it might have been possible to come to the same conclusion without a numerical calculation for the junior and super senior tranches, but the technique is helpful to determine the treatment of the intermediary notes. In practice, it may also be necessary to apply judgment through a qualitative assessment of specific facts and circumstances.



The effect of credit enhancement on the contractually linked instruments test

Q32: What would be the effect on the look-through test for contractually linked instruments if the SPE benefits from credit enhancement through the purchase of a credit default swap?

Analysis

Purchased credit default swaps (CDSs) would generally be viewed as reducing the risk of the underlying pool of financial instruments, provided that the derivative pays out only to compensate loss of principal and interest. However, in practice,

many SPE structures contain written rather than purchased CDSs, which will not be viewed as reducing the credit risk of the underlying pool. Also see the response to Q30.

Investments in collateralised debt obligations (CDOs)

Q33: How would investments in CDOs be accounted for under IFRS 9?

Analysis

It is necessary to distinguish between cash CDOs (in which the SPE holds the underlying reference assets) and synthetic CDOs (in which the reference exposure is achieved through a derivative). Investments in cash CDOs may qualify for amortised cost measurement, as long as the underlying assets qualify for amortised cost accounting and the other requirements of IFRS 9 are met. But an investment in a synthetic CDO would not qualify, as the derivatives on the reference portfolio would not reduce the variability of the cash flows of the assets in the pool or align the cash flows in the manner permitted by IFRS 9. (See the response to Q30).

A practical point to note is that it may be difficult for the holder to perform the look-through test if all the underlying reference assets of the CDO have not been acquired at the time of the investment in the CDO. As a result, the holder will not be able to assess whether all the underlying reference assets of the CDO would qualify for measurement at amortised cost. In such circumstances, we believe that the holder will need to consider amongst other things, the intended objectives of the CDO as well as the investment mandate of the CDO's manager before determining whether the investment qualifies for measurement at amortised cost.



Seizure of a CDO's collateral and its effect on a tranche's classification

Q34: How would the seizure of collateral (in the circumstances described below) affect the classification of an investment in a tranche of a CDO that would otherwise be eligible for measurement at amortised cost?

Additional information

The underlying pool of instruments of a CDO may contain only assets eligible for measurement at amortised cost, but could then change to include property or equity securities when collateral is seized following default by the underlying borrower of an asset in the CDO. The seizure of the collateral may result in derecognition of the original secured asset and recognition of the property/equity security as a new asset by the issuer of the CDO. The property/equity security may then be sold at the discretion of the CDO's investment manager. (Note that paragraph B4.1.26 of the standard explicitly states that if the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the contractually linked instruments test, then the tranche shall be measured at FVTPL).

Analysis

It depends. We do not believe that paragraph B4.1.26 of the standard was intended to capture assets obtained as a result of an event of default, which could arguably be considered an enforcement of the terms of the original instrument rather than a change to the underlying pool of instruments. The individual facts and circumstances would need to be evaluated and consideration given to the following factors amongst others:

- Whether at the inception of the CDO, the foreclosure of such collateral on any individual asset was expected to have a low probability

And

- Whether the terms of the CDO require the investment manager to sell the property/equity security within a reasonably short time frame

We believe that, if the above factors are satisfied, then the investment in the CDO could be measured at amortised cost. However, note that these factors are not meant to be exhaustive and, in other fact patterns, there may be additional factors that would need to be considered before concluding.

Single tranche CDOs

Q35: Would an investment in a single tranche CDO qualify for amortised cost?

Analysis

The contractually linked instrument test refers to "multiple contractually linked instruments that create concentrations of credit risk (tranches)". Also, the Basis for Conclusions refers to classic waterfall structures with different tranches, rather than a single tranche structure. Hence, an investment in a single tranche

securitisation would not be assessed under this test. However, the non-recourse provisions of IFRS 9 probably apply in such cases, and it will be necessary to look through to the underlying assets to determine whether the cash flows on the tranche relate only to payments of principal and interest that represent compensation only for the time value of money and credit risk.



Two tranche CDOs

Q36: Would an investment in a two-tranche structure (i.e., with one tranche of equity and one tranche of debt) fall within the scope of the multiple 'contractually linked instruments' provisions?

Analysis

Although the term 'multiple' could be interpreted to mean 'more than one', we believe that a structure with two tranches is not normally within the scope of the 'multiple contractually linked instruments' provisions. These provisions are designed to deal with tranches that both receive and provide credit protection and, for this to be the case, there needs to be at least three tranches. A two-tranche structure has only equity and debt components,

in which case, the assessment of whether the debt component can be recorded at amortised cost is dependent on factors such as the size of the equity component and, hence, whether the return on the senior tranche is, in substance, that of consideration for the time value of money and credit risk, or else is a participation in the performance of the underlying assets. Therefore, in a two-tranche structure, the guidance on non-recourse assets would be more relevant and would often result in a different conclusion from applying the 'contractually linked instruments' provisions.



Reclassifications

When and only when an entity changes its business model for managing its financial assets, it is required to reclassify all affected financial assets to reflect the revised business model.

Such changes are expected to be infrequent. Reclassification is prohibited in all other circumstances.

The application guidance provides examples of circumstances when a reclassification is required or is not permitted (see Table 5 below).

Table 5: Examples of a change in business model allowing reclassification

- ▶ An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows
- ▶ A financial services firm decides to shut down its retail mortgage business and is no longer accepting new business. The firm actively markets its mortgage loan portfolio for sale

Examples of NO change in business model, thus no reclassification

- ▶ A change in intention related to specific financial assets (even in circumstances of significant changes in market conditions)
- ▶ A temporary disappearance of a particular market for financial assets
- ▶ A transfer of financial assets between existing business models within the entity

The date for recording classifications

Q37: An entity changes its business model during the year, and is required to reclassify all affected financial assets. When is the reclassification recorded?

Analysis

A change in the entity's business model must be accounted for prospectively from the *reclassification date*, which is defined in the standard as 'the first day of the first reporting period following the change in business model'.

For example, an entity with a reporting year-end of 31 December might determine that there is a change in its business model in

August. If the entity prepares and publishes quarterly reports under IFRS, it should apply the old classification up to 30 September and, as of 1 October, reclassify all affected financial assets and apply the new classification prospectively from that date. However, if the entity only prepares annual accounts, the entity is required to reclassify all affected financial assets and apply the new classification as of 1 January of the following year.

Changes in a financial asset's characteristics

Q38: Is reclassification permitted or required when the characteristics of a financial asset change e.g., when the conversion option of a convertible bond lapses? Does the answer differ if the convertible bond is converted into shares of the issuer?

Analysis

Reclassifications are neither permitted nor required when the characteristics of a financial asset vary over the asset's life based on its original contractual terms. Unlike a change in the business model, the contractual terms of a financial asset are known at initial recognition and an entity classifies the financial asset at initial recognition based on the contractual terms over the life of the

instrument (BC4.117 of IFRS 9). Thus, no reclassification is permitted or required when, for instance, the conversion option of a convertible bond lapses. If, however, a convertible bond is converted into shares, the shares represent a new financial asset to be recognised by the entity. The entity would then need to determine the classification category for the new equity investment.



Equity investments

All financial assets that are equity investments within the scope of IFRS 9 are required to be measured at fair value either through Other Comprehensive Income (OCI) or profit or loss. This is an irrevocable choice the entity makes by instrument unless the equity investments are held for trading, in which case, they *must* be measured at FVTPL. When an equity instrument is measured

at fair value through OCI, dividends are recognised in profit or loss unless the dividend clearly represents a recovery of part of the cost of the investment. Amounts presented in OCI (such as other changes in fair value, and gains or losses realised on sale of assets) are not recycled to profit or loss.

Definition of an equity instrument

Q39: How does an entity determine whether a financial asset qualifies as an equity instrument under IFRS 9?

Analysis

Appendix A of IFRS 9 indicates that the definition of 'equity instrument' for the purpose of applying IFRS 9 is that contained in IAS 32 *Financial Instruments: Presentation* (IAS 32). IAS 32

defines an equity instrument as a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Consequently, any instrument that requires settlement in cash would not meet the definition.

Classification of puttable instruments

Q40: Are puttable instruments that are classified as equity instruments by the issuer under the IAS 32 exception eligible for classification as at fair value through OCI by the holder?

Analysis

No, certain puttable instruments are *classified* as equity instruments by the issuer in accordance with IAS 32, but they do meet the **definition** of an equity instrument under IAS 32. Therefore, these are not eligible for classification in the fair value through OCI category by the holder.

Appendix A of IFRS 9 refers to the definition of 'equity instrument' as defined in IAS 32. That definition excludes puttable instruments, since they meet the definition of financial liabilities. Whilst the amendments to IAS 32 regarding puttables permit, as an exception to the normal rules, certain puttable instruments to be classified as equity by the issuer, they do not change the definition of equity.

Classification of callable, perpetual instruments

Q41: Can a callable, perpetual 'Tier 1' debt instrument be classified at fair value through OCI by the holder?

Analysis

Yes, if it meets the definition of 'equity instrument' from the perspective of the issuer.

Consider the example where entity A invests in a callable, perpetual Tier 1 debt instrument, which is essentially a subordinated perpetual liability and is redeemable at the option of the issuer (entity B). The instrument carries a fixed coupon that is deferred if entity B does not pay a dividend to its ordinary shareholders. If a coupon is not paid it will not accrue additional

interest. The instrument does not have a maturity date, however, the coupon steps up to a higher level 20 years after issue and entity B has the right to purchase the instrument after that date for its nominal amount and any unpaid interest. Under IFRS 9, such an instrument would not be eligible for amortised cost accounting by the holder. However, given that Entity B does not have a contractual obligation to pay cash, the instrument will qualify for classification at fair value through OCI, as it meets the definition of equity from the perspective of the issuer in accordance with IAS 32.



Equity derivatives

Q42: Are equity derivatives (such as warrants or options) that meet the definition of equity from the issuer's perspective eligible to be measured at fair value through OCI by the holder?

Analysis

No. Equity instruments that are held for trading are not eligible to be measured at fair value through OCI under IFRS 9. 'Held for trading' is defined in Appendix A of IFRS 9 and that definition is identical to the definition in IAS 39. Since all derivatives are

required to be treated as held for trading, equity derivatives should be considered as trading assets and thus are not eligible for measurement at fair value through OCI under IFRS 9.

IFRS 7 disclosures for fair value through OCI items

Q43: The consequential amendment to IFRS 7 requires disclosure of the fair value at the reporting date of *each* designated investment in equity instruments measured at fair value through OCI. Do entities really need to disclose this for each individual instrument?

Analysis

Yes, the standard is specific that this is required for each such investment. Paragraph 11A, (a) – (c) of IFRS 7 *Financial Instruments: Disclosures* states:

If an entity has designated investments in equity instruments to be measured at fair value through OCI, as permitted by paragraph 5.7.5 of IFRS 9, it shall disclose:

- (a) The investments in equity instruments that have been designated to be measured at fair value through OCI
- (b) The reasons for using this presentation alternative
- (c) The fair value of each such investment at the end of the reporting period (*emphasis added*)

The disclosure requirement will be onerous if an entity makes significant use of the fair value through OCI option and may act as a disincentive for its use, so entities will need to be careful when making the choices available within the standard. A further question is whether it is necessary to provide disclosures at length if each individual instrument is immaterial. We believe that the concept of materiality will need to be applied such that the disclosures required are provided separately for investments that are themselves material and aggregated disclosures may suffice for immaterial items.



Effective date and transition

IFRS 9 must be applied for annual periods beginning on or after 1 January 2013. However, it is possible that the mandatory effective date for IFRS 9 may be deferred to 1 January 2015, in response to constituent feedback during the IASB's recently concluded Effective Dates project.

Earlier application of the standard is permitted and the comparatives need not be restated if the standard is applied for reporting periods beginning before 1 January 2012.

The standard's date of initial application

Q44: What is the date of initial application for the purpose of applying the standard?

Analysis

IFRS 9 is required to be applied retrospectively to those items still held on the date of initial application. Therefore, items derecognised prior to the date of initial application will be accounted for under IAS 39 (Refer to paragraph 7.2.1 of IFRS 9).

However, the assessment of whether instruments are to be measured at amortised cost or at fair value needs to be made based on the business model as at the date of initial application, which will depend on the facts and circumstances existing as at that date. If IFRS 9 is adopted in 2011 or 2012, the date of initial

application will be the first day of the reporting period in which it is adopted. For an entity that publishes quarterly financial statements that comply with IAS 34 *Interim Financial Statements* (IAS 34), we consider reporting period to include interim periods and not necessarily annual reporting periods. Hence, such an entity could designate the start of any quarterly period as its date of initial application.

However, for entities that do not adopt IFRS 9 early, the date of initial application will be the start of the *annual* period beginning on or after 1 January 2013.

Impact of early adopting and not restating comparatives on the annual financial statements

Q45: An entity with a financial year ending on 31 December 2011 decides during 2011 to adopt IFRS 9 with an initial application date of 1 October 2011. If the entity elects not to restate comparative information, what is the effect on its 2011 financial statements?

Analysis

The assessment of whether instruments are to be measured at amortised cost or fair value will need to be made for financial assets recorded on the entity's balance sheet, depending on the business model as at the date of initial application (i.e., 1 October 2011), based on facts and circumstances existing as at that date. After the assessment is made at the date of initial application, the entity is required to apply the classification under IFRS 9 retrospectively. The difference between the previous carrying amounts and the revised carrying amounts of those assets will be recognised in equity, as at the beginning of the annual reporting period (1 January 2011 in this example, assuming the entity is preparing annual financial statements). (Refer to paragraph 7.2.14 of IFRS 9)

If the entity does not restate comparative figures, the comparative figures for 2010 would remain as previously reported. Consequently, the previous classification categories under IAS 39 (held-to-maturity, available-for-sale, etc.) will need to be presented as the prior year numbers in the 2011 balance sheet.

Note also that there would be no adjustment to the 2011 results for financial instruments derecognised during the first three quarters of the year. This could be confusing and may require explanation. We would encourage entities to apply IFRS 9 at the beginning of the annual reporting period rather than an interim reporting period.



Interaction of IFRS 9 with the IAS 39 *Reclassification* Amendments of October 2008

Q46: How does IFRS 9 interact with the *Reclassification* Amendments of October 2008?

Analysis

The amendments to IAS 39 in October 2008 allowed reclassification of certain financial assets from FVTPL to AFS or amortised cost. If an entity made a reclassification to amortised cost in accordance with the amendments, the fair values of the financial assets at the date of the reclassification would have become the new amortised cost of the assets as of that date.

The transitional provisions of IFRS 9 require an entity to apply IFRS 9 retrospectively with a few exceptions. When an entity adopts IFRS 9 and elects to measure the previously reclassified financial assets at amortised cost (assuming all the relevant conditions of IFRS 9 are met), how should the retrospective application be made? Should the effective interest method and the impairment requirements be based on: (i) the original cost of the financial assets at initial recognition; or (ii) the new cost at the date of the reclassification in accordance with IAS 39?

In our view, upon initial application of IFRS 9, an entity is required to apply the effective interest method and the impairment requirements of IAS 39 retrospectively, based on the original cost of such financial assets at initial recognition. Only if it is impracticable (as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) to apply the effective interest method or the impairment requirements of IAS 39 retrospectively, should the entity treat the fair value of a financial asset at the end of each comparative period as its amortised cost. In those circumstances, the fair value of the financial asset at the date of initial application of IFRS 9 should be treated as its new amortised cost.

Business model for loans that are to be held for the foreseeable future

Q47: At the date of transition to IFRS 9, can a portfolio of loans that a bank intends to sell as soon as possible, but is unable to do so due to illiquidity in the market, be considered to be held within a business model whose objective is to hold assets to collect their contractual cash flows? Under IAS 39, the bank had taken advantage of the *Reclassification* Amendments of October 2008 to reclassify this portfolio to loans and receivables given that it had the intention and ability to hold the assets for the 'foreseeable future.'

Analysis

Probably not. Given management's intention to sell the assets as soon as possible, the presumption would be that the portfolio should be held within a FVTPL business model. The fact that the bank may have to hold the portfolio for the foreseeable future due

to the market's illiquidity is not sufficient for the IFRS 9 business model assessment. The standard is clear that the entity's objective should be to hold the assets to collect the contractual cash flows if it intends to use an amortised cost business model.



Business model for financial assets that are held for sale

Q48: At the date of transition to IFRS 9, how should we assess the business model of a portfolio of loans that is part of a business that a bank has decided to dispose of?

Additional information

An international bank has a variety of businesses that are managed separately. Some of these businesses entail holding portfolios of financial assets in order to collect their contractual cash flows. Before IFRS 9's date of initial application, the bank makes a strategic decision to dispose of its auto finance business, which holds loans to collect their contractual cash flows.

Additional facts include:

- ▶ The bank is disposing of the entire auto finance business, including personnel, IT systems and buildings, and not merely a portfolio of loans

And

- ▶ The auto finance loans met the IFRS 9 characteristics test on initial recognition of the assets

Analysis

There is no 'right' answer in respect of these facts and circumstances. Arguments can be articulated to justify either continued measurement at amortised cost or FVTPL treatment.

Proponents of amortised cost would argue that at the date of initial application, even though the bank intends to sell the business at some point in the future, the loans are still held within a business model whose objective is to hold them to collect their contractual cash flows. That objective continues regardless of whether the bank intends to sell the business or is able to. In addition, some of the loans may be fully collected even before the business is sold. Therefore, based on facts and circumstances at the date of initial application, the loans are considered to be held within a business model whose objective is to hold them to collect their contractual cash flows.

On the other hand, proponents of FVTPL treatment would argue that on the date of initial application, the expectation is that the bank will dispose the loans rather than hold them to collect their contractual cash flows. Therefore, from the bank's perspective, the loans are no longer held within a business model whose objective is to hold to collect.

Due to the mixed views and the fact that this is a prevailing issue in the marketplace as a result of regulator and government initiatives to require banks to dispose of non-core business activities or selected businesses due to concerns around the lack of competition, this is one area where further guidance from the IASB or IFRS Interpretations Committee would be welcomed by constituents.

In our opinion, two views are possible for this issue only when transitioning to IFRS 9. If the decision to dispose the business is made subsequent to the adoption of IFRS 9, it is unlikely that the financial assets would need to be reclassified from amortised cost to FVTPL as the threshold for triggering the reclassification requirements in the standard is reasonably high. For example, paragraph B4.4.1 (b) of IFRS 9 states that a financial services firm that decides to shut down its retail mortgage business must be *actively marketing* the portfolio for sale for the assets to be reclassified from amortised cost to FVTPL.



Impact on comparatives for financial assets derecognised prior to the date of initial application

Q49: If an entity adopts IFRS 9 on 1 January 2013 and has AFS financial assets as at 1 January 2012 that are sold during 2012, how will the entity present its comparative information in respect of the assets in its 2013 financial statements?

Analysis

For the purpose of adopting IFRS 9, the entity's date of initial application will be 1 January 2013. However, IFRS 9 is only applied retrospectively to those investments still held on the date of initial application, while investments derecognised prior to the date of initial application will be accounted for under IAS 39 (refer to paragraph 7.2.1 of IFRS 9). As the entity is adopting IFRS 9 after 1 January 2012, it will be required to restate comparatives.

Given that the AFS assets were sold during 2012 and IFRS 9 only applies to investments still held on 1 January 2013, the comparative information will be as follows:

Year ending 31 December 2012

No balance will be disclosed in the balance sheet as at 31 December 2012 as the asset was sold during the year. The gain/loss arising from the disposal will be calculated on an IAS 39 basis and recognised in profit or loss.

Year Ending 31 December 2011

The asset would be disclosed as AFS in the balance sheet as at 31 December 2011 and the entity will not be permitted to restate its comparatives using IFRS 9 as the asset was sold in 2012 before the date of initial application. The fair value movements in the asset during the year ending 31 December 2011 will be recognised outside profit or loss in OCI, as required by IAS 39 for AFS assets.

Assessment date for the contractually linked instruments test

Q50: For the purpose of applying the contractually linked instruments test, as at what date should the relative risks of the tranche held and the underlying assets be measured?

Analysis

Paragraph 3.1.1 requires the classification to be made when the entity becomes party to the contractual provisions of the instrument. The look-through assessment should be performed as at the date that the entity (i.e., the investor) initially recognised the contractually linked instrument. It is inappropriate to make the risk assessment based on the circumstances existing either at the date that the SPE was

first established or the date of initial application of IFRS 9. The transition guidance in paragraph 7.2.4 of IFRS 9 provides that an entity should assess the business model based on the facts and circumstances that exist at the date of initial application, and that the resulting classification should be applied retrospectively. However, this transition relief is not extended to the assessment of the characteristics of the financial asset.



Effective date and transition for first-time adopters of IFRS

Q51: How does IFRS 9 affect first-time adopters?

Analysis

Entities that adopt IFRS in 2011, and choose to adopt IFRS 9 simultaneously, will have broadly the same exemptions and transition relief that are available to existing IFRS preparers. Accordingly, entities adopting IFRS before 1 January 2012 need not adjust comparative information for financial assets to comply with IFRS 9 (but may, instead, present information using their previous GAAP). In addition, the date of initial application of IFRS 9 will be the beginning of the first IFRS reporting period, if entities adopt IFRS (including IFRS 9) for the first time before 1 January 2012, rather than the beginning of the comparative period as generally required by IFRS 1. Entities that adopt IFRS on or after 1 January 2012 will have to present comparative information that complies with IFRS 9 and determine the classification of financial instruments based on circumstances at the date of transition, i.e., the beginning of the comparative period.

A point to note is that while existing IFRS reporters are required to perform the 'characteristics of the financial asset' test on the date of initial recognition of the financial asset, a first time adopter has to carry out that assessment based on facts and circumstances that exist on the date of transition to IFRS (for entities adopting IFRS on or after 1 January 2012) or at the beginning of the first IFRS reporting period (for entities adopting IFRS in 2011).

Q52: In respect of Q50, would the answer differ for a first-time adopter?

Analysis

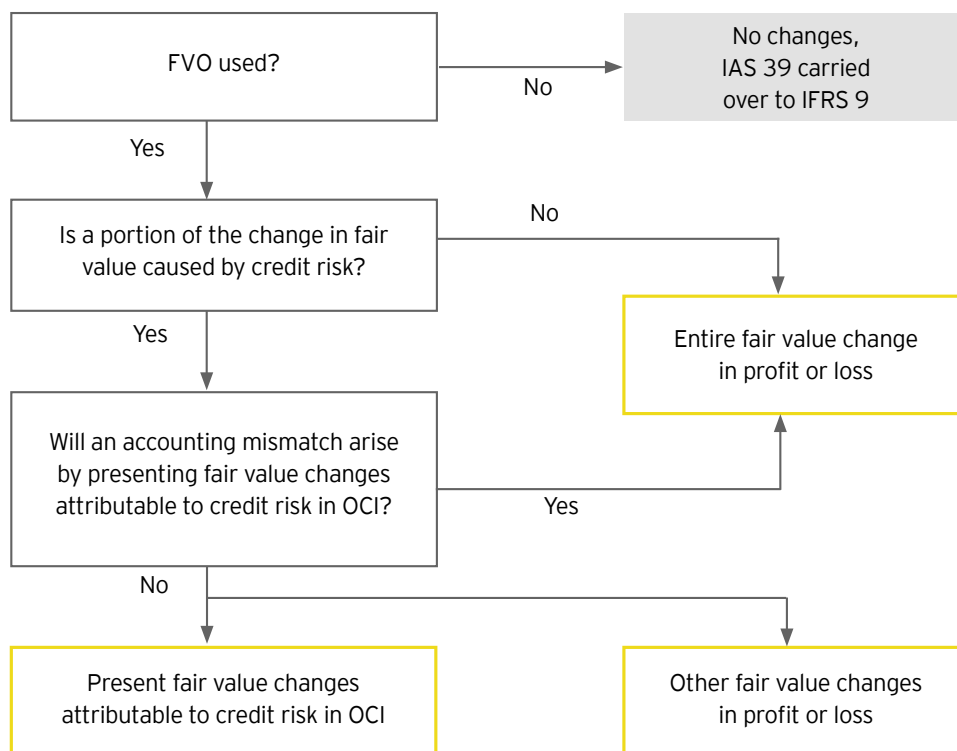
Yes. For first time adopters, the assessment of an asset's characteristics has to be carried out based on facts and circumstances that exist on the date of transition to IFRS (See IFRS 1 *First Time Adoption of International Financial Reporting Standards*, Appendix B8).

As a result, securitised assets of first time adopters are more likely not to meet the contractually linked instruments test (given the financial crisis) as the risks of intermediate tranches would most likely be assessed to be higher on the date of transition to IFRS than on the date of initial recognition of the investment.



Financial liabilities

The amendments to IFRS 9 in respect of financial liabilities is limited to the measurement of FVO liabilities while all other IAS 39 requirements in respect of liabilities have been carried forward into IFRS 9, including the criteria for using the FVO for financial liabilities. The impact of the amendments is summarised in the flow chart below:



The Board's decision to largely retain the requirements of IAS 39 means that, while the complex embedded derivative rules are retained for liabilities, they are no longer applicable to assets under IFRS 9.

The changes for FVO liabilities

The amount of change in the fair value of a liability that is attributable to changes in credit risk must be presented in other comprehensive income (OCI). The remainder of the change in fair value is presented in profit or loss, unless presentation of the fair value change in respect of the liability's credit risk in OCI would create or enlarge an accounting mismatch in profit or loss. To determine whether the treatment would create or enlarge an accounting mismatch, the entity must assess whether it expects the effect of the change in the liability's credit risk will be offset in profit or loss by a change in fair value of another financial instrument, such as where the fair value of an asset is linked to the fair value of the liability. If such a mismatch does arise, an entity will be required to present all fair value changes of the liability in profit or loss. In practice, we would expect such instances to be rare. The determination of whether there will be a mismatch will need to be made at initial recognition of individual liabilities and will not be re-assessed.

Measurement of a liability's credit risk

The amendments carry over the existing guidance (in IFRS 7) on how to measure the change in the fair value of a liability as a result of a change in the liability's credit risk, but with one clarification. The default method in the guidance suggests that any changes in fair value other than changes in market risk factors, such as a benchmark interest rate, are attributable to the credit risk of the liability. It has been clarified that this would include any liquidity premium associated with the liability. Other methods are also acceptable if they provide a more faithful representation of the changes in the fair value of the liability attributable to the changes in its credit risk.

Asset-specific performance risk

In addition, the amendments clarify that credit risk as defined in IFRS 7 is different from asset-specific performance risk. Credit risk is the risk that an entity will fail to discharge a particular obligation. Asset-specific performance risk is the risk that an asset or assets will perform poorly, with a direct impact on the performance of the related liability due to a contractual relationship between the assets and liabilities. For example, in an SPE, amounts due to the SPE's investors may be restricted to the cash flows generated by the SPE's underlying assets. The assets of the SPE are legally isolated and ring-fenced for the benefit of the investors. In these circumstances, the entire movement in the fair value of the liability is deemed to reflect the asset performance and there is no credit risk. Consequently, the entire change in the fair value of the liability is taken to profit or loss.

As a result of the clarification that credit risk is not the same as asset specific performance risk, the IFRS 7 disclosure by some financial institutions in respect of the effect of changes in own credit risk on the fair values of liabilities designated using the FVO may need to change. This might be the case especially where financial institutions consolidate SPEs and do not guarantee the performance of the issued notes.

Recycling

The amendments prohibit any recycling through profit or loss of amounts previously recognised in OCI upon derecognition of the liability. Instead, these amounts would be transferred to retained earnings upon derecognition. This is similar to the treatment of fair value changes on equity investments designated as fair value through OCI.



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