INTRODUCTION

The Mazars Insight series on IFRS aim at helping preparers, users and auditors of financial statements develop their theoretical and practical understanding of IFRSs. Our objective is to provide our readers, whether beginners or experts, with useful tools which provide clarity and insight on the challenging issues that may be encountered when applying IFRSs. Concepts are explained in a pedagogical way and illustrated by numerous practical examples.

This IFRS Insight addresses the accounting for financial instruments under IFRS. It draws on several relevant IFRS standards to tackle, in one manual, the entire range of challenges related to financial instruments among which: recognition and derecognition, classification and measurement, impairment for credit risk, derivatives and hedging, and related disclosures. It includes all the new requirements introduced by IFRS 9 and the related amendments to other standards such as IFRS 7.

After a two-pager providing an overview of IFRS requirements for financial instruments in 10 key points, a table of content shows the list of chapters. Each chapter starts with a detailed table of content to direct readers straight to the topic they are searching for. Many cross references have been inserted for improved reading experience. We draw specific attention to chapter 2 which comprises the definitions and the list of abbreviations and acronyms used in this manual.

Our special thanks are addressed to the international team of authors who contributed to this manual: Egle Mockaityte, Florence Michel, Heike Hartenberger, Mohamed Taghia and Nicolas Millot. Additional thanks go to Isabelle Grauer-Gaynor, Marie Fossat and Marion Platevoet for their precious help in finalising this publication.

Vincent Guillard
IFRS Lead Partner for Financial Instruments
10 KEY POINTS TO REMEMBER

1. Scope
The accounting treatment of financial instruments under IFRS is defined by several standards. IFRS 9 – Financial Instruments provides requirements for recognition and derecognition, classification, measurement (including impairment) and hedge accounting. IAS 32 – Financial Instruments: Presentation provides principles for distinguishing issued debt and equity instruments as well as requirements for offsetting financial assets and financial liabilities. IFRS 7 – Financial Instruments: Disclosures deals with most of the disclosure requirements, and IFRS 13 – Fair Value Measurement provides guidance on fair value measurement and related disclosure requirements. Each of these standards has specific scope exclusions, even for items that meet the definition of financial instruments. (see chapter 1)

2. Initial recognition
All financial instruments are initially recognised when the entity becomes party to the contract. Financial assets or liabilities are initially measured at their fair value plus or minus transaction costs, except financial instruments classified at FV-PL for which transaction costs are directly expensed into profit or loss. However, trade receivables are initially measured at their transaction price if they do not contain a significant financing component in accordance with IFRS 15. When the transaction price differs from the initial fair value of that financial instrument, a so called “day one gain or loss” may need to be recognised upon initial recognition in profit or loss. (see chapter 6)

3. Classification of financial assets
Financial assets whose contractual cash flows are Solely Payments of Principal and Interest (the SPPI test) will be classified in accordance with the entity’s business model for managing the asset: Amortised Cost if they are subject to a Hold-To-Collect business model, FV-OCI if they are held within a Hold-To-Collect-and-Sell business model, or FV-PL in any other situation. Financial assets that do not pass the SPPI test (e.g. derivatives and equity instruments) must be classified in the FV-PL category, except for some equity instruments which the entity may irrevocably classify in FV-OCINR.

Subsequent reclassifications are limited to SPPI financial assets, upon a change in the entity’s business model and are thus expected to be very infrequent.

Subject to specific conditions (e.g. when a situation of an accounting mismatch would otherwise arise), an entity may irrevocably classify any financial asset as measured at FV-PL upon initial recognition. (see chapter 7)

4. Impairment for expected credit losses
Entities must recognise an allowance for expected credit losses for all financial assets classified in the Amortised Cost or FV-OCI category, as well as for most loan commitments and financial guarantees issued. Upon initial recognition of the instrument, the loss allowance is equal to the credit losses that the entity expects as a result from default events occurring within the next 12 months (12MECL). This amount is updated at each reporting date. When a Significant Increase in the Credit Risk (SICR) of the asset is identified, the loss allowance must be measured at an amount equal to the credit losses that the entity expects to occur over the full remaining life of the asset (LTECL).

Purchased or originated credit-impaired (POCI) assets (i.e. assets with existing incurred credit losses upon initial recognition) follow a separate impairment and revenue recognition model.
A simplified expected credit loss impairment approach is mandatory for short term trade receivables and contract assets, and optional for other trade receivables and contract assets, and lease receivables. (see chapter 9).

5. Classification of financial liabilities
Most financial liabilities are classified in the Amortised Cost category unless they are held for trading, or meet the conditions for a voluntarily classification in the FV-PL category upon their initial recognition. (see chapter 8)

6. Debt vs. Equity
Financial instruments issued that are in the scope of IAS 32 must be analysed to determine whether they meet the definition of an equity instrument or that of a financial liability. An instrument is generally classified as a financial liability if it requires the entity either to deliver cash or another financial asset, or to deliver a variable number of its own equity instruments. A derivative may qualify as an equity instrument if it will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of own equity instruments. Compound instruments contain both a liability and an equity component which must be accounted for separately.

7. Embedded derivatives
Derivative instruments may be either stand-alone contracts, or a feature embedded in a financial liability host contract or a non-financial host contract. Embedded derivatives must be bifurcated and accounted for separately as a stand-alone derivative if they are not economically closely related to their host contract. (see chapter 13)

8. Hedge accounting
Under IAS 39 and IFRS 9, most derivatives are by default measured at FV-PL whereas non-derivative financial assets and financial liabilities are often measured at amortised cost or FV-OCI. This situation may trigger accounting mismatches in profit or loss despite a proper economic offset between the hedging derivative and the hedged exposure. To better reflect the hedging strategy of the entity, IFRS 9 provides specific and optional accounting treatments for hedging relationships. The accounting impact depends on the nature of the hedging relationship (fair value hedge, cash flow hedge or net investment hedge). Hedge accounting is subject to eligibility, effectiveness and documentation -related conditions. (see chapter 14)

9. Derecognition
A financial asset is derecognised when and only when the contractual rights to the cash flows expire, or when the asset is transferred and this transfer meets the derecognition requirements. This test relies mainly on two criteria: the transfer of the contractual rights to the cash flows, and the transfer of the risks and rewards of ownership of the financial asset.

A financial liability is removed from the statement of financial position when it is extinguished. An exchange or modification of debt instruments, between an existing lender and borrower, is considered as an extinguishment of the original instrument if the terms of the original and the “new” instrument are substantially different.

10. Disclosures on financial instruments
The disclosure requirements aim at enabling the users to assess the significance of financial instruments for the entity, the nature and extent of risks arising from them, and how the entity manages those risks. (see chapter 16)
MAZARS INSIGHTS ON FINANCIAL INSTRUMENTS

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CHAPTER 2
DEFINITIONS, ACRONYMS AND ABBREVIATIONS USED
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2.1. Definitions

The following definitions are extracted from standards IFRS 9, IAS 32, IFRS 7 or IFRS 13:

2.1.1. General definitions

Financial instrument (IAS 32.11) Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Equity instrument (IAS 32.11) Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Financial asset (IAS 32.11) Any asset that is:
— cash;
— an equity instrument of another entity;
— a contractual right:
  > to receive cash or another financial asset from another entity; or
  > to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
— a contract that will or may be settled in the entity’s own equity instruments and is:
  > a non-derivative for which the entity is or may be obliged to receive a variable number of the entity’s own equity instruments; or
  > a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose the entity’s own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B of IAS 32, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D of IAS 32, or instruments that are contracts for the future receipt or delivery of the entity’s own equity instruments.
**Financial liability**  
(*IAS 32.11*)

Any liability that is:

— a contractual obligation:
  
  > to deliver cash or another financial asset to another entity; or  
  
  > to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

— a contract that will or may be settled in the entity’s own equity instruments and is:

  > a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments; or  
  
  > a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity’s own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B of IAS 32, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D of IAS 32, or instruments that are contracts for the future receipt or delivery of the entity’s own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32.

### 2.1.2. Amortised cost and effective interest rate-related definitions

**Amortised cost**  
*of a financial asset or financial liability*  
(*IFRS 9 Appendix A*)

The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance (see section 2.1.3).

**Effective interest method**  
*of a financial asset or financial liability*  
(*IFRS 9 Appendix A*)

The method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.
**Effective interest rate**  
*IFRS 9 Appendix A*  
The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses (see section 2.1.3). The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

**Credit-adjusted effective interest rate**  
*IFRS 9 Appendix A*  
The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the amortised cost of a financial asset that is a purchased or originated credit-impaired financial asset (see section 2.1.3). When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, extension, call and similar options) and expected credit losses (see section 2.1.3). The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the remaining life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

**Gross carrying amount of a financial asset**  
*IFRS 9 Appendix A*  
The amortised cost of a financial asset, before adjusting for any loss allowance (see section 2.1.3).
Modification gain or loss
(IFRS 9 Appendix A)
The amount arising from adjusting the gross carrying amount of a financial asset to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset’s original effective interest rate (or the original credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10 of IFRS 9. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the expected credit losses, unless the financial asset is a purchased or originated credit-impaired financial asset, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original credit-adjusted effective interest rate.

Transaction costs
(IFRS 9 Appendix A)
Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

2.1.3. Impairment-related definitions

Credit risk
(IFRS 7 Appendix A)
The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation

Credit risk rating grades
(IFRS 7 Appendix A)
Rating of credit risk based on the risk of a default occurring on the financial instrument.

Credit loss
(IFRS 9 Appendix A)
The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.
Credit-impaired financial asset (IFRS 9 Appendix A)

A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:

— significant financial difficulty of the issuer or the borrower;
— a breach of contract, such as a default or past due event;
— the lender(s) of the borrower, for economic or contractual reasons relating to the borrower’s financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
— it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
— the disappearance of an active market for that financial asset because of financial difficulties; or
— the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event - instead, the combined effect of several events may have caused financial assets to become credit-impaired.

Expected credit loss (IFRS 9 Appendix A)

The weighted average of credit losses with the respective risks of a default occurring as the weights.

Impairment gain or loss (IFRS 9 Appendix A)

Gains or losses that are recognised in profit or loss in accordance with paragraph 5.5.8 of IFRS 9 and that arise from applying the impairment requirements in Section 5.5 of IFRS 9.

Lifetime expected credit losses (IFRS 9 Appendix A)

The expected credit losses that result from all possible default events over the expected life of a financial instrument.

12-month expected credit losses (IFRS 9 Appendix A)

The portion of lifetime expected losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

Loss allowance (IFRS 9 Appendix A)

The allowance for expected credit losses on financial assets measured in accordance with paragraph 4.1.2 of IFRS 9, lease receivables and contract assets, the accumulated impairment amount for financial assets measured in accordance with paragraph 4.1.2A of IFRS 9 and the provision for expected credit losses on loan commitments and financial guarantee contracts.
Past due (IFRS 9 Appendix A) A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.

POCI/ Purchased or originated financial asset (IFRS 9 Appendix A) Purchased or originated financial asset(s) that are credit-impaired on initial recognition.

2.1.4. Derivatives and hedging-related definitions

Derivative (IFRS 9 Appendix A) A financial instrument or other contract within the scope of IFRS 9 with all three of the following characteristics:

— its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’).

— it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

— it is settled at a future date.

Embedded derivative (IFRS 9.4.3.1) A component of a contract that also includes a non-derivative host with the effect that some of the cash flows of the combined contract vary in a way similar to a stand-alone derivative.

Firm commitment (IFRS 9 Appendix A) A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

Forecast transaction (IFRS 9 Appendix A) An uncommitted but anticipated future transaction.

Hedge effectiveness (IAS 39.9) The degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

Hedge ratio (IFRS 9 Appendix A) The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.
### 2.1.5. Other definitions

<table>
<thead>
<tr>
<th><strong>Contract assets</strong></th>
<th>Those rights that IFRS 15 – <em>Revenue from Contracts with Customers</em> specifies are accounted for in accordance with IFRS 9 for the purposes of recognising and measuring impairment gains or losses.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Derecognition</strong></td>
<td>The removal of a previously recognised financial asset or financial liability from an entity’s statement of financial position.</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td>Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital.</td>
</tr>
<tr>
<td><strong>Entity</strong></td>
<td>In IAS 32, ‘entity’ includes individuals, partnerships, incorporated bodies, trusts and government agencies.</td>
</tr>
<tr>
<td><strong>Fair value</strong></td>
<td>The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.</td>
</tr>
<tr>
<td><strong>Financial guarantee contract</strong></td>
<td>A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.</td>
</tr>
<tr>
<td><strong>Held for trading</strong></td>
<td>A financial asset or financial liability that:</td>
</tr>
<tr>
<td></td>
<td>— is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;</td>
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<tr>
<td></td>
<td>— on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or</td>
</tr>
<tr>
<td></td>
<td>— is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).</td>
</tr>
<tr>
<td><strong>Puttable instruments</strong></td>
<td>A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.</td>
</tr>
<tr>
<td><strong>Reclassification date</strong></td>
<td>The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.</td>
</tr>
<tr>
<td><strong>Regular way purchase or sale</strong></td>
<td>A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.</td>
</tr>
</tbody>
</table>
Settlement date
(IFRS 9.B3.1.6)
The date that an asset is delivered to or by an entity.

Trade date
(IFRS 9.B3.1.5)
The date that an entity commits itself to purchase or sell an asset.

2.2. Acronyms and abbreviations used

The following acronyms and abbreviations are used in our publication with the meaning explained hereafter:

12MECL
Twelve-Months Expected Credit Losses

12M PD
Twelve-Months Probability of Default

AC
Amortised Cost

AG
Application Guidance (part of an IFRS standard)

BC
Basis for Conclusions

B/S
Balance-Sheet (statement of financial position)

CA-EIR
Credit-Adjusted Effective Interest Rate

CDS
Credit Default Swap

CFH
Cash Flow Hedge

CLI
Contractually-Linked Instruments

CMS
Constant Maturity Swap

CU
Currency Unit

CVA
Credit Valuation Adjustment

DPD
Days Past Due

DVA
Debit Valuation Adjustment

EAD
Exposure At Default

EBA
European Banking Authority

EBITDA
Earnings Before Interest, Tax, Depreciation and Amortisation

EDTF
Enhanced Disclosure Taskforce

ECL
Expected Credit Losses

EIR
Effective Interest Rate

ESMA
European Securities and Markets Authority

EURIBOR
Euro Interbank Offered Rate

FV
Fair Value

FVA
Funding Valuation Adjustment
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>FVH</td>
<td>Fair Value Hedge</td>
</tr>
<tr>
<td>FV-OCI</td>
<td>Fair Value through Other Comprehensive Income with subsequent recycling to profit or loss</td>
</tr>
<tr>
<td>FV-OCINR</td>
<td>Fair Value through Other Comprehensive without subsequent recycling to profit or loss</td>
</tr>
<tr>
<td>FV-PL</td>
<td>Fair Value through Profit or Loss</td>
</tr>
<tr>
<td>HFT</td>
<td>Held-for-Trading financial instruments</td>
</tr>
<tr>
<td>HQLA</td>
<td>High Quality Liquid Assets</td>
</tr>
<tr>
<td>HTC</td>
<td>Hold-to-Collect business model for managing financial assets</td>
</tr>
<tr>
<td>HTCS</td>
<td>Hold-to-Collect-and-Sell business model for managing financial assets</td>
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<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
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<td>IAS</td>
<td>International Accounting Standards</td>
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<tr>
<td>IE</td>
<td>Illustrative Examples</td>
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<tr>
<td>IFRIC</td>
<td>International Financial Reporting Interpretation Committee</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
</tr>
<tr>
<td>IFRS IC</td>
<td>IFRS Interpretations Committee</td>
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<tr>
<td>IG</td>
<td>Implementation Guidance</td>
</tr>
<tr>
<td>IRS</td>
<td>Interest Rate Swap</td>
</tr>
<tr>
<td>ISDA</td>
<td>International Swaps and Derivatives Association</td>
</tr>
<tr>
<td>ITG</td>
<td>IFRS Transition Resource Group for Impairment of Financial Instruments</td>
</tr>
<tr>
<td>LGD</td>
<td>Loss Given Default</td>
</tr>
<tr>
<td>LTECL</td>
<td>Lifetime Expected Credit Losses</td>
</tr>
<tr>
<td>LT PD</td>
<td>Lifetime Probability of Default</td>
</tr>
<tr>
<td>NIH</td>
<td>Net Investment Hedge</td>
</tr>
<tr>
<td>OBS</td>
<td>Off Balance-Sheet</td>
</tr>
<tr>
<td>OCI</td>
<td>Other Comprehensive Income</td>
</tr>
<tr>
<td>PD</td>
<td>Probability of Default</td>
</tr>
<tr>
<td>P&amp;L</td>
<td>Profit or Loss</td>
</tr>
<tr>
<td>POCI</td>
<td>Purchased or Originated Credit Impaired assets</td>
</tr>
<tr>
<td>SICR</td>
<td>Significant Increase in Credit Risk</td>
</tr>
<tr>
<td>SPPI</td>
<td>Solely Payments of Principal and Interest</td>
</tr>
<tr>
<td>SPE</td>
<td>Special Purpose Entity</td>
</tr>
<tr>
<td>SPV</td>
<td>Special Purpose Vehicle</td>
</tr>
</tbody>
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