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.

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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)
CHAPTER 7
CLASSIFICATION OF FINANCIAL ASSETS
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7.1. Overview

Financial assets are classified into four distinct categories that reflect their measurement method:

— financial assets measured at fair value through profit or loss (FV-PL),

— financial assets measured at fair value through other comprehensive income with subsequent recycling to profit or loss (FV-OCI),

— financial assets measured at fair value through other comprehensive income without subsequent recycling to profit or loss (FV-OCINR), and

— financial assets measured at amortised cost.

Each of these categories has its own rules for classification and measurement. The rules for classification are set out in detail in this chapter 7, separately for equity instruments such as investments in shares (see section 7.3), and debt instruments such as loans and bonds or other debt securities held (see section 7.4), whereas the measurement-related aspects are covered in chapters 3, 4 and 9. Section 7.5 deals with the reclassifications of financial assets between categories after their initial recognition.

The classification of financial assets is driven by two major criteria:

— the business model criterion, which refers to the way the cash flows of a financial asset are realised (through collection of contractual cash flows, through sales, or both); and

— the contractual cash flows characteristics criterion (also referred to as the “SPPI” / Solely Payments of Principal and Interest criterion), the aim of which is to ensure that only debt instruments that are basic lending transactions are eligible for amortised cost or FV-OCI measurement. Non-SPPI instruments are measured at FV-PL.

Irrespective of the business model under which they are managed and of their contractual cash flows characteristics, debt instruments held may be optionally designated as measured at FV-PL (subject to conditions).

Equity instruments will be measured at FV-PL as, by nature, they are non-SPPI. However, the entity has the irrevocable option to designate any equity instrument as measured at FV-OCINR upon initial recognition (noting that this option is not available for held-for-trading equity instruments).

The decision tree for the classification of financial assets can be summarised as follows:
7.2. Distinction between equity instruments and debt instruments

The contractual cash flows of equity instruments (such as ordinary shares that do not have a contractually due payment schedule) are of a different nature compared to the contractual cash flows of debt instruments (such as loans, receivables and bonds), contract of which in most cases contains a schedule with interest and principal payments which is set from the origination. As the contractual cash flows analysis is one of the key drivers of the classification of financial assets under IFRS 9, equity instruments and debt instruments will not be eligible to the same categories of financial assets. We have therefore opted to present in this chapter debt instruments separately from equity instruments.

Please note that the definition of equity instruments in IAS 32 will be used to operate this distinction:

— equity instruments (dealt with in section 7.3) are instruments that are classified fully as equity in the financial statements of the issuer in accordance with IAS 32. These instruments do not include any contractual obligation to deliver cash or another financial asset to another entity (IAS 32.16);
— other investments in financial assets will be considered as debt instruments in this chapter (including compound instruments such as bonds convertible into shares having both an equity and a financial liability component from the perspective of the issuer (IFRS 9.4.3.2)).

Stand-alone derivatives (as defined in chapter 13) do not have to undergo the decision tree above, as by definition:

— their cash flows do not meet the SPPI criterion; and
— they do not meet the definition of third party equity instrument either.
Their default classification is therefore FV-PL, unless (when specific conditions are met) they are documented as hedging instruments (please see chapter 14 for more information on hedge accounting under IFRS 9).

7.3. Classification of equity instruments

The classification of investments in equity instruments such as common shares is quite straightforward under IFRS 9. It is described below. However, should such investments confer control, joint control or significant influence over the issuer of the instrument to the entity, the starting point for accounting for them would be the standards on consolidation (i.e. IAS 28, Investments in Associates and Joint Ventures, IFRS 10, Consolidated Financial Statements and IFRS 11, Joint Arrangements) rather than the provisions of IFRS 9 described below.

Given the nature of their cash flows, equity instruments do not meet the SPPI criterion. Their default classification will therefore be at Fair Value through Profit or Loss (FV-PL). However, most equity instruments are also eligible to the Fair Value through Other Comprehensive Income Without Recycling (FV-OCINR) category.

Two situations should be distinguished: equity instruments held for trading, and other equity instruments. They are detailed below.

7.3.1. Investments in equity instruments that are held for trading

Investments in equity instruments that are held for trading (see section 7.4.2.4.1) must be classified at FV-PL and measured accordingly. They are not eligible to the FV-OCINR category (IFRS 9.5.7.5).

7.3.2. Investments in equity instruments that are not held for trading

When an entity acquires an equity instrument that is neither held for trading nor contingent consideration in a business combination to which IFRS 3 applies (IFRS 9.5.7.5, IFRS 9.B5.7.1), it may at initial recognition make an irrevocable election (IFRS 9.4.1.4) to present its subsequent changes in fair value in other comprehensive income but without the possibility to later transfer the realised gain or loss into profit or loss (FV-OCINR). An entity may make this election separately for each new equity instrument (IFRS 9.B5.7.1).

Two options are thus available at initial recognition for any equity instrument that is not held for trading, on an instrument-by-instrument basis:

— FV-PL, or
— FV-OCINR. The accounting treatment of this category is explained in chapters 9 and 12. In a nutshell, the dividends are recognised in profit or loss (as long as they do not represent a recovery of part of the cost of the investment) but the realised gains and losses are never transferred from OCI to profit or loss, even upon the sale of the asset. As a result, this category is not subject to impairment calculations.

The option for a FV-OCINR classification is available only for instruments that meet the definition of equity instruments in accordance with IAS 32 from the perspective of the issuer (see chapter 5). Therefore,
financial instruments that are presented as equity instruments in accordance with IAS 32.16A to 16D following the amendment of IAS 32 for “Puttable financial instruments and obligations arising on liquidation”, but which do not meet the definition of equity instruments of IAS 32, are not eligible to the FV-OCINR classification (IFRS 9.BC5.21).

### 7.4. Classification of debt instruments

#### 7.4.1. Main principles

Under IFRS 9, investments in debt instruments (such as loans, receivables, bonds and other debt securities) are classified into one of the following three measurement categories:

- financial assets measured at amortised cost (AC),
- financial instruments measured at fair value through profit or loss (FV-PL) or
- financial instruments measured at fair value through other comprehensive income with ulterior recycling to profit or loss (FV-OCI) (IFRS 9.5.2.1).

The following two criteria form the basis for classification amongst these three categories:

- **Criterion n° 1** (see section 7.4.2): the entity’s **business model** for managing the financial asset
  
  > This notion refers to how an entity manages its financial assets in order to generate cash flows.
  
  In other words, the entity’s business model determines whether cash flows will result from collecting contractual cash flows, from selling financial assets or both.

  > The standard defines 3 major business models, which are:

    - **Hold-to-Collect** business model (HTC): only assets held within a business model where the objective is to collect contractual cash flows may be measured at **amortised cost (AC)** subject to also meeting the contractual cash flows criterion, as described below.

    - **Hold-to-Collect-and-Sell** business model (HTCS): only assets held within a business model the objective of which is achieved by both collecting contractual cash flows and selling financial assets may be measured at **fair value through other comprehensive income with subsequent recycling to profit or loss (FV-OCI)** subject to also meeting the contractual cash flows criterion, as described below.

    - **Other** business models, such as held-for-trading: assets held within such business models are measured at **fair value through profit or loss (FV-PL)**; entities have no other classification alternative for such assets.

- **Criterion n° 2** (see section 7.4.3): the contractual cash flows characteristics of the financial asset

  > This criterion is also called the “Solely Payments of Principal and Interest”, or the SPPI, criterion.

  > Financial assets that do not meet this criterion (“non-SPPI” assets) are classified at **fair value through profit or loss (FV-PL)**.

  > Financial assets that meet the SPPI criterion (“SPPI assets”) are classified according to the business model within which they are held (see).
An entity may choose to designate any financial asset as measured at FV-PL. This option is elected on an instrument by instrument basis, upon its initial recognition, and is irrevocable. This so called “fair value option” is applicable only when such designation helps to eliminate or significantly reduce an accounting mismatch that would otherwise arise (see section 7.4.5 for more information on the fair value option).

The classification model applicable to investments in debt instruments can be summarised as follows:

**Figure 7.2**

**7.4.2. The business model assessment**

**7.4.2.1. The general principles for the business model assessment**

**7.4.2.1.1. Three main business models**

Financial assets are classified based on (a) the entity’s business model for managing its financial assets and (b) their contractual cash flows characteristics (the “Solely Payments of Principal and Interest” or “SPPI” criterion). This section describes how to assess the business model criterion, assuming the considered instruments have passed the SPPI test and the entity has not elected to classify the asset voluntarily at FV-PL to reduce an accounting mismatch (i.e. no use of the fair value option).
Business models (listed in Figure 7.2) refer to how the entity generates cash flows from the financial assets (by holding them, selling them or both). The business model is determined by key management personnel (as defined in IAS 24.9). The entity’s management approach is assessed only on the basis of scenarios that the entity’s key management personnel reasonably expects to occur, and not on the basis of so-called ‘worst case’ or ‘stress case’ scenarios (IFRS 9.B4.1.2A). Moreover, an entity’s business model is not merely a matter of assertion (IFRS 9.B4.1.2B). It is typically observable through the activities that the entity undertakes to achieve the objective of the business model.

7.4.2.1.2. Indicators and evidence to consider when assessing a business model

Assessing an entity’s business model(s) involves judgement. This assessment is not determined by a single factor or activity. Rather, the entity must consider all relevant facts and circumstances and all evidence available at the date of the assessment, including:

— how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity’s key management personnel (IFRS 9.B4.1.2B(a));

— the type of risks that affect the performance of the business model, and the way in which these risks are managed (IFRS 9.B4.1.2B(b)); and

— how managers of the business are compensated (e.g. whether the compensation is based on the fair value of the financial assets managed, on the contractual cash flows collected, or on the basis of other criteria unrelated to the financial assets managed);

— the frequency, value and timing of sales in prior periods, as well as the reasons for those sales and expectations about future sales activity (IFRS 9.B4.1.2C). However, sales in themselves do not determine the business model and therefore cannot be considered in isolation from the three indicators listed above. Instead, information about past sales and expectations about future sales provide evidence related to how the entity’s stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised.

A business model essentially based on fair value information, where the entity makes decisions based on the assets’ fair values and manages the assets to realise those fair values, is not a Hold-to-Collect or Hold-to-Collect-and-Sell business model (see sections 7.4.2.2 and 7.4.2.3). Financial assets held within such a business model are measured at fair value through profit or loss.

7.4.2.1.3. Level of aggregation at which to assess a business model and number of business models within a reporting entity

The level at which the business model is determined depends on how, and for what purpose, the entity manages its business (i.e. its management approach) (IFRS 9.B4.1.2).

An entity’s business model must not be assessed based on management’s intentions for a single financial asset. The business model should be determined at a higher level of aggregation, i.e. the level at which the entity manages a particular portfolio of financial assets (IFRS 9.B4.1.2). Portfolios can also be divided into sub-portfolios to better reflect the entity’s management approach. The same business model applies to all assets managed at this level.

An entity or group may have more than one business model simultaneously (IFRS 9.B4.1.2).
Example 7.1

An entity holds a trading portfolio of fixed-rate bonds with the objective of making a profit from short-term fluctuations in market interest rates (situation 1). In addition, it holds another portfolio of the same type of fixed-rate bonds, which are held over a longer term to generate a steady rate of interest income from the coupons and to permit the generation of additional returns from securities lending or to act as collateral for obtaining short-term liquidity (situation 2). In the first situation, the bond holdings are classified as financial assets measured at fair value through profit or loss (FV-PL) and in the second situation, as financial assets measured at amortised cost (AC) provided they meet the SPPI criterion.

Example 7.2

If an entity originates or purchases a portfolio of mortgage loans and manages some of the loans with an objective of collecting contractual cash flows (situation 1) and manages the other loans with an objective of selling them (situation 2), there is a minimum of two different business models within that entity (Hold-to-Collect for the assets under situation 1 and Held-for-Trading for the assets under situation 2). However, if the entity is unable to make a clear distinction between loans in situation 1 and loans in situation 2 but rather manages them all on a global basis, the whole portfolio is likely to meet the definition of a Held-to-collect-and-sell business model.

When determining the appropriate level of aggregation for assessing the business model of financial institutions such as banks, the following aspects should, in our opinion, be considered:

- the entity’s organisational structure;
- internal reporting systems;
- investment policies;
- management compensation systems, etc.

7.4.2.1.4. Date at which the business model is to be assessed

The classification of a financial asset (and thus the assessment of the business model criterion) takes place at the date of its initial recognition. In practice however, given the level of aggregation of the business model assessment, a newly purchased or originated asset will generally belong to the business model attached to its portfolio or sub-portfolio upon its initial recognition.

7.4.2.2. Hold-to-Collect business model

Managing SPPI financial assets under the Hold-to-Collect business model is a pre-requisite for measuring them at amortised cost.

When an entity manages its financial asset in a Hold-to-Collect business model, it aims at earning the contractual return of the asset while managing the counterparty risk of the debtor. Thus, an amortised cost measurement method allows the user to have access to the most relevant information in this context: the interest rate return determined by the effective interest rate method, and the impairment allowance representing the credit loss expected by the entity. In this business model, the fair value of the asset is not crucial to understand the financial position of the entity as it does not help to predict its future cash flows.
Managing a financial asset within a “Hold-to-collect” business model does not necessarily mean that the asset must be held to maturity. The sale of a financial asset before it reaches maturity does not, in itself, automatically result in a change of business model for that portfolio. The facts and circumstances of the transaction must be taken into account.

In determining the business model of a portfolio, it is important to consider information about the entity’s past sales and expectations about its future sales. In this situation, it is necessary to consider the frequency, value and timing of such sales, and the reasons for the sales. The context of past sales, as compared to current conditions, should also be considered (IFRS 9.B4.1.2.C). In other words, past sales can affect future classification of financial assets.

However, if there is a large volume of sales, the entity must reassess whether it is still justifiable to consider the business model for that portfolio as being Hold-to-Collect (IFRS 9.B4.1.3). This means that a detailed analysis of the business model is required when assessing sales that have taken place or that are planned in the future.

The following types of sales are consistent with a Hold-to-Collect business model, whatever their amount or frequency (‘permitted sales’):

— Sales due to an increase in the asset’s credit risk, because (a) the credit quality of financial assets is relevant to the entity’s ability to collect contractual cash flows and (b) credit risk management activities that are aimed at minimising potential credit losses due to credit deterioration are integral to such a business model (IFRS 9.B4.1.3A).
  
  > To determine whether there has been an increase in the assets’ credit risk, the entity considers reasonable and supportable information, including forward looking information.
  
  > Selling a financial asset because it no longer meets the credit criteria specified in the entity’s documented investment policy is an example of a sale that has occurred due to an increase in credit risk. The investment policy credit quality requirements may not be aligned with the concept of “significant increase in credit risk” used by IFRS 9 for the impairment staging process (i.e. depending on the investment policy, a sale can be justified based on a change in the credit risk profile even if such change would not have qualified for a transfer from Stage 1 to Stage 2 in accordance with IFRS 9.5.5.3 and 5.5.5).
  
  > The entity needs to demonstrate that the sale occurred following an increase in credit risk.

— Sales made close to the maturity of the financial assets where the proceeds from the sales approximate the collection of the remaining contractual cash flows (IFRS 9.B4.1.3B).

Furthermore, sales that occur for other reasons (such as sales to manage credit concentration risk) may also be consistent with a Hold-to-Collect business model according to IFRS 9.B4.1.3B if they are:

— infrequent (even if significant in value); or

— insignificant in value both individually and in aggregate (even if frequent).

If more than an infrequent number of sales - other than permitted sales (described) - are made out of a held-to-collect portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of

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1 It is to be noted that only sales that lead to the derecognition of the financial asset are taken into account in the business model assessment. As a result, when from a legal point of view there has been a sale but not from an accounting point of view (as is the case for most sale and repurchase (repo) transactions of securities), this sale has no impact on the business model assessment.
collecting contractual cash flows (IFRS 9.B4.1.3B). An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity’s business model.

Whether a third party imposes the requirement to sell the financial assets, or the decision to sell is at the entity’s discretion, is not relevant to this assessment (IFRS 9.B4.1.3B).

7.4.2.3. Hold-to-Collect-and-Sell business model

Managing SPPI financial assets under the Hold-to-Collect-and-Sell (HTCS) business model is a prerequisite for measuring them at **fair value through OCI (FV-OCI)**.

The objective of the business model is to both hold financial assets to collect contractual cash-flows and sell them at a given point to realise capital gains. In other words, the entity’s key management personnel have made a decision that both collecting contractual cash flows and selling financial assets are **integral** to achieving the objective of the business model (IFRS 9.B4.1.4A).

To provide all the relevant information, the Board chose to require a FV-OCI measurement method for this business model. Such measurement method provides the user with information on both the fair value of the asset on the statement of financial position, which is relevant if the instrument’s cash flows are realised through the sale of the asset, and on the amortised cost performance in profit or loss (effective interest rate and expected credit loss impairment model).

IFRS 9 does not define the HTCS business model any further (i.e. no threshold is provided for the frequency or value of sales that should occur in this business model). In practice, it will be a matter of judgement. However, it is expected that it will typically involve greater frequency and value of sales compared to the Hold-to-Collect business model (IFRS 9.B4.1.4B). This is because selling financial assets is integral to achieving the business model’s objective instead of being only incidental to it.

This business model should accommodate quite a large panel of situations as various objectives may be consistent with the Hold-to-Collect-and-Sell business model. The following business model objectives are cited as examples in IFRS 9 (IFRS 9.B4.1.4, IFRS 9.B4.1.4A and IFRS 9.B4.1.4C):

**Example 7.3**

A bank managing its everyday liquidity needs. The entity seeks to minimise the costs of managing those liquidity needs and therefore actively manages the return on the portfolio. That return consists of collecting contractual payments as well as gains and losses from the sale of financial assets. As a result, the entity holds financial assets to collect contractual cash flows and sells financial assets to reinvest in higher yielding financial assets or to better match the duration of its liabilities. In the past, this strategy has resulted in frequent sales activity and such sales have been significant in value. This activity is expected to continue in the future.

**Example 7.4**

An insurer holding financial assets to fund insurance contract liabilities. The insurer uses the proceeds from the contractual cash flows on the financial assets to settle insurance contract liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, the insurer undertakes significant buying and selling activity on a regular basis to rebalance its portfolio of assets and to meet cash flow needs as they arise.
Example 7.5

A corporate investing its excess cash (aimed to fund future capital expenditure) in assets which it will hold to collect and, when an opportunity arises, it will sell the financial assets to re-invest the proceeds in financial assets with a higher return. The manager responsible for the portfolio is remunerated based on the overall return generated by the portfolio.

7.4.2.4. Other business models

Assets that are managed within business models other than Hold-to-Collect or Hold-to-Collect-and-Sell are to be fair-valued through profit or loss (IFRS 9.B4.1.5). This is the case of Held-for-Trading (HFT) activities as well as other business model based on fair value.

7.4.2.4.1. Held-for-Trading financial assets

Held for trading financial assets are to be fair-valued through profit or loss (IFRS 9.B4.1.6).

Non-derivative financial assets are held for trading when they are:

— acquired principally for the purpose of selling them in the near term;
— or when, on initial recognition, they are 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 (IFRS 9 Appendix A Defined terms).

7.4.2.4.2. Other fair value-based business models

One business model that results in measurement at fair value through profit or loss, in addition to the held-for-trading business model described above, is one in which a portfolio of financial assets is managed and where its performance is evaluated on a fair value basis (IFRS 9.B4.1.6).

Generally, an entity manages such financial assets with the objective of realising cash flows through the sale of the assets, often evidenced through active buying and selling of financial assets. The selling / no selling decisions are generally based on the assets’ fair values.

The entity is primarily focused on fair value information and uses that information to assess the assets’ performance and to make decisions. The fair value-based information is provided internally to the entity’s key management personnel – for example, the entity’s Board of Directors and Chief Executive Officer (IFRS 9.4.2.2(b)).

Even though the entity may collect some contractual cash flows while it holds the financial assets that are managed on a fair value basis, such way of managing financial assets is not consistent with a Hold-to-Collect or a Hold-to-Collect-and-Sell business model because the collection of contractual cash flows is only incidental to achieving the business model’s objective rather than being integral to achieving it.
7.4.2.5. Illustrative examples

7.4.2.5.1. Liquidity portfolio of banks

Many banks are subject to regulations requiring them to hold liquidity buffers in order to reduce their liquidity risk, i.e. to prevent liquidity disruptions due to changing market conditions. Such buffers are also known as HQLA portfolios (high-quality liquid assets). The regulations also often impose to demonstrate on a regular basis the practical ability to generate liquidity from these financial assets (a) via sales or (b) by entering into sale and repurchase (repo) transactions.

The essential question when assessing the business model applicable to such portfolios is whether sales imposed by regulations on this portfolio prevent or not these HQLA assets from meeting the Hold-to-Collect criterion.

It is explicitly stated in IFRS 9.B.4.1.4, example 4, that in the situation where the sales imposed by the regulator would be frequent and significant in value, such a portfolio may not be measured at amortised cost because such sales are not compatible with the Hold-to-Collect business model. The fact that a sale is imposed by a regulator (rather than made at the entity’s discretion) is not relevant for the business model assessment (IFRS 9.B.4.1.3B). However, only sales that lead to the derecognition of the assets sold are to be considered in this analysis. That assertion will exclude most repo (sale and repurchase) transactions as these often do not result in the derecognition of the security being sold (see chapters 10 and 11).

In practice the business model assessment for HQLA portfolios will therefore depend how the management of the bank elected to demonstrate the liquidity of this portfolio in the past and on how it plans to proceed in the future. For example:

- if liquidity is demonstrated only via repos, the portfolio should be eligible to a Held-to-Collect qualification;
- if liquidity is demonstrated via regular «true» sales of a portion of the portfolio, this could lead to the classification of the portfolio as Held-to-Collect-and-Sell. The frequency and volumes of sales as well as the expected level of sales is to be considered.

In some situations, to appropriately depict its actual management practice, a bank may have to break down HQLA portfolios into two sub-portfolios with different business models (e.g. Hold-to-Collect and Hold-to-Collect-and-Sell sub-portfolios).

Such business models may typically have to be reassessed in the future if the regulation were to change (by, for instance, no longer permitting demonstration based on repos but requiring only “true” sales).

7.4.2.5.2. Assets subject to securitisations or factoring

For cash management and balance-sheet management purposes, some entities may decide to sell their assets to banks (e.g. corporates selling their trade receivables to a factor) or to securitisation vehicles (e.g. a bank selling loans).
The impact of such sales on the business model assessment will depend on whether the sale leads to the derecognition\(^2\) of these assets or not (i.e. on whether they remain or not on the consolidated statement of financial position of the reporting entity):

— sales that do not lead to derecognition are not to be considered as sales for the purpose of this chapter and therefore have no impact on the analysis of the business model;

— sales that lead to the derecognition of the sold financial assets are to be considered when assessing the entity’s business model for such portfolios of assets. Even when there is no past practice of such sales, any expected future factoring / securitisation that leads to a derecognition of the financial assets sold is to be analysed. The consequence may vary depending on the ability of the entity to identify precisely the assets that will be sold in the future. If those assets can be isolated then the entity will probably distinguish two separate business models and assess them separately. However, if the entity is unable to isolate the assets that are expected to be sold, the business model assessment will have to be performed at the global portfolio level, taking into account the level of expected sale.

7.4.2.6. Changes in business models

Changes in business models may give rise to reclassifications of financial assets, but they are expected to be very rare in practice.

Section 7.5 provides some examples of changes in business model and describes the consequences of different types of reclassifications resulting from changes in business models.

7.4.2.7. What if the volume and frequency of sales differ from what was expected initially?

There may be cases where the reasonable scenarios envisaged by management when determining the applicable business model do not happen as planned, without there being any change in business model as defined in the standard (i.e. there has been no internal or external change significant to the entity’s operations that is demonstrable to external parties). If cash flows are realised in a way that is different from the entity’s expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity’s financial statements (in accordance with IAS 8) as long as the entity considered all relevant information that was available at the time that it made the initial business model assessment for that portfolio (IFRS 9.B4.1.2A).

In such a scenario, all the existing assets of the portfolio should remain in their original measurement category (IFRS 9.B4.1.2A). However, the past sales level has to be taken into account in the assessment of the business model applicable to the new financial assets included in this portfolio, alongside with all other relevant information (IFRS 9.B4.1.2A).

\(^2\) The principles in chapter 3 of IFRS 9 are to be applied to determine whether these assets should be derecognised following their sale (see chapter 10).
7.4.3. The SPPI test

7.4.3.1. The general principles

7.4.3.1.1. Why the SPPI criterion is important

The contractual terms of a financial asset must give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding for it to be eligible to amortised cost measurement (IFRS 9.B4.1.2) or to FV-OCI measurement (IFRS 9.B4.1.2) consistently with the business model in which the asset is managed. This is the so called “SPPI criterion” or the “SPPI test”. Financial assets that do not pass the SPPI test are to be fair-valued through profit or loss, irrespective of the entity’s business model for managing them.

7.4.3.1.2. Date of assessment

The SPPI assessment is made upon the initial recognition of a financial asset in the balance sheet (IFRS 9.3.1.1).

Some features may trigger a different SPPI conclusion depending on the market conditions existing on the SPPI test date. Therefore, the same asset purchased at two different dates may pass the SPPI test at one point in time and fail the same test at a later date (and vice-versa).

Example 7.6

Consider the instrument with an interest rate mismatch feature dealt with in section 7.4.3.1.8, requiring performing a benchmark test. This test will rely on the current market data available at the date of assessment. If the same test is carried out some years later, if market conditions changed significantly in the meantime, the conclusion of the benchmark test might be different. The outcome of the SPPI test could therefore be different for two instruments with exactly the same interest mismatch, but acquired at different dates.

Example 7.7

Consider a 10-year instrument with a structured non-SPPI coupon during the first two years and a vanilla fixed interest rate for years 3 to 10. All other characteristics of the instrument are SPPI. The entity that originates the instrument will have to classify it as non-SPPI because of the structured coupon in years 1 and 2. On the other hand, if the same instrument had been acquired in year 3 or subsequently, the entity would have performed the SPPI test upon the initial recognition of the purchased instrument. At that date the remaining cash flows being fully SPPI, the conclusion of the SPPI test would have been different from the one that would have been performed upon origination.

Off balance sheet commitments are not subject to the SPPI test. However, if they contain embedded derivatives, these derivatives must be analysed in accordance with the provisions of IFRS 9 on embedded derivatives (see chapter 13).

The initial conclusion with regards to the SPPI assessment shall not be revised for a given financial asset, unless that asset undergoes a contractual modification which leads to its derecognition.
7.4.3.1.3. Level of aggregation at which to assess the SPPI criterion

The SPPI criterion is assessed at financial instrument level (i.e. instrument by instrument), rather than at a more aggregated level such as portfolio level at which the business models are assessed (see section 7.4.2.1.3). This is because the SPPI analysis refers to contractual cash flows which may differ significantly from one instrument to another, even when included within the same portfolio.

The SPPI analysis is made for the instrument in its entirety, i.e. it is not possible to break down one contract into several components and to have an SPPI qualification for the “vanilla” component with basic / SPPI cash flows. Therefore, a structured feature will “penalise” the entire contract, as is the case with the conversion feature in investments in convertible bonds: convertible bonds will have to be classified as non-SPPI financial assets in their entirety in investors’ financial statements.

7.4.3.1.4. Objective of the SPPI test & concept of basic lending arrangement

When assessing whether contractual cash flows are SPPI, the entity must consider whether they are consistent with the cash flows of a so-called basic lending arrangement.

In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement.

Contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form (IFRS 9.B4.1.7.A).

Some instruments, such as investments in shares, derivatives, convertible bonds or bonds redeemable in shares do not meet the SPPI criterion because of the nature of their cash flows.

Both principal and interest payments are cash flows of a financial asset and should therefore be considered when assessing the SPPI criterion. The notions of principal and interest are defined below. Even contractual cash flows that are not certain to occur are to be considered (e.g. cash flows – including any compensation for the early repayment – in the scenario where the issuer opts for the early repayment of the instrument), even when their probability of occurrence is low, as long as the clause is genuine.

It is to be noted that the following features are not to be considered in the SPPI analysis, in accordance with IFRS 9.B4.1.18:

— non-genuine contractual characteristics. A contractual cash flow characteristic is not genuine if it would affect the instrument’s cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur; or

— de minimis contractual characteristic (i.e. a feature that could have only a de minimis effect on the contractual cash flows, in each reporting period and cumulatively over the life of the instrument).
The SPPI analysis is performed:

— in the currency of the instrument (IFRS 9.B4.1.8). Thus, a debt instrument denominated in a foreign currency (which would generate volatility in the financial statements because of foreign exchange volatility in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*) may be SPPI as long as its cash flows provide only for a reimbursement of principal and interest in that currency.

— irrespective of whether the cash flows of the asset are qualified as principal and interest from a contractual point of view (IFRS 9.B4.1.15). The actual impact of a feature on the contractual cash flows of a financial asset is analysed regardless of its contractual denomination. To illustrate, cash flows indexed to the use of a particular toll road may be referred to as “interest” in the contract (where the “interest” increases as more automobiles use the road) but they do not meet the definition of interest in IFRS 9 (IFRS 9.B4.1.16).

— and irrespective of the legal form of the asset (IFRS 9.B4.1.7A): the SPPI assessment is to be conducted in the same way for loans, bonds, treasury bills, cash deposits, etc.

The credit quality of the counterparty does not, in itself, alter the outcome of the SPPI test. However, one can expect to have more complex features to analyse in a highly risky corporate loan structured in the context of a restructuring plan than in a vanilla bond issued by a sovereign.

7.4.3.1.5. Definition of principal

**Principal** is the fair value of a financial asset at the date of initial recognition (IFRS 9.4.1.3(a); IFRS 9.B4.1.7B). The principal amount is not the same as the nominal amount. The principal amount is generally equal to the amount for which the financial asset (e.g. a bond) was originally purchased.

**Example 7.8**

> Entity A buys a security with a nominal value of €2m at the time of issue for €1.98m. In this case the principal amount of the security for Entity A is €1.98m.

> At a later date Entity B buys this security from Entity A for €1.7m. This decline in the market value of the security is explained by a sharp rise in interest rates and a deterioration in the issuer’s credit rating. In this case the principal amount of the security for Entity B is €1.7m.

IFRS 9.B4.1.7B indicates that the principal amount may change over time (for example, it decreases if there are repayments of principal, or increases for a zero coupon bond for which interest payments are capitalised and only occur at the maturity of the instrument).

7.4.3.1.6. Definition of interest

**Interest** may consist only of the following components:

— consideration for the time value of money (i.e. consideration only for the passage of time) and

— for the credit risk

— that is associated with the principal amount outstanding

— in the currency in which the financial asset is denominated (IFRS 9.B4.1.8)

— during a particular period of time (IFRS 9.4.1.3(b)), as well as

— interest can also include consideration for other basic lending risks and costs, as well as a profit margin. This can include all costs associated with holding the financial asset for a particular period of time (e.g. processing charges, day-to-day administrative costs). For banks, this may also include regulatory capital requirements-related margin.

To illustrate the definition above, the following types of interest payments would be considered SPPI:

— floating interest composed of the benchmark interest index component and of a credit margin component where:
  > the benchmark rate component is consistent both with the currency of the instrument and with its fixing frequency (i.e. 3-month Euribor reset quarterly on the basis of the 3-month Euribor prevailing at the beginning of the interest period for a contract denominated in EUR), and
  > the credit margin is fixed and known from the initial recognition;
— fixed rate interest, known from the date of the initial recognition of the asset, without any uncertainty as to its amount over the life of the instrument (even if there is a predefined step-up or step-down scheduled).

In extreme economic circumstances interest can be negative. This may happen when, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). Negative interest does not prevent the asset from meeting the SPPI criterion (IFRS 9.B4.1.7A).

The fact that the instrument is originated or purchased at market conditions or not (potentially generating a day one gain or loss (see chapter 6 Recognition and initial measurement) is not taken into account in the SPPI assessment. Indeed, as the principal is the initial fair value of the instrument, any “off market” feature will be neutralised by this definition of principal. For example, if an entity is providing an interest rate free loan to a counterparty the market rate for which would be 2%, the lender will recognise initially the loan at its fair value (below its nominal amount) and potentially a day one loss. Afterwards, this loan will behave like a vanilla zero-coupon loan that is consistent with the definition of a basic lending arrangement and will thus pass the SPPI Test.

7.4.3.1.7. Examples of non-SPPI features

The SPPI criterion is not met when the contractual terms introduce, for example, exposure to changes in equity prices, commodity prices (IFRS 9.B4.1.7A), or when the contractual interest rate is leveraged (IFRS 9.B4.1.9). See section 7.4.3.4 for more examples of non-SPPI clauses.

7.4.3.1.8. Modified time value of money

In many cases the SPPI analysis will be rather straightforward, but there may be situations where entities have to apply judgement, namely when assessing whether the time value element provides consideration only for the passage of time. Judgement will be needed whenever the time value of money element is modified (IFRS 9.B4.1.9B), i.e. whenever it is inconsistent with the classical remuneration for the passage of time in a basic lending arrangement.
Examples of such modifications include **particular methods of determining interest rates for floating rate instruments**, such as resetting to an average value of the index over a given period (rather than the value of the index as observed at the beginning of the interest period), or an interest rate reset mismatch feature (whereby the tenor of the index used does not match the contractual frequency of interest fixing - e.g. Euribor 12 months that is reset quarterly instead of annually).

A modified time value of money element does not necessarily result in failing the SPPI test. Rather, the entity must assess the impact of the modification on the instrument’s cash flows qualitatively and, where necessary, quantitatively.

Such assessment is referred to as the “benchmark test”. The entity must compare

- the **undiscounted contractual cash flows** of the asset undergoing the SPPI assessment;
- with the undiscounted cash flows of the same financial asset for which the time value of money element is not modified (the “benchmark instrument”).

If this difference is significant, the SPPI criterion is not met. Otherwise (i.e. in cases where the contractual cash flows do not differ significantly from those of the benchmark instrument), the modified time-value of money element meets the SPPI criterion (IFRS 9.B4.1.9C).

This assessment is made considering the effect of the modified time value of money element in each reporting period, and cumulatively over the life of the financial instrument. (IFRS 9.B4.1.9C).

If it is clear with little or no analysis whether the contractual (undiscounted) cash flows on a financial asset could be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment (IFRS 9.B4.1.9C). When assessing this criterion, factors and scenarios that could affect future cash flows should be taken into account (IFRS 9.B4.1.9D). Only reasonably possible scenarios must be considered; an entity need not consider each and every possible scenario of future interest rate changes.

**IFRS 9 does not prescribe any precise methodology for performing the benchmark test. This analysis will therefore require judgement, in particular regarding:**

- the type of assessment – qualitative or quantitative – to be performed. In practice, a qualitative assessment will be sufficient for very small or very significant mismatches;
- the way the quantitative test is performed in practice (dollar offset comparison, statistical regression analysis...);
- the materiality threshold to be set for what is to be considered a “significant” difference between the contractual cash flows and the benchmark / “perfectly SPPI” cash flows (that would result in the modified time value of money element failing the SPPI criterion);
- the data to be used to perform this comparison.

As regards the choice of the benchmark instrument in the case of an interest rate reset mismatch, IFRS 9 indicates that the benchmark instrument shall have the same fixing frequency as the instrument undergoing assessment. For example, for a loan paying a floating rate calculated on the basis of Euribor 3 months fixed every 6 months, the benchmark instrument would be a loan where interest is calculated on the basis of Euribor 6 months fixed every 6 months (and not on Euribor 3 months fixed every 3 months).
7.4.3.1.9. Contractual terms that change the timing or amount of contractual cash flows

If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are SPPI (IFRS 9.B4.1.10).

To make this determination, the entity must assess the contractual cash flows that could arise both (a) before, and (b) after the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (i.e. the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor, it may be an indicator. For instance, it is more likely that cash flows resulting from an “exotic” trigger\(^3\) will fail the SPPI criterion than cash flows resulting from a trigger that has a direct relationship with the basic components of interest such as credit risk\(^4\). Some examples of contractual features that change the timing or amount of contractual cash flows are analysed in section 7.4.3.3, namely prepayment features (see section 7.4.3.3.2) and extension features (see section 7.4.3.3.3).

7.4.3.2. Features and / or contracts that normally pass the SPPI test

We present below some examples of contractual features or instruments that usually meet the SPPI criterion. This list is not exhaustive.

7.4.3.2.1. Trade receivables

Trade receivables are financial assets resulting from contracts that transfer goods or services to customers. These are generally simple assets, with a single cash flow at the maturity of the related invoice. They therefore generally meet the SPPI criterion.

7.4.3.2.2. Fixed rate non-callable vanilla bonds

Supposing all the cash flows of a quoted bond are known when purchasing the bond and, putting aside the counterparty credit risk, certain to occur (meaning the interest rate is fixed and there are no optional features such as early prepayment option / call, interest deferral clauses, term extension features, etc.): it is likely that their contractual cash flows will represent solely payments of principal and interest. It can be noted that in some jurisdictions most bonds bear a fixed rate of interest and are not callable.

An interest rate can be contractually fixed at different levels depending on the period considered. For example, a 10-year bond may pay a fixed interest rate of 2% for the first 3 years, and a 5% fixed interest rate for the remaining life of the bond. This will be considered as a fixed rate instrument and will not alter the outcome of the SPPI test.

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\(^3\) E.g. an interest rate that is reset to a higher rate if a specified equity index reaches a particular level.

\(^4\) E.g. an interest rate that is reset to a higher rate if the debtor fails to comply with a debt/equity covenant.
7.4.3.2.3. Floating rate instruments without mismatch features

For floating rate instruments, interest is often contractually defined as the sum of (a) a publicly observable floating rate ("the reference index") and (b) a contractually specified margin. Their SPPI analysis is more complex than that of fixed rate instruments. The following contractual features in relation to interest rate determination have to be considered:

- contract currency,
- reference index (Euribor? Libor? etc.),
- tenor of the reference index (1 month? 3 months? 12 months? other?),
- date at which reference index value is observed at the beginning of the interest rate period (pre-fixed)? At the end of the period (post fixed or "in-arrears")? Average over a predefined period?
- interest rate fixing frequency (monthly, quarterly? annual? etc.),
- interest margin, and whether it is fixed once and for all at the initial recognition of the asset, or whether it depends on any specific indicator / underlying.

An example of a perfectly SPPI floating rate would be that of a loan or a bond:

- for which the nominal amount and interest are denominated in EUR,
- indexed to Euribor 3 months,
- with a rate that is reset every three months to the current 3-month Euribor spot rate observed as of the beginning of the interest rate period,
- and where its contractual margin is fixed from the outset (e.g. 2%).

The cash flows of interest of such an instrument are SPPI as they reflect consideration for the time value of money and for the credit risk associated with the instrument. It is explicitly stated in IFRS 9.B4.1.11(a) that the consideration for credit risk may be determined at initial recognition only, and so may be fixed.

Of course, all the other contractual features (e.g. early prepayment amount, term extension options, etc.) would have to be further analysed before concluding that this loan / bond is SPPI. In many jurisdictions, floating interest is often set as described in the example above.

For less common instruments where the interest is not set as described in the example above, the floating interest rate clause may bear a modified time value of money element that could require the entity to perform a benchmark test (see examples in sections 7.4.3.3.1 and 7.4.3.4.1).

The fact that a contract’s floating-rate is floored or capped does not normally have any consequence whatsoever on the SPPI assessment, provided this cap / floor feature is “vanilla” (i.e. without any leveraged effect or other structured component). So, re-using the example above, capping the contractual reference rate at 5% whenever 3-month Euribor goes above 5% would still be compatible with the SPPI criterion. This is because such a contractual term can be viewed as simply reducing cash flow variability by setting a limit on a variable interest rate (IFRS 9.B4.1.13, example with Instrument C). A capped / floored floating rate may also be viewed as a simple combination of a floating rate (before the cap / floor is activated) and a fixed rate (after the cap / floor has been activated).
7.4.3.2.4. Inflation-linked instruments without leverage and without currency mismatch features

According to IFRS 9.B4.1.13 (example with instrument A), indexation of contractual cash flows to an inflation index (also referred to as consumer price index / CPI) is SPPI-compliant as long as:

- cash flows are indexed to the inflation rate of the currency in which the instrument is denominated (e.g. an instrument in euro indexed to the Euro zone inflation rate),
- and the inflation indexation formula is not leveraged.

This is because linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects “real” interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.

Even though the example of Instrument A in IFRS 9.B4.1.13 mentions a capital-protected instrument, we consider that an inflation-indexed instrument without capital protection (in case of deflation) is SPPI-compliant as long as the two criteria described above are met. This is because, when the inflation rate is negative, having no floor on the inflation index simply allows to set the time value of money to a current level thus reflecting “real” interest. This is consistent with the fact that a negative interest rate environment does not impact the SPPI assessment (IFRS 9.B4.1.7A).

7.4.3.2.5. Subordination features in the event of debtor’s default

In almost every lending transaction the creditor’s instrument is ranked relative to the instruments of the debtor’s other creditors. For example, a trade receivable that ranks its creditor as a general creditor is subordinated to a loan issued by the same debtor that is collateralised. In the event of the debtor’s bankruptcy, the loan holder would have priority over the claims of the general creditor in respect of the collateral but the creditor of the trade receivable would still be entitled to get unpaid principal and other amounts due.

According to IFRS 9.B4.1.19, an instrument that is subordinated to other instruments may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if:

- the debtor’s non-payment is a breach of contract, and
- the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor’s bankruptcy.

If we revert to the example of the trade receivable presented above, that specific subordination feature is SPPI as it only defines the priority of payments in the event of default but does not affect the contractual right of the general creditor to unpaid amounts.

7.4.3.2.6. Collateralised full recourse vanilla loans

Consider a full recourse loan secured by collateral. The contractual cash flows of the loan are those of a basic lending arrangement. The fact that a full recourse loan is collateralized does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding (IFRS 9.B4.1.13 Instrument D).
For non-recourse loans the analysis is more complex, see section 7.4.3.5.3.

7.4.3.3. Features that may not pass the SPPI test

Below are some examples of contractual features or instruments that may or may not pass the SPPI criterion depending on how the cash flows resulting from specific clauses are determined in the contract. This list is not exhaustive.

7.4.3.3.1. Floating rates with interest rate mismatch(es)

Section 7.4.3.2.3 provides an example of a floating rate instrument that is considered as SPPI-compliant. Its reference index is 3-month Euribor and its fixing frequency is every three months to the current 3-month spot rate observed as of the beginning of the interest rate period.

Consider now the following two instruments with interest rate mismatch features:

Example 7.9

Instrument with a **refixing mismatch**: consider an instrument similar to that analysed in the example in section 7.4.3.2.3, also indexed to a 3-month Euribor index, but with a rate which is reset annually instead of quarterly:

> such instrument includes a refixing mismatch,

> refixing mismatches are situations where the time value of money element is modified and where a benchmark test has to be performed (IFRS 9.B4.1.9B, and B4.1.13 Instrument B).

Example 7.10

Instrument with an **averaged interest rate**: consider an instrument similar to that analysed in the example in section 7.4.3.2.3, also indexed to a 3-month Euribor index, but where the rate depends on an average of 3-month Euribor rates observed over a 3-month period preceding the reset date, instead of being fixed on the basis of the 3-month Euribor spot rate at the beginning of the interest rate period:

> this is another example of a modified time value of money element (IFRS 9.B4.1.9B) that would require a benchmark test assessment.

Such ”interest rate mismatches” require additional qualitative or quantitative analysis (IFRS 9.B4.1.13 Instrument B). Benchmark tests have to be performed to demonstrate that the cash flows of such instruments do not differ significantly from those of a basic lending transaction bearing a floating rate of interest without interest rate mismatch features (benchmark instrument). For more information on benchmark tests and modified time value of money, see section 7.4.3.1.8.

7.4.3.3.2. Prepayment clauses

Debt instruments often contain early prepayment clauses, meaning the instrument may be terminated before its contractual maturity by the issuer repaying the remaining amounts earlier than they were initially due. The contractual terms used to define this clause vary depending on the legal form of the instrument (bond vs. loan). This option is often at the hand of the borrower but can be at the hand of the lender, or even both as well. A wide range of prepayment feature exists.
It is quite common for the contract to stipulate that the party imposing early prepayment has to compensate the other party for the early termination of the contract. In less frequent cases the party exercising the early termination option may receive compensation for early prepayment as well.

Whatever the legal form of the instrument, the SPPI criterion will be met in cases where the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable compensation for the early termination of the contract (IFRS 9.B4.1.11(b)).

To illustrate the principle above, consider the following examples:

— A prepayment option for an amount equal to the remaining unpaid principal amount and accrued interests as of prepayment date, without any compensation for early prepayment is considered SPPI.

— In cases where a lump-sum type prepayment fee is included (e.g. 1,000 EUR or 5% of the principal amount that has been prepaid), judgement must be exercised to determine whether this compensation is “reasonable” as the standard does not include additional guidance or examples on this aspect. It is to be noted that the materiality of prepayment fees is to be assessed in respect of the principal amount of the instrument rather than its notional amount / par amount.

— In situations where the financial asset is pre-payable at an amount that includes the fair value cost to terminate an associated hedging instrument, such clause may or may not pass the SPPI test depending on the circumstances. For instance, when the calculation of the prepayment amount is intended to approximate unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate, such prepayment clause meets the SPPI criterion (IFRS 9.BC4.232).

— A prepayment option for an amount equal to the present value of all the remaining cash flows to be paid until maturity, discounted at a risk-free interest rate is considered SPPI. This is because the compensation included in the prepayment amount is in this case reasonable as it is equivalent to the cost of carry that the borrower would bear if he chose not to early reimburse and rather invest an amount of cash in a risk-free instrument.

IFRS 9 was amended in 2017 to state explicitly that a compensation does not contradict the SPPI criterion solely because it is received by the counterparty that exercises the option (IFRS 9.B4.1.12.A).

This amendment introduced as well in its basis for conclusions a sentence that states that there may be circumstances in which a prepayment option at fair value results in SPPI cash flows. (IFRS 9.BC4.232).

IFRS 9.B4.1.12 contains specific guidance for the analysis of early prepayment features in financial assets acquired or originated at a premium or discount to the contractual par amount. In this specific case, if:

— the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable compensation for the early termination of the contract; and

— when the entity initially recognises the financial asset the fair value of the prepayment feature is insignificant,

the prepayment option feature would meet the SPPI criterion irrespective of the fact that the existence of that discount / premium would have otherwise failed the SPPI criterion applying IFRS 9.B4.1.10 & B4.1.11(b).
This specific guidance in IFRS 9.B4.1.12 may apply for example to loans purchased at a premium / discount in the context of a separate loan portfolio purchase, or in the context of a business combination.

Given that the SPPI criterion and the “reasonableness” of any compensation for early prepayment has to be assessed against the principal amount (i.e. acquisition price, as described in section 7.4.3.1.5) rather than the nominal amount of a financial asset, even assets redeemable at par might have failed the SPPI criterion in IFRS 9.B4.1.11(b) had the guidance in IFRS 9.B4.1.12 not been included.

To illustrate further such situation, consider the following example:

— a non-amortising floating rate loan purchased at a discount (e.g. at 70 while its nominal amount is 100);
— the discount results from the fact that the creditworthiness of the issuer has deteriorated since the loan was originated;
— the loan contract states the loan may be early redeemed at its nominal amount (i.e. 100);
— assuming the loan is early redeemed for 100, the new lender (i.e. the party who purchased the loan on the secondary market) would in substance receive a compensation of 30 upon early repayment.

Should the entity’s accounting policy state that lump-sum prepayment penalties that are above 10% of the principal amount are not reasonable, the loan would have failed the SPPI test without the guidance in IFRS 9.B4.1.12, in accordance with IFRS 9.B4.11(b).

However, applying the principles in IFRS 9.B4.1.12 described above, the entity would probably conclude that this prepayment clause is SPPI as:

— the prepayment amount corresponds exactly to the contractual par amount, and
— the initial fair value of the prepayment feature upon initial recognition of the loan is likely to be insignificant.

7.4.3.3.3. Option to extend the contractual maturity

A contractual term that permits the issuer or the holder to extend the contractual maturity of a debt instrument (i.e. an extension option) will be considered to meet the SPPI criterion in cases where the terms of the extension option result in SPPI contractual cash flows during the extension period, which may include reasonable additional compensation for the extension of the contract.

In our opinion, regarding the 1st criterion above, the following two methods for determining interest during the extension period both meet the SPPI criterion:

— extension feature where post-extension interest rate is fixed and known from the outset;
— extension feature where the initially set interest rate is adjusted upon extension to take account of market conditions observed when the term extension option is exercised.

Note: The date of the initial recognition of the asset on the balance sheet.
The assessment of whether the extension fees, if any, are “reasonable” will require exercising judgement.

7.4.3.3.4. Option to switch from a floating rate to a fixed rate

Some contracts specify that the contract bears initially a floating interest rate but include an option to switch from this floating rate interest formula to a fixed rate interest formula at a later date. IFRS 9 does not contain any specific guidance as to how such clauses should be analysed.

In our opinion, the following two types of options to switch to a fixed rate both meet the SPPI criterion:

— the level of the fixed rate is known from the outset (as, in such case, this feature may be analysed by analogy to a vanilla cap that simply limits the variability of the instruments’ cash flows, as explained in section 7.4.3.2.3);

— the level of the fixed rate is not known initially but will be determined based on the current market conditions, taking into account the residual maturity of the instrument. For example, the reference rate used to fix the rate will be the then applicable:

> 10-year swap rate if the option is exercised when 10 years remain to the maturity of the contract,

> 5-year swap rate if the option is exercised when 5 years remain to the maturity of the contract, etc.

In situations where the rate is fixed in such a way that it refers to an interest rate index which tenor is fixed whatever the residual maturity of the contract upon exercise of the conversion option (e.g. reference to a 5-year swap rate even if 10 years remain to maturity), the feature contains a mismatch that must be assessed using a benchmark test (see section 7.4.3.1.8).

7.4.3.3.5. Write-down or conversion imposed by a regulator

Some instruments issued by regulated entities (such as banks) may be subject to a legislation that permits or requires a national resolving authority to impose losses on the holders of such instruments. For example, the national resolving authority may have the power to write down the par amount of that instrument or to convert it into a fixed number of the issuer’s ordinary shares if the national resolving authority determines that the issuer is having severe financial difficulties, needs additional regulatory capital or is ‘failing’.

The holder would:

— analyse the contractual terms of the financial instrument to determine whether they give rise to SPPI cash flows,

— but would not consider the payments that arise only as a result of the national resolving authority’s power to impose losses on the holders of that instrument (IFRS 9.B4.1.13, Example with instrument E). That is because that power, and the resulting payments, are not contractual terms of the financial instrument.
7.4.3.3.6. Option to differ interest payment (coupon deferral)

Some financial assets provide the issuer with the right to defer the payment of coupons. This feature is considered SPPI only if the deferred coupons are mandatory and accrue additional interests (IFRS 9. B4.1.14 Instrument H).

7.4.3.3.7. Perpetual bonds

Perpetual bonds are quite common financial instruments that do not have a stated maturity date, which means repayment of principal is not contractually due. This feature does not lead in itself to failing the SPPI test (IFRS 9.B4.1.13, example with Instrument H). This is because perpetual instruments have continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.

If the perpetual bond is callable (meaning the issuer may decide to prepay the instrument), the terms and conditions of the call – including any early termination fees / compensation – will have to be analysed as well (see section 7.4.3.3.2).

A perpetual instrument may also contain a coupon deferral mechanism (see section 7.4.3.3.6).

7.4.3.3.8. Regulated interest rate

In some jurisdictions, the government or a regulatory authority sets interest rates. For example, such government regulation of interest rates may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, a regulated interest rate is considered a proxy for the time value of money element if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement (IFRS 9.B4.1.9E).

In its basis for conclusions, IFRS 9 mentions the French interest rate applicable to “Livret A” saving accounts as an example of regulated interest rate that pass the SPPI test. The interest rate is determined by the central bank and the government according to a formula that reflects protection against inflation and an adequate remuneration that incentivises entities to use these particular savings accounts. This is because legislation requires a particular portion of the amounts collected by the retail banks to be lent to a governmental agency that uses the proceeds for social programmes. The IASB noted that the time value element of interest on these accounts may not provide consideration for only the passage of time; however, the IASB believes that amortised cost would provide relevant and useful information as long as the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement (IFRS 9.BC4.180).

7.4.3.4. Features that normally do not pass the SPPI test

Below are some examples of contractual features or instruments that usually do not meet the SPPI criterion. This list is not exhaustive.
7.4.3.4.1. Floating rate with a currency-index mismatch feature

The floating rate instrument described in section 7.4.3.2.3 is considered as SPPI-compliant. That instrument is issued in EUR and its reference index is Euribor.

Consider however the following example: a loan is issued in EUR but it is indexed to a USD Libor, rather than Euribor. This instrument contains a currency-index mismatch. In our opinion, whenever the contractual terms include such a feature, the contract does not meet the SPPI criterion.

7.4.3.4.2. Leverage / multiple of a benchmark interest rate

Leverage is a contractual cash flow characteristic of some financial assets. Leverage may increase or modify the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest (IFRS 9.B4.1.9).

As a result, the following instruments are not SPPI-compliant:

- stand-alone derivatives (such as options, forwards and swaps) that by definition include such leverage;
- debt instruments with structured interest rate including a leverage factor in the interest formula.

In our opinion a leverage is identified when a coefficient \( > 1 \) is applied to an interest rate index (e.g. a floating rate instrument indexed to \( 1.5 \times \text{Euribor} \)).

7.4.3.4.3. Inverse floater

Some debt instruments pay an inverse floating interest rate: the interest rate has an inverse relationship to market interest rates. For example, a debt instrument paying interest equal to 5% minus Euribor is an inverse floater.

The contractual cash flows of such instruments are not SPPI as the interest amounts are not consideration for the time value of money on the principal amount outstanding (IFRS 9.B4.1.14, example with instrument G). The fact that the variability of such payoff may be limited by setting a cap or floor level in the contract has no impact on such conclusion.

7.4.3.4.4. Payoff indexed on commodities index, share price or stock market index

Contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding (IFRS 9.B4.1.7A).

7.4.3.4.5. Debt instruments convertible or redeemable in shares

Instruments convertible into (or redeemable in) a fixed number of equity instruments of the issuer, or another entity, must undergo the SPPI analysis in their entirety. Their contractual cash flows are not SPPI
because they reflect a return that is inconsistent with a basic lending arrangement, i.e. the return is linked to the value of the equity of the issuer (IFRS 9.B4.1.7A and IFRS 9.B4.1.14, example with instrument F).

If, however, the number of shares delivered is variable to provide to the holder a value equal to a fixed amount of currency, then the instrument may pass the SPPI test. Indeed, in this case the holder is not exposed to the changes in the underlying share price over the life of the debt instrument.

7.4.3.5. Specific types of instruments subject to additional guidance

7.4.3.5.1. Contractually linked instruments (e.g. multi-tranche ABSs or CLOs)

In some transactions, an issuer may prioritise payments to the holders of financial assets using multiple Contractually Linked Instruments (CLI) that create concentrations of credit risk (tranches). Each has a subordination ranking tranche (e.g. senior, mezzanine or junior tranche) that specifies the order in which any cash flows generated by the issuer are allocated to the tranche (with senior tranches being paid first, then mezzanine tranches and junior tranches in the very end). In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches (IFRS 9.B4.1.20). In such structures, there is a reallocation of the credit risk of a portfolio of underlying loans or debt securities over several categories of instruments with different risk levels. Contractually Linked Instruments are commonly used in multi-tranche securitisation vehicles (e.g. ABS / asset backed securities, RMBS / residential mortgage backed securities, CLO / collateralised loan obligations).

IFRS 9 contains specific guidance for these instruments. Contractually linked instruments must satisfy all three criteria below to be considered SPPI:

- **criterion n° 1**: the contractual terms of the tranche being assessed are SPPI, e.g. the interest rate on the tranche is not linked to a commodity index (IFRS 9.B4.1.21(a)). This criterion is not specific to contractually linked instruments. As for any other financial asset, the entity must analyse the interest rate clauses, any prepayment and interest deferral clauses, etc.;

- **criterion n° 2**: the underlying pool of financial instruments also meets the SPPI criterion (IFRS 9.B4.1.21(b)). This criterion is further detailed below;

- **criterion n° 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 the underlying pool of financial instruments (IFRS 9.B4.1.21(c)). This will be the case, for example, when the credit rating of the tranche being assessed for classification is equal to or higher than the credit rating that would apply to a single tranche that funded the underlying pool of financial instruments). This criterion is further detailed below.

**Criterion n° 2** is in practice the most complex criterion to implement as it requires a “look-through” analysis of the underlying assets to make sure the pool contains only instruments that meet the SPPI criterion (IFRS 9.B4.1.23 and B4.1.25). An exception to this principle exists: derivatives by definition do not meet the SPPI criterion but some derivatives included in the pool may be disregarded in the analysis of criterion n° 2 (i.e. they do not make the tranche fail the SPPI criterion if they (a) reduce the cash flow variability of the final instrument (for example, a derivative hedging interest rate risk or foreign exchange risk, or a contract that reduces the credit risk on some or all of the instruments of the pool) or (b) align the cash flows of the underlying pool with those of the final instrument (IFRS 9.B4.1.24).
The underlying pool will not meet the “look through” criterion in the following situations (this list is not exhaustive):

- in the case of “synthetic” securitisations (where the issuer obtains exposure to the credit risk of selected counterparties by writing CDSs on these counterparties rather than investing in debt instruments issued by these counterparties),
- in the case of securities having lease contracts that expose the securitisation vehicle to the risk of the residual value of the leased property,
- or when the underlying pool contains non-SPPI financial investments such as equity instruments or funds shares.

The standard specifies that a detailed instrument-by-instrument analysis of the pool may not be necessary. This is crucial as the investor generally does not have the same level of information when investing in such structure than if he had purchased directly each asset individually. An entity must however perform sufficient analysis under IFRS 9 (including the provisions relating to de minimis features – see section 7.4.3.1.4) to determine whether the instruments in the pool meet the SPPI criterion (IFRS 9. B4.1.25). This will require a significant level of judgement.

Besides, all the possible changes to the underlying pool of financial instruments over the lifetime of the tranche must be considered. If the vehicle having issued the tranche is rechargeable in such a way that the underlying pool of instruments may include non-SPPI assets (other than derivative instruments used for risk management purposes by the securitisation vehicle as described) the tranche does not meet the SPPI criterion and must be fair-valued through profit or loss (IFRS 9.B4.1.26).

However, if the underlying pool includes instruments that are collateralised by assets that do not meet the SPPI criterion, the ability to take possession of such assets must be disregarded unless the entity acquired the tranche with the intention of controlling the collateral (IFRS 9.B4.1.26).

This analysis is to be carried out as of the date of the initial recognition of the tranche. Where the holder of the tranche is unable to conduct this “look-through” analysis, the instrument will be measured at fair value through profit or loss by default (IFRS 9.B4.1.26).

In the case of asset securitisations where the underlying pool of assets contains tranches resulting from other securitisations, the “look-through” analysis must make it possible to trace the underlying original assets of the initial securitisation. This is because IFRS 9 requires the entity to “look through” until it can identify the underlying pool of instruments that are creating (instead of passing through) the cash flows (IFRS 9.B4.1.22). Should such analysis not be possible, the asset will be measured at fair value through profit or loss (IFRS 9.B4.1.26).

Criterion n° 3 requires verifying whether the credit risk of the instruments is equal to or lower than the average risk of the underlying assets as a whole. The risk of the instrument in question must be compared with the rating that would have been obtained by the issued notes as a whole if no tranching had taken place, on the basis of the information available (e.g. probability of default, rating, etc.). This criterion would not be met, for instance, by most subordinated / junior tranches which absorb the first losses in the pool of the underlying assets. Investments in such tranches must be fair-valued through profit or loss. On the opposite end of the spectrum, this criterion will always be met for the most senior tranche of the issuing vehicle.
This analysis is to be carried out as of the date of the initial recognition of the tranche. It may be complex to implement for mezzanine tranches where the information of the risk level of the tranche and of the underlying is not available as of the initial recognition date. Where the holder of the tranche is unable to conduct this analysis, the instrument will be measured at fair value through profit or loss by default (IFRS 9.B4.1.26).

7.4.3.5.2. Instruments representing an investment in particular assets or cash flows

In some cases, a financial asset may have contractual cash flows that are described as principal and interest, but those cash flows do not represent the payment of principal and interest on the principal amount outstanding (IFRS 9.B4.1.15).

This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not SPPI:

- For example, if the contractual terms stipulate that the financial asset’s cash flows increase as more automobiles use a particular toll road, those contractual cash flows are inconsistent with a basic lending arrangement (IFRS 9.B4.1.16).

- This could also be the case when a creditor’s claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a ‘non-recourse’ financial asset). Not all non-recourse assets are non-SPPI, see section 7.4.3.5.3 for more information.

7.4.3.5.3. Non-recourse financial assets

Non-recourse financial assets are, for example, loans for which the lender’s recourse is limited to an identified asset. A non-recourse loan always has an underlying project or asset (with or without the creation of an SPV, a special purpose vehicle). In the case of a default of the debtor, the recourse of the lender is limited to the underlying asset or project. The lender has no recourse against the rest of the balance sheet of the debtor. Such situations can lead the lender to take a significant risk on the value of the underlying asset, which could prevent the loan from meeting the SPPI criterion.

A lending arrangement can be either explicitly non-recourse, or implicitly non-recourse. For example, a loan granted to a SPV that holds only one non-financial asset may be presented contractually ‘with recourse’, but its risk profile may not be different from a loan granted to a large corporate with a recourse limited to a single asset. Therefore, judgement must be exercised on any lending arrangement granted to limited purpose entities (SPV, SPE...) to assess whether it is, in substance, a non-recourse lending transaction.

The fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the SPPI criterion. In such situations, the creditor is required to assess (‘look through to’) the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are SPPI.

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6 Special Purpose Vehicles (SPV) / Special Purpose Entities (SPE) are entities that are created to accomplish a narrow and well-defined objective (e.g. to carry a lease, research and development activities, a securitisation of financial assets or carry out a project such as a windfarm). In SPV financing generally the underlying financed asset guarantees the loan / notes issued by the vehicle without any additional collateral and is often the only source of reimbursement in case of default of the SPV (as the activities of the entity are limited).
If the terms of a non-recourse financial asset:

— give rise to any other cash flows,
— or limit the cash flows in a manner inconsistent with payments representing principal and interest,

the financial asset does not meet the SPPI criterion. Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment (IFRS 9.B4.1.17).

In our opinion, the guidance in IFRS 9.B4.1.17 implies that a non-recourse financial asset will not pass the SPPI test if either of the following criteria are met:

— the lender can benefit from a positive performance of the financed asset (i.e. following the borrower’s default, the sale of the assets received as a guarantee / collateral for the non-recourse asset can result in a profit for the lender, because the lender doesn’t give back to the borrower the gain realised upon the sale), or
— the «non-recourse» nature of the instrument exposes the lender mainly to the asset’s value risk rather than to a counterparty risk. The following factors must be considered in this assessment:
  > Loan-To-Value ratio (the lower this ratio is the more likely it is that the non-recourse asset will pass the SPPI test) and loss-absorption mechanisms protecting the lender (equity tranche, guarantees received from third parties...), if any;
  > the probability of default of the debtor (the lesser the probability of default the more likely it is that the non-recourse asset will pass the SPPI test);
  > in the case of a non-recourse project financing loans: the technical feasibility of the project financed and its capacity to generate cash flows necessary to reimburse the non-recourse financing.

The analysis must be performed considering the global contractual arrangements together with an “in substance” analysis of the risk profile. For instance, where the non-recourse analysis is carried out for a financing to an SPV holding a single non-financial asset, this asset could be leased to a corporate which is committed to pay the rentals and provides strong guarantee to the SPV. In such situations, taking into account all the facts and circumstances of the transaction, the investor may conclude that the main risk he is exposed to is a basic lending risk with the corporate entity as counterparty and that the non-recourse feature meets the SPPI criterion.

It is to be noted that the analysis of non-recourse financial assets is to be carried out upon the initial recognition of a non-recourse asset and the initial conclusion is not reassessed subsequently, even upon a change in the facts and circumstances surrounding this financing. This analysis is often complex to implement and requires understanding the economic rationale and the viability of the financial set-up.

If the non-recourse financing takes the form of a contractually linked instrument (e.g. a multi-tranche ABS / CLO), more specific guidance on contractually linked instruments applies (see section 7.4.3.5.1).
7.4.4. Puttable mutual fund shares

Puttable mutual fund shares do not generally meet the core definition of an equity instrument provided by IAS 32 even if they may be presented within equity thanks to the presentation exception that exists in IAS 32 for puttable instruments. Therefore, puttable mutual fund shares are not eligible to the FV-OCINR category (see section 7.3.2 regarding the eligibility criteria to the FV-OCINR category).

These puttable mutual fund shares will generally fail the SPPI test as well, as:

— the return paid to the investor is based on the change in the fund net asset value; and
— the fund manager generally has discretion on the amounts that are transferred by the fund to the shareholders (i.e. no pre-agreed schedule for payments of principal and interest).

As a result, the only possible category for classifying puttable mutual fund shares will normally be FV-PL, irrespective of the entity’s business model applied for managing these shares.

7.4.5. Fair value option

Upon the initial recognition of a financial asset, an entity may make an irrevocable election to classify that asset (or a group of financial assets) as measured at fair value through profit or loss if and only if:

— such designation results in more relevant information (IFRS 9.B4.1.27)
— by eliminating or significantly reducing a measurement or recognition inconsistency (accounting mismatch) (IFRS 9.4.1.5). Such inconsistencies arise from measuring financial assets (or financial assets and liabilities) that are economically related on different bases.

The following are examples where the above conditions could be met (IFRS 9.B4.1.30):

Example 7.11

An entity has financial assets, financial liabilities, or both, that share a risk, such as interest rate risk, and that give rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (for example, those that are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met because, for example, the requirements for hedge effectiveness in IFRS 9.6.4.1 are not met.

Example 7.12

An entity has financial assets, financial liabilities, or both, that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and none of the financial assets or financial liabilities qualifies for designation as a hedging instrument because they are not measured at fair value through profit or loss. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of the recognition of the gains and losses that would otherwise arise from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.
This so-called ‘fair value option’ may only be applied at initial recognition of financial assets and cannot subsequently be reconsidered until the derecognition of the asset. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at FV-PL at its initial recognition and, at that time, any remaining transactions are expected to occur (IFRS 9.B4.1.31).

It would not be acceptable to designate only some of the financial assets that give rise to the inconsistency as at FV-PL if doing so would not eliminate or significantly reduce the accounting mismatch and would therefore not result in more relevant information. However, it would be acceptable to designate as measured at FV-PL only some of a number of similar financial assets if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. As designation as at FV-PL can be applied only to the whole of a financial instrument, the entity must designate one or more assets in their entirety. It may not designate either a component or a proportion of a financial asset (IFRS 9.B4.1.32).

If an entity elects to designate financial assets as at FV-PL, specific disclosures must be provided in the notes to financial statements (see chapter 16).

It is to be noted that chapter 6.7 of IFRS 9 permits in specific circumstances to designate a credit exposure as measured at fair value through profit or loss, as an alternative to hedge accounting. Such designation is described in chapter 14. It differs from the designation at FV-PL described in section 7.4.5 in that it (a) can be elected after the initial recognition of the asset, and (b) is revocable or might have to be discontinued (subject to specific conditions). Entities that continue using the requirements on hedge accounting in IAS 39 (as permitted by IFRS 9.7.2.21) are not allowed to use this specific designation.

7.5. Reclassifications of financial assets

7.5.1. Main principles

Entities shall not subsequently reclassify investments in equity instruments, as their classification is determined once and for all at their initial recognition.

Financial assets that are debt instruments (loans, bonds...) meeting the SPPI criterion must be reclassified only when an entity changes its business model for managing these assets (IFRS 9.4.4.1). However, some debt instruments should never be reclassified, even following a change in their business model. These are:

- assets designated as measured at FV-PL (see section 7.4.5), as the fair value option is irrevocable;
- Assets initially measured at FV-PL because they do not meet the SPPI criterion.

The contractual cash flows (or the SPPI) criterion is assessed at initial recognition of a financial asset. This criterion is not reassessed later and consequently cannot give rise to reclassifications.
Changes in business model that require reclassification are expected to be very infrequent in practice as they only occur when an entity either begins or ceases to perform an activity that is significant to its operations (IFRS 9.B4.4.1). A change in business model occurs when all of the following criteria are met:

- the change in business model is determined by the entity’s senior management as a result of external or internal changes;
- the change is significant to the entity’s operations;
- the change is demonstrable to external parties; and
- the change in business model has already been agreed at the time of reclassification (IFRS 9.B4.4.1 and B4.4.2).

In the event of a change of business model, all the assets concerned should be reclassified as of the reclassification date (see section 7.5.4) into the category associated with the new business model. A reclassification of financial assets is applied prospectively (IFRS 9.5.6.1), without restating prior figures.

The consequences of reclassifications are detailed in section 7.5.4.

7.5.2. Examples

Examples of a change in business model include the following (IFRS 9.B4.4.1):

Example 7.13

An entity has a portfolio of commercial loans that it holds to sell in the short term. It acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer held for sale; it is now held to collect the contractual cash flows.

Example 7.14

An entity decides to shut down its retail mortgage business. It takes on no new business and actively markets its mortgage loan portfolio for sale.

The following situations are not changes in business model (IFRS 9.B4.4.3):

- a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);
- the temporary disappearance of a particular market for financial assets;
- a transfer of financial assets between parts of the entity with different business models.

7.5.3. Reclassification date

The reclassification date is the first day of the reporting period that follows the effective date of change in business model resulting in the reclassification (IFRS 9, Appendix A). In practice this may lead to a time-lag between the date on which the business model is modified and the date of accounting reclassification (IFRS 9.B4.4.2).
Example 7.15

Assume that:

> the termination of a business line previously considered as managed under a Held-to-Collect model is announced on 18 November of year N,
> management will from now manage the assets with a view to short-term disposal,
> no new assets are acquired or originated between 18 November and 31 December,
> the active search for buyers for the existing assets is in progress at 31 December.

The financial assets will still be accounted for and presented in the financial statements at 31 December in year N in accordance with the previous business model (i.e. at amortised cost if the SPPI criterion is satisfied). The provisions applicable to the accounting category under the new business model (and any impacts due to reclassification) will only take effect as of 1 January of the year N+1.

7.5.4. Accounting for a reclassification

The reclassification is carried out in accordance with the general classification principles set out in IFRS 9.4.1.1 - 4.1.4. Gains, losses and interest recognised prior to the reclassification date are not restated, as reclassifications are applied prospectively (IFRS 9.5.6.1).

The accounting impacts on the reclassification date depend on the type of reclassification:

- If a financial asset is reclassified from amortised cost (AC) to fair value through profit or loss (FV-PL), its fair value is measured at the reclassification date. The difference between the previous amortised cost (i.e. the carrying amount) and the fair value is recorded in profit or loss (IFRS 9.5.6.2).

- If a financial asset is reclassified from FV-PL to AC, its fair value at the reclassification date becomes its new amortised cost (i.e. its gross carrying amount) (IFRS 9.5.6.3).

- If a financial asset is reclassified from AC to FV-OCI, the fair value of the financial asset is measured at the reclassification date. Any gains or losses arising from the difference between the previous carrying amount (i.e. the amortised cost) and the fair value is recorded in other comprehensive income. Neither the effective interest rate nor the expected credit losses are adjusted as a result of the reclassification (IFRS 9.5.6.4).

- If a financial asset is reclassified from FV-OCI to AC, the financial asset is reclassified at its fair value at the reclassification date. The cumulative gains and losses previously recognised in other comprehensive income are removed from equity and adjusted against the fair value of the financial asset at the reclassification date. As a result, the financial asset is measured at the reclassification date as if it had always been measured at amortised cost. The adjustment only affects other comprehensive income, and not the profit or loss section of the statement of comprehensive income or the separate statement of profit or loss (if presented). In other words, this is not a reclassification adjustment (see IAS 1.40). The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification (IFRS 9.5.6.5).

- If a financial asset is reclassified from FV-PL to FV-OCI, the financial asset is reclassified at its fair value (IFRS 9.5.6.6).

- If a financial asset is reclassified from FV-OCI to FV-PL, the financial asset continues to be measured at fair value. The cumulative gains and losses previously recognised in other comprehensive income are reclassified from equity to the profit or loss section of the statement of comprehensive income or the separate statement of profit or loss (if presented) (IFRS 9.5.6.7).
The AC and FV-OCI categories require that interest revenue be accounted for using the effective interest rate method. Both of those measurement categories also require that an impairment allowance be recorded for expected credit losses. Thus, following a reclassification from AC to FV-OCI (or the other way around) there is no impact on (a) the recognition of interest revenue and (b) the amount of expected credit losses. However, the presentation of the impairment allowance changes:

- If a financial asset is reclassified from FV-OCI to AC, a loss allowance is recognised as an adjustment to the gross carrying amount of the financial asset (and no longer within OCI).
- If a financial asset is reclassified from AC to FV-OCI, the loss allowance recognised as an adjustment to the gross carrying amount is derecognised (IFRS 9.B5.6.1), and an identical accumulated impairment amount is instead recognised within OCI and disclosed in accordance with IFRS 7.

An entity is not required to separately recognise and update interest revenue or impairment gains or losses for financial assets measured at FV-PL. Consequently, when an entity reclassifies a financial asset out of the FV-PL category, the effective interest rate is determined based on the fair value of the asset at the reclassification date. In addition, the date of the reclassification is treated as the date of initial recognition for the purposes of measuring expected credit losses (IFRS 9.B5.6.2).

The SPPI criterion is assessed only upon initial recognition of a financial asset. Thus, the SPPI status of the instrument is not reconsidered upon reclassification.

The accounting impacts associated with each type of reclassification are summarised in the table below:

**Figure 7.3**

<table>
<thead>
<tr>
<th>Initial business model and initial accounting category</th>
<th>New business model</th>
<th>New category</th>
<th>Consequences of the reclassification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Held-to-Collect / Amortised cost</td>
<td>Held-to-Collect- and-Sell</td>
<td>FV-OCI</td>
<td>The difference between the measurement of the asset at amortised cost and at fair value must be accounted for in equity / OCI at the reclassification date (with no impact in profit or loss). The recognition of interest income does not change (the EIR is not modified). The measurement of credit losses does not change, as the same impairment approach is applied to both accounting categories. However, impairment is no longer entered as a deduction from the instrument’s book value on the asset side but in a dedicated account within equity / OCI.</td>
</tr>
<tr>
<td>&quot;Other&quot; business model (incl. Held-for-Trading)</td>
<td></td>
<td>FV-PL</td>
<td>The difference between the measurement of the asset at amortised cost and at fair value must be accounted for in profit or loss at the reclassification date. The reclassified financial asset is no longer subject to IFRS 9 impairment rules (any previously booked impairment must be reversed).</td>
</tr>
</tbody>
</table>

The SPPI criterion is assessed only upon initial recognition of a financial asset. Thus, the SPPI status of the instrument is not reconsidered upon reclassification.
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</tr>
</thead>
<tbody>
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<td>Held-to-Collect-and-Sell / FV-OCI</td>
<td>Held-to-Collect</td>
<td>Amortised cost</td>
<td>The unrealised gains and losses due to measurement at fair value that are booked in equity / OCI must be reversed against a fair value adjustment account on the B/S thus bringing its book value to the carrying amount that would have been obtained had the asset always been measured at amortised cost. The recognition of interest income does not change (the EIR is not modified). The measurement of credit losses does not change, as the same impairment approach is applied to both accounting categories. However, impairment is no longer entered in a dedicated account within equity / OCI but as a deduction from the instrument’s book value on the asset side.</td>
</tr>
<tr>
<td>Held-to-Collect-and-Sell / FV-OCI</td>
<td>&quot;Other&quot; business model (incl. Held-for-Trading)</td>
<td>FV-PL</td>
<td>The unrealised gains and losses due to measurement at fair value that are booked in equity/OCI is recycled into profit or loss at the reclassification date. The reclassified financial asset is no longer subject to IFRS 9 impairment rules (any previously booked impairment allowance must be reversed). The instrument is subsequently subject to the accounting treatment applicable to financial assets measured at FV-PL.</td>
</tr>
<tr>
<td>&quot;Other&quot; business model / FV-PL</td>
<td>Held-to-Collect-and-Sell</td>
<td>FV-OCI (if SPPI criterion met)</td>
<td>At the reclassification date, an impairment allowance is recorded for 12-month expected credit losses. After reclassification, the instrument is subject to the accounting treatment applicable to financial assets measured at FV-OCI.</td>
</tr>
<tr>
<td>&quot;Other&quot; business model / FV-PL</td>
<td>Held-to-Collect</td>
<td>Amortised cost (if SPPI criterion met)</td>
<td>At the reclassification date, an impairment allowance is recorded for 12-month expected credit losses. The fair value at the reclassification date becomes the initial amortised cost of the instrument. The instrument is subsequently subject to the accounting treatment applicable to financial assets measured at amortised cost.</td>
</tr>
</tbody>
</table>