Acknowledgement This material is based on IFRS 9 (published by IASB) and Get ready for IFRS 9 (published by Grant Thornton)

Required

For Examples 1 to 7, determine the objective of the business model.

Example 1

An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to the entity’s estimated funding needs. The entity performs credit risk management activities with the objective of minimising credit losses. In the past, sales have typically occurred when the financial assets’ credit risk has increased such that the assets no longer meet the credit criteria specified in the entity’s documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs. Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.

Example 2

An entity’s business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired. If payment on the loans is not made on a timely basis, the entity attempts to realise the contractual cash flows through various means—for example, by contacting the debtor by mail, telephone or other methods. The entity’s objective is to collect the contractual cash flows and the entity does not manage any of the loans in this portfolio with an objective of realising cash flows by selling them. In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.
Example 3

An entity has a business model with the objective of originating loans to customers and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.

Example 4

A financial institution holds financial assets to meet liquidity needs in a ‘stress case’ scenario (e.g. a run on the bank’s deposits). The entity does not anticipate selling these assets except in such scenarios. The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets on the basis of interest revenue earned and credit losses realised. However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realised if the entity needed to sell the assets in a stress case scenario would be sufficient to meet the entity’s liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity.

Example 5

An entity anticipates capital expenditure in a few years. The entity invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity’s anticipated investment period. The entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.
Example 6

A financial institution holds financial assets to meet its everyday liquidity needs. The entity seeks to minimize 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

An insurer holds financial assets in order 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.
Required

For Instruments A to H, determine whether the cash flows are solely payments of principal and interest.

Instrument A

Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.

Instrument B

Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term.

Instrument C

Instrument C is a bond with a stated maturity date and pays a variable market interest rate. That variable interest rate is capped.

Instrument D

Instrument D is a full recourse loan and is secured by collateral.
**Instrument E**

Instrument E is issued by a regulated bank and has a stated maturity date. The instrument pays a fixed interest rate and all contractual cash flows are non-discretionary.

However, the issuer is subject to legislation that permits or requires a national resolving authority to impose losses on holders of particular instruments, including Instrument E, in particular circumstances. For example, the national resolving authority has the power to write down the par amount of Instrument E 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’.

**Instrument F**

Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer.

**Instrument G**

Instrument G is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates).

**Instrument H**

Instrument H is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due. Instrument H pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest.
Case 1

12 month versus lifetime expected credit losses

Entity B has a reporting date of 31 December. On 1 July 20X1 Entity B advanced a 3-year interest-bearing loan of CU2million to Entity A. Management estimates the following risks of defaults and losses that would result from default at 1 July 20X1 and at 31 December 20X1 and 20X2:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>(A+B) + C</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Risk of default in next 12 months</td>
<td>Risk of default in months 13-36</td>
<td>Loss that would result from default (CU)</td>
<td>Lifetime expected credit losses (CU)</td>
</tr>
<tr>
<td>At 1 July 20X1</td>
<td>2.5%</td>
<td>5.0%</td>
<td>800,000</td>
<td>60,000</td>
</tr>
<tr>
<td>At 31 Dec 20X1</td>
<td>3.0%</td>
<td>10.0%</td>
<td>700,000</td>
<td>91,000</td>
</tr>
<tr>
<td>At 31 Dec 20X2</td>
<td>1.0%</td>
<td>2.0%</td>
<td>500,000</td>
<td>15,000</td>
</tr>
</tbody>
</table>

Note that the loss that will transpire should a loss occur in the event of default in the next 12 months does not correspond to the expected cash shortfalls in the next 12 months.

What credit loss provision should Entity B book at

1. 1 July 20X1
2. 31 December 20X1
3. 31 December 20X2

Case 2

Loans

a) Lender A makes a 5 year amortising loan with payments of principal and interest payable in regular monthly instalments. The borrower is also subject to six-monthly financial covenants.

b) Lender B makes a 5 year loan with interest payable monthly and principal all due on maturity.

Required

For each scenario above, determine an appropriate definition of default.