

Impact of a payment holiday

– an example

A numerical example of a fair value hedge if the payment holiday is not a substantial modification and a hedging relationship is not discontinued

Fact pattern

- At the beginning of Year 1, Company X buys a financial asset for 100 that has five years of 7% annual cash flows and a notional amount of 100 with a bullet repayment. The original effective interest rate is 7%.
- Immediately after the purchase, X designates the asset as the hedged item for a fair value hedge of benchmark interest rate (IBOR) risk. The hedged item is four-sevenths of each coupon flow (i.e. 4% based on the original coupon of 7%), plus the principal repayment of the loan – being the benchmark portion of the fixed-rate asset at inception.
- The hedging instrument is an interest rate swap that receives IBOR and pays 4%. All of the critical terms of the swap and the hedged item match and the fair value of the swap is 0 at the inception date.
- At the end of Year 1, IBOR has changed to 3.5%.
- At the beginning of Year 2, a payment holiday is given on the financial asset – all interest in Year 2 and half of the interest in Year 3 is forgiven.
- X accounts for the modification under paragraph 5.4.3 of IFRS 9. For simplicity, this example ignores the accounting for expected credit losses.

Analysis

At the beginning of Year 1

	Debit	Credit
Financial asset	100	
Cash		100
<i>To recognise financial asset</i>		

At the end of Year 1

	Debit	Credit
Cash	7	
Interest income (profit or loss)		7
<i>To recognise interest income on financial asset</i>		
Financial asset – Hedge adjustment	1.84 ⁽¹⁾	
Hedge revaluation gain (profit or loss)		1.84
<i>To recognise change in fair value of financial asset due to hedged risk</i>		
Derivative revaluation loss (profit or loss)	1.84 ⁽²⁾	
Derivative (liability)		1.84
<i>To recognise change in fair value of interest rate swap</i>		

Notes

1. The hedge adjustment is calculated as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5
A. Hedged cash flows		4.00	4.00	4.00	104.00
B. Discounted at 3.5%		3.86	3.73	3.61	90.63
C. Sum of the discounted cash flows	101.84				
D. Beginning balance – discounted at 4%	100.00				
E. Hedge adjustment (= C - D)	1.84				

2. The fair value of the interest rate swap is calculated as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5
A. Fixed leg (pay 4%)		(4.00)	(4.00)	(4.00)	(4.00)
B. Floating leg (receive IBOR)		3.50	3.50	3.50	3.50
C. Net cash flows (= A + B)		(0.50)	(0.50)	(0.50)	(0.50)
D. Discounted at 3.5%		(0.48)	(0.47)	(0.45)	(0.44)
E. Sum of the discounted cash flows	(1.84)				

At the beginning of Year 2**Scenario 1. If amortisation of the hedge adjustment has not started**

	Debit	Credit
Modification loss (profit or loss)	9.6 ⁽¹⁾	
Financial asset		9.6
<i>To recognise modification loss on financial asset due to payment holiday</i>		
Hedge revaluation loss (profit or loss)	0.04 ⁽²⁾	
Financial asset – hedge adjustment		0.04
<i>To recognise change in hedge adjustment of financial asset</i>		

Notes

1. The modification loss is calculated as follows.

A. The present value of the modified cash flows discounted at the original effective interest rate (7%) is calculated as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5
Modified cash flows		0.00	3.50	7.00	107.00
Discounted at 7%		0.00	3.06	5.71	81.63
Sum of the discounted cash flows	90.40				

B. The gross carrying amount of the hedged item excluding any hedge adjustments was 100 immediately before modification.

C. The modification loss is calculated as (9.60) (= 90.40 - 100).

2. The fair value hedge adjustment is recalculated as follows.

A. The hedged portion of the modified cash flows discounted at the benchmark interest rate at the inception of the hedge is calculated as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5
Modified hedged cash flows		0.00	2.00	4.00	104.00
Discounted at 4.0%		0.00	1.85	3.56	88.90
Sum of the discounted cash flows	94.30				

B. The hedged portion of the modified cash flows discounted at the current benchmark interest rate is calculated as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5
Modified hedged cash flows		0.00	2.00	4.00	104.00
Discounted at 3.5%		0.00	1.87	3.61	90.63
Sum of the discounted cash flows	96.10				

C. The new hedge adjustment is calculated as 1.80 (= 96.10 - 94.30).

D. Therefore, the change in the hedge adjustment is (0.04) (= 1.80 - 1.84).

Scenario 2. If amortisation of the hedge adjustment has started

	Debit	Credit
Modification loss (profit or loss)	9.65 ⁽¹⁾	
Financial asset		7.81
Financial asset – hedge adjustment		1.84
<i>To recognise modification loss on financial asset due to payment holiday</i>		

Notes

1. The modification loss is calculated as follows.

A. The present value of the modified cash flows discounted at the revised effective interest rate (6.46%⁽²⁾) is calculated as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5
Modified cash flows		0.00	3.50	7.00	107.00
Discounted at 6.46%		0.00	3.09	5.80	83.30
Sum of the discounted cash flows	92.19				

B. The carrying amount of the hedged item including the hedge adjustments immediately before modification is 101.84.

C. The modification loss is calculated as (9.65) (=92.19 - 101.84).

2. The revised effective interest rate is calculated as follows.

A. The gross carrying amount of the financial asset including the hedge adjustment is 101.84.

B. The remaining cash flows of the financial asset (before considering the payment holiday) are as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5
Cash flows		7.00	7.00	7.00	107.00

C. The effective interest rate, which makes the present value of cash flows in B equal to 101.84, is 6.46%.

$$\frac{7}{(1+r)} + \frac{7}{(1+r)^2} + \frac{7}{(1+r)^3} + \frac{107}{(1+r)^4} = 101.84$$

$$r = 6.46\%$$

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