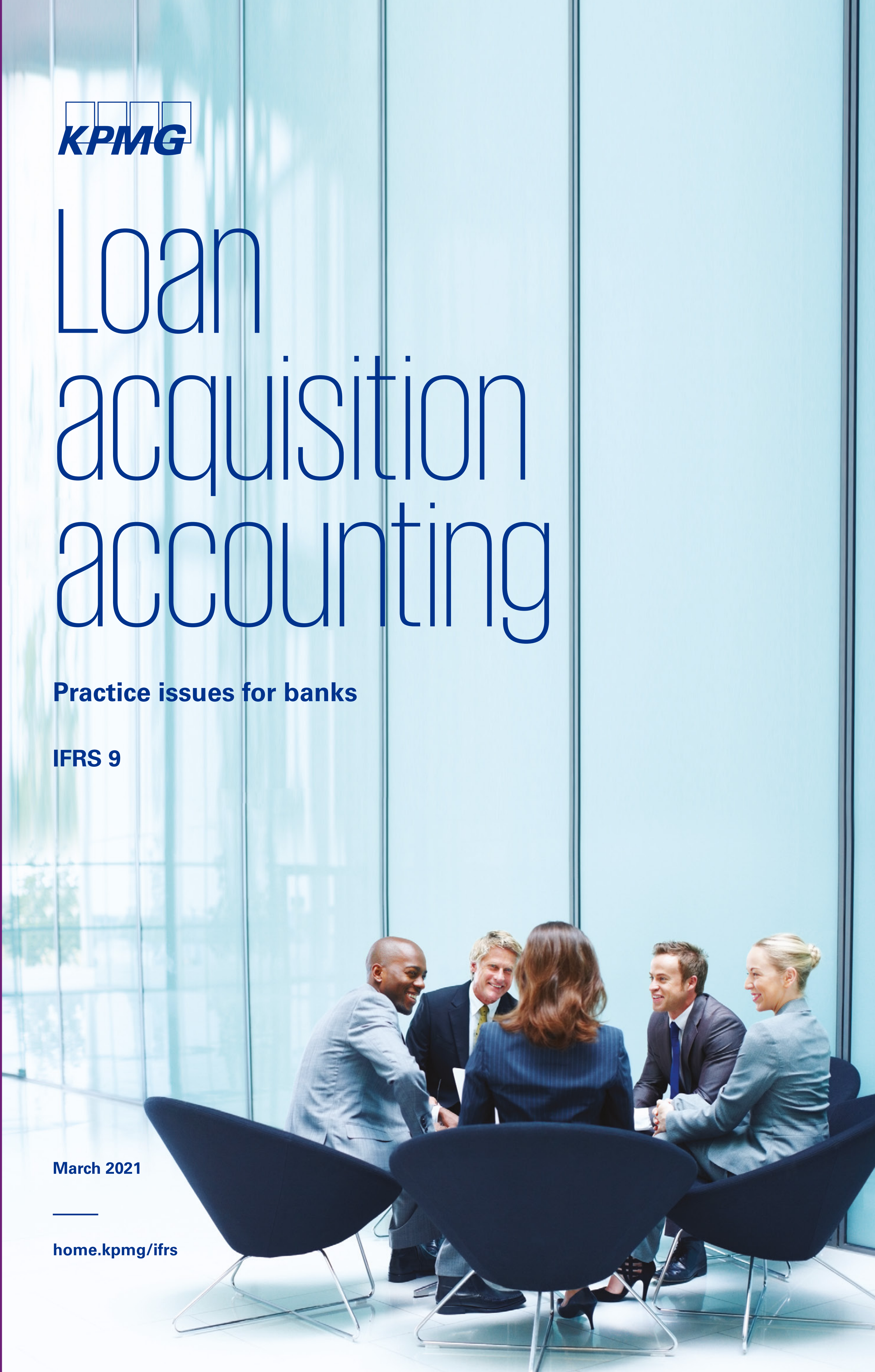

Loan acquisition accounting

Practice issues for banks

IFRS 9

March 2021

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Contents

Addressing complexity in loan acquisitions

Loan portfolio sales and acquisitions are a common way for many banks to rationalise their portfolios. From the purchaser's perspective, acquisitions, including those that are part of business combinations, have made it possible to acquire loans suited to their risk appetite without the need to complete full origination processes. They have also enabled purchasers to take advantage of attractively priced loan portfolios.

Acquiring loan portfolios can involve complex accounting issues or a need to apply general accounting guidance to the specific circumstances of a business combination or a direct loan acquisition. This publication discusses some of these issues and provides practical examples.

On an acquisition of loans, key items for banks to consider include the following.

- The amount to be recognised initially, taking into account the transaction price, fair value, and the items included in the acquisition.
- How to determine whether the acquired loans are SPPI-compliant and so could be eligible for accounting at amortised cost.
- How to account for loans that are credit-impaired at the time of acquisition.
- The treatment of any loan commitments acquired or indemnities/guarantees received in relation to the acquisition.

The primary standard providing guidance on the accounting for loans is IFRS 9 *Financial Instruments*. It sets out the general principles for recognising and measuring financial assets, which are to be applied to loans and certain loan commitments, both those that are originated and those that are acquired.

The term *loan* used throughout this publication refers to a financial asset with fixed or determinable payments that is not in the legal form of a security and so refers to the general use of the term by banks. The term is not explicitly defined in IFRS® Standards.

This publication addresses initial recognition, classification and subsequent measurement of loans acquired either separately or as part of a business combination. Financial reporting for loans and other financial instruments, including disclosure requirements, is discussed in Insights into IFRS, our practical guide to IFRS Standards.

Chris Spall
Leader, KPMG global IFRS financial instruments team

1 When to recognise a loan

A loan is recognised on the balance sheet when the entity becomes party to a loan agreement.

IFRS 9.3.1.1

Like other financial instruments, a loan is recognised on the balance sheet when the entity becomes party to a contract that is a loan.

This may be the case when an entity:

– originates a new loan;

– acquires a loan in a direct purchase; or

– acquires a loan as part of a business combination.

IFRS 3.8, 10

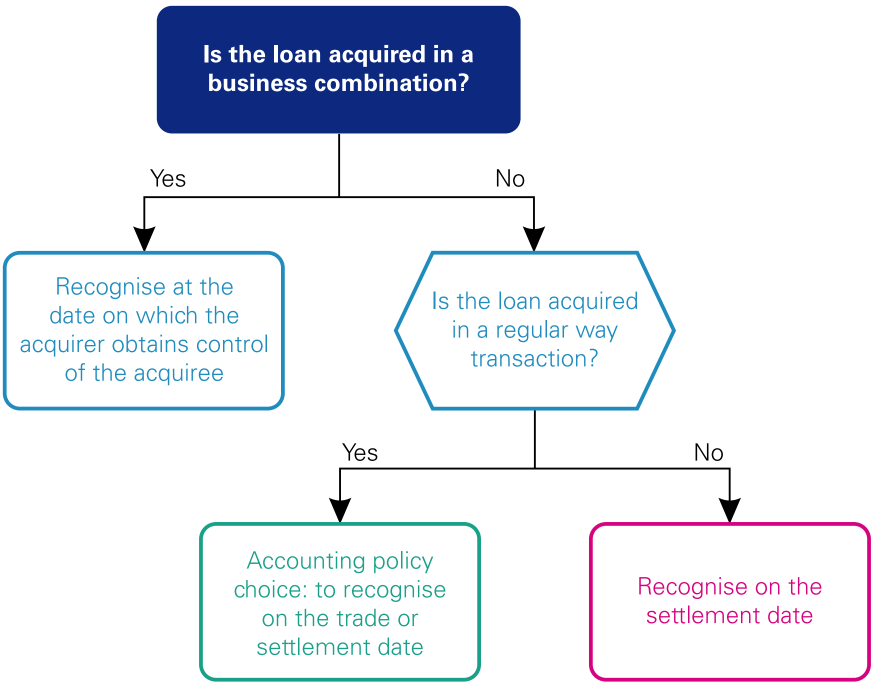
Loans acquired as part of a business combination are recognised in the acquirer's consolidated financial statements on the date of acquisition, which is the date on which the acquirer obtains control of the acquiree.

IFRS 9.B3.1.2

Planned but uncommitted future transactions, no matter how likely, are not financial assets because they do not represent situations in which the entity becomes a party to a contract.

Similarly, when an entity makes an offer to enter into a contract to buy or sell a loan, the entity has not become party to a loan contract. The entity does not account for such an offer until the counterparty accepts the offer and the entity becomes a party to a contractual arrangement.

The diagram below summarises the timing of the recognition of a purchased loan.



1.1 Contract to acquire a loan

IAS 32.11

A contract to acquire a loan in a direct purchase is itself generally a financial instrument. Unless the contract is a regular-way transaction (see Section 1.2), the loan to be acquired is not recognised until the acquisition contract is settled because this is usually when the purchaser becomes a party to the contract that is a loan. In this case, the contract to acquire a loan is a derivative that is measured at fair value through profit or loss (FVTPL) in the period between the trade date and the settlement date. In addition and subject to meeting certain criteria, this derivative may be designated as a hedging instrument in an all-in-one cash flow hedge of the variability of the consideration to be paid in the forecast purchase of the loan itself.

The fair value of this derivative contract immediately before settlement usually equals the difference between the fair value of the acquired loan at settlement and the purchase price payable at settlement, which means that no additional gain or loss arises on settlement

However, if the contract to acquire a loan is a regular-way transaction, then it is not accounted for as a derivative between the trade and settlement dates.

1.2 Regular-way transactions

IFRS 9.3.1.2, B3.1.3, IFRS 9.A, IG. B.28

A regular-way transaction is the purchase or sale of a financial asset under a contract that will be settled within the time frame established by regulation or convention in the market concerned. The market need not necessarily be an organised market such as a formal stock exchange or organised over-the-counter market. Instead, the 'market' means the environment in which the financial asset is customarily exchanged.

IFRS 9.BA.4, IG. B.28

A regular-way purchase gives rise to a fixed price commitment between the trade and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative. Instead, IFRS 9 provides for special accounting for such contracts. The term 'short duration refers to the period reasonably and customarily required for the parties to complete the transaction and prepare and execute the closing documents. Loans typically are not traded in an organised market and the amount of time between trade execution and settlement date is often influenced by a number of factors, such as the type of loan, legal and regulatory requirements in a particular jurisdiction, and the transacting parties' processing capabilities. Accordingly, judgement may be needed to determine whether a loan is acquired in a regular-way transaction.

IFRS 9.3.1.2, B3.1.3

Loans acquired in a regular-way transaction can be initially recognised either on the trade date or the settlement date. An entity needs to choose a method and apply it consistently to all purchases and all sales of financial assets that are classified in the same way under IFRS 9 – e.g. all financial assets at amortised cost.

1.3 Trade date vs settlement date accounting

If an entity applies trade date accounting to a loan acquired in a regular-way transaction, then it recognises the loan on its balance sheet on the date it commits to the purchase and derecognises it on the date it commits to the sale. If an entity applies settlement date accounting, then it recognises/derecognises a loan when the transaction settles.

IFRS 9.B.3.1.5–B.3.1.6, IG.D.2.1

Irrespective of whether an entity applies trade or settlement date accounting, it accounts for changes in the fair value of the loan between the trade and settlement dates in the same way as it accounts for fair value changes that happen after recognition of the loan. This is consistent with the logic that these changes in fair value between the trade and settlement dates are attributable to the buyer rather than the seller because the seller's right to changes in the fair value ceases on the trade date.

IFRS 9.5.1.2, 5.7.4, B3.1.6, IG.D.2.1

For example, if the purchased loan is subsequently measured at amortised cost, then the purchaser recognises the loan at its trade date fair value. It makes no further adjustment for any changes in the fair value between the trade date and settlement dates regardless of whether it applies trade date or settlement date accounting.

IFRS 9.5.7.4, B.3.1.6, IG.D.2.1

Conversely, if the purchased loan is subsequently measured at fair value, then the purchaser recognises any changes in the fair value of the loan between the trade and settlement dates. Therefore, under settlement date accounting, any fair value adjustment following the trade date is shown in the balance sheet as a receivable or payable until the settlement date, at which point the receivable or payable adjusts the amount recognised initially for the loan. This results in the loan being measured at its fair value on the settlement date. Fair value changes between the trade date and the settlement date are recognised in profit or loss for loans classified as at FVTPL, or in other comprehensive income for loans classified as at fair value through other comprehensive income (FVOCI).

IFRS 9.5.7.4

The trade date is considered to be the date of initial recognition when applying the impairment requirements under IFRS 9. See Chapter 5 for further guidance on impairment of acquired loans.

2 Measuring loans on initial recognition

The amount at which a loan is initially recognised may depend on how it was acquired.

A loan may be acquired in one of the following ways:

– purchase of a single loan;

– purchase as part of a group of assets; or

– purchase as part of a business combination.

The amount at which a loan is initially recognised may depend on how it was acquired. This is discussed below.

2.1 Purchase of a single loan

IFRS 9.5.1.1

On initial recognition, a loan acquired in a direct purchase is generally measured as follows:

Loan	Measurement on initial recognition
Loan subsequently measured at FVTPL	Generally fair value. Any additional transaction costs (i.e. costs that are directly attributable to the acquisition of the loan – see Section 2.9) are not part of the initial measurement
Other loans	Generally fair value plus eligible additional transaction costs

IFRS 9.5.1.1A, B5.1.2A

Normally, the fair value of a loan on initial recognition is equal to the transaction price – i.e. the fair value of the consideration paid for the loan is usually the best evidence of the fair value on initial recognition of the loan acquired. However, this is not always the case (see Section 2.8) and then the entity needs to consider how to account for the difference between the transaction price and its estimate of the fair value of the loan on initial recognition:

– if the fair value of the loan is based on a valuation technique that uses only data from observable markets, then the difference is recognised immediately as a gain; and

– if the fair value of the loan does not meet this observability condition, then the difference is adjusted against the carrying amount of the loan on initial recognition – i.e. the loan is initially measured at the transaction price plus, for a loan not measured at FVTPL, any eligible transaction costs. See Section 2.8 for discussion of how this difference is subsequently accounted for.

If the contract to acquire the loan was accounted for as a derivative prior to settlement (see Section 1.1), then settlement comprises the receipt of the loan asset in exchange for both the cash purchase price payable under the contract and settlement of the fair value of any recognised derivative asset or liability. The fair value of the derivative reflects any changes in the fair value of the loan resulting from changes in circumstances between the date the contract was entered into and the date of settlement – i.e. the date the purchaser initially recognises the loan. Since the fair value of the derivative at settlement usually equals the difference between the fair value of the loan at that time and the cash purchase price, no additional gain or loss or difference between the transaction price and fair value arises on settlement/initial recognition of the loan.

2.2 Does the transaction price include compensation for something else?

IFRS 9.B5.1.1, 13.58, B4

The transaction price is normally the best evidence of the fair value of a financial asset on initial recognition. However, in some cases, the transaction price might include consideration for something else (see Section 2.11).

When an entity acquires a loan, it needs to determine whether the consideration paid represents solely the transaction price to acquire the loan, or whether there are additional elements to consider. If additional elements are included in the transaction price, then the entity measures the fair value of the loan in accordance with IFRS 13 *Fair Value Measurement* and accounts for the additional elements acquired separately.

IFRS 9.B5.1.1

For example, for a long-term loan that carries no interest, the fair value can be measured as the present value of all future cash receipts discounted using the prevailing market interest rate for a similar loan. Any additional amount lent is an expense or a reduction in income unless it qualifies for recognition as an asset or is an equity transaction with a shareholder (see Section 2.11).

The acquisition of customer-related intangible assets together with a loan portfolio is discussed in Section 2.5.

2.3 Purchase as part of a group of assets

IFRS 3.2(b)

IFRS 3 *Business Combinations* includes guidance on scenarios where an entity acquires a group of assets and liabilities that does not constitute a business. The standard requires the purchaser to allocate the cost of the group to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of acquisition.

IU 11–17

In November 2017, the IFRS Interpretations Committee considered how this requirement should be applied when:

– the sum of the individual fair values of the identifiable assets and liabilities is different from the transaction price; and

– the group includes assets and liabilities initially measured both at cost and an amount other than cost.

The Committee noted that in this case the entity first reviews its procedures for determining fair values to assess whether the difference between the sum of the individual fair values of the identifiable assets and liabilities and the transaction price truly exists. The entity needs to consider whether there are factors specific to the transaction and/or to the group that indicate that the total transaction price may not be representative of the total fair value of the identifiable assets and liabilities.

If this is the case, then the entity applies one of the two following approaches.

Approach 1

- Determine the transaction price for each identifiable asset and liability by allocating the purchase price based on the relative fair values of those assets and liabilities at the date of acquisition.
- Apply the initial measurement requirements of the relevant standard to each asset and liability, including the requirements on how to account for any difference between the transaction price and the amount at which the asset or liability is initially recognised under the relevant standard.

Approach 2

- Measure each identifiable asset and liability initially measured at an amount other than cost, as specified by the relevant standard.
- Allocate the remaining purchase price to the remaining identifiable assets and liabilities based on the relative fair values of those assets and liabilities at the date of the acquisition.

When applying Approach 1, an entity looks to the requirements of IFRS 9 (see Sections 2.1 and 2.2) to determine how to account for the difference between the allocated transaction price and the fair value of each individual loan acquired. When applying Approach 2, an entity generally measures each individual loan acquired initially at fair value (plus any eligible transaction costs for loans not subsequently measured at FVTPL), considering the guidance in Section 2.2. If an entity acquires only loans or other financial instruments, then the acquisition would not be a case covered by the Committee's specific analysis and Approach 2 could not be applied in this way because there are no other identifiable assets and liabilities.

An entity applies the chosen approach consistently to all acquisitions of a group of assets that do not constitute a business combination.

Example 1 – Initial measurement of a loan acquired as part of a group of assets

Bank P acquires a group of assets that does not constitute a business for 330. P estimates the sum of the individual fair values of the assets acquired to be 350. P reviews its procedures for determining the fair value of the individual assets acquired and concludes that they are appropriate. Its analysis indicates that the discount of 20 arises because P acquired the entire group of assets in a single transaction. P identifies the following assets acquired:

	Fair value at the date of acquisition
Property, plant and equipment	100
Loan	250
Total	350

Under Approach 1, P would apply the following steps.

- Determine the individual transaction price for each asset by allocating the purchase price based on the relative fair values of the asset.

	Allocation of purchase price
Property, plant and equipment (100 × 330 / 350)	94
Loan (250 × 330 / 350)	236
Total	330

- Apply IFRS 9 to account for the difference between the transaction price for the loan of 236 and its fair value of 250 (see Section 2.8).

Under Approach 2, P would apply the following steps.

- Measure the loan at fair value.
- Allocate the residual purchase price of the acquired group to the remaining asset (or if there is more than one remaining asset, then based on their relative fair values).

	Allocation of purchase price
Property, plant and equipment (residual amount)	80
Loan (fair value)	250
Total	330

The principle for accounting for eligible transaction costs is the same as for a loan acquired individually.

2.4 Purchase as part of a business combination

IFRS 3.18, 53

When a loan is acquired as part of a business combination, it is initially measured at fair value. The acquisition-related costs incurred to effect the business combination are accounted for as an expense in the period in which they are incurred with one exception: the costs to issue debt or equity securities are recognised in accordance with IAS 32 *Financial Instruments: Presentation* and IFRS 9.

2.5 Which other assets might be acquired as part of the purchase of a loan portfolio?

IFRS 9.B5.1.1, IAS 38.18

A bank may pay a premium to acquire a loan portfolio – e.g. it may pay a transaction price that is higher than the fair value of the loans in the portfolio because the purchase price includes intangible assets, such as customer contracts and related customer relationships. Because many of the services performed by banks are based on contractual relationships with their customers, there are several types of customer-related intangible assets that may be present when a loan portfolio is acquired, either directly or through a business combination.

IAS 38.8–17, 21

An intangible asset is an identifiable non-monetary asset without physical substance. An asset is 'identifiable' if it either is separable (e.g. can be separated from the entity and sold or transferred) or arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations. These recognition criteria apply to all intangible assets, whether they are acquired separately or in a business combination.

What types of intangible assets might be acquired as part of a loan portfolio?

IAS 38.12, 18, IFRS 3.15

Customer-related intangible assets may meet the contractual-legal and/or the separability criterion. The relationship that an entity has with its customers may encompass a number of distinct intangible assets that need to be recognised separately from each other – e.g. a specific contract with a customer may need to be recognised separately from the relationship with that customer.

IFRS 3.IE23

To ensure that all identifiable intangible assets are recognised, careful consideration should be given to the customer relationships from which projected cash flows originate.

Typical customer-related intangible assets (both contractual and non-contractual) an entity may acquire as part of a loan portfolio include:

- customer relationships (e.g. borrower base or banking service relationships);
- purchased credit card relationships;
- customer lists; and
- management/servicing rights.

IAS 38.18, IFRS 3.15

When identifying the rights, relationships and contracts relating to the loan portfolio acquired, an entity should also consider its ability to market additional services and/or cross-selling opportunities (as detailed in the deal documentation, and in its due diligence and valuation models).

Other types of intangible assets may also be present – e.g. trademarks and brands.

How does an entity determine a valuation for intangible assets acquired as part of a loan portfolio?

IAS 38.35

A purchaser gathers facts about the elements of the entity or the group of assets acquired to develop reliable valuations for the intangible assets identified and considers the potential cash flows when measuring those intangible assets.

Entities should also determine whether they have obtained sufficient and supportable information for use in their valuations. This analysis, and defining the appropriate valuation model(s) that they will use, helps in:

- allocating the purchase price;
- subsequent periodic impairment evaluations; and
- determining the useful life and the pattern in which future benefits are expected to flow to the purchaser from the intangible assets.

2.6 Determining the fair value of a loan

The fair value of a financial instrument is determined in accordance with IFRS 13.

IFRS 13.9, 11

IFRS 13 defines the fair value of an asset as the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date. Fair value is a market-based measurement, rather than an entity-specific measurement, and is determined using assumptions that market participants would use in pricing the asset.

IFRS 13.61, 67, 77

The most reliable evidence of fair value is a quoted price in an active market. However, in our experience this is rarely available for a loan because loans generally are not traded in an active market and often require non-observable inputs in their valuation. As a result, their fair value is usually determined using another valuation technique. IFRS 13 requires that the use of observable inputs is maximised when using a valuation technique and the use of unobservable inputs is minimised.

Which factors should an entity take into account to determine whether the interest charged on a loan is at a market rate?

When assessing whether the interest charged on a loan is at a market rate, an entity should consider the terms and conditions of the loan, local industry practice and local market circumstances. Evidence that a loan is at market rates might include the interest rate currently charged by the entity or by other market participants for loans with similar remaining maturities, cash flow patterns, currency, credit risk, liquidity risk, collateral, interest basis and other factors.

IFRS 13.B40

If an entity uses multiple valuation techniques to measure the fair value of a loan, then it evaluates the results and weighs them based on the reasonableness of the range of values indicated by those results. The objective is to find a point within the range that is most representative of fair value. This is a matter of judgement – it is not appropriate to simply calculate an average of the outcomes from the various valuation techniques.

Banks often use their existing internal valuation models and comparisons with recent market loan portfolio transactions – i.e. relative value analyses – to develop a base value for a portfolio of loans that they acquire.

These internal valuation models can take the form of discounted future cash flows, which include:

– credit spreads derived from credit default swaps or from corporate bonds of similar credit quality to the instruments being valued;

– pricing data for loans that the banks are originating themselves;

– the terms and conditions of the loans within the portfolio (e.g. existence and type of collateral, expected prepayment patterns); and

– current market conditions.

Discount rates generally take into account expected maturities, cash flow patterns, the underlying currency of the loans, credit risk, collateral, interest basis and other factors.

Banks often use this base value as a reference point in negotiating the price of a transaction.

IFRS 13.11, 89

Because a valuation model should incorporate only factors that market participants would consider in setting a price, it is inappropriate to include entity-specific factors – e.g. liquidity or administration costs – in a model-based valuation. It is also inappropriate to adjust the results of a valuation technique to reflect the model risk of the valuation model used, unless other market participants would make similar adjustments. The validity of the results of the technique needs to be tested regularly so that the technique can be calibrated as required.[1]

Example 2 – Entity-specific input

Bank P acquires a portfolio of credit-impaired loans for 30 from Bank S. The purchase price of 30 reflects the assumptions that a market participant would make in arriving at the fair value of the portfolio. The carrying amount of the loans in S's financial statements is 29 (a face value of 100, less an allowance for expected credit losses of 71). P has superior cash collection processes in place and accordingly values the loan portfolio at 36. P determines that 30 represents the transaction price for acquiring the loan and there are no additional elements to consider.

The valuation technique used to arrive at the value of 36 takes into account P's superior cash collection processes, which is an entity-specific rather than a market-based measurement. As a result, it is not an appropriate input for calculating fair value under IFRS 13.

Consequently, P initially recognises the loans acquired at the transaction price. P's estimates in respect of the amounts and timing of cash flows are used instead to determine the loans' credit-adjusted effective interest rate. See Section 4.1 for further discussion of effective interest rates and subsequent measurement.

2.7 Can fair value be calculated on a portfolio basis?

IFRS 13.14, BC47

The fair value of a financial instrument in the scope of IFRS 9 – e.g. a loan – is generally determined on an instrument-by-instrument basis.

Can a portfolio valuation be used as a practical expedient?

IFRS 13.69

No, the unit of account for loan assets is the individual loan. However, in some cases observed sales transactions may relate to portfolios of loans. Therefore, an entity needs to determine the relevance of the price for the sale of a portfolio of similar loans for the purpose of valuing an individual loan. In doing that, the entity needs to consider whether a different liquidity discount or similar adjustment is implied in the portfolio price compared with that which would apply to the sale of an individual loan – e.g. a sale of a large portfolio of loans may include a blockage factor (discount) that would not apply to a sale of a smaller individual loan.

1. For further information on valuation approaches and techniques under IFRS 13, see Chapter 2.4 of the 17th Edition 2020/21 of our publication Insights into IFRS.

2.8 Recognising a gain or loss when transaction price differs from fair value

Where an entity believes that the initial fair value of a loan differs from the consideration paid or received for the loan (see Section 2.2), a question arises over whether this gain or loss can be recognised immediately in profit or loss.

Can an entity recognise a gain or loss on initial recognition of a loan if it determines that the transaction price for the loan differs from fair value?

IFRS 9.5.1.1A, B5.1.2A

It depends. If the entity's fair value measurement is evidenced by a quoted price in an active market for an identical asset or is based on another valuation technique that uses only data from observable markets, then the entity recognises a gain or loss immediately. This gain or loss is equal to the difference between the fair value on initial recognition and the transaction price. However, such evidence is rarely available for a loan because loans are generally not traded in an active market and often require non-observable inputs in their valuation.

If the entity's valuation technique does not use solely data from observable markets, then IFRS 9 prohibits the recognition of an immediate gain or loss on initial recognition. The difference between their fair value and the transaction price arising on initial recognition is deferred and recognised subsequently as a gain or loss. This gain or loss is recognised only to the extent that it arises from a change in a factor that a market participant would take into account in setting a price for the loan.

2.9 Accounting for acquisition-related transaction costs

IFRS 9.5.1.1

The amount recognised initially for loans that are purchased directly (i.e. not as part of a business combination) and not measured subsequently at FVTPL includes directly attributable transaction costs. Transaction costs for loans measured at FVTPL are recognised immediately in profit or loss.

IFRS 9.5.1.1, B5.4.8

Transaction costs that are included in the initial measurement of a loan are only those costs that are directly attributable to acquiring the loan. These are incremental costs that would not have been incurred if the loan had not been acquired – e.g. fees and commissions paid to agents, advisers and brokers, credit assessment fees and similar costs.

Can internal costs meet the definition of transaction costs in IFRS 9?

It depends. In practice, few internal costs are likely to meet the requirement of being incremental costs that would not have been incurred if the loan had not been acquired.

Generally, the only internal costs that meet the definition of transaction costs and are therefore included in the initial measurement of a loan are commissions, bonuses and other payments that are made to employees solely on completion of each individual transaction. Conversely, internal semi-variable costs (e.g. the costs of marketing a new product or of employing additional staff to deal with an increase in the volume of transactions) do not qualify as transaction costs.

IFRS 3.53

When loans are acquired as part of a business combination, acquisition-related costs incurred to effect the combination are generally accounted for as an expense in the period in which they are incurred (see Section 2.4).

2.10 Recognising an allowance for expected credit losses on initial recognition

IFRS 9.5.5.1, BC5.198

An allowance for expected credit losses (ECLs) is recognised for all loans other than purchased or originated credit-impaired (POCI) loans (see Section 5.3) and even for those that are newly acquired. Although there is no specific requirement to recognise a loss allowance on initial recognition of a financial asset, IFRS 9 mandates the recognition of an ECL at the next reporting date, even if this is on the same date as initial recognition. Therefore, the effect is to recognise an upfront loss because the transaction price would have included the market participant's estimate of ECLs.

IFRS 3.B41

Under IFRS 3, a financial asset acquired as part of a business combination does not attract a loss allowance at its date of acquisition because the effects of uncertainty about future cash flows are included in the acquisition date fair values. This guidance is provided specifically for calculating goodwill, because any reduction in fair value by the loss allowance would have resulted in an overstatement of goodwill. Accordingly, a loan acquired in a business combination would attract an ECL at the next reporting date, even if that is the date on which the business combination has taken place. This effectively means that, for the recognition of impairment, loans acquired as part of business combination are treated in the same way as other loans.

For further guidance on the calculation of ECLs, see Chapter 5.

2.11 Acquiring a loan from a related party

IFRS 9.5.1.1, B5.1.1

The requirement to recognise all financial assets at fair value applies to all loans, including those purchased from related parties. Similar to acquiring a loan from a third party, if a loan is acquired from a related party then the purchaser assesses whether:

- part of the consideration given is for something else; and
- the transaction price differs from fair value.

The principles of this assessment are the same as those outlined above for third parties.

If an entity acquires a loan from a shareholder acting in their capacity as shareholder and the loan is not on market terms, then the entity may need to recognise in equity a capital contribution or distribution reflecting the non-market terms of the acquisition.

3 Classification of acquired loans

On initial recognition a loan is classified into one of three measurement categories.

IFRS 9.4.1.1

On initial recognition, an acquired loan is classified into one of the three measurement categories for financial assets as defined in IFRS 9:

- amortised cost;
- fair value through other comprehensive income (FVOCI); or
- fair value through profit or loss (FVTPL).

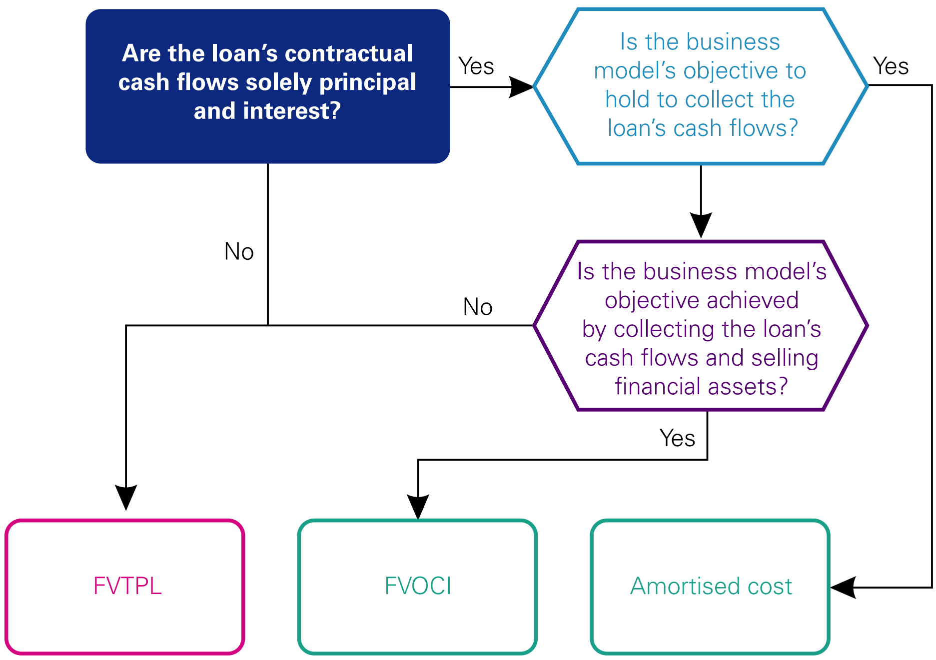
IFRS 3.16

How the acquired loan is classified is based on conditions that exist on the date of purchase or business combination – i.e. the date on which the purchaser first becomes party to the loan's contractual provisions. The classification of the acquired loan by the purchaser may differ to that in the seller's financial statements.

Although many loans are classified as measured at amortised cost, some are mandatorily (or voluntarily) classified as at FVTPL or FVOCI.

These classification criteria also apply to loans that are credit-impaired at the time of acquisition.

The flowchart below summarises the classification of loans.



3.1 Loans measured at amortised cost

IFRS 9.4.1.2

An acquired loan is measured at amortised cost only if it meets both of the following conditions at the date of acquisition.

- The loan is held within a business model whose objective is to hold assets to collect contractual cash flows (the held-to-collect business model).
- The contractual terms of the loan give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (the SPPI criterion).

3.2 Loans measured at FVOCI

IFRS 9.4.1.2A

An acquired loan is measured at FVOCI if both of the following conditions are met at the date of acquisition.

- The loan is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.
- The contractual terms of the loan give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

3.3 Loans measured at FVTPL

IFRS 9.4.1.4–4.1.5

All acquired loans that meet either of the following criteria are classified as financial assets measured at FVTPL:

- the loans are not held in either a held-to-collect or a held to collect and for sale business model; and
- the loans' contractual cash flows are not SPPI-compliant

In addition, a purchaser has an option on initial recognition to irrevocably designate a loan at FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency – i.e. an 'accounting mismatch' – that would otherwise arise from measuring the loans or recognising the gains or losses on them on a different basis.

3.4 Assessing the business model

IFRS 9 4.1.1–4.1.2A

The table below summarises the key features of each type of business model and the resultant measurement category.

Business model	Key features	Category
Held-to-collect	– Objective of the business model is to hold assets to collect contractual cash flows – Sales are incidental to the objective of the model – Typically involves the lowest level of sales compared with other business models (in frequency and volume)	Amortised cost, if it also meets the SPPI criterion (see Section 3.1).
Both held-to-collect and for sale	– Both collecting contractual cash flows and sales are integral to achieving the objective of the business model – Typically has more sales (in frequency and volume) than the held-to-collect business model	FVOCI, if it also meets the SPPI criterion (see Section 3.2).
Other business models, including: – trading – managing assets on a fair value basis – maximising cash flows through sale	– Objective of the business models is neither held-to-collect nor held to collect and for sale – Collection of contractual cash flows is incidental to the business model's objective	FVTPL (see Section 3.3)

IFRS 9.B4.1.2, BC4.20

An entity's business model is determined at a level that reflects how a portfolio of loans is managed together to achieve a particular business objective. The business model is not determined on an instrument-by-instrument basis. Generally, an entity's business model is a matter of fact and can be observed from the way in which the entity is managed and the information that is provided to management.

In some circumstances, it may be appropriate to separate an acquired portfolio of loans into sub-portfolios. For example, this would be the case if a bank purchases a portfolio of loans and intends to manage some of the loans with an objective of collecting contractual cash flows and the other loans with an objective of selling them. This can also apply to portions of loans.

Example 3 – Classifying portions of a loan

Bank Z generally acquires loans to collect contractual cash flows. However, it plans to sell portions of the acquired loans that exceed the credit approval limits shortly after acquisition.

Z allocates the purchased loans into its business models, as follows:

– loans (or portion of loans) that it intends to hold to collect the contractual cash flows to the held-to-collect model; and
– loans (or portion of loans) that it intends to sell in the near term to the held-for-trading model.

If a purchaser allocates purchased loans to one of its existing portfolios, does it need to consider how cash flows were realised in the past for the portfolio?

IFRS 9.B4.1.2A

Yes. When an entity assesses the business model for newly acquired loans that will be added to a particular existing held-to-collect (or held to collect and for sale) portfolio, it needs to consider information about how cash flows in that portfolio were realised in the past as part of determining whether the relevant business model criteria continue to be met and to determine the appropriate business model for the newly acquired loans.

Is the acquisition of loans for the purpose of selling them to a securitisation vehicle consistent with a held-to-collect business model?

It depends. A portfolio of loans acquired with the objective of selling them to a securitisation vehicle may be consistent with a held-to-collect business model, depending on the circumstances. If selling the loans to the vehicle would result in derecognition, then the objective would be inconsistent with a held-to-collect objective. However, if selling the assets to the vehicle would not result in derecognition, then further analysis would be required.

The assessment of the business model may differ between the financial statements of the legal entity that sells to the securitisation vehicle and the consolidated financial statements.

Example 4 – Loans acquired with the objective of selling to a securitisation vehicle

IFRS 9.B4.1.4.Ex3

Bank D's business model is to acquire portfolios of loans for the purpose of selling them to a securitisation vehicle, which D controls and consolidates. The loans held in this business model are derecognised in D's separate financial statements at the time of sale and recognised in those of the securitisation vehicle. On consolidation, the loans remain within the consolidated group.

In the consolidated financial statements, the held-to-collect criterion is met because the consolidated group acquired the loans with the objective of collecting the contractual cash flows.

However, in D's separate financial statements the held-to-collect criterion is not met. This is because the individual entity has acquired the loans with the objective of selling them to the securitisation vehicle, rather than holding them to collect the contractual cash flows.

3.5 The SPPI criterion

IFRS 9 4.1.1– 4.1.2

To determine whether an acquired loan should be classified as measured at amortised cost or FVOCI, the purchaser assesses whether the cash flows from the loan represent, on specified dates, solely payments of principal and interest on the principal amount outstanding – i.e. the SPPI criterion.

IFRS 9.4.1.3, B4.1.7A

Contractual cash flows that are SPPI are consistent with a basic lending arrangement. In these arrangements, the consideration for the time value of money and credit risk are typically the most significant elements of interest. However, interest can also include consideration for other basic lending risks (e.g. liquidity risk) and costs (e.g. administrative costs) associated with holding the loan.

IFRS 9.B4.1.7B

The principal is defined as the fair value of the financial asset on initial recognition. However, that principal amount may change over the life of the financial asset – e.g. if there are repayments of principal.

Can the purchaser's SPPI assessment differ from that of the seller?

Yes. The SPPI assessment could differ for the purchaser of a loan. This might be because the contractual cash flows change over the life of the loan. For example, at origination a loan may have features that are inconsistent with the SPPI criterion but that have expired before the loan is acquired. Therefore, although such a loan may have needed to be measured at FVTPL by the seller, it may meet the criteria for measurement at amortised cost by the purchaser.

3.5.1 Leverage features

IFRS 9.B4.1.9

Some loans contain a leverage feature. Leverage increases the variability of the contractual cash flows such that they do not have the economic characteristics of interest. Loans containing such features do not meet the SPPI criterion.

Do floating interest rate loans acquired at a deep discount contain leverage?

It depends. A floating-rate, non-prepayable loan may be acquired at a deep discount to its stated par amount. The discount usually represents a charge for credit risk and/or liquidity risk because investors typically demand a higher effective yield than the stated contractual interest rate for these risks.

A question arises over whether the discount results in a leverage feature that would cause the instrument to fail the SPPI criterion. This is because the coupons are calculated by multiplying the stated floating interest rate by the stated par amount of the loan, which is greater than the principal amount as defined in IFRS 9. The way in which the coupons are calculated therefore results in increased variability in the contractual cash flows.

The instrument would be consistent with a basic lending arrangement if all of the following conditions are met:

- interest is payable based on an unleveraged floating rate applied to the par amount;
- the instrument contractually requires the borrower to repay the entire par amount; and
- there are no other problematic features that would cause the instrument to fail the SPPI criterion.

This is because leverage has not been incorporated into the terms of the instrument and the discount reflects what market participants would demand for an increase in credit and/or liquidity risk.

Example 5 – Variable-rate loan acquired at a discount

Bank X acquires a floating-rate non-prepayable loan at 80. The loan has a par amount of 100 and the borrower is contractually required to pay 100 on maturity. The loan pays interest on the par amount based on three-month IBOR, reset every three months. The discount of 20 arose because investors require a higher effective yield than the stated contractual interest rate due to credit risk and liquidity risk at the time of purchase by X.

In this example, there is increased variability in the contractual cash flows. This is because interest is calculated by multiplying the three-month IBOR rate by the par amount of 100, which is greater than the principal of 80. However, the borrower is required to repay 100 on maturity. Therefore, the loan meets the SPPI criterion because leverage has not been incorporated into the instrument – i.e. the discount reflects what market participants would demand for an increase in credit and/or liquidity risk.

Modifying the example, if the borrower was contractually required to pay X only 80 on maturity but the interest on the loan was still based on the par amount of 100, then the loan would not meet the SPPI criterion because leverage would exist.

3.5.2 Prepayment options

IFRS 9.B4.1.11

IFRS 9 has specific requirements relating to prepayment options. For a prepayment option to be consistent with the SPPI criterion, the prepayment amount has to substantially represent 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.B4.1.7B

A potential problem could arise because loans are often prepayable at their par amount plus accrued contractual interest (plus, in some cases, a penalty). However, the standard defines 'principal' as the fair value of the financial asset on initial acquisition. For the purchaser, this may differ from the par amount.

IFRS 9.B4.1.12

IFRS 9 has an exception for certain prepayment features at par that is particularly relevant for purchases of loans that are credit-impaired. Under this exception, if a financial asset would otherwise meet the SPPI criterion, but fails to do so only as a result of a contractual term that permits or requires prepayment before maturity, or permits or requires the holder to put the instrument back to the issuer, then the asset can be measured at amortised cost or FVOCI if:

i. the relevant business model condition is satisfied;

ii. the entity acquired or originated the financial asset at a premium or discount to the contractual par amount;

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

iv. on initial recognition of the financial asset, the fair value of the prepayment feature is insignificant.

IFRS 9 does not define the term 'contractual par amount'. If the contract does not define the term, then the 'contractual par amount' could be interpreted as either the nominal amount or the original issue price.

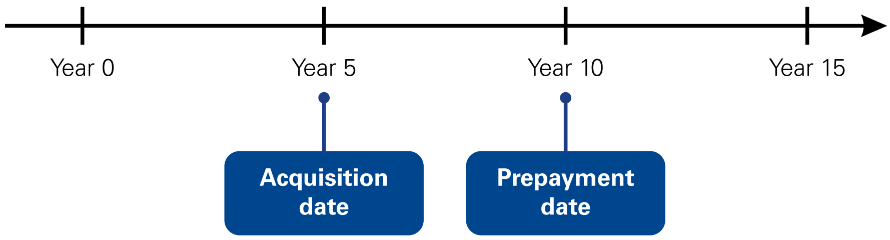
The fair value of the prepayment feature referred to in (iv) above may be determined by comparing the fair value of an otherwise identical loan without the prepayment feature with the fair value of the actual loan with the prepayment feature. The fair value of the prepayment feature cannot be determined by comparing the fair value on acquisition with the contractual par amount.

Some instruments may contain prepayment features that may qualify under this exception. This may be the case in circumstances where the borrower may have the contractual ability to prepay at par, but the contractual prepayment feature would have an insignificant fair value because it is very unlikely that a prepayment will occur.

If the exception for prepayments at par does not apply, then can a loan purchased at a premium still meet the SPPI criterion?

Yes. If the exception for certain prepayment features at par does not apply, it is still possible that a loan acquired at a premium and prepayable only at a specific point in time after acquisition may meet the SPPI criterion. This is because, if the premium is effectively repaid through coupon payments during the period before the prepayment date, then at the time when the prepayment option can and is expected to be exercised, a fixed prepayment amount may equal unpaid amounts of principal and interest.

Example 6 – Acquisition at a premium to par amount: Loan acquired in a business combination



Entity C issues a loan at par that matures in 15 years and has a fixed interest rate of 4%. Bank B acquires the loan in Year 5 in a business combination. The fair value at this time is 112 following a significant decrease in the market interest rates for these loans. The loan can be prepaid by C only in Year 10 at a par of 100. Following the drop in market interest rates, the fair value of the prepayment feature at the date of the business combination is significant. Market participants valuing the loan at the date of acquisition would assume that it is highly likely that the prepayment option would be exercised at the prepayment date – i.e. five years after the acquisition.

The principal on initial recognition of the loan by B is 112, but this amount changes over time as a result of payments received. In this case, B determines that the premium of 12 relates to the first five years and that the coupon payments will represent, in economic terms, partly interest and partly repayments of principal. When the prepayment option can and is expected to be exercised, the unpaid amount of principal will be 100 and the exercise price of the prepayment option will also be 100.

Therefore, the loan meets the SPPI criterion.

Modifying the example, if the prepayment option was exercisable at par at any time after acquisition of the loan but only in the event of a specified change in tax law that is considered very unlikely, then the prepayment amount would not substantially represent unpaid amounts of principal and interest. This is because the contingent event could occur at any time and the principal amount is currently 112 and the prepayment amount is 100. Therefore, the SPPI criterion would probably not be met. However, the loan may still be eligible for classification at amortised cost or FVOCI if the fair value of the prepayment feature is insignificant on initial recognition. This is because the loan was acquired at a premium and the prepayment amount substantially represents the contractual par amount and accrued contractual interest.

For some fixed-rate retail mortgage or other loans, the borrower may have a prepayment option that is exercisable at the contractual par amount plus accrued unpaid interest at any time. If market interest rates fall, then this increases the likelihood that borrowers may exercise their prepayment options. However, not all borrowers act 'rationally' in an economic sense and they may not exercise their prepayment options even when it appears to be in their financial interest to do so. This reduces the fair value of the prepayment option, which is based on market participant views of the probability and possible timing of prepayment. If a loan is acquired at a premium to the par amount and is prepayable at the par amount, and the fair value of the prepayment feature is significant on initial recognition, then the loan does not meet the exception for certain prepayment features at par.

Example 7 – Retail mortgage loans prepayable at par

Bank B acquires a fixed-rate retail mortgage loan with a par value of 100 in a business combination. Because market interest rates have declined since origination of the loan, B acquires it at a premium (i.e. for 112). Borrower C can prepay the loan at the contractual par amount (i.e. 100) plus accrued unpaid interest at any time. Although the interest rate on the mortgage loan is above the current market interest rate that C would pay if C were to refinance with a new lender, historical experience and current expectations are that a significant proportion of customers, like C, do not seek a refinancing in these circumstances but will continue with the current product.

B determines the fair value of the prepayment option by comparing the fair value of an otherwise identical loan without the prepayment option with the fair value of the loan to C. The fair value of an otherwise identical loan without the prepayment option is 125. The fair value of the loan to C, which includes market-consistent assumptions about the likelihood of C exercising its prepayment option, is 112. Under this method, the fair value of the prepayment option is 13. B determines that the fair value of the prepayment feature of 13 is significant on initial recognition, and the loan therefore fails to qualify for measurement at amortised cost or FVOCI.

3.6 Purchased or originated credit-impaired loans

Some entities acquire distressed loans – i.e. loans that are credit impaired on initial recognition.

IFRS 9.B4.1.4

Acquiring credit-impaired loans is not in itself inconsistent with a held-to-collect business model. The classification would still depend on the specific business model for these loans and whether they meet the SPPI criterion. For example, an entity would have a held-to-collect business model for the acquired loans if, following the acquisition, it intended to collect the contractual cash flows by taking the necessary actions to maximise recoveries.

IFRS 9.BC4.193

The exception for certain prepayment features at par discussed above is also relevant for acquisitions of POCI loans that can be prepaid at par. This is because such loans are purchased at a large discount and so, the principal amount differs significantly from the par amount. If an entity purchases POCI loans at a deep discount to par, then prepayment is very unlikely because the loan is impaired and the borrower is unlikely to have funds to prepay the loan.

An entity may acquire distressed loans as part of a business combination that are POCI loans in the group financial statements but not in the acquired subsidiary's financial statements. For example, these loans might have been originated by the subsidiary and become credit-impaired before the date of acquisition.

4 Subsequent measurement

Initial classification determines the subsequent measurement of acquired loans in the financial statements of the acquirer.

IFRS 9.5.2

The subsequent measurement of acquired loans depends on their initial classification – i.e. they can be subsequently measured at amortised cost, FVOCI or FVTPL.

The recognition and presentation of gains and losses for each measurement category are as follows.

	Profit or loss	OCI
IFRS 9.5.4.1–.5.4.2 **Amortised cost**	– Interest revenue using the effective interest method – Foreign exchange gains and losses – ECLs and reversals – Gain or loss on derecognition of the loan	
IFRS 9.5.7.10 **FVOCI**	– Interest revenue using the effective interest method – Foreign exchange gains and losses – ECLs and reversals – On derecognition of the loan, the cumulative gain or loss previously recognised in OCI is reclassified from equity	– Gains and losses not recognised in profit or loss – The cumulative gain or loss transferred to profit or loss on derecognition of the loan
IFRS 9.5.7.1 **FVTPL**	– All gains and losses on subsequent measurement and derecognition of the loan	

4.1 Effective interest method

The effective interest method is used to determine interest income for all loans measured at amortised cost and at FVOCI. A similar approach is also used if interest on an FVTPL loan is presented separately from other fair value changes.

IFRS 9.A, B5.4.4

The effective interest rate is calculated on initial recognition of a loan and reflects a constant periodic return on the carrying amount of the loan. It is the rate that exactly discounts the estimated future cash receipts (without considering ECLs) through the expected life of the loan to the gross carrying amount of the loan on initial recognition. There is a presumption that the cash flows and the expected life of a group of similar loans can be estimated reliably.

How is the effective interest rate calculated on an acquired loan?

The purchaser uses the fair value of the loan at the date of acquisition, the eligible transaction costs and the total cash flows expected over the remaining term of the loan to calculate the effective interest rate.

When a loan is acquired as part of a business combination, this new effective interest rate is used in the consolidated financial statements and may differ from the effective interest rate in the books of the acquiree. However, this has no impact on the acquiree's accounting in its own financial statements.

IFRS 9.5.4.1

Interest income is calculated by applying the effective interest rate to the gross carrying amount of the loan. However, if a loan becomes credit-impaired after acquisition, then interest income is calculated by applying the effective interest rate to the amortised cost of the loan – i.e. the gross carrying amount less the loss allowance for impairment.

When a loan gives either the borrower or the lender the option to require the loan to be repaid early, and the terms are such that it is not certain whether the option will be exercised, the acquirer assesses the probability of the option being exercised when determining the estimated cash flows. It is possible that the acquirer's estimate will differ from that made by the acquiree when it initially recognised the loan.

In the rare cases when it is not possible to estimate the timing or amount of future cash flows reliably, either for an individual loan or for a portfolio of similar loans, IFRS 9 indicates that an entity should use the contractual cash flows over the full contractual term of the loan or the portfolio. In some cases (e.g. prepayable mortgages), historical prepayment patterns may be useful when estimating expected lives.

How do changes in expected contractual cash flows impact the gross carrying amount of a loan?

IFRS 9.B5.4.6

If there is a change in the timing or amount of estimated cash flows (other than because of changes in estimates of ECLs), then the gross carrying amount of the loan is adjusted in the period of change to reflect the revised actual and estimated cash flows. The revised gross carrying amount of the loan is recalculated by discounting the revised estimated future cash flows at the loan's original effective interest rate (or credit-adjusted effective interest rate for POCI loans). The corresponding income or expense is recognised in profit or loss.

Example 8 – Re-estimating cash flows when expectations change

On 1 January 2020, Bank Y purchases a portfolio of prepayable loans with a total par amount of 50,000. Y pays 49,000 for the portfolio, which is equal to its fair value on that date. The loans pay a fixed interest rate of 3% annually on the last day of each year. The expected average life of the portfolio as determined by Y is five years; assume for simplicity that the total par amount will be paid back on 31 December 2024.

Y determines the effective interest rate to be 3.4% (this is the internal rate of return assuming the initial cash outflow of 49,000 and inflows of annual coupons of 1,500 and par amount of 50,000 at the end of 2024). Y starts accreting the initial gross carrying amount of 49,000 to the par amount of 50,000 over the five years using the effective interest rate.

On 31 December 2020, the prepayment expectations for the portfolio increase such that the expected average life of the portfolio is revised to three years from that date – i.e. a year shorter than Y's original expectation at the date of acquisition. Assume for simplicity that the total par amount will be paid back at the end of 2023.

Y recalculates the gross carrying amount at 31 December 2020 reflecting the revised estimated cash flows. These include earlier receipt of the loan portfolio's par amount, offset partially by a year of foregone interest, and discounted at the original effective interest rate for the portfolio of 3.4%. The resulting gain of 193 is recognised immediately in profit or loss.

4.2 Discounts or premiums on acquisition

Generally, any discounts or premiums that arise on acquisition of a loan are recognised over its expected life using the effective interest method. Straight-line amortisation of discounts or premiums is not permitted. In some cases, discounts or premiums are recognised over a shorter period if they relate to a specific period – e.g. when the variable is repriced to market rates before the expected maturity of the loan.

IFRS 9 B5.4.4

If a discount or premium arises on the acquisition of a floating-rate loan, then it is important to identify the reason for it. For example, to the extent that it reflects changes in benchmark interest rates since the floating rate loan was last repriced, it will be amortised to the next repricing date. Alternatively, to the extent that the premium or discount results from a change in credit spread, it is amortised over the expected life of the loan. Therefore, a loan portfolio acquisition may require a discount or premium to be separated into two parts; one part reflecting changes in benchmark interest rates and the other, changes in credit risk. These may need to be amortised over different periods.

If interest-bearing loans are acquired between interest payment dates, then normally the purchaser has an obligation to pay the accrued interest to the seller when it is received. Alternatively, it pays a higher price for the loans to reimburse the seller for the accrued interest that will be paid to the purchaser by the borrowers. Interest that has accrued on interest-bearing loans before they are acquired is not recognised as income. If there is an obligation to pay the accrued interest to the seller, then a receivable and a corresponding payable are recognised in respect of accrued interest.

4.3 Effective interest method for POCI loans

IFRS 9.B5.4.7

The effective interest rate for POCI loans is calculated differently from the general requirements. The calculations include expected cash flows that include lifetime ECLs estimated on initial recognition of the POCI loan – i.e. the estimated contractual cash flows are reduced by the lifetime ECLs. The resulting rate is defined as a credit-adjusted effective interest rate.

Interest income on a POCI loan is calculated by applying the credit-adjusted effective interest rate to the amortised cost of the loan.

Example 9 – Initial recognition of POCI loans

Bank S buys a portfolio of amortising credit-impaired loans with a remaining life of four years for 800, which is the fair value at that date. The remaining contractual cash flows at the time of purchase are 1,000 and the expected cash flows are as follows. Assume that all cash flows are expected to be paid at the year end.

Year	1	2	3	4
Expected cash flows	220	220	220	220

The credit-adjusted effective interest rate of 3.925% is calculated as the internal rate of return of the initial purchase price (i.e. 800) and the cash flows expected to be collected.

S records the following entry on initial recognition.

	Debit	**Credit**
Loan asset	800	
Cash		800
To recognise loans on initial recognition		

Example 10 – Subsequent measurement of POCI loans

Continuing Example 9, Bank S's expectation about future cash flows from the portfolio at the end of Year 1 has not changed since initial recognition.

At the end of Year 1, S calculates interest income to be 31 by applying the effective interest rate (i.e. 3.925%) to the amortised cost of the loan of 800. In addition, S receives a cash payment of 220.

S records the following entries in Year 1.

	Debit	Credit
Loan assets	31	
Interest income		31
To recognise interest income in Year 1		
Cash	220	
Loan assets		220
To recognise receipt of cash in Year 1		

At the end of Year 1, the loan portfolio is recognised in the balance sheet at 611. This is its gross carrying amount and amortised cost (i.e. 800 plus interest of 31 less cash received of 220).

This example illustrates that no impairment expense or allowance is recognised if, in subsequent periods, experience and expectations about the collectability of cash flows are unchanged from expectations on initial recognition.

Example 12 in Section 5.3 illustrates a scenario where expected cash flows increase after acquiring a POCI loan.

4.4 Loans acquired in a business combination

IFRS 3.18

Similar to originated loans and loans acquired in a separate transaction, loans acquired as part of a business combination are initially measured by the acquirer at their fair value at the date of acquisition.

IFRS 9.A

The acquirer uses the fair value of the loan at the date of acquisition and the total cash flows expected over its expected life to calculate a new, original effective interest rate. This rate is used to determine the interest income in the acquirer's consolidated financial statements but has no impact on the accounting in the acquiree's financial statements.

5 Impairment of acquired loans

Loans measured at amortised cost or FVOCI are subject to the impairment requirements of IFRS 9; those measured at FVTPL are not.

IFRS 9.5.5.1

The impairment model in IFRS 9 is an ECL model, which means it is not necessary for a loss event to occur before an impairment loss is recognised. Accordingly, all loans subject to impairment requirements (other than certain POCI loans – see Sections 3.6 and 5.3) carry an ECL allowance. This means that a purchaser will suffer an impairment charge in profit or loss from recognising ECLs on newly acquired loans that are not POCI loans and are not measured subsequently at FVTPL.

To measure ECLs on the acquired loans, the purchaser needs to determine :

- which loans are POCI loans, because the ECL model for POCI loans is different (see Section 5.3);
- the effective interest rate that will be used to recognise the time value of money when calculating ECLs (see Sections 5.1 and 5.3); and
- the relevant date of initial recognition for allocating the acquired loans to stages (see Section 5.2).

Acquired loan commitments that are not measured at FVTPL are also subject to ECL requirements (see Section 6.4).

5.1 Reflecting the time value of money in estimating ECLs

IFRS 9.5.5.17, B5.5.29

ECLs on acquired non-POCI loans are measured as the present value of cash shortfalls – i.e. the difference between all contractual cash flows due and the cash flows that the entity expects to receive, discounted at the loan's effective interest rate. The effective interest rate that the purchaser uses for the calculation is likely to differ from the rate used by the seller, because it is calculated with reference to the initial amount at which the loan was recognised by the purchaser (see Section 4.1). A different effective interest rate will lead to a different amount of ECLs recognised by the acquirer, compared with the seller.

5.2 Stage allocation

IFRS 9.5.5.3, 5.5.5

Under the general approach, impairment is measured as either 12-month ECLs (often referred to as Stage 1) or lifetime ECLs (often referred to as Stage 2), depending on whether there has been a significant increase in credit risk since initial recognition. If a significant increase in credit risk of a loan has occurred since its initial recognition, then impairment is measured as lifetime ECLs. Lifetime ECLs also apply if a loan deteriorates to becoming credit-impaired after initial recognition (often referred to as Stage 3).

IFRS 9.5.5.6, 5.7.4, B5.5.47

The table below identifies the date of initial recognition for the purpose of determining whether there has been a significant increase in credit risk since initial recognition (i.e. stage allocation) in different potential acquisition scenarios.

Loan	Date of initial recognition for the purposes of stage allocation
Loan purchased directly	Trade date, irrespective of whether the entity applies trade date or settlement date accounting (see Section 1.2)
Loan acquired in a business combination	The date on which the acquirer obtains control of the acquiree
Loan arising from a purchased loan commitment, where the commitment is not measured at FVTPL	The date on which the loan commitment was purchased
Loan arising from a purchased loan commitment, where the commitment is measured at FVTPL	An entity chooses an accounting policy, to be applied consistently to use one of the following as the date of initial recognition of the loan: – the date on which the loan commitment was purchased; or – the date on which the loan is drawn down.

Example 11 – Significant increase in credit risk: A relative concept

Bank B uses an internal credit rating system of 1 to 10, with 1 denoting the lowest credit risk and 10 denoting the highest credit risk. B considers an increase of two rating grades to represent a significant increase in credit risk.

At the reporting date, B has the following two loans outstanding.

	Grade on initial recognition	Grade at reporting date
Loan A	2	5
Loan B	4	5

The grades of the loans on initial recognition differed because they were acquired at different dates.

B assesses whether there has been a significant increase in credit risk in respect of the loans and reaches the following conclusions.

	Significant credit risk increase?	Recognise allowance equal to…
Loan A	Yes	Lifetime ECLs
Loan B	No	12-month ECLs

The measurement basis for the loss allowance differ despite the fact that both loans have the same grade at the reporting date. This is because only the credit risk of Loan A has increased significantly since initial recognition.

If an entity acquires a loan that is allocated to Stage 2 by the seller, then does it remain a Stage 2 loan for the acquirer?

No. The acquirer allocates the loan to Stage 1 because all loans that are not credit-impaired on initial recognition are allocated to Stage 1. The acquirer assesses whether the credit risk on the loan has increased significantly from the date it acquired it. This means that in a business combination scenario, the stage allocation of a loan may differ between the financial statements of the acquired subsidiary and the consolidated financial statements.

See Chapter 7.8 in the 17th Edition 2020/21 of our publication Insights into IFRS for further guidance on accounting for the impairment of financial assets.

5.3 POCI loans

IFRS 9.5.5.13

On initial recognition, POCI loans (i.e. loans that are credit-impaired on initial recognition) do not carry an impairment allowance, even if the date of initial recognition is the same as the reporting date. Instead, lifetime ECLs at the date of initial recognition are incorporated into the calculation of the credit-adjusted effective interest rate (see Section 4.3).

ECLs for POCI loans are always measured at an amount equal to lifetime ECLs. However, the amount recognised as a loss allowance for these loans is not the total amount of lifetime ECLs, but the changes in lifetime ECLs since initial recognition of the loan. Favourable changes in lifetime ECLs are recognised as an impairment gain. This is the case even if the favourable changes exceed the amount, if any, previously recognised in profit or loss as an impairment loss.

Example 12 – Subsequent measurement of POCI loans: Improved credit worthiness

Continuing Example 9, the credit worthiness of the borrowers in the portfolio has improved and at the end of Year 1, S expects to collect the following cash flows. These reflect an increase of 30 per year from those expected on acquisition of the loans.

Year	2	3	4
Expected cash flows	250	250	250

At the end of Year 1, S calculates interest income as 31 by applying the credit-adjusted effective interest rate (3.925%) to the amortised cost of the loans of 800. It records the following entries to recognise interest income and cash received.

	Debit	Credit
Loan assets	31	
Interest income		31
To recognise interest income in Year 1		
Cash	220	
Loan assets		220
To recognise receipt of cash in Year 1		

The revised expected cash flows are discounted using the original effective interest rate and the resulting favourable change in lifetime ECLs of 83 ((30 / 1.03925) + (30 / 1.03925^2) + (30 / 1.03925^3)) is recognised as an impairment gain at the end of Year 1, as follows.

	Debit	Credit
Loss allowance	83	
Impairment gain		83
To recognise impairment gain for Year 1		

At the end of Year 1, S recognises the loan portfolio on its balance sheet at its amortised cost of 694, comprising:

- a gross carrying amount of 611 (800 plus interest of 31 less cash received of 220); and
- a loss allowance, being a debit balance of 83.

The loss allowance at the end of Year 1 is a debit balance because there has been a cumulative decrease in ECLs since initial recognition. For POCI loans, the loss allowance reflects only changes in lifetime ECLs since initial recognition. This is in contrast to non-POCI loans, for which the loss allowance reflects the full 12-month or lifetime ECLs.

5.4 Loans acquired in a business combination

IFRS 3.B41

As discussed in Section 2.10, under IFRS 3 a loan acquired as part of a business combination does not attract a loss allowance at its date of acquisition. This guidance is provided specifically for the purpose of calculating goodwill, because any reduction in fair value by the loss allowance would have resulted in overstatement of goodwill.

Accordingly, under IFRS 9 a loan acquired in a business combination would attract a loss allowance at the first reporting date after it is recognised, even if that date is the date on which the business combination has taken place. This effectively means that, for the recognition of impairment, these loans are treated in the same way as loans that are originated or acquired in a direct purchase transaction.

6 Loan commitments

Acquired loan portfolios often include commitments to provide further loans. A purchaser needs to evaluate whether the portfolio includes loan commitments and determine how they should be initially recognised and subsequently measured.

An acquired loan portfolio can often include commitments to provide further loans, either to the borrowers that have already drawn down some amounts or to other borrowers. A purchaser of a loan portfolio evaluates whether the portfolio includes loan commitments and determines at what amount the loan commitments should be initially recognised and how they should be subsequently measured.

A loan commitment is an arrangement under which either:

- both the lender and the borrower are committed to a future loan transaction; or
- more commonly, the lender is obliged contractually to grant a loan but the borrower is not required to take the loan.

IFRS 9. BCZ2.2

A loan commitment is a firm commitment to provide credit under pre-specified terms and conditions that meets the definition of a financial instrument.

IFRS 9.2.1(g), 2.3

Loan commitments, both issued and held, are generally excluded from the scope of IFRS 9, except for the derecognition requirements and, for loan commitments issued, impairment requirements. In certain circumstances, a loan commitment falls *entirely* in the scope of IFRS 9.

6.1 Accounting for purchased loan commitments

IFRS 9.2.3

The following loan commitments are in the scope of IFRS 9.

Type of loan commitment	Accounting treatment
Loan commitment that can be settled net in cash	FVTPL
Where the entity has a past practice of selling the asset resulting from the loan commitments in the same class shortly after their origination/acquisition	FVTPL for all loan commitments in the same class
Loan commitment that the entity chooses to designate on initial recognition as FVTPL (see Section 6.3)	FVTPL
Commitment to provide a loan at below market rate	See Section 6.2

IFRS 9.2.1(g), B5.4.2–B5.4.3

Other purchased loan commitments issued are outside of the scope of IFRS 9, except for the derecognition and ECL requirements (see Section 6.4). If these loan commitments are acquired as part of a portfolio of loans and other assets, then they are initially measured applying the principles discussed in Section 2.3. If they are acquired as part of a business combination, then under IFRS 3 they are initially measured at fair value in the purchaser's financial statements. The amounts initially recognised are akin to fees received for providing a loan commitment and are subsequently measured as follows:

- if it is probable that the purchaser will make a loan under the commitment then the amount initially recognised is included in the calculation of the effective interest rate of the related loan; and
- if it is unlikely that the purchaser will make a loan under the commitment then the amount initially recognised is recognised in accordance with IFRS 15 *Revenue from Contracts with Customers*.

6.2 Loan commitment to provide a loan at below-market interest rate

IFRS 9.4.2.1(d)

When an entity enters into a commitment to provide a loan at a below-market interest rate and the entity has not designated the loan commitment as at FVTPL, the loan commitment is measured initially at fair value and subsequently at the higher of:

- the amount of the loss allowance in accordance with IFRS 9 (see Chapter 5); and
- the amount recognised initially less the cumulative amount of income recognised under the principles of IFRS 15.

If a loan commitment was granted at a market rate by the seller, then does the purchaser need to reassess whether it is at market rate at the time of acquisition?

Yes. A purchaser of a loan portfolio evaluates on initial recognition – i.e. on the date of acquisition – whether the portfolio includes commitments to provide loans at below-market rates. This may arise, for example, if market rates of interest have increased between origination of the loan commitment and purchase of the loan portfolio.

In making the evaluation, the purchaser considers all of the terms of the loan commitment, including whether there are clauses that allow the lender to change the rate of interest to market rate at the time of draw-down or cancel the commitment.

If at the date of acquisition, the portfolio includes commitments to provide loans at rates of interest that are below-market at that time, then the commitments fall entirely in the scope of IFRS 9. This applies from the purchaser's perspective, irrespective of whether the seller previously considered them as in scope.

6.3 Designation of loan commitments as at FVTPL

An entity may acquire loan commitments that the seller had previously designated as at FVTPL and those for which the seller had made no such designation.

IFRS 3.15–16, IFRS 9.2.3(a), 4.2.2

Can a purchaser choose to designate the acquired loan commitment as at FVTPL?

Yes. Acquiring a loan commitment, through either direct purchase or a business combination, results in the acquirer becoming a party to the contract that is the loan commitment. This means that the designation options available on initial recognition of a loan commitment can be adopted, provided that the designation criteria in IFRS 9 are met from the purchaser's perspective. IFRS 3 specifically refers to the acquirer making such designations on the basis of the contractual terms and other pertinent conditions existing at the date of acquisition.

Therefore, the purchaser can designate the acquired loan commitment as at FVTPL for the purposes of its financial statements. The purchaser can choose to do this even if the loan commitment had not previously been classified as such in the seller's financial statements. Alternatively, the purchaser can choose not to apply the FVTPL designation previously adopted by the seller or acquired entity.

This means that the classification of loan commitments acquired as part of a business combination may differ between the consolidated financial statements of the purchaser and the financial statements of the acquired subsidiary.

6.4 Loan commitments subject to ECL

IFRS 9.B5.5.30

Loan commitments issued that are not subsequently measured at FVTPL are subject to the impairment requirements of IFRS 9 (see Chapter 5). This means that a purchaser is generally required to recognise a loss allowance on these acquired loan commitments. Similar to acquired loans, this results in a day-one profit or loss impact (except that an impairment charge is recognised for commitments to extend a loan at a below-market rate of interest only if the loss allowance exceeds the unamortised amount of the initial fair value).

The purchaser allocates acquired loan commitments that are not credit-impaired to Stage 1 of the ECL model, even if the seller has previously allocated them to Stage 2.

7 Indemnities provided by the seller

Indemnities received from the seller in a business combination are accounted for as indemnification assets. Accounting for an indemnity received from the seller in a direct purchase depends on whether it is a financial guarantee contract and, if so, whether it is an integral element of a loan.

When loans are acquired in a direct purchase or as part of a business combination, the seller may provide indemnities to the purchaser in respect of the loans.

7.1 Indemnities provided in a direct purchase

There is no specific guidance on the accounting by the purchaser when an indemnity or other guarantee is provided by the seller in a direct purchase of loans, other than when the indemnity meets the definition of a financial guarantee contract. An indemnity may impact the analysis of whether the seller should derecognise the loans and the purchaser should recognise them. If the derecognition requirements are not met, then the purchaser recognises a receivable from the seller rather than the loan assets transferred. The following paragraphs assume that the purchaser recognises the loans in its balance sheet.

IFRS 9.A

As a first step, the purchaser assesses whether the indemnity meets the definition of a financial guarantee contract. This is the case if the indemnity requires the issuer to make specified payments to reimburse the holder for a loss that it incurs because a specified borrower fails to make payment when it is due in accordance with the terms of the loan. Credit-related contracts that require payment in other circumstances are not financial guarantee contracts but may be credit derivatives measured at FVTPL.

IFRS 9. B5.5.55

If the indemnity provided by the seller does meet the definition of a financial guarantee contract, then the purchaser determines whether the guarantee is an integral element of the loan.

If the guarantee is considered integral to the loan, then the holder accounts for the loan and the guarantee as one single instrument. As a result, the purchaser considers the effect of the protection when measuring the fair value of the related loan and in estimating the expected cashflows from the loan when assessing impairment of the loan. Any premium paid is accounted for as a transaction cost of acquiring the related loan.

Conversely, if the holder assesses the guarantee as being non-integral, then the loan and the guarantee are accounted for separately. If no explicit premium is paid, then the purchaser allocates part of the acquisition cost of the loans to the financial guarantee contract acquired. Generally, the holder accounts for such a financial guarantee contract as a prepayment of the guarantee premium (equal to the premium paid or allocation of the acquisition cost of loans) and a compensation right by analogy to the guidance for reimbursements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, an entity may choose an accounting policy, to be applied consistently, to measure a non-integral financial guarantee contract that it holds at FVTPL if the contract:

- is held for trading, by analogy to the requirements for financial assets held for trading under IFRS 9; or
- guarantees a debt instrument that is measured at FVTPL to reduce any accounting mismatch that would otherwise arise.

How does a purchaser determine whether a financial guarantee contract provided by the seller is an integral element of the purchased loan?

IFRS 9A, B5.5.55

A financial guarantee is an integral element of a loan if it is part of the contractual terms of the loan and is not recognised separately. To be integral, a financial guarantee does not need to be explicitly included in the contractual terms of a loan. Judgement may be required in assessing whether a financial guarantee held is part of the contractual terms of a loan.

It may be challenging to conclude that the guarantee is part of the contractual terms if it is received some time after the original loan contract was signed and was not contemplated at the time the loan was originated. However, the purchaser should consider the relevant facts and circumstances. Possible indicators that the guarantee should be considered part of the contractual terms may include factors such as: whether the documented terms of the loan have been amended or supplemented to refer to the guarantee (e.g. there is correspondence with the borrower regarding the inclusion of the guarantee) and whether the benefit of the guarantee would transfer to another purchaser if the loan was resold.

If a financial guarantee scheme covers credit losses on a group of loans and it is subject to deductibles from claims or limits on coverage or claims that are calculated at the level of the group of loans, then this is an indicator that the guarantee is not integral to any individual loan. This is because there is an interdependency between the claims on different loans in the group.

See Chapter 7.1 in the 17th Edition 2020/21 of our publication Insights into IFRS for further guidance on accounting issues related to financial guarantee contracts.

7.2 Indemnities provided as part of a business combination

IFRS 3.27

When a seller issues an indemnity in a transaction that is a business combination, the purchaser recognises an indemnification asset under IFRS 3.

IFRS 3.27–28, 57

The indemnification asset is measured on the same basis as the indemnified item, subject to management's assessment of the collectability of the asset.

This accounting does not apply for general representations and warranties provided by the seller that do not create a specific right of reimbursement.

8 Acquisition of a subsidiary: Consolidation adjustments

At each reporting date, a purchaser records consolidation adjustments to reflect a loan portfolio acquired as part of a business combination in its consolidated financial statements. These adjustments are often complex.

IFRS 3.18, IFRS 10

If a loan portfolio is acquired as part of the purchase of a business, then it is recognised initially at fair value in the purchaser's consolidated financial statements. The accounting in the acquiree's financial statements is not affected. At each reporting date, the purchaser records consolidation adjustments to reflect the differences between the two sets of financial statements.

These adjustments are often complex and require sufficiently detailed data to reflect adjustments for classification, calculation of the effective interest rate, interest income, impairment losses and the carrying amounts of the related loans. From the purchaser's perspective, often the full removal of the acquiree's accounting for the loan portfolio and the recording of the purchaser's accounting from the date of acquisition is the simplest way to process the consolidation adjustments.

The following example illustrates some of the differences that may arise between the financial statements of an acquiree (Bank S) and the consolidated financial statements of the purchaser (Bank T) in respect of loan portfolios held by the acquiree (Bank S).

IFRS 7.8–9, 35H-I, 35K, 35M

In addition, the acquirer needs to consider the impact on the disclosures required by IFRS 7 *Financial Instruments: Disclosures*. These disclosures will reflect the differences between the accounting by the subsidiary and the accounting by the acquirer in the consolidated financial statements. Examples may include:

- classification of the loan and disclosures related to the fair value option;
- disclosures relating to measuring ECLs (e.g. staging analysis) and identifying POCI assets; and
- credit enhancements obtained.

Example 13 – Loan portfolio acquired as part of a business combination: Consolidation adjustments

	Financial statements Bank S	Consolidated financial statements Bank T
1 January 2020	On 1 January 2020 Bank S originates a loan with a par amount of 1,000,000, which pays an annual fixed coupon of 5% on the last day of the year.	

	S determines that the expected life of the loan is equal to its contractual life of four years. In this illustrative example, we have assumed that there are no transaction costs or fees. Therefore, the effective interest rate of the loan is also 5%. S classifies the loan as measured at amortised cost.	
31 December 2020	On 31 December 2020, S assesses that the credit risk of the loan has increased significantly since initial recognition. It calculates the loss allowance on the loan to be 4,000 as at 31 December 2020. Bank S records the following amounts in its income statement for the year ended 31 Dec 2020: – interest income of 50,000; and – an impairment loss of 4,000. S includes the following balances in the balance sheet as at 31 December 2020 in respect of the loan: – gross carrying amount of 1,000,000; – loss allowance of 4,000; and – net carrying amount of 996,000.	
1 January 2021		On 1 January 2021 Bank T acquires S in a transaction that meets the definition of a business combination. T calculates the fair value of the loan at that date to be 992,000. T determines the effective interest rate over the remaining expected life to be 5.3%. This is the

		rate that discounts the expected future receipts, without considering ECLs, (i.e. 50,000 annual interest on 31 December 2021 to 2023 and the repayment of the par of 1,000,000 at the end of 2023) to the loan's fair value on initial recognition (992,000). T classifies the loan as measured at amortised cost.
31 December 2021	For the year ended 31 December 2021, S records the following amounts in its financial statements. Interest income of 50,000 (1,000,000 × 5%) S concludes that the recognition of lifetime ECLs continues to be appropriate and makes the following estimates: – the loan has a lifetime probability of default (PD) of 2%; and – the loss given default (LGD) is 25% and would occur on average in 24 months' time if the loan were to default. The loss allowance as at 31 December 2021 is calculated as follows: 1,050,000 (contractual par amount and interest receivable in 24 months' time[1]) × 2% (PD) × 25% (LGD) / $(1.05)^2$ (discounted using the effective interest rate for 2 years) = 4,762	For the year ended 31 December 2021, T records the following amounts in its consolidated financial statements. Interest income of 52,530 (992,000 × 5.3%) T concludes that the recognition of 12-month ECLs is appropriate, because there has been no significant increase in credit risk since initial recognition in the consolidated financial statements[2]. T makes the following estimates: – the loan has a 12-month PD of 1%; and – the LGD is 25% and would occur in 12 months' time if the loan were to default. The loss allowance as at 31 December 2021 is calculated as follows:

	The impairment loss for the year ended 31 December 2021 is 762 (4,762 – 4,000) S includes the following balances on its balance sheet as at 31 December 2021 in respect of the loan: – gross carrying amount of 1,000,000; – loss allowance of 4,762; and – net carrying amount of 995,238	1,050,000 (contractual par amount and interest receivable in 12 months' time) × 1% (PD) ×25% (LGD) / 1.053 (discounted using the effective interest rate for one year) = 2,492 The impairment loss for the year ended 31 December 2021 is 2,492 T includes the following balances in its consolidated balance sheet as at 31 December 2021 in respect of the loan: – gross carrying amount of 994,530 – i.e. the initial fair value recognised at the date of the business combination (992,000) + interest income (52,530) – interest received (50,000); – loss allowance of 2,492; and – net carrying amount of 992,038

Notes

1. We have assumed that the interest for the year ended 31 December 2022 would be paid in full.
2. The staging of the loan therefore differs from S's financial statements, where the loan was recognised initially one year earlier and there is a significant increase in credit risk since that earlier date of initial recognition.

Therefore, in preparing the consolidated financial statements for 2021, T records consolidation adjustments for the following:

– gross carrying amount of the loan;

– loss allowance;

– interest income; and

– impairment loss.

In addition, T reflects its own ECL assumptions when making disclosures under IFRS 7 (e.g. staging analysis).

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