PKF R.S. Bernaldo & Associates

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The Professional Regulatory Board of Accountancy adopted Philippine Interpretations Committee (PIC) Q&A No. 2022 – 04: PFRS 9 Business Model Assessment Practical Issues as part of the Philippine Accounting Standards to provide guidance in applying the business model assessment in practice.

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PHILIPPINE INTERPRETATIONS COMMITTEE (PIC) Q&A NO. 2022 – 04: PFRS 9 BUSINESS MODEL ASSESSMENT PRACTICAL ISSUES

The Philippine Financial and Sustainability Reporting Standards Council (FSRSC) has approved and submitted Philippine Interpretations Committee (PIC) Q&A No. 2022 – 04: PFRS 9 Business Model Assessment Practical Issues which was adopted by Professional Regulatory Board of Accountancy (Board) as part of the Philippine Accounting Standards to provide guidance in applying the business model assessment in practice.

TRANSITION AND EFFECTIVE DATE

The effective date of this resolution is ***March 29, 2023***. The consensus in this Q&A is to be applied ***retrospectively***.

BACKGROUND

Business model refers to how an entity manages its financial assets in order to generate cash flows. It is determined at a level that reflects how groups of financial assets are managed rather than at an instrument level.

PFRS 9 identifies three (3) types of business models:

a. hold to collect
b. hold to collect and sell; and
c. other

Hold to collect holds financial assets to collect their contractual cash flows, rather than with a view to selling the assets to generate cash flows.

Hold to collect and sell both collect the contractual cash flows and sell the financial asset.

Other business models are all those that do not meet the 'hold to collect' or 'hold to collect and sell' qualifying criteria. Some examples are:

- business models for which the primary objective is realizing cash flows through sale (i.e., collecting contractual cash flows is incidental)
- business models which are managed and performance evaluated on a fair value basis
- held for trading business models

PFRS 9 4.1.1 states that an entity shall classify financial assets as subsequently measured at amortized cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

a. the entity's business model for managing the financial assets; and
b. the contractual cash flow characteristics of the financial asset.

Under PFRS 9 4.1.2A, a financial asset shall be measured at amortized cost if both of the following conditions are met:

a. the financial asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
b. the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

ISSUES AND CONCLUSION

1. How does an entity determine whether there has been a change in business model or a change in intention in managing financial assets?

   PFRS 9.B4.4.1 provides that reclassification of financial assets shall be allowed when and only when, an entity changes its business model for managing financial assets. PFRS 9 B4.4.3 also specifically provides that a **change in intention** related to particular financial assets even in circumstances of significant changes in market conditions **is not considered to be a change in business model.** A question arises as to how an entity should distinguish whether changes in the way financial assets managed result from a change in business model or in intention a change are only.

   Determining if there is a change in business model or change in intention in managing financial assets

   A change in business model occurs only when an entity either begins or ceases to perform an activity that is significant to its operations and demonstrable to external parties whereas a change in intention relates to a choice or decision on how to manage an individual or a portfolio of financial assets at a particular point in time (e.g., a voluntary decision to sell financial assets as a clear reaction to changes in market conditions).

   Paragraph B4.4.1 of PFRS 9 provides the circumstances under which changes in the business model for managing financial assets will occur and notes that these changes are **expected to be very infrequent**. They must be determined by an entity's senior management as a result of external or internal changes and **must be significant to the entity's operations and demonstrable to external parties**.

   The following are examples that may result in changes in an entity's business model (list not exhaustive):

   - When a bank decides to shut down its retail mortgage business, the bank no longer accepts new business and is actively marketing its mortgage loan portfolio for sale.
   - When a bank has changed its fundamental strategy in managing a portfolio of securities as a result of a merger activity.
   - As a result of a change in the entity's funding and liquidity profile after an acquisition of a new business, a shift in strategy from being a retail-funded bank into a wholesale-funded bank or vice versa.
   - Due to internal and external changes that fundamentally altered an entity's operations and consequently its risk profile, a change in portfolio strategy by prioritizing the stability of capital ratio and interest margin instead of the fair value performance of the securities (e.g., a change from an opportunistic portfolio management involving significant sales into a stable portfolio management where the securities are no longer expected to be sold frequently based on the entity's extensive liquidity analysis; they are to be sold only during stress case scenarios or due to increase in the assets' credit risk). The change is supported by change in investment policy, reorganization of the treasury department and new governance and operating limits based on the new business objectives to ensure that there will be no significant and frequent sales of securities subsequently.

   The above examples show that a significant activity must have commenced or ceased before assets can qualify to be reclassified. **The activity that is commencing or ceasing does not refer to the act of implementing different buying or selling decisions with regard to a portfolio of financial assets, but rather the activity needs to be evidenced by a fundamental change in the entity's operations. In other words, a change in business model is a significant event and is expected to be very infrequent**.

In the absence of a fundamental change in business activity, an entity will not be able to support a change in business model and it would not be appropriate to reclassify financial assets. In some instances, an entity may have been prompted to change the way they manage existing assets in response to external events such as the pandemic or Ukraine-Russia war. Even if the entity is committed to changing the way they manage an existing portfolio of financial assets, if this is not accompanied by the commencement or cessation of a significant operational activity, such will only be assessed as a change in intention for the particular portfolio of financial assets.

2. When can an entity classify newly acquired or originated financial assets as Hold-to-Collect (HTC) again after a prior change in business model that resulted in the reclassification of previously held HTC financial assets or a prior change in intention in managing HTC financial assets leading into disposals?

Reestablishment of an amortized cost (i.e., HTC) business model

In accordance with PFRS 9 B4 1.2B, an entity considers all relevant evidence that are available at the date of the assessment to determine its business model for managing financial assets. The following are examples of relevant and objective evidence:

a. How the performance of the business model (and the financial assets held within that business model) is evaluated and reported to the entity's key management personnel.
b. The risks that affect the performance of the business model (and the financial assets held within the business model) and how those risks are managed (e.g., the main focus of its review of financial information is on the credit quality and contractual returns).
c. How managers of the business are compensated (e.g., whether compensation is based on the fair value of the assets or the contractual cash flows collected).

In addition to these three forms of evidence, in most circumstances the expected frequency volume and timing of sales are also important aspects of the assessment. The foregoing considered, the following are examples (not exhaustive) of scenarios where a bank can reestablish or could have an HTC business model:

a. If the bank can demonstrate that the significant change in business environment due to the effects of black swan events such as the COVID-19 pandemic and Ukraine-Russia war have greatly impacted the entity and consequently requires significant changes in the entity's operations and long-term business strategy from the time it had previously changed its business model, and it can be demonstrated that the securities to be acquired are to be held solely to collect contractual cash flows (e.g., to generate accrual income as a remedy for low loan growth) supported by a strengthened governance process and setting of appropriate limits within the bank to ensure that the securities will not be sold frequently afterwards, such can be the bases for classifying newly acquired securities under the amortized cost business model.
b. A bank allocates investments into maturity bands to match the expected duration of time deposits. The invested assets have a similar maturity profile and amount to the corresponding deposits. The target ratio of assets to deposits for each maturity band has pre-determined minimum and maximum levels. In the past, if the ratio exceeds the maximum level because of an unexpected withdrawal of deposits, the bank sells some assets to reduce the ratio. Meanwhile, new assets will be acquired when necessary (e.g., when the ratio falls below the pre-determined level). The expected repayment profile of the deposits would be updated on a quarterly basis, based on changes in customer behavior. If the bank has a good track record of forecasting its deposit repayments for liquidity risk management purposes, so that sales of investments matching the deposits are expected to be infrequent and will only be made during stress case scenarios or when there is an increase in the assets' credit risk, it is possible that the objective of the business model is HTC.

There is no definite date or period as to when an entity can or should reestablish an amortized cost business model. PFRS 9 does not specifically preclude an entity from nor prescribe, a time frame for reestablishing an HTC business model after a previous change in business model that resulted in the termination of a prior HTC business model or a prior change in intention in managing HTC financial assets, provided it can demonstrate its reestablished objective to collect contractual cash flows from the financial assets considering current conditions and expectations on future sales (i.e., there is no tainting concept).

Therefore, for entities that was assessed that there is only a change in intention and not a change in business model may again classify newly acquired securities as HTC if the conditions or circumstances that compelled the entity to resort to frequent and significant sales of securities in the past no longer exist and cannot be reasonably expected to occur in the near term (i.e., its huge losses due to the COVID-19 pandemic). **This is a matter of judgment so the entity must be able to clearly demonstrate that its HTC objective has been re-established.**

Further, while a long gap between a previous change in business model or change in intention in managing financial assets and current period is not in itself necessarily a basis (e.g., more than 2 years), if the entity can justify that such period is long enough for it to have demonstrated its reestablished HTC objective for a portfolio given any significant internal and external changes observed during that period, the entity should not necessarily be precluded from classifying new securities as HTC.

PFRS 9 B4.1.2 also provides that in some circumstances, it may be appropriate to separate a portfolio of financial assets into sub-portfolios in order to reflect the level at which an entity manages those financial assets. Thus, for the case at hand, as long as the assets to be held in the previous and new sub-portfolios are defined and can be clearly demonstrated as being managed separately, the entity will not be precluded from establishing a new HTC sub-portfolio if, as mentioned in foregoing discussions, the conditions that compelled the entity to resort to frequent and significant sales of securities no longer exist and cannot be reasonably expected to occur in the near term, and based on its established governance policies, the securities in the new sub-portfolio may only be sold in future stress case scenarios or when there is an increase in the assets' credit risk (i.e., there is no frequent and significant sales in the sub-portfolio moving forward).

3. Is reclassification of financial assets allowed for a portfolio of financial assets if an entity changes the way it manages a portfolio of financial assets as a result of black swan events (that are rare, unprecedented, unpredictable and have wide-ranging severe effect) such as the COVID-19 pandemic and Ukraine-Russia war?

Change in management of financial assets due to black swan events

Under PFRS 9.B4.4.1, reclassification of financial assets is only required if the entity changes its business model for managing those financial assets. Such changes are expected to be very infrequent and determined by the entity's senior management as a result of significant external or internal changes and demonstrable to third parties.

PFRS 9 B4.4.3 (a) further provides that a change in intention related to particular financial assets even in circumstances of significant change in market conditions is not a change in business model.

Given the high threshold for a change in business model under PFRS 9, if the entity cannot justify having commenced or ceased performing a significant activity that is significant to its operations, the requirements for reclassification are unlikely to be triggered.

As an entity's business model does not relate to a choice, the significant activity does not merely refer to the act of implementing buying or selling decisions for the portfolio of financial assets but rather such should be evidenced by a fundamental change in the entity's broader operations. The foregoing discussions considered, **<u>if an entity can therefore clearly demonstrate that there has been a fundamental change in its significant business activities or operations resulting in a change in business model that is demonstrable to third parties due to the knock-on effects of black swan events, reclassification of financial assets is not precluded.</u>** This calls for entities to ensure having robust risk management and governance processes in place to establish safeguards against frequent selling in the future of the financial assets to be reclassified.

4. How does the entity determine whether selling financial assets within the portfolio are considered integral or incidental to its business model?

<u>Assessing whether sales are integral or incidental to the business model</u>

In accordance with PFRS 9 B4.1.3, an entity's business model can be HTC even when sales of the financial assets occur or are expected to occur in the future if these sales are incidental to the business model. On the other hand, under the FVOCI business 12 model, selling financial assets is integral to achieving the business model's objective rather than only incidental to it. It is therefore important to determine when selling is considered incidental rather than integral to the business model to assess whether the business model for a portfolio of financial assets is HTC or not.

Sales of financial assets are considered integral to the business model when the sales are considered necessary in achieving the objective of the business model. Per PFRS 9.B4.1.2C, sales in themselves do not determine the business model, but provide evidence as to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realized. For example, as indicated in PFRS B4.1,3A, in a business model whose objective is to hold assets to collect contractual cash flows, and entity may still sell financial assets when there is an increase in the assets' credit risk considering reasonable and supportable information, including forward looking information. In here, sales are considered integral but is consistent with the objective of the HTC business model, as credit risk management activities that are aimed at minimizing potential credit losses due to credit deterioration are integral to such a business model.

In a business model whose objective is both hold to collect and to sell, the entity's key management personnel have decided that both collecting contractual cash flows and selling financial assets are fundamental in achieving the objective of the business model. **<u>Thus, under this business model, sales are expected to be more than infrequent and more than insignificant.</u>** Examples of objectives that may be consistent with this business model include managing everyday liquidity needs, maintaining a particular interest yield profile or periodic rebalancing of a portfolio financial assets to meet cash flow needs to settle liabilities the assets are funding. In these examples, sales are considered integral as it is consistent with the objective of managing the said portfolio, i.e., selling is integral in liquidity risk, interest yield or duration management.

On the other hand, the overarching principle to assess that sales are considered incidental is if it is the collection contractual cash flows that is integral to achieving the objective of the business model. Under this objective, an entity will not normally expect that sales will be more than infrequent and more than insignificant in value.

5. What are the factors/approaches an entity can use to determine whether the sales out of an HTC portfolio are considered more than insignificant and more than infrequent?

<u>Determining the significance and frequency of sales out of the HTC Portfolio</u>

Assessing whether sales are insignificant in value Under PFRS 9 B4.1.3B, sales need to be 'insignificant' in value both individually and in aggregate to be consistent with the HTC business model. The reference point to measuring 'insignificant in value' could therefore be considered to be the portfolio, particularly as it is the portfolio that is subject to the business model assessment.

The assessment of more than insignificant in value therefore requires consideration of the sales value against the total size of the portfolio. This approach is a literal interpretation of the wordings in PFRS 9. As the standard did not provide any threshold in assessing the significance of sales, judgement will have to be applied. In setting an internal threshold for the assessment, the entity may consider the guidance on what is considered significant in other standards (e.g., 20% based on PAS 28 Investment in Associates and Joint Ventures in assessing significant influence) and regulatory guidance (e.g., 10% for assessing materiality under the Philippine SEC rules). Interpreting "in aggregate" means assessing the size or return of the portfolio over its average life and not over the reporting period. The average life of the portfolio seems to be relevant as portfolios with very long average maturities might be completely turned over during the reporting period. If to be based on the reporting period, the determination of whether sales are insignificant in value would depend on the length of the period, which means that two entities with identical portfolios but with different lengths of the reporting period would arrive at different assessments.

Assessing whether sales are infrequent

PFRS 9 does not provide a threshold for the frequency of sales that must occur in the HTC portfolio. In assessing sales within an HTC business model, such sales should be determined whether they are consistent with the objective of the HTC business model.

Under PFRS 9.B4.1.3B, an increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an HTC objective if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's business model and, hence, sales will in future be lower in frequency or value. When an entity has made a decision to sell in tranches a portion of the portfolio of financial assets, such sales should not be considered as multiple sales if the sale is considered a one-time activity (i.e., for a single reason or purpose) by the entity and a single approval by the BOD was made for the sale within the portfolio of financial assets.

6. How does an entity use information about past sales and expectations about future sales as evidence of the entity's business model for managing financial assets?

Determining the significance and frequency of sales out of the HTC Portfolio

Under PFRS 9 B4.1.3, although the objective of an entity's business model may be holding financial assets to collect contractual cash flows, the entity need not hold all those financial assets until maturity. Thus, an entity's business model can be HTC even when sales of financial assets occur or are expected to occur in the future. In determining whether cash flows are going to be realized by collecting the financial assets' contractual cash flows, it is necessary to consider the frequency and value of sales in prior periods, whether the sales were of assets close to maturity, the reasons for those sales, and expectations about future sales activity. The standard states that sales, however, cannot be considered in isolation. An entity must consider information about past sales in terms of the reasons for the sales and the conditions that existed at that time compared to current conditions. The key point is that the standard requires the consideration of expected future sales while past sales are of relevance only as a source of evidence. This assessment is about expectations and not about intent. For instance, the fact that it was not the entity's intent to frequently sell the financial assets from a portfolio is not sufficient to conclude that measurement at amortized cost is appropriate. The entity should be able to forecast with reasonable confidence that it will indeed hold the assets that it determines to be HTC.

For the full text of PRC BOA Resolution No. 9, series of 2023 and PIC Q&A No. 2022-04: PFRS 9 Business Model Assessment Practical Issues, refer to the link below.

https://www.prc.gov.ph/sites/default/files/2023-09%20published.pdf

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