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| **Project** | **Financial Instruments: Classification and Measurement** | | |
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| Paper topic | Business Model Assessment: Hold to Collect Business Model | | |
| CONTACT(S) | Nicholas Milone | nkmilone@fasb.org | +1 203 956 5344 |
| | Rahul Gupta | rgupta@fasb.org | +1 203 956 5317 |
| | Riana Wiesner | rwiesner@ifrs.org | +44(0)20 7246 6926 |
| | Yulia Feygina | yfeygina@ifrs.org | +44(0)20 7332 2743 |

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## Purpose and structure of the paper

1. This is the second paper in the series of papers for the November joint board meeting on the **business model assessment** in IFRS 9 *Financial Instruments,* and the FASB's proposed Accounting Standards Update *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ('the FASB's proposed ASU').

2. This paper discusses the hold to collect business model for classifying financial assets at amortised cost. Specifically, this paper:

   (a) Provides the relevant background information, including a summary of the guidance for the **hold to collect** business model in the FASB's proposed ASU and IFRS 9 (as it would be amended by the proposed guidance in the IASB's exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments

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to IFRS 9 (2010)) ('IASB's Limited Amendments ED')) (paragraphs 5-19);

(b) Summarises the relevant feedback received from the FASB and IASB respondents on the hold to collect business model in the FASB's proposed ASU and the IASB's Limited Amendments ED (paragraphs 20-37); and

(c) Provides staff analysis, recommendations and questions for the boards (paragraphs 38-62).

3. Financial assets that meet the hold to collect business model would be eligible for classification at amortised cost (subject to the contractual cash flow characteristics assessment)[1]. This paper does not discuss how financial assets would be classified if they do not meet the hold to collect business model; ie whether those assets would be classified at fair value through other comprehensive income (FVOCI) or fair value through profit or loss (FVPL). This is discussed in Agenda paper 6C/FASB Memo 251R.

4. The staff note that the recommendations made in this agenda paper are only clarifications to the guidance in IFRS 9 and the boards' respective proposals. The staff have not recommended any fundamental changes to the articulation and assessment of the hold to collect business model.

[1] The FASB will discuss at a future joint meeting whether they would like to confirm the solely principal and interest condition for assessing the contractual cash flow characteristics of financial assets or whether they would like to pursue a different model.

## Background

### *IFRS 9 and the FASB's tentative model prior to joint deliberations*

*IFRS 9*

5. IFRS 9 only allows assets to be measured at amortised cost if it is held within a business model whose objective is to hold to collect contractual cash flows. This is because amortised cost provides information about the entity's likely cash flows if the financial assets are held within such a business model[2].

6. Feedback received by the IASB in the consultations leading up to the issuance of IFRS 9 indicated consistent support for the hold to collect business model.

7. IFRS 9 provides guidance on the application of the hold to collect business model. Specifically, paragraph B4.1.3 explains that an entity need not hold all of the financial assets in the hold to collect business model until maturity and sales may occur, for example, if the financial asset no longer meets the entity's investment policy because its credit rating declines below the level required by the policy. However, if more than an infrequent number of sales are made out of a hold to collect portfolio, an entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

8. IFRS 9 does not contain a so called 'tainting' notion. That is, the sale of financial assets out of the hold to collect business model would not call into question the classification of other similar *existing* financial instruments classified in the hold to collect business model nor in itself prevent new financial assets being so classified. However, there are specific presentation and disclosure requirements for sales of financial assets out of the amortised cost category.

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[2] In this paper, we have assumed that the financial asset has cash flows that are solely payments of principal and interest.

9. Subsequent to the issuance of IFRS 9, the IASB became aware of questions on the application of the hold to collect business model and different emerging interpretations. In particular, the IASB received questions on how to assess whether the frequency and volume of sales would be consistent with a hold to collect business model. Consequently, the IASB decided to propose clarifying the application of the hold to collect business model in its Limited Amendments ED.

*FASB's tentative model prior to joint deliberations*

10. The FASB's tentative model prior to the boards' joint deliberations also included the notion of holding financial assets for the collection of contractual cash flows as a condition for classifying financial assets at amortised cost. As discussed in Agenda Paper 6A / FASB Memo 249R, that notion was captured under the business activity described as 'lending/customer financing' and similar to IFRS 9 focused on the ***objective*** ('strategy') for holding the assets rather than requiring an entity to hold the assets for a particular period of time per se. Consequently, the FASB's tentative model did not require that the entity hold all these assets until maturity. Rather, it required collection of 'substantially all' of the contractual cash flows. In addition, that tentative model permitted sales of financial assets in specified circumstances. For example, sales would be permitted to minimise losses due to deteriorating credit. The FASB's tentative model also included further specific application guidance on the hold to collect business model, notably examples of activities that would typically be associated with the hold to collect business model. Similar to IFRS 9, the FASB's tentative model did not include a tainting notion.

11. The FASB performed extensive outreach on its tentative model prior to the joint deliberations and the feedback received indicated overall support for the hold to collect condition. However, similar to the feedback received by the IASB on IFRS 9, the FASB's respondents raised questions on the application of the hold to collect condition.

### *Tentative decisions in the boards' joint deliberations*

12. In the joint deliberations the boards re-affirmed the hold to collect notion for the amortised cost measurement category. They noted that amortised cost would provide useful information about the entity's likely future cash flows (ie a cash realisation concept) for financial assets whose value is realised through the collection of contractual cash flows. However, based on the feedback received on the hold to collect condition and the different emerging interpretations of IFRS 9, the boards acknowledged the need to clarify the application of the hold to collect condition. Consequently, the FASB's proposed ASU and the IASB's Limited Amendments ED proposed application guidance on how the hold to collect business model should be assessed, including guidance on both the types of business activities and the level of (ie frequency and volume) and reasons for sales that would (and would not) be consistent with the hold to collect business model.

### *Application guidance proposed in the boards' respective EDs*

13. The FASB's proposed ASU and the IASB's Limited Amendments ED both indicate that, although the objective of an entity's business model is to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. For example, sales that are made close to the maturity of the financial assets could be consistent with that objective. This is because the proceeds from such sales could approximate the collection of the remaining contractual cash flows. Furthermore, sales that relate to the credit deterioration of the financial asset could also be consistent with that objective. This is because the credit quality of financial assets is relevant to the entity's ***ability*** to collect their contractual cash flows and therefore is fundamental to achieving the hold to collect objective.

14. More generally, when classifying assets at initial recognition, an entity would be required to assess the *level* (ie frequency and volume) of sales of financial assets in prior periods and the *reasons* for those sales, as well as *expectations* about the

sales activity in the future in determining whether the assets are held for the collection of the contractual cash flows.

15. The guidance proposed in the boards' respective exposure drafts was consistent in many respects but was not identical. That guidance is summarised below.

### *The FASB's proposed ASU*

16. Examples of the types of sales that would be consistent with the objective of holding financial assets for the collection of contractual cash flows and classifying those assets at amortised cost under the FASB's proposed ASU include:

    (a) Sales as a result of a ***significant deterioration*** in the issuer's creditworthiness, provided the purpose of those sales is to maximise the collection of contractual cash flows through sales rather than through cash collection. However, sales of financial assets that result from managing credit exposure due to concentrations of credit risk would **not** be consistent with the hold to collect objective.

    (b) Sales that result from events other than a significant deterioration in the issuer's creditworthiness that are ***isolated, nonrecurring, and unusual*** for the entity, and result from events that could not have been reasonably anticipated. The FASB's proposed ASU indicates that sales for reasons other than managing credit exposure should be "***very infrequent***" and includes examples of events that would be very infrequent.

    (c) Sales that occur ***close to the maturity*** of the financial assets, where the proceeds from those sales approximate the collection of the remaining contractual cash flows.

(d) Sales ***required by a regulator*** to demonstrate such assets are liquid, provided such sales are to comply with regulatory requirements that affect the industry (rather than the entity specifically)[3].

### *The IASB's Limited Amendments ED*

17. Examples of the types of sales of financial assets that would be consistent with the objective of amortised cost classification under IFRS 9 as it would be amended by the proposed guidance in the IASB's Limited Amendments ED include:

    (a) Sales where the credit quality of the assets has ***deteriorated*** such that it no longer meets the entity's documented investment policy[4].

    (b) Sales that are ***infrequent*** (even if significant) ***or insignificant*** both individually and in aggregate (even if frequent).

    (c) Sales that occur ***close to the maturity*** of the financial assets, where the proceeds from those sales approximate the collection of the remaining contractual cash flows.

18. Unlike the FASB's proposed ASU, IFRS 9 and the IASB's Limited Amendments ED do not provide specific guidance for sales required by a regulator. Moreover, IFRS 9 and the IASB's Limited Amendments ED do not specifically discuss sales that result from managing concentrations of credit risk or state that sales for reasons other than managing credit exposure should be very infrequent. Rather,

[3] In contrast, if a regulator directs a specific entity (rather than all entities supervised by the regulator) to sell or transfer financial assets, the FASB's proposed ASU indicates that those sales and transfers are inconsistent with the hold to collect business model. However, circumstances that cause a regulator to direct a specific entity to sell securities possibly could be considered an event that is isolated, nonrecurring, and unusual such that it could not have been reasonably anticipated at acquisition of the assets, in which case it would not be inconsistent with the primary objective of a hold to collect business model.

[4] The IASB's Limited Amendments ED states that no longer meeting the entity's documented investment policy is not the only evidence that the financial asset's credit quality has deteriorated such that a sale is necessary. However, the IASB's Limited Amendments ED indicates that in the absence of such a policy, it may be difficult for an entity to demonstrate that the sale is necessary as a result of the deterioration in the asset's credit quality.

such sales would be assessed consistently with all other sales in the business model (ie as summarised in paragraph 17(a)-(c)).

19. To conclude:

    (a) Both the FASB's proposed ASU and the IASB's Limited Amendments ED would allow for sales as a result of the credit deterioration of financial assets, although the thresholds for such credit deterioration are articulated differently (as noted in paragraph 16(a) and 17(a) of this paper). The boards concluded that sales due to credit deterioration are not inconsistent with the objective of holding financial assets to collect contractual cash flows because the credit quality of financial assets is directly relevant to an entity's ability to collect contractual cash flows.

    (b) For sales due to reasons other than credit deterioration, both the FASB's proposed ASU and the IASB's Limited Amendments ED would allow for sales of low volume and/or frequency, although the thresholds for the acceptable level of such sales activity are articulated differently (as noted in paragraphs 16(b) and 17(b) of this paper). The boards concluded that sales of low volume and/or frequency do not contradict the overall objective of holding financial assets to collect contractual cash flows and amortised cost would provide useful information about such financial assets.

    (c) The FASB's proposed ASU is explicit in stating that sales resulting from managing credit exposure arising from concentrations of credit risk are not consistent with the objective of the hold to collect business model (as noted in paragraph 16(a) of this paper). IFRS 9 and the IASB's Limited Amendments ED do not specifically address sales due to concentrations of credit risk. Rather, the general requirements are applied to such sales.

    (d) The FASB's proposed ASU would consider sales required by a regulator to be consistent with the hold to collect business model as

long as those regulatory requirements affect the industry (rather than the entity specifically). IFRS 9 and the IASB's Limited Amendments ED do not contain specific guidance on sales required by a regulator. Rather, such sales would be assessed under the general requirements and be consistent with the hold to collect business model if they are infrequent and/or insignificant.

## Feedback

20. The feedback received by the IASB and the FASB on their respective proposals contained a number of common themes. However, due to differences in the proposed application guidance (summarised in paragraph 19) and the boards' different starting points (discussed in paragraphs 5-11), each board received a number of specific messages from their respective respondent groups. The paragraphs below outline the common themes and the feedback specific to each board.

### *Common themes*

21. Respondents to both the FASB's proposed ASU and the IASB's Limited Amendments ED generally agreed that financial assets should be measured on the basis of the objective of the business model in which the assets are held, and specifically agreed with the hold to collect business model for classifying financial assets at amortised cost.

22. However, many respondents expressed concerns about what they perceived as an unduly narrow amortised cost category and the **restrictive nature** of the proposed guidance, notably related to the types of sales that are consistent with the hold to collect business model. Respondents questioned why particular types of sales would not be consistent with the objective of the hold to collect business model.

23. Many respondents said that the sales guidance in the FASB's proposed ASU and the IASB's Limited Amendments ED is **similar to the guidance for held-to-maturity assets** in Topic 320 *Investments – Debt and Equity Securities*, and IAS 39 *Financial Instruments: Recognition and Measurement*. Those respondents noted that the current U.S. GAAP and IFRS guidance is very restrictive regarding which assets can be classified as held-to-maturity.

24. As noted in Agenda Paper 6A /FASB Memo 249R, some respondents were concerned that the proposed guidance for the hold to collect business model places **too much emphasis on the level (ie frequency and volume) of sales** instead of focusing on the reasons for sales and whether such types of sales are consistent with a hold to collect business model. These respondents believed that the focus on the level of sales is inconsistent with a principles-based model. They argued the guidance on sales resulted in the hold to collect business model being unduly restrictive and rules-based.

25. A large number of respondents noted their view that **sound/prudent credit risk management** practices should be considered consistent with the notion of hold to collect. For example, a majority of respondents cited the need to be able to sell out of the hold to collect business model due to managing **concentrations of credit risk**, such as managing portfolio risk in terms of geography or line of business.

26. Respondents also raised questions about when sales due to **deterioration in the credit quality of financial assets** would be consistent with the hold to collect business model. Even though IFRS 9 and the FASB's proposed ASU allow for sales due to credit deterioration ("significant" credit deterioration in the FASB's proposed ASU) in the hold to collect business model, these respondents were concerned that sales that would satisfy this guidance would be "too late" in the pattern of credit deterioration. That is, they worried that sales would be permitted under this guidance only if such sales occurred once the entity actually incurs a loss, rather than if sales were made to prevent realising such a loss. Respondents believed that sales made to avoid actual credit losses should be consistent with the

hold to collect business model —and that the guidance should be explicit on that point.

27. Many respondents raised concerns related to the restrictions on **sales made due to regulatory requirements**. These respondents noted that it is operationally difficult to predict what, if any, assets will need to be sold as a result of a directive from a regulator. Due to that uncertainty, some of these respondents went so far as to say that the proposed guidance could be read to preclude an entity from classifying any financial assets in the amortised cost category if the entity is subject to regulatory oversight. Some respondents stated that sales required by a regulator are not a part of the entity's business model established by the entity for managing the financial assets and/or expressed a view that sales due to regulatory requirements were not inconsistent with the hold to collect business model and, thus, should not preclude financial assets from being measured at amortised cost. Finally, some respondents noted that under the Basel III framework financial institutions will increase their investments in highly liquid securities in order to comply with the new regulatory requirements and may be required to sell such securities from time to time to comply with regulatory guidance.

28. Finally, while many respondents welcomed the boards' convergence efforts and noted that the key principles related to the hold to collect business model appear the same in the FASB's proposed ASU and IFRS 9 (including the proposals in the IASB's Limited Amendments ED), some expressed concerns about differences in the detailed guidance. Those respondents stated that **differences in wording and application guidance** (specifically the guidance around the types and number of sales that are consistent with the hold to collect business model discussed in paragraphs 16 through 19 of this paper) could result in different outcomes in a number of fact patterns. Regardless of their views on convergence in general, many of these respondents requested that if the boards ultimately agree on the key principles related to the hold to collect business model, they should use consistent wording in their respective final standards. They argued that users of financial statements may be confused by subtle differences.

### *Feedback specific to the FASB*

29. **Sales for reasons other than significant credit deterioration** – A number of financial institutions in the U.S. noted that in most periods they sell a very small percentage of their loan portfolio classified as "held for investment" under current U.S. GAAP[5]. These sales are generally due to a combination of factors, including:

    (a) Significant credit deterioration of specific obligors,

    (b) Managing concentration risk to specific countries/jurisdictions, industries, or across the client relationship as a whole (eg taking into account debt securities, derivatives, clearing relationships, and other activities), and/or

    (c) An entity's decision to exit particular client relationships for cost/benefit reasons.

    While the entity may consider the total amount of sales to be insignificant compared to the total loan portfolio, these respondents note that the guidance under the FASB's proposed ASU could be interpreted to require all or a significant majority of such loan portfolios to be classified as FVOCI. That is because sales have occurred in the past and are expected to occur in the future for reasons other than significant credit deterioration.

30. Many respondents noted that the proposed guidance related to the hold to collect business model would require sales to be "very infrequent" if they occur for reasons other than significant credit deterioration and many interpreted that as a very high threshold such that it places the tolerance for sales at virtually zero. Given this interpretation, many respondents noted that the FASB's proposed ASU would result in significantly more financial instruments being measured at FVOCI

[5] Under current U.S. GAAP, loans classified as "held for investment" are measured at amortised cost.

or FVPL as compared with current U.S. GAAP. Therefore, a vast majority of respondents recommended that the FASB reconsider the language regarding sales from the hold to collect category.

31. Many respondents noted a preference for the sales guidance in the IASB's Limited Amendments ED, which would permit "infrequent" (even if significant) or "insignificant" (even if frequent) sales from the hold to collect business model.

32. **Sales made due to significant credit deterioration** – In addition to comments discussed in paragraph 26, many respondents expressed a concern about the proposed guidance on sales made due to **significant** credit deterioration of a financial asset. They noted that this guidance is more restrictive than the relevant guidance in the IASB's Limited Amendments ED, which indicates that sales of financial assets due to credit deterioration would be consistent with a hold to collect business model if those assets no longer meet the entity's documented investment policy. Accordingly, some respondents suggested that the FASB use the language in the IASB's Limited Amendments ED.

33. **Sales made due to regulatory requirements** – In addition to the comments discussed in paragraph 27, some respondents expressed concern that the guidance in the FASB's proposed ASU related to regulatory sales was confusing because it allowed industry directed regulatory sales, but prohibited entity-specific directed regulatory sales (unless the latter can be considered an event that is isolated, nonrecurring and unusual). It was unclear to these respondents why such a distinction should be made when assessing whether such sales are consistent with the hold to collect business model.

34. **The notion of tainting** – The majority of respondents supported excluding an explicit tainting notion. However, many respondents noted that there seemed to be an *implicit* tainting notion in the FASB's proposed ASU because sales out of the amortised cost category that occur for reasons other than those described in the proposed guidance can call into question the classification of *future* instruments. A minority of respondents also went further by noting that the restrictions on sale

guidance could create a retrospective tainting issue (ie such sales could be viewed as evidence that the initial classification of the financial asset was an error) and perhaps create a risk of restatement. Many of these respondents noted that classification and measurement should rely on the hold to collect principle and acknowledged that the business model assessment would require judgment—and expressed the view that an implicit or explicit tainting notion is not necessary or appropriate.

35. **Application of the hold to collect business model to loans** – Some of the respondents who expressed a view that the proposals for sales in the FASB's proposed ASU are similar to the existing guidance in Topic 320 for held-to-maturity securities also raised a concern that extending that guidance to loans would result in an unduly narrow amortised cost category.

### *Feedback specific to the IASB*

36. **Scope of the amortised cost category compared to IFRS 9** – Some respondents were concerned with what they considered to be inappropriate limitations on the hold to collect business model—due either to the proposed clarifications to the hold to collect business model, or due to the introduction of the FVOCI category. These respondents expressed the view that the proposed guidance in the Limited Amendments ED narrowed the scope of the amortised cost category compared to IFRS 9.

37. **Application of the guidance on sales** – Some respondents to the IASB's Limited Amendments ED raised questions about how the *infrequency* and *insignificance* of sales should be assessed (eg by reference to profit or loss, the carrying value of the portfolio, or some other measure).

## Staff discussion and analysis

38. The staff note that the business model assessment in IFRS 9 and the IASB's Limited Amendments ED, as well as the FASB's proposed ASU, focuses on **how financial assets are actually managed in order to generate cash flows and create value for the entity** – ie whether the likely actual cash flows will result primarily from the collection of contractual cash flows, sales proceeds or both. The staff note that the vast majority of both the IASB's and FASB's respondents agree that measuring assets based on the business model will provide relevant and useful information about the likely amounts, timing and uncertainty of future cash flows.

39. The staff further note that for the hold to collect business model, an entity's objective in managing the financial assets is to hold the assets to collect their contractual cash flows, and the cash flows are realised via that collection activity —that is, holding financial assets to collect contractual cash flows is both the **objective and the outcome** of this business model. The hold to collect objective will always result in amortised cost classification, and there are no other objectives that result in amortised cost classification. (This is in contrast to FVOCI, which can have various business model objectives, as discussed in Agenda Paper 6C / FASB Memo 251R.)

40. As discussed in Agenda Paper 6B / FASB Memo 242 for the joint September board meeting, amortised cost is a simple measurement technique that allocates the effective return on a financial asset over time. That return is based on the contractual cash flows. Accordingly, amortised cost provides useful information about amounts, timing and uncertainty of cash flows for financial assets if these assets are held for collection of contractual cash flows.

41. The staff note that most respondents continued to express support for measuring financial assets at amortised cost if the assets are held within a business model whose objective is to hold assets to collect contractual cash flows. The concerns expressed by both IASB and FASB respondents did not relate to that principle per

se, but rather largely related to the perceived overly restrictive scope of the hold to collect business model. The staff note that most of the concerns about the scope of the hold to collect business model were primarily related to the guidance on sales out of the hold to collect business model.

42. Accordingly, the staff believe that the boards should clarify the hold to collect business model and the role of sales in assessing whether a business model has the objective of holding assets to collect their contractual cash flows. The staff do not believe it is possible or helpful to develop an exhaustive list of sales that are—or could be—consistent with a hold to collect business model. Rather, the staff believe that the guidance needs to be clarified by emphasising and enhancing the objective of a hold to collect business model and clarifying the guidance about the information that needs to be considered when determining whether the business model is to hold the assets to collect contractual cash flows, as well as the role of sales in making that assessment. The recommendations in this paper are consistent with the proposed clarifications to the business model assessment generally, which are discussed in Agenda Paper 6A / FASB Memo 249R for this month's meeting.

### *Hold to collect business model*

43. In order to improve the clarity of the guidance and assist preparers in applying the business model assessment, consistent with the discussion in Agenda Paper 6A / FASB Memo 249R, the staff believe the boards could:

    (a) Discuss—and provide examples of—the specific activities that are commonly associated with the hold to collect business model and that are aimed at achieving the objective of that business model; and

    (b) Provide guidance on the nature of information an entity should consider in assessing the hold to collect business model (ie current objectives and the reasons for originating or acquiring the financial assets).

### *Activities aimed at achieving the hold to collect business model objective*

44. As discussed in Agenda Paper 6A / FASB Memo 249R, the staff believe the business model for managing financial assets is usually observable through the particular activities that are undertaken to achieve the objective of the business model.

45. Examples of activities that would typically be associated with the hold to collect business model include[6]:

    (a) Managing financial assets to generate interest income via collection of interest and principal over the life of the instrument. That is, the financial assets are held and managed with the objective of holding *these* assets to collect contractual cash flows (rather than managing the overall yield on the portfolio).

    (b) Performing credit risk management activities on financial assets with the objective of minimising credit losses. In managing the assets, credit risk is the primary risk assessed and monitored by management (acknowledging that management typically monitors the fair value of these financial assets as part of its overall risk management process)[7].

    (c) Managing financial assets within a business model where the performance of the business model might be evaluated based on:

        (i) The interest revenue recognised using the effective interest method; and/or

        (ii) The impairment charges recognised on the financial assets.

[6] These are examples, not an exhaustive list.

[7] Credit risk activities and related sales are discussed in detail in paragraphs 53-57.

46. In contrast, the following are examples of activities that typically would *not* be associated with a hold to collect business model[8]:

    (a) Financial assets are held and managed by the entity for trading purposes;

    (b) Financial assets are originated, purchased or sold for short-term profit taking;

    (c) Financial assets are actively managed to maximise fair value gains and the fair value of the portfolio is the key performance indicator evaluated by management;

    (d) Compensation to employees who manage the financial assets is based on changes in fair value of those assets;

    (e) Financial assets are held in a liquidity portfolio and significant portions of the portfolio are frequently sold to meet liquidity needs;

    (f) The entity seeks to maintain a particular yield profile or to manage its exposure to interest rate risk by holding and selling financial assets in accordance with a stated risk management policy.

*Nature of the information to be considered*

47. As discussed in Agenda Paper 6A / FASB Memo 249R, both IFRS 9 and the FASB's proposed ASU require the business model assessment to be performed at the date of initial recognition. That assessment should consider all relevant and objective information available at that time to assess how cash flows will be realised—ie collecting contractual cash flows rather than sales proceeds—for example:

    (a) Historical information about how cash flows were realised and value created in the hold to collect business model;

[8] These are examples, not an exhaustive list.

(b) Current objectives and the reasons for originating or acquiring the financial assets; for example, originating or acquiring financial assets to earn a return on the initial outlay of cash through the collection of interest and fees over the life of the instrument would be consistent with the hold to collect business model; and

(c) Future expectations about how the assets' cash flows will be realised in the hold to collect business model.

48. This information should reflect the entity's **actual objective** for managing the financial assets. The entity should not necessarily consider (and base its business model assessment on) every 'what if' scenario or the worst-case scenario. For example, if an entity expects to sell a particular portfolio of financial assets **only** in a stress-case scenario—and the entity has no reason to expect that such a scenario is likely to occur—that scenario should not drive the business model assessment[9].

49. For example, if financial assets could be used in managing the entity's liquidity needs but would only be sold in a stress case scenario that would be infrequent – and indeed *any* financial asset held by the entity could be sold in such a stress case scenario – that would not be inconsistent with the hold to collect business model. Similarly, *any* financial asset could potentially be sold if an entity is offered the 'right' price on such an asset. However that is not inconsistent with the hold to collect business model as long as maximising fair value gains is not the entity's objective in managing the assets **and** such sales would be infrequent or/and insignificant.

[9] The role of sales in assessing the hold to collect business model is discussed in a subsequent section of this paper.

### *The role of sales out of the hold to collect business model*

50. As discussed in paragraphs 7, 10 and 13, the boards have consistently acknowledged that, although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Therefore some sales out of the hold to collect business model are expected to occur. The reasons for and the level (ie frequency and volume) of sales activity **play a role** in assessing the entity's business model in managing its financial assets. However, sales do not drive the business model assessment. Rather, information about past sales and expectations about future sales (including their frequency, volume and nature) provides evidence related to the entity's objective for the business model and can be used to confirm the business model assessment indicated by other sources of information.

51. As discussed in Agenda Paper 6A / FASB Memo 249R, in assessing the business model, an entity needs to consider both historical information about sales and expectations about the future. Historical sales information and patterns could provide useful information and evidence about how an entity currently manages its financial assets and how cash flows will be realised and value will be created. Historical sales information helps an entity support and verify its business model assessment—ie whether cash flows have been realised in a manner consistent with the entity's stated objective for managing those assets. However, sales information should not be considered in isolation and, as noted above, is **not determinative**. Rather such information should be considered in the context of the reasons for those sales and the conditions that existed at that time as this can help in assessing whether cash flows are in fact realised and value created by collecting contractual cash flows. Moreover, historical information should always be considered in conjunction with the entity's expectations about future sales activities, including the reasons for those expected future sales, to assess whether the objective is to collect contractual cash flows.

52. Sales out of the hold to collect business model typically will be less frequent and significant than sales out of the other business models. This is discussed in greater detail in paragraph 58. This is because selling financial assets to realise cash flows (including fair value changes) is only incidental to a business model that has an objective of collecting contractual cash flows. However, this is not intended to imply that from period to period newly acquired (or originated) assets would be classified differently solely on the basis of the level of sales in the prior period. Said differently, fluctuations in the amount of selling in particular periods would not necessarily mean that the business model has changed. If the entity can explain the nature of those sales and why they are not indicative of a change in its overall strategy for the business, such sales may not indicate a change in the entity's business model. Indeed, the staff believe that in order to assess the entity's business model, an entity should first consider the *reasons* for those sales and whether such sales are consistent with the hold to collect business model.

53. Some sales are consistent with the hold to collect objective and indeed important to achieving that objective. For example, sales due to credit deterioration of a financial asset enhance the entity's *ability* to collect contractual cash flows. The staff note that this concept already exists in the boards' respective proposals but needs to be clarified and emphasized in response to the feedback received.

54. Specifically, the staff believe that it is consistent with an objective of collecting contractual cash flows to sell a financial asset when concerns are raised about the collectability of those cash flows. The staff do not think that such guidance requires that the entity wait until there is an incurred credit loss or until significant credit deterioration has occurred (and the asset is transferred into Stage 2 under the impairment model currently being developed by the IASB). Rather, a sale would be consistent with an objective of holding to collect contractual cash flows if the asset's credit quality has deteriorated (based on reasonable and supportable, including forward-looking, information.

55. Sales made with the objective of managing credit concentration risk may or may not be consistent with the hold to collect objective depending on specific facts and

circumstances. Some staff members believe that sales of financial assets due to credit concentration risk, such that the financial assets no longer meet an entity's documented investment policy and/or credit risk management protocols, is consistent with the objective of holding to collect contractual cash flows. Entities perform a significant amount of analysis in establishing credit concentration thresholds which are reviewed on a periodic basis by key management personnel. These staff members believe that thresholds for concentrations of credit risk are fundamental to credit risk management and, similar to activities around credit deterioration, are inherently established with an eye towards managing assets to minimise credit losses and maximise the collection of contractual cash flows. Thus, these staff believe that sales as a result of breaching credit concentration thresholds as established by the entity's documented investment policy and/or credit risk management protocols are consistent with the objective of collecting contractual cash flows. These staff also believe that such sales would not be expected to be significant and frequent. The specific facts and circumstances related to significant and frequent sales due to breaching documented credit concentration thresholds would have to be evaluated to determine the entity's expectations about future sales activity, and whether such sales are consistent with an objective of collecting contractual cash flows.

56. However, other staff members do not agree with this view. The reason for the difference in staff view is that they believe the above would allow instruments to be classified at amortised even if such sales are frequent and significant. They believe that the notion of credit concentration risk is applied fairly broadly in practice and may include changes in the investment policy or strategy that is not related to credit deterioration. These staff members believe sales labelled as due to credit concentration risk which are not related to credit deterioration, are not consistent with the objective of collecting contractual cash flows unless they are infrequent or / and insignificant.

57. All the staff believe that if an entity is aware that the credit quality of financial assets issued in a particular jurisdiction or industry has deteriorated (considering

all reasonable and supportable forward-looking information) and therefore decides to reduce its exposure to such assets or exit those markets completely (eg in order to minimise expected credit losses), such sales would be consistent with managing the assets to collect contractual cash flows.

58. If an entity sells financial assets for reasons other than deterioration in credit quality, those sales may be consistent with the hold to collect business model if such sales are *insignificant* (even if frequent as long as cumulatively they are still insignificant) and/or *infrequent* (even if significant), regardless of the reason for the sale. That is because the entity will realise cash flows and create value largely through the collection of contractual cash flows rather than through sales. Therefore amortised cost would provide useful information about the entity's likely actual cash flows. The staff do not believe that notions of infrequent or insignificant sales should be quantified in the guidance. Rather, determining whether sales are *insignificant* (both individually and in the aggregate) and/or *infrequent* is a matter of judgment and would be based on facts and circumstances. As noted in the preceding paragraphs, if sales are more than infrequent and more than insignificant, the entity must assess and verify whether and how such sales are consistent with an objective of collecting contractual cash flows.

59. An example of infrequent sales could be particular **regulator-directed sales**. Such sales are not inconsistent with the objective of holding assets to collect contractual cash flows if they will only occur in a stress scenario (eg a run on a bank's deposits) and based on past experience and future expectations, the entity does not anticipate selling these assets except in such scenarios because in this case the overall objective is still to collect contractual cash flows. In contrast, if the entity is required by its regulator to routinely sell significant volumes of financial assets to demonstrate that the assets are liquid, the staff believe that the entity's business model is not to hold such financial assets to collect contractual cash flows. This is because the realisation of cash flows through sales becomes more relevant, thus making amortised cost information less relevant – the reason for the sale does not change this effect.

60. Another example of a sale that would not be inconsistent with the hold to collect business model is a sale of financial assets that is made **close to the maturity** of the financial assets where the proceeds from the sales approximate the collection of the remaining contractual cash flows. In this scenario, the entity would have effectively collected all of the contractual cash flows on the financial asset. Therefore, such sales are not inconsistent with the hold to collect business model and classifying financial assets at amortised cost would provide useful information to users of financial statements.

61. The staff note that both IFRS 9 and the FASB's proposed ASU contain specific presentation and disclosure requirements for sales of financial assets out of the amortised cost category.[10] These requirements include the presentation or disclosure of the realised gains or losses on the asset(s) sold, as well as a description of the circumstances/reasons that led to the sales. The staff believe that those presentation and disclosure requirements will provide users of financial statements with relevant information and specifically will provide transparency in situations where an entity has measured financial assets at amortised cost on the basis of having an objective of managing those assets in order to collect the contractual cash flows but then has realised those cash flows through sales.

## Staff recommendation

62. Based on the analysis above, the staff recommend that the boards:

    (a) Re-enforce the current hold to collect "cash flows (value) realisation" concept by:

[10] Paragraph 82(aa) in IAS 1 *Presentation of Financial Statements* and paragraph 20A in IFRS 7 *Financial Instruments: Disclosures* provide the relevant presentation and disclosure requirements. Paragraph 825-10-50-35 in the FASB's proposed ASU provides the relevant disclosure requirements.

(i) Discussing—and providing examples of— the specific activities that are commonly associated with the hold to collect business model and that are aimed at achieving the objective of that business model (such as those outlined in paragraph 45); and

(ii) Providing guidance on the nature of information an entity should consider in assessing the hold to collect business model (ie current objectives and the reasons for originating or acquiring the financial assets) (paragraphs 47-49).

(b) Emphasise that *insignificant* and/or *infrequent* sales may not be inconsistent with the hold to collect business model and classifying financial assets at amortised cost regardless of the reason for such sales. Do not quantify the notions of infrequent and insignificant sales. Clarify that determining whether sales are *insignificant* (both individually and in the aggregate) and/or *infrequent* is a matter of judgment and would be based on facts and circumstances.

(c) Clarify that historical sales information and patterns could provide useful information and evidence about how an entity currently manages its financial assets and how cash flows will be realised and value will be created. Historical sales information helps an entity support and verify its business model assessment —ie whether cash flows have been realised in a manner consistent with the entity's stated objective for managing those assets. However, sales information should not be considered in isolation and is not determinative. Also historical sales information is not intended to imply that from period to period newly acquired (or originated) assets would be classified differently solely on the basis of sales in the prior periods, that is, fluctuations in the amount of selling in particular periods would not necessarily mean that the business model has changed.

(d) Clarify that credit risk management activities aimed at minimising potential credit losses due to credit deterioration, are integral to the hold to collect objective.

(i) Some staff members recommend stating in the guidance that sales of financial assets due to credit concentration risk, such that the financial assets no longer meet an entity's documented investment policy and/or credit risk management protocols, should be considered consistent with the objective of holding to collect contractual cash flows. These staff members believe that thresholds for concentrations of credit risk are fundamental to credit risk management and, similar to activities around credit deterioration, are inherently established to minimise credit losses and maximise the collection of contractual cash flows. These staff believe such activities are consistent with the objective of collecting contractual cash flows and also would not expect such sales made in managing concentration of credit to be frequent and significant.

(ii) Other staff believe that sales made in managing concentration of credit risk should be assessed in the same way as any other sales made in the business model. That is, an entity needs to assess whether the asset's credit quality has deteriorated (based on reasonable and supportable information, including forward-looking information) and if so, such sales would be consistent with the hold to collect business model. If not, an entity would need to assess the nature, the frequency and the volume of sales in assessing whether they are consistent with the hold to collect business model.

| **Question 1 for the boards** |
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| Do the boards agree with the staff recommendations in paragraphs 62(a) through 62(c) to clarify the cash flow realisation concept in the context of the hold to collect objective and the role of sales in the assessment of that business model? |

| **Question 2 for the boards** |
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| With respect to the assessment of sales due to credit deterioration and credit concentration deterioration, do the boards agree with the staff recommendation outlined in paragraph 62(d)(i) or 62(d)(ii)? |