

**PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)  
QUESTIONS AND ANSWERS (Q&A)**

**Q&A No. 2022-04**

## **PFRS 9 Business Model Assessment Practical Issues**

The business model assessment is one of the two steps to classify debt financial assets under PFRS 9 *Financial Instruments*. An entity's business model reflects how it manages its financial assets in order to generate cash flows; its business model determines whether cash flows will result from collecting contractual cash flows, selling the financial assets or both.

Ever since the implementation of PFRS 9 on January 1, 2018, several practical issues on business model assessment have arisen particularly from the banking industry. As such, the following are intended to provide guidance in applying the business model assessment in practice.

***Be it noted that the guidance and illustrations provided in this Q&A are by no means exhaustive and their applicability depends on the specific facts and circumstances of the entity.***

### **1. Determining if there is a change in business model or change in intention in managing financial assets**

#### **Issue**

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

#### **Background**

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. The standard 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 are managed result from a change in business model or a change in intention only.

As an example: Both Bank A and Bank B have sub-portfolios of investment securities under the Hold-to-Collect (HTC) business model. The objective for these portfolios is to collect contractual cash flows, thus credit risk management involves monitoring the credit quality of the financial assets to minimize credit losses. Further, both portfolios are specifically matched with the expected duration of stable core deposits to maintain a certain asset and liability maturity profile for liquidity risk management purposes. These securities will only be sold during liquidity stress case scenarios or when there has been an increase in the asset's credit risk. There were no sales involving these sub-portfolios in the past.

In the case of Bank A, the sub-portfolio of investment securities under HTC is matched against the stable funding source of its foreign operations in a particular region (see below):

ASSETS (in millions)	<1M	1-3M	3-6M	6-12M	1-3Y	3-5Y	>5Y	No Maturity	TOTAL
Cash	24,399.28	-	-	-	-	-	-	-	24,399.28
Due from Bangko Sentral ng Pilipinas (BSP) & Other Banks	31,367.18	-	-	-	-	-	-	110,293.47	141,660.65
Interbank Loans	15,050.00	-	-	-	-	-	-	-	15,050.00
Fair Value through Profit or Loss (FVTPL) investments	2,698.06	-	-	-	-	-	-	90.06	2,788.12
Fair Value through Other Comprehensive Income (FVOCI)	625.73	222,066.68	1,470.12	10,288.54	40,831.64	32,203.71	98,241.81	4,914.88	410,643.10
<b>HTC Portfolio A*</b>	125.16	215.15	1,515.15	725.15	1,315.16	726.16	11,511.56	-	16,133.50
HTC Portfolio B	80.15	1,415.15	121.52	151.56	951.52	151.12	1,116.16	-	3,987.17
HTC Portfolio C	427.34	815.59	5,161.09	2,590.57	115,538.81	17,372.25	20,607.85	-	162,513.50
Loans Portfolio	164,178.07	100,745.53	37,455.80	63,041.02	142,426.50	58,854.91	264,546.77	33,543.69	864,792.30
Other Assets	3,315.40	1,643.38	139.31	2,245.00	88.90	89.79	199.25	60,237.66	67,958.70
<b>TOTAL ASSETS (A)</b>	<b>242,266.37</b>	<b>326,901.49</b>	<b>45,862.99</b>	<b>79,041.85</b>	<b>301,152.53</b>	<b>109,397.95</b>	<b>396,223.41</b>	<b>209,079.75</b>	<b>1,709,926.33</b>
<b>LIABILITIES (in millions)</b>									
Deposit Liabilities									
Non-Core Deposits	56,886.90	82,908.75	14,182.42	32,567.20	29,551.36	36,360.62	-	282,944.31	535,401.54
<b>Core CASA and Time Deposits (Region A)*</b>	124.25	211.41	1,495.90	699.62	1,313.88	722.46	10,984.89	191,891.35	207,443.77
Core CASA and Time Deposits (Region B)	35.77	419.31	1,179.23	649.12	2,492.50	681.14	15,109.35	133,105.13	153,671.54
Core CASA and Time Deposits (Local Operations)	146,911.51	55,989.19	24,991.12	33,771.42	24,256.13	17,241.67	22,998.14	225,999.17	552,158.35
Bills Payable	805.23	-	158.58	322.44	18,143.13	35,000.00	-	-	54,429.38
Other Liabilities	25,922.78	5,344.89	2,244.76	104.72	-	2,073.46	-	8,605.44	44,296.04
<b>TOTAL LIABILITIES</b>	<b>230,686.43</b>	<b>144,873.55</b>	<b>44,252.00</b>	<b>68,114.52</b>	<b>75,756.99</b>	<b>92,079.35</b>	<b>49,092.38</b>	<b>842,545.40</b>	<b>1,547,400.61</b>
<b>EQUITIES</b>	-	-	-	-	-	-	-	132,141.52	132,141.52
<b>TOTAL LIABILITIES &amp; EQUITIES (B)</b>	<b>230,686.43</b>	<b>144,873.55</b>	<b>44,252.00</b>	<b>68,114.52</b>	<b>75,756.99</b>	<b>92,079.35</b>	<b>49,092.38</b>	<b>974,686.92</b>	<b>1,679,542.13</b>
<b>Total Periodic Gap (A - B)</b>	<b>11,579.95</b>	<b>182,027.94</b>	<b>1,610.98</b>	<b>10,927.33</b>	<b>225,395.54</b>	<b>17,318.60</b>	<b>347,131.03</b>	<b>(765,607.16)</b>	
<b>Total Cumulative Gap</b>	<b>11,579.95</b>	<b>193,607.89</b>	<b>195,218.87</b>	<b>206,146.20</b>	<b>431,541.74</b>	<b>448,860.34</b>	<b>795,991.37</b>	<b>30,384.21</b>	

\*The HTC securities are specifically matched against the Core CASA and Time Deposits of Region A

Additional Note: For simplicity, other components and sources of liquidity were not shown/included in the table above.

On the other hand, Bank B has no foreign operations and uses the sub-portfolio of securities under HTC for maintaining liquid assets that will match its stable core deposits.

Subsequently, Both Bank A and Bank B had been severely affected by the COVID-19 pandemic resulting in them recognizing significant credit losses, reduction in interest revenue and losses from its existing investment securities not measured at amortized cost. Both banks made sales within the abovementioned HTC sub-portfolios.

- For Bank A, sales were made after making strategic changes in its foreign operations. As approved by its key management personnel and Board of Directors (BOD), Bank A decided to wind down its lending and deposit business in Region A which was determined to be no longer profitable and would further contribute losses to Bank A as an effect of the pandemic. Region A accounts for a portion that is considered significant relative to the total foreign operations of Bank A. Employees in Region A were either repurposed to another role within the bank or retrenched. Announcements were made to its depositors and borrowers about the decision to sell the business in Region A to another bank. Because of the wind down, Bank A deems that holding securities under the HTC sub-portfolio is no longer necessary and decides to sell them since the core deposits to which they are matched will no longer be present. As the securities are liquid, Bank A expects to sell all the securities within a short period of time.
- For Bank B, sales were made out of the sub-portfolio as a result of its decision to cover the heavy losses it is experiencing due to the pandemic (i.e., to manage its liquidity). There are no changes in Bank B's key management personnel and no significant changes in its operations. Bank B also expects that future sales may continue to be frequent and significant until such time that the impact of the pandemic subsides (i.e.,

the sales are not considered a one-off event), while maintaining an acceptable level of securities to match its core deposits.

*Did Bank A and Bank B have a change in business model that would warrant reclassification of the remaining securities in their affected sub-portfolios?*

### **Guidance/Conclusion and Discussion**

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.

Given the foregoing, the assessment for Bank A and Bank B is as follows:

- For Bank A, it is assessed that there is a change in its business model for the securities from HTC to holding to sell. In this example, the change would be demonstrable to external parties as a significant portion of its foreign operations has been discontinued. There would apparently be significant changes to the entity which would evidence a fundamental change in its operations. Reclassification of the remaining securities in the sub-portfolio from HTC to fair value through profit or loss (FVTPL) will hence be required.
- For Bank B, it is assessed that there is only a change in intention whether to continue to hold or to sell the assets in the sub-portfolio in response to an unfavorable change in market conditions and not a change in business model. While the disposals of securities may be considered as have been made as a result of an unprecedented stress scenario (e.g., due to the pandemic), there were no significant changes in the operations of Bank B to support a change in its business model. Thus, Bank B will not be allowed to reclassify the remaining securities in the sub-portfolio. However, for the new securities to be acquired subsequently by Bank B, fair value through other comprehensive income (FVOCI) or FVTPL classification will be more appropriate given Bank B's circumstances and the change in the way assets are managed within the sub-portfolio (i.e., to stand ready to sell them when favorable to do so for liquidity management purposes during the pandemic).

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

### **Issue**

When can an entity classify newly acquired or originated financial assets as 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?

### **Background**

For Bank B in the example in number 1 above, after some time that it was not able to classify newly acquired securities in the affected sub-portfolio as HTC due to its change in

intention in managing the securities and series of internal and external events that have significantly affected Bank B, it has undergone a thorough analysis of its liquidity (see below) and determined that new securities to be acquired can now be held in a separate sub-portfolio with the objective of collecting contractual cash flows as they are to be sold only during stress or worst case scenarios and not for the deployment of excess funds under normal scenarios.

Asset Liability Matching (in PHP Million)						
6/30/20XX						
Time Bucket	Assets*	Liabilities	Gaps	Cumulative Gap	Approved Maximum Cumulative Outflow (MCO) Limit	Within/(Over)
Up to 1 Year	2,134	(1,863)	271	271	(4,200)	4,471
> 1 Year - 2 Years	920	(435)	485	756	(4,200)	4,956
> 2 Years - 3 Years	764	(580)	184	940	(4,200)	5,140
> 3 Years - 4 Years	382	(156)	226	1,166	(4,200)	5,366
> 4 Years - 5 Years	347	(169)	178	1,344	(4,200)	5,544
> 5 Years - 6 Years	443	(252)	191	1,535	(4,200)	5,735
> 6 Years - 7 Years	295	(124)	171	1,706	(4,200)	5,906
> 7 Years - 8 Years	1,153	(828)	325	2,031	(4,200)	6,231
> 8 Years - 9 Years	1,579	(257)	1,322	3,353	(4,200)	7,553
> 9 Years - 10 Years	354	(128)	226	3,579	(4,200)	7,779
Over 10 Years	548	(252)	296	3,874	(4,200)	8,074
<b>TOTAL</b>	<b>2,303</b>	<b>(2,292)</b>				

\*Assuming certain investment securities will be classified as HTC

Based on the above, the gaps are positive in all tenors and thus the securities that are to be classified as HTC are not expected to be sold during normal scenarios.

As these securities are meant to address liquidity needs during stress or worst-case scenarios, the securities should qualify as high-quality liquidity assets (HQLA) to be used in compliance with the Liquidity Coverage Ratio (LCR) requirement of the central bank.

*Would Bank B be required to classify the new securities in this sub-portfolio as HTC given that it was deemed to have had a change in intention in managing financial assets in its previous sub-portfolio of HTC securities?*

### Guidance/Conclusion and Discussion

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:

- 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.
- 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).
- 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, Bank B may again classify newly acquired securities as HTC in the previous sub-portfolio where previous sales were made and in the new sub-portfolio 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 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.

PFRS9.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. Change in management of financial assets due to black swan events**

#### **Issue**

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 (events that are rare, unprecedented, unpredictable and have wide-ranging severe effect) such as the COVID-19 pandemic and Ukraine-Russia war?

#### **Background**

Bank C has a portfolio of investments that is intended to fund for the growth of the priority loan products of a particular business line (see Bank C's liquidity gap analysis below) and as such Bank C has assessed that the business model for the investments meets the criteria for FVOCI classification, having determined that its objective results in holding to collect and to sell the financial assets.

ASSETS (in millions)	<1M	1-3M	3-6M	6-12M	1-3Y	3-5Y	>5Y	No Maturity	TOTAL
Cash	25,399.28	-	-	-	-	-	-	-	25,399.28
Due from BSP & Other Banks	31,367.18	-	-	-	-	-	-	110,293.47	141,660.65
Interbank Loans	33,050.00	-	-	-	-	-	-	-	33,050.00
FVTPL investments	3,998.06	-	-	-	-	-	-	-	3,998.06
FVOCI investments (for normal daily liquidity)	187.72	620.00	441.03	3,086.56	18,249.49	45,661.11	89,472.54	1,474.46	159,192.93
<b>FVOCI investments (for loan growth)*</b>	<b>438.01</b>	<b>1,446.67</b>	<b>1,029.08</b>	<b>7,201.98</b>	<b>42,582.15</b>	<b>106,542.60</b>	<b>208,769.26</b>	-	<b>368,009.76</b>
HTC investments	632.65	2,445.90	6,797.76	3,467.28	117,805.48	18,249.53	33,235.58	-	182,634.18
Loans Portfolio	133,845.92	167,358.05	83,031.42	105,805.77	37,261.25	52,545.32	121,388.89	33,543.69	734,780.31
Other Assets	3,315.40	1,643.38	139.31	2,245.00	88.90	89.79	199.25	60,237.66	67,958.70
<b>TOTAL ASSETS (A)</b>	<b>232,234.22</b>	<b>173,514.01</b>	<b>91,438.60</b>	<b>121,806.60</b>	<b>215,987.27</b>	<b>223,088.36</b>	<b>453,065.53</b>	<b>205,549.28</b>	<b>1,716,683.87</b>
<b>LIABILITIES (in millions)</b>									
CASA	41,859.87	4,009.04	4,174.22	2,508.30	2,750.17	2,696.26	-	436,282.77	494,280.64
Time Deposits	162,098.55	135,519.62	37,674.45	65,179.06	54,863.69	52,309.62	-	446,749.57	954,394.57
Bills Payable	805.23	-	158.58	322.44	18,143.13	35,000.00	-	-	54,429.38
Bonds Payable	315.19	315.19	315.19	315.19	315.19	24,315.19	-	-	25,891.11
Other Liabilities	25,922.78	5,344.89	2,244.76	104.72	-	2,073.46	-	8,605.44	44,296.04
<b>TOTAL LIABILITIES</b>	<b>231,001.61</b>	<b>145,188.73</b>	<b>44,567.19</b>	<b>68,429.71</b>	<b>76,072.18</b>	<b>116,394.53</b>	-	<b>891,637.78</b>	<b>1,573,291.72</b>
<b>EQUITIES (in millions)</b>									
<b>TOTAL LIABILITIES &amp; EQUITIES (B)</b>	<b>231,001.61</b>	<b>145,188.73</b>	<b>44,567.19</b>	<b>68,429.71</b>	<b>76,072.18</b>	<b>116,394.53</b>	-	<b>1,023,779.30</b>	<b>1,573,291.72</b>
<b>Periodic Gap (A - B)</b>	<b>1,232.61</b>	<b>28,325.28</b>	<b>46,871.41</b>	<b>53,376.89</b>	<b>139,915.10</b>	<b>106,693.83</b>	<b>453,065.53</b>	<b>(818,230.01)</b>	
<b>Total Cumulative Positive Gap</b>	<b>1,232.61</b>	<b>29,557.89</b>	<b>76,429.30</b>	<b>129,806.19</b>	<b>269,721.29</b>	<b>376,415.12</b>	<b>829,480.64</b>	<b>11,250.63</b>	
<b>Projected Loan Growth*</b>	<b>315.99</b>	<b>1,305.99</b>	<b>1,015.50</b>	<b>7,199.85</b>	<b>43,895.12</b>	<b>115,345.78</b>	<b>210,990.87</b>	-	<b>xxx,xxx</b>
<b>Total Cumulative Gap after Loan Growth</b>	<b>916.62</b>	<b>28,251.90</b>	<b>75,413.80</b>	<b>122,606.34</b>	<b>225,826.17</b>	<b>261,069.34</b>	<b>618,489.78</b>	<b>11,250.63</b>	

\*The FVOCI securities are specifically maintained to fund the Bank's projected loan growth

Additional Note: For simplicity, other components and sources of liquidity were not shown/included in the table above.

Similarly, Bank D has a portfolio of investments that is intended to fund its business expansion on a particular unbanked sector, i.e., low income earning individuals, as part of growth engine. Prior to launch, liquidity and capital considerations were made and it was deemed that both would remain adequate and above the thresholds in the coming years to finance the expansion (see Bank D's liquidity gap analysis below). As the objective for the securities also results in the collection of cash flows and selling, the securities were also classified as at FVOCI by Bank D. As the portfolio is specifically set aside to fund the business expansion, this is being managed and monitored (performance and liquidity wise) separately by a unit within Bank D's treasury department.

ASSETS (in millions)	<1M	1-3M	3-6M	6-12M	1-3Y	3-5Y	>5Y	No Maturity	TOTAL
Cash	29,399.28	-	-	-	-	-	-	-	24,399.28
Due from BSP & Other Banks	36,367.18	-	-	-	-	-	-	110,293.47	141,660.65
Interbank Loans	20,050.00	-	-	-	-	-	-	-	15,050.00
FVTPL investments	6,998.06	-	-	-	-	-	-	90.06	2,788.12
FVOCI investments (for normal daily liquidity)	187.72	620.00	441.03	3,086.56	18,249.49	45,661.11	89,472.54	4,914.88	162,633.34
<b>FVOCI investments (for expansion)*</b>	<b>438.01</b>	<b>1,446.67</b>	<b>1,029.08</b>	<b>7,201.98</b>	<b>42,582.15</b>	<b>106,542.60</b>	<b>208,769.26</b>	-	<b>368,009.76</b>
HTC investments	632.65	2,445.90	6,797.76	3,467.28	117,805.48	18,249.53	33,235.58	-	182,634.18
Loans Portfolio	133,845.92	167,358.05	83,031.42	105,805.77	37,261.25	52,545.32	121,388.89	33,543.69	734,780.31
Other Assets	3,315.40	1,643.38	139.31	2,245.00	88.90	89.79	199.25	60,237.66	67,958.70
<b>TOTAL ASSETS (A)</b>	<b>231,234.22</b>	<b>173,514.01</b>	<b>91,438.60</b>	<b>121,806.60</b>	<b>215,987.27</b>	<b>223,088.36</b>	<b>453,065.53</b>	<b>209,079.75</b>	<b>1,719,214.34</b>
<b>LIABILITIES (in millions)</b>									
CASA	41,859.87	4,009.04	4,174.22	2,508.30	2,750.17	2,696.26	-	436,282.77	494,280.64
Time Deposits	162,098.55	135,519.62	37,674.45	65,179.06	54,863.69	52,309.62	-	446,749.57	954,394.57
Bills Payable	805.23	-	158.58	322.44	18,143.13	35,000.00	-	-	54,429.38
Other Liabilities	25,922.78	5,344.89	2,244.76	104.72	-	2,073.46	-	8,605.44	44,296.04
<b>TOTAL LIABILITIES</b>	<b>230,686.43</b>	<b>144,873.55</b>	<b>44,252.00</b>	<b>68,114.52</b>	<b>75,756.99</b>	<b>92,079.35</b>	-	<b>891,637.78</b>	<b>1,547,400.61</b>
<b>EQUITIES (in millions)</b>									
<b>TOTAL LIABILITIES &amp; EQUITIES (B)</b>	<b>230,686.43</b>	<b>144,873.55</b>	<b>44,252.00</b>	<b>68,114.52</b>	<b>75,756.99</b>	<b>92,079.35</b>	-	<b>1,023,779.30</b>	<b>1,679,542.13</b>
<b>Periodic Gap (A - B)</b>	<b>547.80</b>	<b>28,640.46</b>	<b>47,186.60</b>	<b>53,692.08</b>	<b>140,230.28</b>	<b>131,009.01</b>	<b>453,065.53</b>	<b>(814,699.54)</b>	
<b>Total Cumulative Positive Gap</b>	<b>547.80</b>	<b>29,188.26</b>	<b>76,374.85</b>	<b>130,066.93</b>	<b>270,297.22</b>	<b>401,306.23</b>	<b>854,371.75</b>	<b>39,672.21</b>	
<b>Funding for business expansion*</b>	<b>415.90</b>	<b>1,465.68</b>	<b>995.83</b>	<b>7,118.56</b>	<b>42,525.68</b>	<b>104,550.25</b>	<b>209,860.13</b>	-	
<b>Total Cumulative Gap after Business Expansion</b>	<b>131.90</b>	<b>27,722.58</b>	<b>75,379.03</b>	<b>122,948.37</b>	<b>227,771.54</b>	<b>296,755.98</b>	<b>644,511.63</b>	<b>39,672.21</b>	

\*The FVOCI securities are specifically maintained to fund the Bank's business expansion

Additional Note: For simplicity, other components and sources of liquidity were not shown/included in the table above.

At the onset of the COVID-19 pandemic, Bank C expected that clients would have called on their existing and approved credit lines and loan demand from new borrowers would have been accelerated, as could be reasonably expected in a crisis. However, loan growth of the



banking industry has lagged system-wide liquidity growth as a result of a combination of loan prepayments, reluctance of businesses to expand and/or borrow, and bond buying initiatives of the central bank. The graph below shows that during the pandemic (March 2020 onwards), the system liquidity growth (blue line) is significantly higher than loan growth (red line) for an extended period of time.



As a result, Bank C's original expectation of loan demand for the priority loan products did not play out as anticipated and it has determined that there is no longer a need to maintain the same level of funding and capital for the demand of these loan products due to the lingering effect of the pandemic.

Similarly, due also to the significant change in market conditions brought by the pandemic discussed above, the new business of Bank D did not pan out as it found the target market to be less appealing and Bank D's capital level has significantly dwindled due to decline in fair value of its FVOCI securities putting it at risk of not complying with the required Capital Adequacy Ratio (CAR). Accordingly, Bank D decides to not pursue further the business expansion.

The effect of the pandemic coupled by the unforeseen Ukraine-Russia war prompted the senior management of Bank C and Bank D to revisit their strategies for their business operations, including its desired overall loan, liquidity and deposit levels. With the extended period of low interest levels then followed by a faster than expected tightening of financial conditions to rein in inflation as the market moves out of the pandemic and withstand the knock-on effects of Ukraine-Russia war, Bank C and Bank D deemed that their overall risk profile in the long-term horizon has changed and there is a need to reset their business operations.

In the views of Bank C and Bank D, upon revisiting their strategies, the objective for their existing FVOCI portfolios has changed, as it would no longer allow them to maintain the

overall risk profile in the medium/long term horizon, consistent with their objectives for the sub-portfolios prior to the pandemic. As the liquidity requirements they were to fund are no longer expected to occur, the portfolios will now be held for accrual income generation and hence, contractual cash flows will only be collected and reinvested to ensure that the desired balance sheet structure is achieved in the most efficient manner. This change is supported by the creation of a new treasury desk with a new head, new policies for the management of the financial assets and risk and operational limits as safeguards so that there will be no significant and frequent selling of the securities except during stress case scenarios. The following are the salient features of the new policies of both banks:

- The portfolios were reset taking into consideration the revised funding and liquidity needs of the banks.
- Performance measurement of the portfolios is now mainly focused on interest revenue earned. Risk management focuses on minimizing credit losses of the portfolios. Liquidity risk is considered in terms of the cash amount that would be realized in a stress case scenario would be sufficient to meet liquidity needs.

*Would Bank C and Bank D be required to reclassify the securities in the subject portfolios from FVOCI to HTC?*

### **Guidance/Conclusion and Discussion**

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, 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. 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.

In the case of Bank C and Bank D, the decision to change their overall strategy have been made by their senior management due to internal and/or external changes (i.e., unrealized

loan demand for the priority loan products due to industry-wide lagged loan growth and stalled business expansion), and these have a significant effect to the entities' operations that is demonstrable to external parties (e.g., halt of the priority loan products or discontinuance of a new lending segment). Given that the fundamental change in strategies and business operations of Bank C and Bank D resulted in the portfolios now being managed to realize cash flows through collection only (i.e., accrual income generation), both entities may meet the requirements for reclassification for the decision to no longer both hold and sell their financial assets may not be assessed as a result of a mere change in intention but rather a result of changes in their business models. This may be supported by the fact that the impact to the Philippines of the pandemic related supply disruptions and inflation pressure coupled with that of the Ukraine-Russia war result from black-swan events which go beyond a mere change in market conditions and have significantly altered the banks' strategies and operations.

It is expected that banks would have subjected their business models to stress tests that would allow for the viability of the portfolios even during stress scenarios. However, most of these stress scenarios are from past periods of stress (e.g., the Asian financial crisis, Global financial crisis, Taper tantrum, etc.). The COVID-19 pandemic and the Ukraine-Russia war are black swan events that were not included in these stress scenarios. The resultant supply disruptions and the economic effects of the Ukraine-Russia war have led banks to revisit their strategies and risk management activities to cope with the expected prolonged crisis. The change in business strategies as a response to black swan events is fundamental for the banks to continue their operations.

As the loan growth and business expansion that are to be funded specifically by the portfolios of Bank C and Bank D, respectively, are no longer expected to occur, the original objective (i.e., for funding requirements) which results in selling the securities being integral to the management of the securities no longer exist as well and sales will now be incidental only. If Bank C and Bank D can clearly show based on their liquidity analyses that selling will indeed be incidental only (e.g., only during stress case scenarios or when there is an increase in the assets' credit risks) and there are safeguards in place to ensure that there will be no significant and frequent sales moving forward, reclassification may not be precluded.

#### **4. Assessing whether sales are integral or incidental to the business model**

##### **Issue**

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

##### **Background**

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 as long as these sales are incidental to the business model. On the other hand, under the FVOCI business

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 is selling 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.

### **Guidance/Conclusion and Discussion**

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 itself do not determine the business model, but provides 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 not inconsistent 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 made a decision that both collecting contractual cash flows and selling financial assets are fundamental in achieving the objective of the business model. Thus, under this business model, sales are expected to be more than infrequent and more than insignificant. 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. Determining the significance and frequency of sales out of the HTC portfolio**

### **Issue**

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

## Background

In assessing sales from a portfolio with HTC objective, one of the key considerations is whether those sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). If more than an infrequent number of such sales are made out of a portfolio and those sales are more than insignificant in value (either individually or in aggregate) and these sales are for reasons other than due to increase in the asset's credit risk, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. Thus, a question arises as to how an entity determines whether sales are considered more insignificant and more than infrequent.

## Guidance/Conclusion and Discussion

### 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 in order 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. Assessing past sales information and expectation of future sales out of a portfolio of financial assets**

### **Issue**

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?

### **Background**

PFRS 9.B4.1.2C provides that past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is going to be achieved and, specifically, how cash flows are going to be realized. A question thus arises as to how past sales information and expectation of future sales should be considered when performing the business model assessment for a portfolio of financial assets.

### **Guidance/Conclusion and Discussion**

Under PFRS 9B4.1.3, 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 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 in itself to be able 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.

### **Transition and Effective Date**

The effective date of this Q&A is upon approval by the FSRSC. The consensus in this Q&A is to be applied retrospectively.

Date approved by PIC: December 9, 2022

**PIC Members**

**Zaldy D. Aguirre, Chairman**

**Emmanuel Y. Artiza**

**Ma. Gracia F. Casals-Diaz**

**Christian Francis S. Felismino**

**Cyril Jasmin B. Valencia**

**Jenny Isabel Menes**

**Ferdinand George A. Florendo**

**Gervacio I. Piator**

**Eduardo M. Olbes**

**Anthony D. Paño**

**Lyn I. Javier**

**Maria Isabel E. Comedia**

**Arnel Onesimo O. Uy**

**Jerome Antonio B. Constantino**

**Lovely M. Del Amen-Aquino**

Date approved by FSRSC: January 12, 2023

## Accounting References

### PFRS 9 4.1.1

Unless paragraph 4.1.5 applies, 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.

### PFRS 9 4.1.2

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 financial assets in order to collect contractual cash flows and
- 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.

### PFRS 9 4.4.1

When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets in accordance with paragraphs 4.1.1-4.1.4.

See paragraphs 5.6.1-5.6.7, B4.4.1-B4.4.3 and B5.6.1-B5.6.2 for additional guidance on reclassifying financial assets.

### PFRS 9 B4.1.1

Paragraph 4.1.1(a) requires an entity to classify financial assets on the basis of the entity's business model for managing the financial assets, unless paragraph 4.1.5 applies. An entity assesses whether its financial assets meet the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a) on the basis of the business model as determined by the entity's key management personnel (as defined in PAS 24 Related Party Disclosures).

### PFRS 9 4.1.2

An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realize fair value changes. Similarly, 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. For example, that may be the case if an entity originates or purchases a portfolio of mortgage loans and manages some of the loans with an objective of collecting contractual cash flows and manages the other loans with an objective of selling them.



#### PFRS 9 B4.1.2A

An entity's business model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur. If cash flows are realized in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements nor does it change the classification of the remaining financial assets held in that business model (i.e., those assets that the entity recognized in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the business model assessment. However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realized in the past, along with all other relevant information.

#### PFRS 9 B4.1.2B

An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model. An entity will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

- a. how the performance of the business model and the financial assets held within that business model are 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 that business model) and, in particular, the way in which those risks are managed; and
- c. how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

#### PFRS 9 B4.1.2C

Financial assets that are held within a business model whose objective is to hold assets in order to collect contractual cash flows are managed to realize cash flows by collecting contractual payments over the life of the instrument. That is, the entity manages the assets held within the portfolio to collect those particular contractual cash flows (instead of managing the overall return on the portfolio by both holding and selling assets). 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, value and timing of sales in prior periods, the reasons for those sales and expectations about future sales activity. However, sales in themselves do not determine the business model and therefore cannot be considered in isolation. Instead, information about past

sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realized. An entity must consider information about past sales within the context of the reasons for those sales and the conditions that existed at that time as compared to current conditions.

### PFRS 9 B4.1.3

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. Thus, an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur or are expected to occur in the future.

### PFRS 9 B4.1.3A

The business model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the assets' credit risk. To determine whether there has been an increase in the assets' credit risk, the entity considers reasonable and supportable information, including forward looking information. Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a business model whose objective is to hold financial assets to collect contractual cash flows because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. Credit risk management activities that are aimed at minimizing potential credit losses due to credit deterioration are integral to such a business model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity may demonstrate in other ways that the sale occurred due to an increase in credit risk.

### PFRS 9 B4.1.3B

Sales that occur for other reasons, such as sales made to manage credit concentration risk (without an increase in the assets' credit risk), may also be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows. In particular, such sales may be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows if those sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). If more than an infrequent number of such sales are made out of a portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to this assessment. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, 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. In addition, sales may be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales.

#### PFRS 9 B4.4.1

Paragraph 4.4.1 requires an entity to reclassify financial assets if the entity changes its business model for managing those financial assets. Such changes are expected to be very infrequent. Such changes are determined by the 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. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line. Examples of a change in business model include the following:

- a. An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
- b. A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

#### PFRS 9 B4.4.3

The following are not changes in business model:

- a. a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).
- b. the temporary disappearance of a particular market for financial assets.
- c. a transfer of financial assets between parts of the entity with different business models.