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IFRS 9 CLASSIFICATION OF BONDS

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BOX 4: IFRS 9 CLASSIFICATION OF BONDS[1]

The aim of this boxed article is to provide a concise overview of the classification and measurement of bonds under IFRS 9, including familiarisation with accounting concepts and terminology. This, particularly in the context of the methodology and assumptions of the stress test exercises conducted by the Bank that reflect any gains or losses arising from holding respective instruments, amongst others.

By investing in bonds, banks can generate income by either retaining them to collect the principal upon maturity and any coupon payments in the interim, or else by selling them, ideally under favourable market price conditions. Linked to these intentions, IFRS 9 identifies three types of business models, namely: *hold to collect*, *hold to collect and sell*, and *other*. These business models reflect the objective and the approach that banks adopt to generate cashflows from the management of their bond holdings. Business models do not depend on management's intentions for an individual instrument but are determined on a higher level of aggregation. Indeed, banks may have more than one business model for managing their bond holdings. Moreover, although expected to be very infrequent, it is possible for banks to re-classify bonds when business model changes, as long as the necessary conditions are met.

Under the *hold to collect* business model, the objective is to hold assets to collect contractual cashflows over the life of the instrument. However, the entity need not hold all of those instruments until maturity and some sales out of the *hold to collect* business model are expected to occur as long as they are consistent with business model's objective.

Under the *hold to collect and sell* business model, the objective is achieved by both collecting contractual cash flows and selling financial assets. In contrast to the *hold to collect* business model, sales are integral rather than incidental, and consequently, this business model typically involves a greater frequency and value of sales.

Any residual objectives that differ from those applicable to the *hold to collect* and *hold to collect and sell* would instead be classified under the *others* business model category. These are typically associated, but not limited to, the realisation of cash flows through the sale of bonds. The collection of contractual cash flows is not integral to achieving the business model's objective but instead is incidental to it.

The measurement category of each bond holding depends on the business model within which it is held, and whether its contractual terms give rise to cash flows that qualify as Solely Payments of Principal and Interest (the SPPI test). Bonds that satisfy the SPPI test and are in the *hold to collect* business model would be measured at amortised cost (AMC). Those bonds that satisfy the SPPI test and are in the *hold to collect and sell* business model would be measured at fair value through other comprehensive income (FVOCI). The remaining bonds that are not measured at AMC or at FVOCI are to be measured at fair value through profit and loss (FVTPL).

Figure 1 summarises the measurement categories of bonds.

Bonds are measured at AMC using the effective interest method for amortisation, considering any difference between the initial amount and the maturity amount adjusted for any loss allowance. Consequently,

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Figure 1
SUMMARY OF MEASUREMENT CATEGORIES FOR BONDS

Measurement category	*AMC*	*FVOCI*	*FVTPL*
Valuation method	Amortisation based on original value at purchase and redemption value upon maturity	At FV, reflecting the current market price	At FV, reflecting the current market price
Recognition of changes in market price	Not applicable (Does not impact the valuation)	Unrealised gains or losses from price changes charged directly to capital	Unrealised gains or losses from price changes charged to the Statement for Profit and Loss
Recognition of credit risk	ECL model for provisions	ECL model for provisions	Not applicable (Provisions are not required)

Source: Central Bank of Malta.

while market price changes are not recognised for bonds measured at AMC, banks must apply the impairment requirements and recognise a loss allowance for ECLs.

In the case of bonds valued at FVOCI, which belong to the *hold to collect and sell* business model, changes in FV result in *unrealised gains* or *unrealised losses*, which directly impact capital (recognised as part of Other Comprehensive Income). Bonds measured under the FVOCI category are also subject to impairment requirements for the recognition and measurement of a loss allowance for ECL.

For the remaining bonds measured at FVTPL, where income generation is linked to sales, changes in FV whilst holding these bonds, result in *unrealised gains* or *unrealised losses* which are recognised in the Statement for Profit and Loss (P&L). Moreover, unlike the former two measurement categories, bonds measured at FVTPL are not subject to impairment requirements.

Domestic banks hold AMC and FVOCI instruments in the main, although recently, the share of bonds measured at AMC has increased. While subject to impairment loss assessments, the valuation of AMC bonds is insulated from "unrealised losses" linked to increasing yields. However, should banks be required to sell these bonds, say for liquidity purposes, banks might incur realised losses depending on the discrepancy between the book value and the market value of the instrument at the time of sale; thereby having implications on banks' profitability and ultimately their capital position. Nonetheless, given that domestic banks have been operating with ample liquidity for the past years, and given that the majority of bonds held by banks are eligible for ECB funding under normal monetary policy operations, the need for selling bonds measured at AMC for liquidity purposes is rather low.