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Simply payment of principal and interest

Is it really simple?

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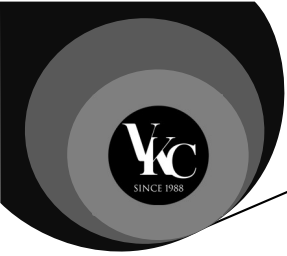
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Indian Accounting Standards (Ind AS) has turned out to be a whole new ball game for the companies in India. There are several new concepts, several new theories and several new accounting conventions that the companies will have to absorb under the new set of standards.

In terms of complexities involved, Ind AS 109 surely stands out to be one of the most complicated standards. Though the standard elaborately covers the various aspects of dealing in financial instruments, but the descriptions are more complex than what it looks. The entire structure of the standard revolves around how financial instruments recognized initially in the books of accounts of the reporting entity¹. A financial instrument which is a financial asset for the reporting entity can be classified in either of the three categories – a) Amortised Cost (AC); b) Fair Value through Other Comprehensive Income (FVOCI); or c) Fair Value through Profit or Loss (FVTPL). The parameters for classification have been laid down in the standard itself. There are two tests that a reporting entity has to apply in order to determine which category to choose – a) Business Model test (BM test); and b) Solely Payment of Principal and Interest test (SPPI test).

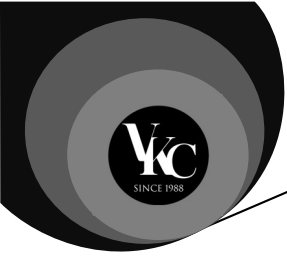
In this article we intend to deliberate on the various issues relating to SPPI test. While SPPI may seem to be a simple and direct concept, but deep down it has several layers to it which needs to be unfolded.

What are the components of SPPI Test?

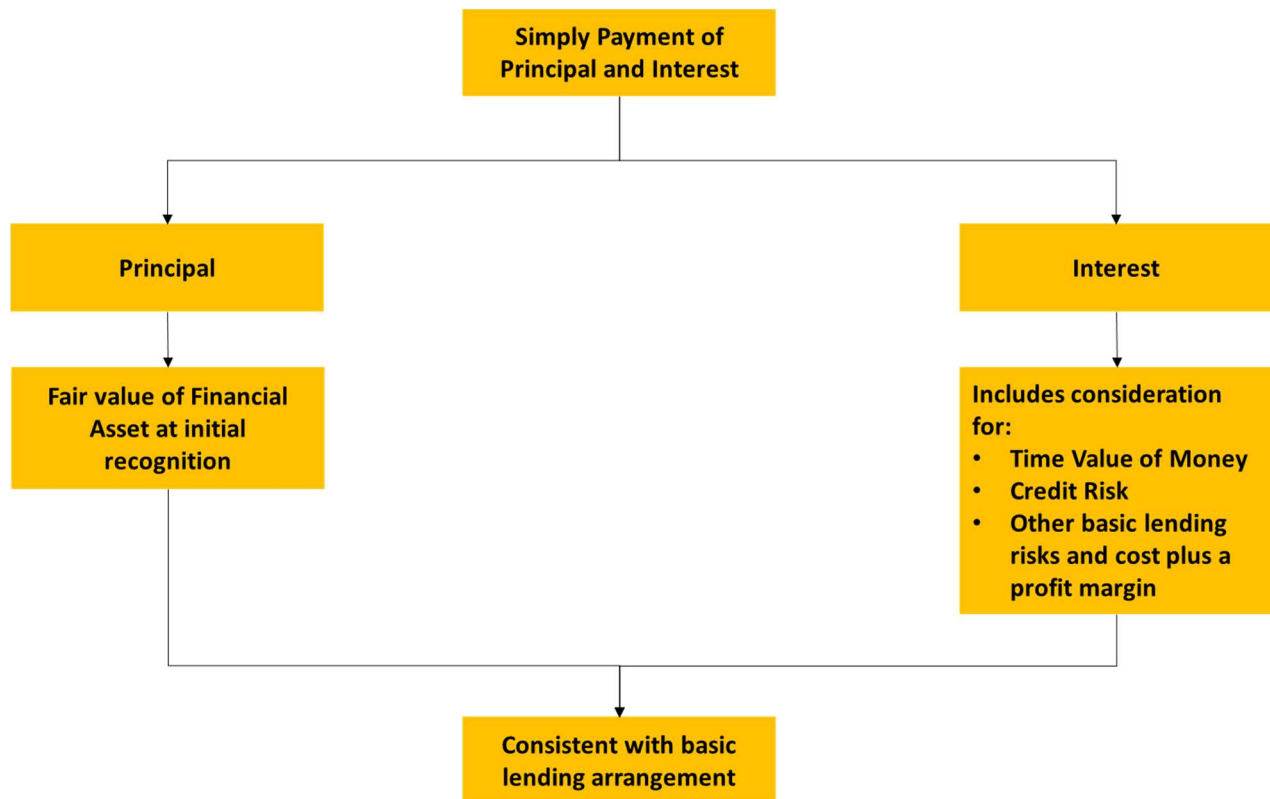
An SPPI test is one of the two tests that are required to be passed for a financial asset to be classified either as subsequently measured at AC or at FVOCI. The test says that the contractual cash flows from the asset, on specified dates, should comprise only of principal payments and interest payments on the principal amount outstanding. The primary rationale for classifying the asset as at AC or FVOCI if it satisfies the SPPI criterion, is that, these bases of accounting are meaningful for “simple” and “basic” financial assets. Also, unlike the BM test, SPPI test is done on an instrument-by-instrument basis.

The pictorial representation makes it easy to understand the components of SPPI test.

¹ A financial instrument could be a financial liability or financial asset, however, the theme of this article is related to financial assets only.



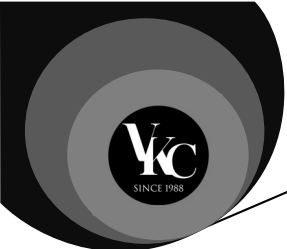
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The following provides a further explanation to the diagram as above.

- The principal should be the fair value of financial asset at initial recognition – but obviously, the amount of principal will get amortised over the tenure of the transaction as repayments are made.
- Interest should consist of consideration for time value for money, credit risk and other basic lending cost and risk with a profit margin. In extreme, economic circumstances, even negative interest rate paid, wherein the lender pays for the use of money, for a particular period of time, and where the consideration received is greater than its TVM plus credit risk and basic lending arrangement cost and profit, shall be said to pass the SPPI test.
- All in all, the asset will satisfy the SPPI test only if the contractual cash flows from it will be nothing more than principal and interest in a basic lending arrangement. A purchased or originated financial asset may or may not be a loan in its legal form.

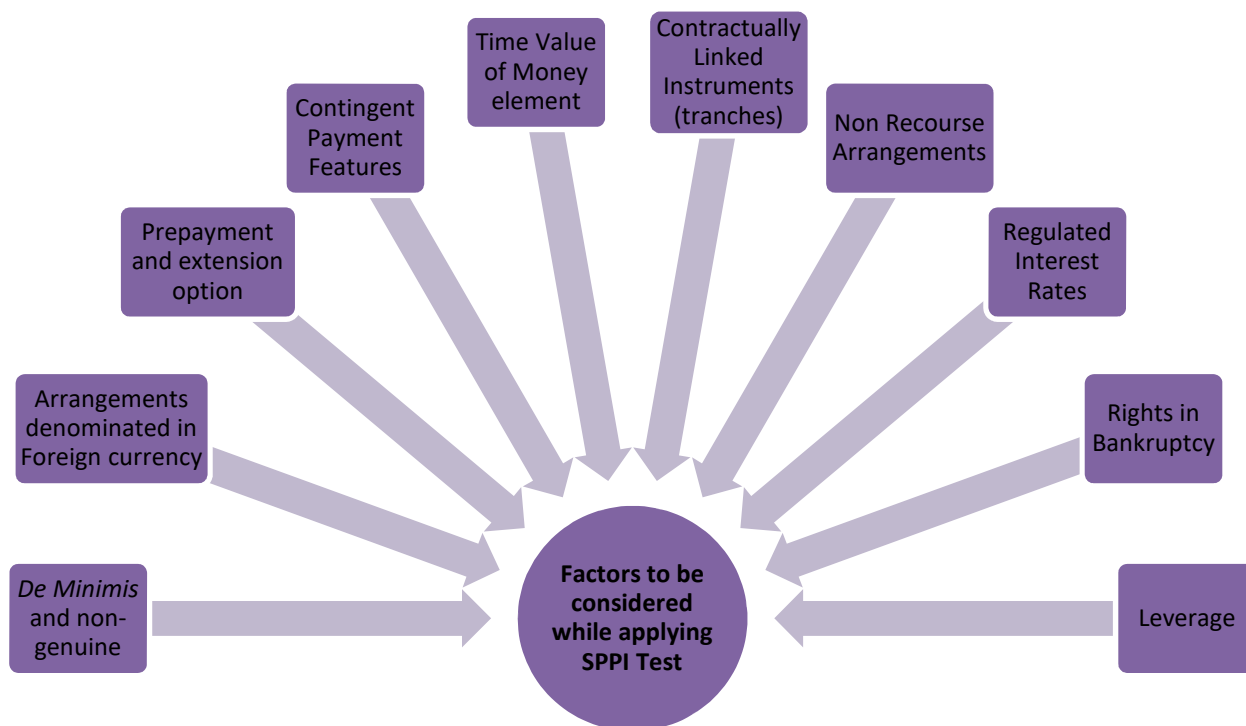
In essence, if the basic lending arrangement is not met and cashflows are exposed to uncertainties like volatility risk or anything else, the SPPI test will fail.



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Various aspects of SPPI test

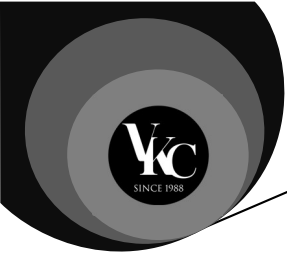
The standard has done a very elaborate jobby focusing on the various contractual arrangements that could affect the SPPI nature of the cashflows. The graphic below gives us an idea about the various contractual factors that one has to consider while examining the SPPI nature of the cashflows.



Factor 1: “De Minimis” or “non-genuine” payment terms

A contractual cash flow characteristic will not affect the classification of financial assets if:

- * The contractual cash flow characteristic is *de minimis*, i.e., is minimal. This shall be determined by considering the possible effect of the cash flow characteristic in each reporting period *and* cumulatively over the life of the asset.
- * The contractual cash flow characteristic, though, not *de minimis*, but is not genuine. To determine whether the cash flow characteristic is genuine or not, one should evaluate its effect on the cash flows of the instrument. If it is based on an event, the occurrence of which is very rare, highly abnormal and very unlikely to occur, the same shall be considered to be not genuine.



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Hence, for a payment term to affect the classification of financial instrument under SPPI test, a payment term should be both:

- a. genuine; and
- b. not *de minimis*.

A cash flow characteristic would be considered genuine if the probability that a payment will be made is more than remote. Use of judgement may be applied to understand what is remote.

Example:

A de minimis cash flow would be 0.1 % of the entire fair value of the financial asset. The cashflow is too trivial to consider in each reporting period and cumulatively over the life of the financial asset. Such a cashflow characteristic will not be considered for SPPI Test.

A genuine cash flow is something whose chance of occurring is more than remote like the receipt of loan payment of a 2 year loan from a company whose history of payment is clean without any default. The chances of cashflow occurring is not ingenuine. Thus, SPPI test criterion is met. An example of a “non-genuine” cash flow characteristic could be a “regulatory change” clause. A 'regulatory change' clause is generally found in the terms of capital instruments issued by financial institutions such as banks and insurance companies. Such entities are generally required by local regulators to maintain certain minimum levels of equity or highly subordinated debt (generally referred to as regulatory capital) in order to be allowed to do business. A 'regulatory change' clause can be regarded as a contingent settlement provision which is 'not genuine.

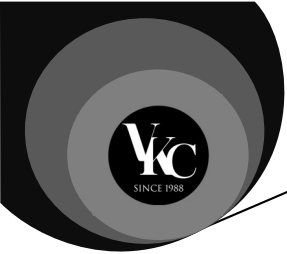
Factor 2: Arrangements denominated in foreign currency

The contractual cash flows comprising of solely principal and interest on outstanding principal should be denominated in the same foreign currency as is the financial asset. Thus, for the SPPI test to be applicable as per the Standard, all the payments under the lending arrangement should be denominated in the same foreign currency. Different foreign currencies for different payments under the same lending arrangement would give rise to embedded foreign currency derivatives, which is not covered by the Standard.

Factor 3: Prepayment and extension option

The Standard says that a contract term that permits the issuer to prepay a debt instrument, or the holder to put a debt instrument back to the issuer before maturity, does not violate the SPPI test in the following situations:

- a. The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, or
- b. The prepayment amount substantially represents:
 - the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, when



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- the entity acquires or originates the financial asset at a premium or discount to the contractual par amount; and
- when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.

In both cases, the prepayment amount can include reasonable additional compensation for the early termination of the contract.

Examples can be:

- a. Credit-impaired assets acquired at a deep discount to par,
- b. Loan extended to a customer as a part of marketing incentive such that the loan's fair value at initial recognition is below the contractual par amount advanced.

In both the cases, prepayment feature will have an insignificant value as it is very unlikely that a prepayment will occur. This is because in the first example, the asset is impaired, so it is unlikely that the borrower will prepay. In the second example, it is unlikely that the customer will prepay because he has financial advantage of borrowing at a lower than market rate.

Similarly, the SPPI test is not violated if an arrangement includes an option that allows the issuer or borrower to *extend* the contractual term of a debt instrument and the terms of the option result in:

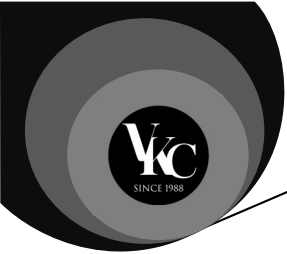
- Contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.
- Payments may include a reasonable amount of additional compensation for the extension of the contract.

Ind AS 109 requires that the entity assess whether the fair value of the prepayment feature is significant for loans acquired or issued at a premium or discount. Therefore, this adds to the complexity of the analysis for the classification of such instruments. Entities will need to develop a policy to assess "significance" in this context. This will depend on the judgement and analysis.

Factor 4: Contingent Features

Lending agreements often include contingent payment terms, which could change the timing or amount of contractual cashflows for reasons other than changes in market rates of interest, prepayments or term extensions. The Standard gives two such examples:

- A contractual term where the interest rate specified in the arrangement resets to a higher rate if the debtor misses a particular number of payments.
- A contractual term where the specified interest rate resets to a higher rate if a specified equity index reaches a particular level.



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For such features, Ind AS 109 states that an entity must assess whether the contractual cashflows that could arise both before, and after, such a change gives rise to cashflows that are solely payments of principal and interest.

It also states that while the nature of the contingent event (i.e., the trigger) is not a *determinative* factor, it may be an *indicator*.

For example, it is more likely that the interest rate reset in the first case results in payments that are solely payments of principal and interest because of the *relationship or link* between the missed payments and an increase in credit risk.

In the basis of conclusion, it is emphasized that there should be no difference in the way prepayment and other contingent payment features are evaluated. As a result, it is always appropriate to consider whether a contingent payment feature has a significant impact on cashflows. It rarely will be the case that an entity will be able to form a judgment whether the SPPI test is met in contingent payments arrangements without considering the nature of the contingent event.

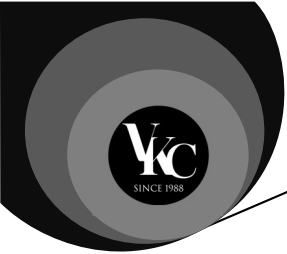
In the second case, the increase in the interest rate as the result of the change in the equity index, would most likely be viewed as a return for accepting equity price exposure rather than interest income. This would bring more volatility or risk in the contractual cash flows. In effect, the lender is taking a position on the future direction of equity prices, which is not consistent with a basic lending arrangement. Therefore, the same shall not be considered to be in line with the SPPI nature of cashflows.

Factor 5: Time Value of Money

The main intention of imposing the SPPI test was to establish whether the terms of a transaction are that of a normal financial transaction. In a pure vanilla financial arrangement, the borrower is expected to compensate the lender for the loss it incurs due to the time value of money, in the form of interest. Therefore, whether the terms of transaction requires the borrower to compensate for the time value turns out to be the most important component of SPPI.

The standard states that in determining whether a particular interest rate provides consideration only for the passage of time, an entity applies *judgment* and considers relevant factors such as the *currency* in which the financial asset is denominated and the period for which the interest rate is set. Time Value of Money (TVM) does not provide consideration for any cost or risk associated with holding the asset.

In addition to TVM, the Standard has brought in the concept of "*Modified Time Value of Money*" wherein the relationship between the passage of time and interest rate is imperfect. Two examples are cited to demonstrate modified TVM, they are:



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1. A financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate.
Example: the interest rate resets every month to a one-year rate instead of one-month rate.
2. A financial asset's interest rate is periodically reset to an average of particular short- and long-term interest rates.
Example: the interest rate resets every month to an average of one-year and six-month rate instead of one-month rate.

In both such cases, an entity is required to assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. This can be brought about either by qualitative assessment or quantitative assessment. When assessing a modified time value of money element, the objective is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). If the difference is found to be significant, SPPI test fails. In making the assessment, it is imperative to keep a track of the relationship between benchmark and contractual cash flows that could change over time.

To make this determination, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument. If it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment.

Example: ²

Question: An entity invests in 15-year floating rate government bonds and the coupons are reset every six months by referencing to the 10-year rate. Would the instrument qualify for amortised cost measurement?

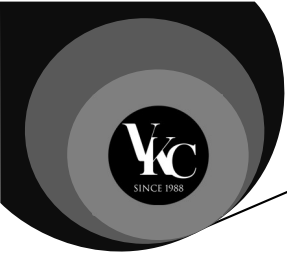
Answer:

Analysis

The interest rate tenor mismatch feature modifies the time value of money element of the instrument. If such a modification is present in the contractual terms, the entity compares the undiscounted contractual cash flows of the instrument to the undiscounted cash flows that would arise if the time value of money element were not modified (benchmark cash

²

https://www.ey.com/Publication/vwLUAssets/Applying_IFRS: Classification of financial instruments under IFRS 9./%24File/Apply-FI-May2015.pdf



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flows), i.e., if the interest rate were reset to a six month floating rate every six month. If the modified time value of money element results in cash flows that are significantly different from the benchmark cash flows, the instrument does not meet the SPPI test.

In doing the assessment, an entity must consider interest rate scenarios that are reasonably possible. It cannot conclude that the contractual cash flows are SPPI simply because the interest rate curve at the time of the assessment is such that the difference between the six-month and 10-year rates does not lead to significantly different cash flows. In some circumstances, the entity may be able to make that determination by performing a qualitative assessment of the time value of money element whereas, in other circumstances, it may be necessary to perform a quantitative assessment (refer to section 4.3.2 above).

To make this assessment, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument.

If the entity considers future developments, it will be unlikely that it can conclude that the contractual cash flows could not be significantly different from the benchmark cash flows, considering the magnitude of the mismatch between the interest rate tenors of the instrument specified in the question.

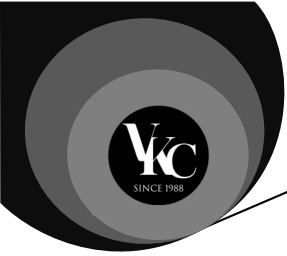
Therefore, the instrument specified in the question is not likely to meet the SPPI test.

Factor 6: Contractually Linked Instruments (Tranches)

Ind AS 109 contains complex requirements for debt instruments issued in tranches whose terms create concentrations of credit risk (i.e., lower ranking tranches absorb the first dollars of credit risk before higher ranking tranches) often occurring in interests held in securitizations. In some types of transactions, an issuer may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches). By way of tranching, subordination ranking is created wherein the order of tranche is specified and the tranche holder gets the payment of principal and interest on outstanding principal once the higher tranche holder claims are satisfied.

The following are the steps to be followed to “look-through” if contractually linked tranche payments satisfy the SPPI test:

1. The contractual terms of the *tranche being assessed* for classification (without looking through to the underlying pool of financial instruments) should give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (eg the interest rate on the tranche is not linked to a commodity index). If the condition is not satisfied, then SPPI test fails.



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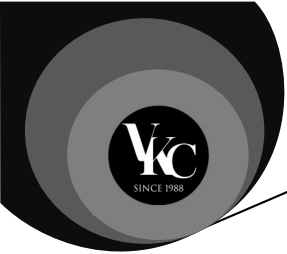
2. If condition 1 is satisfied, then one sees if:
 - a. the *underlying pool of financial instruments* contains only instruments that meet the SPPI criterion (at least one such instrument is there in the pool), and
 - b. the underlying pool of financial instruments contains potentially other instruments that:
 - reduce the cashflow variability such that they are SPPI in nature, e.g. an interest rate cap or floor, or
 - align the cashflows of the tranches with the cashflows of the pool of underlying instruments to address differences in whether the interest rate is fixed or floating or in the currency or in the timing of the cash flows.
3. If conditions 1 and 2 are not satisfied, then SPPI test fails. However, if the above conditions are satisfied then one rechecks if the pool can later change in a way that will later not honor either of the above conditions. If there is no such change in the pool, then only one can further go down the SPPI test procedure.
4. If the exposure to credit risk inherent in the tranche equal to or less than the credit risk of the underlying pool of financial instruments, then the SPPI test is fulfilled.

Use of judgment and sufficient analysis required to assess the underlying pool of financial instruments, although for this, an instrument-by-instrument approach may not be needed. The look-through approach is carried on the underlying pool that create, rather than pass through, the cash flows.

If the underlying pool includes instruments that are collateralised by assets that do not meet the SPPI criterion, then the ability to take possession of such assets is not taken into consideration to determine if the tranche meets the SPPI test unless however, the entity acquired the tranche with the intention of controlling it.

Example:

Mortgage Backed Security (MBS) is an example of a contractually linked instrument. MBS has an underlying mortgage loan pool/s. These pools contain different mortgage loans with varying maturity and varying risk rates. High risk mortgage pools provide higher interest compensation and low risk mortgage pools have lower interest compensation. There are two types of MBS- pass through or participation certificates (PCs) and collateralized mortgage obligations (CMOs). CMOs create payments in the form of principal and interest on outstanding principal with different maturities and coupon. Based on the cashflows from the underlying pool, the SPE issues securities to the investors. These underlying mortgage pool assets create cashflows to be given to the investors who are being paid in tranches.



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Let us take an example to understand the concept.³

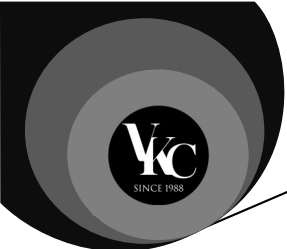
Bank A is the sponsor of a securitisation vehicle (the SPE) and holds the junior notes issued by the SPE. The SPE's assets consist of a portfolio of residential mortgages that were originated and transferred to the SPE by Bank A. The SPE does not hold any derivatives. A number of other banks invest in the mezzanine, senior and super senior tranches of notes issued by the SPE. None of the banks has any further involvement with the SPE and all banks have assessed that the SPE should not be consolidated in their respective financial statements. The total notional amount of mortgage assets and notes issued is CU 1,000.* The following table shows a range of expected credit losses for the portfolio of mortgages as at inception and the estimated probability that those scenarios will occur:

Scenarios	Loss (CU)	Estimated probability of loss (%)	Estimated weighted average loss (CU)
Scenario I	40	10	4
Scenario I	70	25	18
Scenario I	110	30	33
Scenario I	180	25	45
Scenario I	230	10	23
Weighted average loss expectancy			123

* The example does not address the question of non-consolidation of the SPE and should not be referred to for the purpose of a control assessment in similar fact patterns.

The probability weighted expected losses of the underlying assets represent therefore 12.3%. The following table illustrates how an entity may compare the credit risk of the tranche with that of the underlying pool of financial instruments:

Tranche		Super Senior	Senior One	Senior Two	Mezzanine	Junior	Total
Notional amount in CU (A)		630	150	100	40	80	1,000
Scenario I	Probability	<u>Probability</u>	<u>Weighted</u>	<u>Expected</u>	<u>Losses</u>	<u>Of the</u>	<u>Tranches</u> <u>**</u>
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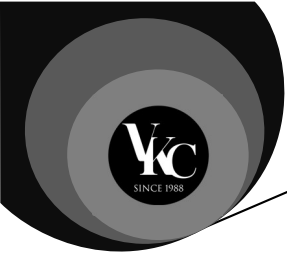
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Scenario I	10%	-	-	-	-	4	4
Scenario II	25%	-	-	-	9	18	18
Scenario III	30%	-	-	-	10	24	33
Scenario IV	25%	-	-	15	4	20	45
Scenario V	10%	-	1	10	-	8	23
Expected loss by Tranche (B)		-	1	25	23	74	123
Expected loss in % by Tranche [(B)/(A)]		0.0	0.01	25.0	57.5	92.5	12.3
Credit risk of tranche is less than the credit risk of the underlying assets?		Yes	Yes	No	No	No	
Tranche passes the SPPI test		Yes	Yes	No	No	No	

**For each scenario, expected losses are first allocated to the junior tranches and progressively to the more senior tranches until all expected losses are absorbed. For example, in Scenario IV, the loss of CU180 would be absorbed by the Junior tranche (CU80), mezzanine tranche (CU40) and senior two tranche (CU60). The probability weight of 25% for Scenario IV is then applied to the expected losses allocated to each tranche.

The junior notes have an expected loss which is, in percentage terms, greater than the overall expected loss on the underlying portfolio. Therefore, these notes must be accounted for at FVTPL. Similarly, the mezzanine notes and senior two notes have a greater expected loss than the underlying pool and would not pass the SPPI test.

The expected losses on the senior notes and the super senior notes are lower than the overall expected loss on the underlying pool of instruments and may qualify for amortised cost or FVOCI treatment, provided all other IFRS 9 requirements are met and the instruments are not held for trading.



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In this example, it might have been possible to come to the same conclusion without a numerical calculation for the junior and super senior tranches, but the technique is helpful to determine the treatment of the intermediary notes. In practice, it may also be necessary to apply judgement through a qualitative assessment of specific facts and circumstances.

Factor 7: Non-Recourse Arrangements

Ind ASes have focused on the concept of “substance over form”. So is the scenario, in SPPI case.

The fact that a financial asset may have contractual cash flows that *in form* qualify as principal and interest does not necessarily mean that the asset will pass the SPPI test. To pass the SPPI test, it should *in substance*, qualify as principal and interest.

Under non-recourse lending arrangements, the lender does not have recourse to the borrower in case of default. All it has is the underlying collateral asset with which it can recover the loss incurred. Thus, such lending arrangements where a creditor’s claim is limited to specified assets of the debtor or the cash flows from specified asset, may not satisfy the SPPI test. However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset.

For such arrangements, the lender must “look through” to the underlying assets or cash flows in making this determination. If the terms of the financial asset give rise to any other cash flows or otherwise limit the cash flows, the asset does not meet the SPPI test.

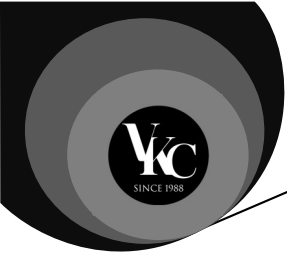
For example:

Let us consider a non-recourse loan whose principal amount finances 100% of the cost of a portfolio of equity instruments that will be sold when the loan is due. Hence, a decline in the value of the portfolio below its cost will reduce the cash flows available to repay the lender; i.e., under the terms of the arrangement the lender is exposed to changes in the value of the equity portfolio (in effect, the lender has written a put option on the portfolio). The SPPI test thus is not met.

Factor 8: Regulated Interest Rates

As part of broad macroeconomic policy or the need to ramp up a particular sector by boosting investment in it, a government or a regulatory authority may set interest rates to encourage entities to invest in those sectors. This intervention to bring about regulation of interest rates may seem to tamper with the time value of money concept, but it is not so, if certain conditions are satisfied. In these cases, the objective of time value of money is not to provide consideration for *only* passage of time.

Regulated interest rate will serve as “proxy” for time value of money element, if:



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- * The regulated interest rate provides consideration *broadly* consistent with passage of time, and
- * There is no exposure to volatility or risk in contractual cash flows inconsistent with a basic lending arrangement.

Example: French retail banks collecting deposits on special savings account, wherein the interest is regulated and determined by government and central bank to provide protection against inflation and remuneration to incentivize entities to use these accounts. These amounts were lent to government agencies which used the proceeds for social programs. Hence, as the above two conditions were satisfied, the regulated interest rate consideration was consistent with the concept of time value for money and satisfied the SPPI criterion.

Factor 9: Rights in Bankruptcy

In a lending transaction, the lender or the creditor receives periodic payments from the borrower or debtor. The creditor's instrument is given a ranking relative to the other instruments of the debtor's other creditors.

A subordinated instrument may still have cash flows in the nature of principal and interest on outstanding principal only if:

- * Debtor's non-payment is a breach of contract, and
- * Even in the event of debtor's bankruptcy, the lender or creditor has contractual right to unpaid amounts of principal and interest on outstanding principal.

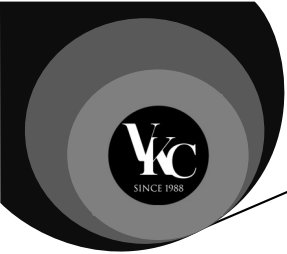
Example of satisfying SPPI Test:

A debtor that ranked its creditor as a general creditor would classify as having cash flows comprising principal and interest on principal outstanding only. Even if the debtor issued loans that are collateralised, which in the event of bankruptcy would give that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal and other amounts due, SPPI test would be satisfied.

Example of not satisfying SPPI Test:

An investment in preferred shares that is mandatorily redeemable at par plus accrued dividends may not meet the SPPI criterion. Typically on bankruptcy such shares are entitled to a priority claim in any remaining net assets up to their preference amount, but not a fixed legal claim on the preference amount itself. Accordingly, investments in mandatorily redeemable preference shares may fail the SPPI test.

Specific examples to be considered:



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Can subordinated debt instrument be considered to satisfy the SPPI test?

Subordinated debt instruments are the debt instruments used to raise money from the debt holders and their claim to assets of the company are after their senior ranked debt holders are paid. Therefore, these debt holders are also called junior security holders. Although, the payments of principal and interest are subordinated to a senior tranche, but the junior debt holders' contractual rights to payment of principal and interest are intact. Hence, SPPI test is satisfied.

Can perpetual debt instruments be considered to satisfy the SPPI test?

Perpetual debt is a debt with no maturity date where the principal is not required to be redeemed and the coupon payments are made perpetually. These debt instruments are treated as equity and not as debt. Also, after say 10 years or so they might become callable in the scenario of falling interest rates. There is no set maturity date. Such complexities cannot be factored in SPPI basis of accounting.

Factor 10: Leverage

Some financial assets have leverage as a contractual cash flow characteristic. Leverage increases the variability of a contractual cash flow such that they lose the economic characteristic of interest.

Under such a circumstance, the financial asset would not qualify the SPPI test and hence would not be classified at AC or FVOCI.

Examples of such leveraged cash flows would be in assets like stand-alone option, forward and swap contracts.

Conclusion

SPPI test is one of the major pillars of financial asset classification. If the test is failed, the asset is classified as FVTPL. Throughout the write-up we have seen several instruments like plain vanilla bonds, bonds linked with unleveraged inflation index, bond with interest reset to LIBOR at reset date, bond paying variable interest rate, full recourse loan secured by collateral and instrument paying non-discretionary contractual cash flows, satisfying SPPI test. At the same time, we have also seen a number of instruments like bonds convertible into fixed number of equity, loan paying inverse floating interest rate, instrument paying variable interest but where payment cannot be made unless the issuer is able to remain solvent immediately afterwards, perpetual instrument that can be called anytime and accrued interest paid thereon, failing the SPPI test.

Time and again we have discussed the importance of judgement on the part of the reporting entity for determining the SPPI test.

Though the standard has laid down elaborate principles for determination of SPPI, however, the subjective nature of the same is likely to create several confusions in financing structures, especially the ones containing one or more uncommon features.