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This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

IFRS 9 PIR – Analysis of issues identified through initial feedback - Issues Paper

Objective

1 Based on the EFRAG Board decisions of 9 June 2021, EFRAG TEG members will be asked to identify a list of key issues relating to IFRS 9 for which views on the technical merits need to be developed (at a further meeting).

2 The categorisation presented in this paper for discussion is tentative. EFRAG Secretariat plans also to consult with the FIWG to get their views on the categorisation.

Categorisation of issues

3 The EFRAG Secretariat has made a proposal for EFRAG TEG to discuss and in doing so divided the list of issues reported into four categories:

(a) Category A: issues where the existing EFRAG position can be repeated;

(b) Category B: issues for which standard setting is required;

(c) Category C: issues for which the EFRAG Secretariat has identified some prevalence; and

(d) Category D: issues which are inherently complex and/or standard setting would not necessarily lead to a favourable cost-benefit trade-off.

Category A: Issues where the existing EFRAG position can be repeated[1]

1	*Equity instruments measured at FVOCI without impairment and recycling – long term financing*
13	*Treatment of equity instruments (puttable financial instruments)*

Category B: Issues for which standard setting is required

4 Based on the criteria identified, the EFRAG Secretariat identified the following issues:

	Issue	***Criterion***
2	*Sustainable finance – SPPI test*	*Emerging issue*
3	*SPPI – use of administrative rates – using rates other than benchmark rates*	*Lack of clarity in IFRS 9*

[1] The numbering of the issues refers to the list as described in Appendix 1.

6	*Contractually linked instruments – non-recourse*	*Lack of clarity in IFRS 9*
10	*Comparatives – financial instruments derecognised at initial application*	*Unintended consequences – already on IASB agenda*
18	*Varia – accounting for TLTRO III*	*Emerging issue*

Category C: Issues for which the EFRAG Secretariat has identified some prevalence

5 The EFRAG Secretariat identified the following issue:

16	*Benchmark test for last-reset rates due to IBOR reform*

Category D: Issues which are inherently complex and/or standard setting would not lead to a favourable cost-benefit trade-off

6 The EFRAG Secretariat identified the following issues:

4	*Business model – boundary HTC /HTCS (liquidity buffers banks – loan syndicates)*
5	*Business model – sales - COVID*
7	*Reclassification and IFRS 5 – scope of IFRS 9*
8	*Credit risk*
9	*Variable rates*
11	*Prepayments*
12	*Modifications of cash flows*
14	*Embedded derivatives*
15	*Reporting gains on gross basis*
17	*Measurement of derivatives to meet obligations to policyholders*
18	*Varia: dealing with COVID moratoria - issues related to BMR*

Appendix 1: List of issues that have been identified

7 The working groups have identified the following issues on classification, measurement.

	Issue identified
1	*Equity instruments measured at FVOCI without impairment and recycling – long term financing*
2	*Sustainable finance – SPPI test*
3	*SPPI – use of administrative rates – using rates other than benchmark rates*
4	*Business model – boundary HTC /HTCS (liquidity buffers banks – loan syndicates)*
5	*Business model – sales - COVID*
6	*Contractually linked instruments – non-recourse*
7	*Reclassification and IFRS 5 – scope of IFRS 9*
8	*Credit risk*
9	*Variable rates*
10	*Comparatives – financial instruments derecognised at initial application*
11	*Prepayments*
12	*Modifications of cash flows*
13	*Treatment of equity instruments (puttable financial instruments)*
14	*Embedded derivatives*
15	*Reporting gains on gross basis*
16	*Benchmark test for last-reset rates due to IBOR reform*
17	*Measurement of derivatives to meet obligations to policyholders*
18	*Varia: dealing with COVID moratoria - accounting for TLTRO III – issues related to BMR*

Issue 1 - Equity instruments measured at FVOCI

8 In accordance with IFRS 9, entities can measure equity instruments at FVOCI. Gains and losses on these instruments cannot be recycled to P&L which does not permit to show the performance achieved in line with the long-term business model. The use of the FVOCI without recycling for equity instruments is seen by users as bringing useful information.

9 In contrast, preparers have a different view and note that the prohibition of recycling gains and losses on disposals into P&L may have detrimental effects on long-term

investments. Moreover, a FVOCI measurement with no recycling is not relevant to measure performance of such instruments regards to their business model.

Issue 2 – Sustainable finance – SPPI test

10 IFRS 9 does not currently specify if sustainable products[2] should be account at fair value even when they fail the SPPI test as it may trigger additional regulatory capital considerations. Banks might be indirectly discouraged from mainstreaming this type of lending.

11 Incorporating ESG[3] factors and risks into the business model analysis and definition could improve the long-term business strategies to mitigate and reduce environmental harmful activities and promote environmentally sustainable activities. Preparers noted that the alignment of the accounting to the business model may have positive effects on long-term sustainable investments.

Issue 3 - SPPI test – use of administrative rates

12 It was noted that more and more financial instruments with so called administrated rates are being issued on the market. Due to the absence of term structure in such rates problems arise in coping with the SPPI test, triggering a need for further guidance (in addition to IFRS 9.B.41.9E).

13 In addition, some note the SPPI test receives too much focus in the standard: many loans to corporates and SME's and retail loans are priced using a mechanism other than relying on benchmark rates.

Issue 4 – Business model – boundary HTC/HTCS (held to collect/held to collect and sell)

Liquidity buffers of banks

Transfer between banking departments (written input)

14 In the context of liquidity management, an Investment Banking department may purchase on the wholesale market securities that are resold to the Group's Retail entities for liquidity portfolio management. The limitation of circumstances that are considered as reclassifications of financial assets generates mismatches between the valuation of securities purchased on the wholesale market and these same securities resold within the group. Securities that are valued at fair value in respect of the Investment Banking activity, can no longer be valued at amortised cost when they are transferred to Group entities or departments that intend to hold them for the purpose of a "hold to collect" business model. To be eligible for amortised cost, these securities would have to be purchased by the entities or departments directly on the market, in most cases at a higher cost. The fact not to recognise reclassifications of financial assets between departments or entities within a group does not accurately reflect the economic purpose of the transactions.

Reclassification in periods of stress

15 In cases of market stress the classification of these bonds can vary significantly depending on the business model chosen. It was noted that for financial assets – part of a liquidity buffer of a bank – the reclassification requirements in these circumstances are a too high hurdle and the change is very difficult to demonstrate to external parties.

16 It was suggested to identify the HTC business model as a default category, while FVPL would be redefined as trading.

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[2] Green bonds, green loans, green deposit products etc.

[3] Environmental, Social or Governance characteristics that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual.

Loan syndications (written input)

17 Concerning loan syndications, the objective for the bank is to define, prior to the syndication, the portion of the loans retained, and the portion of the loans sold, in order to apply to the former a “hold to collect” business model and to the latter a “collect and sell” or “hold to sell” business model. However, it is not uncommon that some of the loans that were initially to be sold are not sold and that, as a result, the bank decides to retain them and allocate them to “hold to collect” portfolio. In this case, these loans will have to be valued at fair value over their entire life excluding amortized cost measurement because of the initial intent. This does not correspond to the management objective of a “hold to collect” business model that will prevail until the end of the life of these outstanding loans.

Issue 5 – Business model – sales - COVID

18 Diversity in practice occurs on how to assess “frequent and significant sales” of financial assets under the business model held to collect.

19 In the context of COVID, more guidance is sought on how to assess changes in business models (whether sales of financial assets under the business model held to collect are permitted sales).

Issue 6 – Contractually linked instruments – non-recourse

20 IFRS 9 contains requirements (paragraph B.4.1.20 and following) for debt instruments issued in tranches whose terms create concentrations of credit risk and a special exception for loans that pay a negative interest rate. The payments on these financial assets are contractually linked to payments received on a pool of other instruments.

21 Diversity in practice is noted with application of the non-recourse guidance and contractually linked instruments. More detailed guidance is needed to resolve these inconsistencies in particular with regard to the scope of applying the “look through to” approach.

(a) Non-recourse vs contractually linked:

The contractually linked definition could be seen as very broad with no explicit guidance on what constitutes a tranche. In order to distinguish between non-recourse financing and contractually linked, some believe it is necessary to consider the nature and substance of an arrangement.

(b) Interpretation of contractually linked guidance:

The contractually linked guidance requires the underlying pool to ‘contain one or more instruments that give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding’. The key question to some is what constitutes an ‘instrument’ for the purposes of contractually linked guidance.

22 The issue reported is also related with the reclassification requirements as it is argued by some that a change in processes would also qualify as a change in business model.

23 Also the look-through approach is considered difficult in some cases, as the required details are not available for every line of underlying investments.

Issue 7 – Reclassification and IFRS 5 – scope of IFRS 9

24 The measurement provisions of IFRS 5 scope out financial assets within the scope of IFRS 9. It is noted that the interaction between the strict reclassification requirements under IFRS 9 and the scope of IFRS 5 create issues in case where there is a restructuring. In such situations, losses are sometimes not recognised early enough.

Issue 8 – Credit risk

25 Diversity in practice is noted how entities disclose their credit risk exposure between financial assets measured at FVPL and those measured at FVOCI.

Issue 9 – Variable rates

26 It was noted that the IFRS 9 paragraphs B.4.5.5. and B.4.5.6 provide insufficient guidance to assess variables rates in some circumstances.

Issue 10 - Comparatives – financial instruments derecognised at initial application

27 At transition, IFRS 9 cannot be applied to items that have already been derecognised at the date of initial application. Insurance entities applying IFRS 9 and IFRS 17 together as from 2023 would prefer to provide full comparative information on IFRS 9 requirements.

Issue 11 - Prepayments

28 Diversity in practice was noted in how entities apply the guidance on prepayment features with negative compensation.

Issue 12 – Modifications of cash flows

29 The guidance on modification of cash flows for financial assets is considered to be insufficient. Banks are monitoring loans modified after forbearance and provision them on a one-to-one basis. The accounting question that arises is the following: when does a forbearance event (modification for credit reasons) trigger derecognition (which also means that the new loan doesn't have any provisioning attached despite being a problem loan). The 10% threshold of the liabilities may not be representative or applicable to assess this.

Issue 13 – Treatment of equity instruments

30 It was noted by some that the FVPL measurement of equity-type instruments such as funds introduces volatility that cannot be hedged. In addition, fair valuing certain untraded equities is considered difficult (companies whose value of shareholder equity is not equivalent to its liquidation value as a consequence of contractual agreements with shareholders or due to state regulations such as Mutual Guarantee Companies).

Issue 14 – Embedded derivatives

31 The lack of bifurcation of embedded derivatives on financial assets is noted to limit the possibility as a bank to act as a liquidity agent in issuances of own structured notes (as repurchasing the portfolio from clients does not pass the SPPI-test and hence leads to a FVPL measurement).

Issue 15 – Reporting gains on gross basis

32 The performance of the banks is not reflected when there is an obligation of the banks to allocate gains on gross basis to certain beneficiaries. In addition, those gains on debt instruments sold should be reported on a gross basis in the PL when such gains are not distributable to banks' shareholders.

33 According to some, this information is not useful enough mainly related to insurance activities.

Issue 16 – Benchmark test for last-reset rates due to IBOR reform (written input)[4]

34 Entities may identify the need to perform the SPPI benchmark test for significance of interest mismatches between:

[4] The issue of application of the SPPI test to particular rates has been discussed at EFRAG TEG and FIWG in the course of drafting the comment letter on the Phase 2 IBOR exposure draft

(a) the last reset rates containing a time lag feature due to being calculated and known in advance at the start of the current interest period as averages of risk-free overnight rates over the previous interest period; and

(b) rates representing time value of money due to being calculated based on the risk-free rates development in the current interest period (known at the end of the period).

35 The issue would arise separately for:

(a) legacy portfolios which are subject to the IBOR rates replacements falling back to the last rest rates; and

(b) new portfolios where entities decide to use the last reset rates.

36 The issue raised is:

(a) whether and to what extent the need to perform the quantitative benchmark test arises and whether this brings any inappropriate burden to entities;

(b) whether there are any failures in the SPPI benchmark test resulting in non-SPPI financial assets measured at FVPL to the extent which entities would not consider as appropriate since they deem them as basic lending agreements from business perspective

Issue 17 - Measurement of derivatives to meet obligations to policyholders (written input)

37 As an alternative to the application of hedge accounting, the current classification and measurement requirements in IFRS 9 for derivatives could be reviewed to better reflect the risk management, in particular of the interest rate risk, that insurance companies have had in place for a very long time. Measuring all derivatives at FV-PL leads to volatility and is difficult to explain the performance when all the remaining investment portfolios of insurers will be measured at FV-OCI. As an alternative treatment, a specific scope of derivatives could be measured at FV-OCI if certain conditions are met.

Issue 18: Varia: dealing with COVID moratoria - accounting for TLTRO[5] III – issues related to BMR[6]

38 No further information provided.

(ED/2020/1). EFRAG concluded that an assessment of such rates would go beyond the scope of the IBOR project and is rather a general issue in the context of SPPI assessment.

[5] TLTRO : Targeted longer-term refinancing operations

[6] BMR : Benchmark Regulation