EFRAG
European Financial Reporting Advisory Group

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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 *Financial Instruments* – Classification and Measurement – Post Implementation Review

You can submit your comments on EFRAG's draft comment letter by using the 'Express your views' page on EFRAG's website, then open the relevant news item and click on the 'Comment publication' link at the end of the news item.

Comments should be submitted by 14 January 2022.

International Accounting Standards Board
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

[XX January 2022]

Dear Mr Barckow,

Re: Request for Information – Post Implementation Review of IFRS 9 – Classification and Measurement

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the *Request for Information - Post-implementation Review, IFRS 9 Financial Instruments – Classification and Measurement,* issued by the IASB on 28 September 2021. (the 'RFI').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

Based upon preparatory work for this consultation EFRAG notes a number of issues are prevalent in Europe and deserve standard setting activities or educational guidance, some of those have already been included in the RFI.

These issues are:

(a) *Recycling changes in FV accumulated in OCI for equity instruments (ref. Spotlight 4 and Question 4 in the RFI) (High priority);*

(b) *Treatment of equity-like instruments (issue not mentioned in the RFI) (High priority);*

(c) *Sustainable finance – SPPI test (ref. Spotlight 3.1 and Question 3 of the RFI) (High priority);*

(d) *Supply-chain financing – reverse factoring (issue not mentioned in the RFI) (High priority);*

(e) *Modification of cash flows (ref. Question 6 of the RFI) (Medium priority);*

(f) *Contractually linked instruments – non- recourse (ref. Spotlight 3.2 and Question 3 of the RFI) (Medium priority);*

(g) *Factoring of trade receivables (issue not mentioned in the RFI) (Medium priority);*

(h) *SPPI – use of administrative rates (issue not mentioned in the RFI) (Medium priority);*

(i) *Financial guarantees (issue not mentioned in the RFI) (Low priority).*

Note to EFRAG TEG

EFRAG Secretariat understands that mixed views exist on whether the lack of guidance on modification and the lack of clarity on the treatment of financial guarantees should be considered to deserve standard setting activities. A specific question is included in this Agenda Paper.

The Appendices provides detailed feedback on these issues.

EFRAG brings to the attention of the IASB in particular the following, which relates to the first three issues listed above:

- For one of the topics, sustainable finance – SPPI-test, it is pointed out that this is so prevalent in Europe that in EFRAG's view this should be lifted from the PIR process and be treated as an urgent issue separately, so that the IASB can start working on it without waiting for the completion of the RFI process. EFRAG confirms its commitment and willingness to assist the IASB in the assessment of this issue.
- EFRAG considers the IASB should expeditiously review the non-recycling treatment of equity instruments within IFRS 9, testing whether the Conceptual Framework would justify the recycling of FVOCI gains and losses on such instruments when realised. If recycling was to be reintroduced, the IASB should also consider the features of a robust impairment model, including the reversal of impairment losses.
- EFRAG supports that similar fact patterns should be treated similarly, and noted that some mutual funds and puttable instruments, respond to movements in market variables in a similar way to equity instruments even though these do not meet the definition of an equity instrument under IAS 32.

EFRAG considers that generally the application of the SPPI test provides an appropriate basis to align the measurement of financial instruments with how they are managed. EFRAG also considers that the principle underlying the SPPI requirement generally leads to the provision of useful information about the amount, timing and uncertainty of future cash flows. the SPPI-requirement requires a re-assessment in the light of specific financial instruments such as financial instruments with ESG features or contractually linked financial instruments.

EFRAG has been informed that in some circumstances the business model could not be applied consistently, however EFRAG does not consider that further standard setting activity is needed.

EFRAG considers that the effective interest rate method generally provides useful information and notes that IFRS 9 includes scope limitations or corrections to the method for particular financial instruments. EFRAG further notes that more and more financial

instruments incorporate conditions that may affect the future contractual interest cash flows when being fulfilled or fail to be fulfilled by the reporting entity or a third party. Examples are TLTRO related loans and financial instruments with ESG features. The financial instruments including such conditions are pervasive in Europe. EFRAG notes that for these financial instruments the EIR cannot be reliably applied.

EFRAG further considers that the absence of guidance to deal with modifications of financial assets leads to diversity in practice and affects the comparability of financial statements and their usefulness to users.

EFRAG's detailed comments and responses to the questions in the RFI are set out in the Appendices.

If you would like to discuss our comments further, please do not hesitate to contact Didier Andries, Almudena Alcalá, Galina Borisova or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1 - EFRAG's responses to the questions raised in the RFI

Notes to constituents – Summary of proposals in the RFI

1 *The IFRS 9 approach to classifying and measuring financial assets was developed in response to long-standing and widespread stakeholder views that the approach in IAS 39 was too rule-based and complex. IAS 39 had many classification categories for financial assets, each category with its own rules for determining which financial assets were required or permitted to belong in that category, and for identifying and measuring impairment. IFRS 9 provides a principle-based approach that applies to all financial assets. That approach aligns measurement with the contractual cash flow characteristics of the assets and the way the entity manages them. Measurement aligned to both these factors provides users of financial statements with useful information about the amount, timing and uncertainty of the entity's future cash flows.*

2 *The Board retained the IAS 39 classification and measurement requirements for financial liabilities substantially unchanged in IFRS 9 because feedback suggested the requirements for financial liabilities in IAS 39 worked well. However, IFRS 9 addressed the one issue consistently raised by stakeholders regarding financial liabilities—the so called 'own credit issue' relating to gains and losses arising from changes in the credit risk of financial liabilities an entity elected to be measured at fair value through profit or loss.*

Question 1 – Classification and measurement

Do the classification and measurement requirements in IFRS 9:

(a) enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?

(b) result in an entity providing useful information to the users of the financial statements about the nature, timing and uncertainty of future cash flows?

Why or why not?

Please provide information about the effects of the classification and measurement changes introduced by IFRS 9, including the ongoing costs and benefits in preparing, auditing, enforcing or using information about financial instruments.

This question aims to help the Board understand respondents' overall views and experiences relating to the IFRS 9 classification and measurement requirements. Sections 2–8 seek more detailed information on the specific requirements.

EFRAG's response

EFRAG considers that generally the application of the SPPI test has proved to provide an appropriate basis to align the measurement of financial instruments with how they are managed. Nevertheless, there are areas of attention where the lack of guidance results in operational difficulties or where it leads to diversity in practice. Examples here are the use administrative rates and financial instruments with ESG features.

Question (a)

3 EFRAG welcomes the question in the RFI as a very relevant one. The border between amortised cost and fair value measurement has always been a highly debated issue. In its endorsement advice for IFRS 9 (September 2015), EFRAG

considered that, except for a few cases, the application of the solely payment of principal and interest test provides a sound basis to aggregate financial instruments into those that qualify for amortised cost and those that qualify for fair value in the balance sheet.

4 However, EFRAG notes that (i) some economic characteristics of financial instruments were insufficiently considered when IFRS 9 was developed and (ii) other economic characteristics evolve over time. Some characteristics gain in prevalence, others lose in prevalence (see our answer to Q3). Hence, EFRAG welcomes this PIR as a good opportunity to re-evaluate the treatment of cash flow characteristics under IFRS 9 and bring them in line with how entities manage these assets.

SPPI – use of administrative rates

5 One situation that IFRS 9 pays insufficient attention to is the use of administrative rates. In some jurisdictions the loan terms of financial instruments, both fixed and floating refer to “the general interest level”. In practice, that means that a “composite” rate is created using the composition of the actual funding of the bank/mortgage institution. In other jurisdictions the use of administrative rates occurs sometimes in intra-group loans.

6 EFRAG notes that, while entities were able to achieve the desired classification for these financial instruments, the process for doing so has been unnecessary onerous as the criteria of the SPPI-test, as currently worded, are considered of being too strict.

7 EFRAG understands that in practice when administrative rates are compatible with the concept of the lender’s cost of funding the instrument they may be considered as having the characteristics of a basic lending instrument. EFRAG has been informed that in jurisdictions where they prevail, administrative rates are used in very competitive markets. EFRAG finally notes that IFRS 9 focuses too much on benchmark rates and considers that it would be useful if the IFRS 9 requirements would address this issue explicitly by providing further guidance, as was done for regulated rates.

Financial instruments with ESG features

8 In our answer to Question 3 (a) EFRAG notes that currently the impact of ESG features is assessed to be minimal, therefore not resulting in failing the SPPI-test. However, in the future, it is expected this may be the case.

Question (b)

9 As mentioned in our answer to Question 1 (a) EFRAG is of the view that the classification and measurements of IFRS 9 generally provide useful information to the users of the financial statements about the nature, timing and uncertainty of future cash flows. However, EFRAG is also of the view that for some areas (as elaborated under Question 1 (a)) there is a need for improvement.

Notes to constituents – Summary of proposals in the RFI

10 *In the context of IFRS 9, a ‘business model’ refers to how an entity manages its financial assets to generate cash flows—by collecting contractual cash flows, selling financial assets or both. Consequently, classification and measurement based on the business model provides information that is useful in assessing the amounts, timing and uncertainty of an entity’s future cash flows.*

11 An entity determines the business model at a level of aggregation that reflects how it manages groups of financial assets to achieve a business objective. An entity’s business model is typically observable through the entity’s activities to achieve its

business objective. An entity considers all available relevant evidence to determine the business model.

12 *Changes in the classification and measurement of financial assets subsequent to initial recognition can make financial statements more difficult to understand, particularly when comparing information from period to period. Therefore, the Board established conditions for reclassification that it intended would be met only on occurrence of a significant event. IFRS 9 requires financial assets to be reclassified between measurement categories when—and only when—the entity's business model for managing them changes. In accordance with IFRS 9, a change in business model is a significant event and is expected to be rare.*

Question 2 – Business model for managing financial assets

(a) **Is the business model assessment working as the Board intended? Why or why not?**

Please explain whether requiring entities to classify and measure financial assets based on the business model assessment achieves the Board's objective of entities providing users of financial statements with useful information about how an entity manages its financial assets to generate cash flows.

(b) **Can the business model assessment be applied consistently? Why or why not?**

Please explain whether the distinction between the different business models in IFRS 9 is clear and whether the application guidance on the evidence an entity considers in determining the business model is sufficient.

If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) **Are there any unexpected effects arising from the business model assessment? How significant are those effects?**

Please explain the costs and benefits of the business model assessment, considering any financial reporting or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about reclassification of financial assets (see Spotlight 2).

EFRAG's response

EFRAG has preliminary assessed that the business model assessment generally leads to the provision of useful information about the use of financial instruments.

EFRAG has been informed that in some circumstances the business model could not be applied consistently, however EFRAG does not consider that further standard setting activity is needed.

Question (a)

13 EFRAG is of the view that the business model assessment generally leads to the provision of useful information about financial instruments. However, EFRAG has been informed that in a number of situations, as described below, the business model assessment leads to non-representative outcomes.

14 EFRAG analysed different situations when the entities decided to change the business model. Those situations were triggered by the following circumstances:

(a) Liquidity buffers of banks, including:

(i) transfer between banking departments; and

(ii) reclassification in particular circumstances (i.e., COVID 19 crisis); and

(b) Loan syndications.

Liquidity buffers of banks

Transfer between banking departments

15 Transfers within a group: in the context of liquidity management, market and investment banking departments happen to purchase financial assets such as securities. Those assets are then resold to the retail departments (of the same group) to meet their day-to-day liquidity management needs and their liquidity portfolio management. At the acquisition date, those assets are held within a business model that is neither held to collect (HTC) nor held to collect and sell (HTCS) and thus, are measured at fair value through profit or loss (FVPL). However, after being transferred, those assets are usually held within a HTC business model but their classification cannot be changed to amortised cost[1].

16 Amortised cost measurement would apply only if the retail departments were to acquire the financial assets directly, but this would require additional costs. If one wanted to reclassify the asset this should be first sold by the market department to a third party just to re-acquire it through the retail department shortly after.

Reclassification in particular circumstances (i.e., COVID 19)

17 In particular circumstances the measurement of bonds can vary significantly depending on the business model applied. EFRAG is aware that IFRS 9, paragraph B4.1.2A notes that the business model assessment is not performed on the basis of worst case or stress case scenarios. In addition, paragraph B.4.4.3 of IFRS 9 noted that a change in intention even in circumstances of significant changes in market conditions is not seen as a change in the business model. However, EFRAG notes that the effects caused by COVID 19 are of a different nature than what happened during the financial crisis of 2007-2008. In the recent COVID 19 situation regulatory pressure was added to banks to reduce their exposure to non-performing loans.

18 Some European constituents suggested to identify the HTC business model as a default category, while FVPL would be redefined as trading.

Loan syndications

19 Before the syndication, the entity determines the portion of loans it expects to retain and the portion it expects to sell considering all relevant information at that date. This assessment determines the portion of the loans that are held in HTC and in HTCS business models, and if the loans meet the SPPI criterion, the portions of loans that are measured at fair value or at amortised cost. However, the portion of loans sold may differ from the entity's expectations. Applying paragraph B4.1.2A of IFRS 9, this does not change the classification of the financial assets. When the entity sells a lower portion of loans than expected, it is required to continue to measure the excess unsold loans at FVPL while amortised cost would provide more useful information in those circumstances.

[1] In IFRS 9, paragraph B4.4.3 is stated "The following are not changes in business model: […] (c) a transfer of financial assets between parts of the entity with different business models.]

Question (b)

20 During EFRAG's preliminary outreach with regard to the issues mentioned under Question 2 (a) EFRAG considered that accounting should not continuously be adapted for changes in regulation.

Question (c)

21 As mentioned in our answer to Question 2 (a) EFRAG considers that COVID 19 has had an unexpected impact on the ability of many companies to pay back their loans. Hence, banks would take measures to protect their loan portfolios, including the sale of some of these loans.

22 However, EFRAG assessed on the IFRS 9 endorsement advice in 2015 that reclassifications triggered solely based on a change in intentions due to market conditions would create tension in terms of reliability of the information. In addition, information was lacking about large numbers of sales as a result of this fact pattern. In addition, EFRAG has been informed that is seen by some more as a regulatory than as an accounting issue.

23 EFRAG was satisfied that IFRS 9 requires an entity to reclassify financial instruments if a change in business model has been decided in response to a change in market conditions. As a result, EFRAG assessed the requirements for reclassification of financial assets as leading to relevant information.

Notes to constituents – Summary of proposals in the RFI

24 Amortised cost is a simple measurement technique that allocates interest payments using the effective interest method over the life of a financial instrument. In the Board's view, amortised cost can provide useful information only if the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement. Therefore, one condition for determining how to classify and measure a financial asset is whether 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 (SPPI). Only financial assets with SPPI cash flows are eligible for measurement using amortised cost or fair value through OCI, subject to the business model in which the asset is held.

25 The objective of the effective interest method for financial instruments measured at amortised cost is to allocate interest revenue or expense to the relevant period. Cash flows that are interest are always closely related to the amount advanced to the debtor. The effective interest method, combined with the expected credit loss impairment model, provides relevant information for financial assets with SPPI cash flows. When the Board developed IFRS 9, it noted that the effective interest method is inappropriate for allocating cash flows that are not SPPI.

26 Unlike IAS 39, IFRS 9 does not require or permit embedded derivatives to be separated from financial assets. Accordingly, an entity assesses the contractual cash flow characteristics of a financial asset in its entirety.

Question 3 – Contractual cash flow characteristics

(a) **Is the cash flow characteristic assessment working as the Board intended? Why or why not?**

Please explain whether requiring entities to classify and measure a financial asset considering the asset's cash flow characteristics achieves the Board's objective of entities providing users of financial statements with useful information about the amount, timing and uncertainty of future cash flows.

If, in your view, useful information could be provided about a financial asset with cash flows that are not SPPI applying IFRS 9 (that is, an asset that is required to

be measured at fair value through profit or loss applying IFRS 9) by applying a different measurement approach (that is, using amortised cost or fair value through OCI) please explain:

(i) why the asset is required to be measured at fair value through profit or loss (that is, why, applying IFRS 9, the entity concludes that the asset has cash flows that are not SPPI).

(ii) which measurement approach you think could provide useful information about the asset and why, including an explanation of how that approach would apply. For example, please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk). (See Section 7 for more questions about applying the effective interest method.)

(b) **Can the cash flow characteristics assessment be applied consistently? Why or why not?**

Please explain whether the requirements are clear and comprehensive enough to enable the assessment to be applied in a consistent manner to all financial assets within the scope of IFRS 9 (including financial assets with new product features such as sustainability-linked features).

If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) **Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?**

Please explain the costs and benefits of the contractual cash flow assessment, considering any financial reporting effects or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about financial instruments with sustainability-linked features (see Spotlight 3.1) and contractually linked instruments (see Spotlight 3.2).

EFRAG's response

EFRAG considers that the principle underlying the SPPI requirement generally leads to the provision of useful information about the amount, timing and uncertainty of future cash flows. However, the SPPI-requirement requires a re-assessment in the light of specific financial instruments such as financial instruments with ESG features or contractually linked financial instruments. EFRAG advocates that the issue of financial instruments with ESG features is lifted from the PIR of IFRS 9 and treated separately as an urgent issue.

Introduction

Financial instruments with ESG features

27 By 2050, Europe aims to become the world's first climate-neutral continent. On 14 July 2021, the European Commission adopted a series of legislative proposals setting out how it intends to achieve climate neutrality in the EU by 2050, including the intermediate target of an at least 55% net reduction in greenhouse gas emissions by 2030.

28 Banks and insurers should make sustainability considerations as an integral part of its financial policy in order to support European Green Deal. Sustainable finance has a key role to play in delivering on the policy objectives. The European Union strongly supports the transition to a low-carbon, more resource-efficient and sustainable economy and has been at the forefront of efforts to build a financial

system that supports sustainable growth through the banking and insurance industry.

29 European constituents anticipate in the coming years a sharp increase in volumes of debt instruments with contractual features that link the cash flows with the ESG profile of the borrower and observe that such features may trigger the classification of the financial asset at fair value through profit or loss, should they fail the SPPI test.

30 These stakeholders are concerned that such a classification would not be reflective of the way such instruments are managed (as they are considered as part of the lending business which is measured at amortised cost). Banks might be indirectly discouraged from mainstreaming this type of lending.

31 The current global volume of these emission is in the size of about 700[2] billion in 2020, and just in H1 2021 a little bit over 500 billion of which more than 50% relates to European issuers. As an example, only Germany, France and Spain together issued in the H1 2021 a total of 60 billion.

Contractually linked instruments – non- recourse

32 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.

33 EFRAG has been informed that these rules-based requirements may lead to contradictory outcomes (passing SPPI or not) depending on the nature of the guidance (contractually linked or non-recourse) being applied. This while the two types of structures are considered to be essentially the same by some stakeholders. EFRAG has been further informed that – due to the "late" introduction of the non-recourse guidance in IFRS 9, the interaction between the two sets of requirements have not been fully explored.

34 As a result, diversity in practice is noted with application of the non-recourse guidance and contractually linked instruments. During its preparation for this comment letter, EFRAG has been informed about the following issues that arise in this regard:

(a) The "look through" approach considered difficult in some cases, as the required details are not available for every line of underlying investments;

(b) 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, EFRAG has heard that some believe it is necessary to consider the nature and substance of an arrangement;

(c) IFRS 9 had been developed with public securitisations in mind, but currently there are all sorts of financing in terms of structured finance and corporate real estate. A fact pattern where two tranches of a debt in a structure could be seen as creating contractually-linked instruments, even though the junior tranche had the substance of equity but did not meet IAS 32 equity;

(d) 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

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[2] Sustainable Debt Highlights H1 2021

to some is what constitutes an 'instrument' for the purposes of contractually linked guidance.

(e) The issue reported relates also to the reclassification requirements as it is argued by some that a change in processes (i.e., whether to apply the non-recourse guidance or the CLI-guidance) would also qualify as a change in business model.

35 EFRAG requests the IASB to provide additional guidance to address these issues.

36 Examples of such structures are provided in Appendix 2.

Question (a)

37 EFRAG is supportive of principal-based standards, but it is known that, especially in border areas, an unrestricted application of principles can in some cases lead to debatable outcomes, necessitating corrections. This was the case for the treatment of an asset's cash flow characteristics under IFRS 9.

Financial instruments with ESG features

38 EFRAG notes that financial instruments with ESG features are often held under a business model of held to collect or held to collect or sell. EFRAG understands that currently the impact of these features is assessed to be minimal, so not resulting in failing the SPPI test. However, in the future, in order to meet the anticipated ambitious sustainability targets offering appropriate incentives, stakeholders expect a higher impact.

39 EFRAG considers that ESG-related step-ups are not necessarily in conflict with the SPPI requirement, as long as a link can be demonstrated between the ESG criteria on which the step-up/step down is based and the credit quality of the entity. However, EFRAG notes that this link could be complicated to demonstrate and document. In addition, EFRAG notes that difficulties arise in applying the EIR due to the impossibility to reliably estimate the ESG linked features.

40 Given the prevalence of this issue for European constituents, EFRAG is of the view that this issue should be lifted from the Post-implementation Review of IFRS 9 and should be addressed separately as an urgent issue.

Contractually linked instruments – non- recourse

41 EFRAG has included a number of examples in Appendix 2 to this letter to demonstrate the uncertainties raised in the accounting analysis.

Questions to constituents

42 Are there financial instruments for which you think the cash flow characteristics assessment is not leading to an appropriate measurement outcome other than the sustainable finance products and the contractually linked instruments identified in this DCL? Please explain the fact patterns underpinning these financial instruments.

43 If yes, please also explain how the desired measurement provides users with useful information about (i) amount, (ii) timing, and (iii) uncertainty of future cash flows.

Question (b)

44 EFRAG understands that currently the impact of the ESG features as described in paragraphs 27 to 31 are assessed to be minimal, so not resulting in failing the SPPI test. However, in the future, in order to meet the anticipated ambitious sustainability targets offering appropriate incentives, the size and number of features is expected to increase.

Questions to constituents

45 In addition to considering the 'de minimis' and the possible link to the credit spread, what additional approach could be considered in order to avoid failures of the SPPI tests?

46 What do you consider the economic nature of the ESG linked variability to be?

Question (c)

47 This part will be updated based on comments received during the consultation phase.

Notes to constituents – Summary of proposals in the RFI

48 Equity instruments do not have SPPI cash flows and therefore are measured at fair value through profit or loss. As explained in paragraph BC5.22 of the Basis for Conclusions on IFRS 9, in the Board's view, fair value provides the most useful information about the amount, timing and uncertainty of the cash flows arising from investments in equity instruments.

49 The Board acknowledged when it developed IFRS 9 that, in a narrow set of circumstances, presenting fair value gains and losses from equity investments in profit or loss may not be indicative of the entity's performance. Therefore, IFRS 9 permits an entity to make an irrevocable election at initial recognition to present in OCI changes in the value of an investment in an equity instrument not held for trading. Those gains and losses are not 'recycled' to profit or loss on disposal of the investment, and the investment is not subject to impairment requirements.

50 Some stakeholders questioned whether non-recycling for investments in equity instruments in IFRS 9 is consistent with the Conceptual Framework for Financial Reporting. The Conceptual Framework explains that, in principle, income and expenses included in OCI in one period are reclassified into profit or loss in a future period when doing so results in the statement of profit or loss providing more relevant information or providing a more faithful representation of the entity's financial performance for that future period. However, if, for example, there is no clear basis for identifying the period in which reclassification would have that result, or the amount that should be reclassified, the Board may, in developing Standards, decide that income and expenses included in OCI are not to be subsequently reclassified.

Question 4 – Equity instruments and other comprehensive income

(a) **Is the option to present fair value changes on investments in equity instruments in other comprehensive income working as the Board intended? Why or why not?**

Please explain whether the information about investments in equity instruments prepared applying IFRS 9 is useful to users of financial statements (considering both (i) equity instruments measured at fair value through profit and loss; and (ii) equity instruments to which the OCI presentation option has been applied).

For equity instruments to which the OCI presentation option has been applied, please explain whether information about those investments is useful considering the types of investments for which the Board intended the option to apply, the prohibition from recycling gains and losses on disposal and the disclosures required by IFRS 7.

(b) **For what equity instruments do entities elect to present fair value changes in other comprehensive income?**

Please explain the characteristics of these equity instruments, an entity's reason for choosing to use the option for those instruments, and what proportion of the entity's equity investment portfolio comprises those instruments.

(c) **Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in other comprehensive income? How significant are these effects?**

Please explain whether the requirements introduced by IFRS 9 had any effects on entities' investment decisions. If yes, why, how and to what extent? Please provide any available evidence supporting your response which will enable the Board to understand the context and significance of the effects.

In responding to (a)–(c), please include information about recycling of gains and losses (see Spotlight 4).

EFRAG's response

EFRAG considers the IASB should expeditiously review the non-recycling treatment of equity instruments within IFRS 9, testing whether the Conceptual Framework would justify the recycling of FVOCI gains and losses on such instruments when realised. If recycling was to be reintroduced, the IASB should also consider the features of a robust impairment model, including the reversal of impairment losses.

EFRAG supports that similar fact patterns should be treated similarly, and noted that some mutual funds and puttable instruments, respond to movements in market variables in a similar way to equity instruments even though these do not meet the definition of an equity instrument under IAS 32 *Financial Instruments – Presentation.*

As a working assumption, EFRAG considers that the definition of equity-type instruments should be limited to units of funds and puttable instruments that invest in equity instruments, associated derivatives, and necessary cash holdings.

Question (a)

51 EFRAG welcomes the question in the RFI. The option to present fair value changes on investments in equity instruments in OCI has been considered extensively by EFRAG mainly because the changes in fair value cannot be recycled when the instrument is sold. Additionally, EFRAG considered whether this option should be extended to equity-like type instruments.

52 In June 2018, the European Commission (EC) requested EFRAG to consider alternative accounting treatments to measurement at FVPL for equity instruments. Possible accounting treatments should properly portray the performance and risk of long-term investment business models in particular for those equity and equity type investments that are much needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on climate change.

53 In May 2019 EFRAG launched a public consultation to gather constituents' views on whether alternative accounting treatments to those in IFRS 9 are needed to portray the performance and risks of equity and equity-type instruments held in long-term investment business models. EFRAG received 63 responses: this number confirms that this is a topic that generates considerable interest in Europe, specifically, but not exclusively, for the financial sector. Seventy (70%) of respondents considered that an alternative accounting treatment was relevant to meet the objective to reduce or prevent detrimental effects on long-term investments. However, 30% of respondents did not consider that an alternative

accounting treatment is needed. Seventy-eight percent (78%) of those who supported an alternative treatment (corresponding to 52% of the total respondents) favoured a model based on fair value through other comprehensive income ('FVOCI') with recycling and impairment, with a scope that is similar to the FVOCI option under IFRS 9. EFRAG notes that the concerns expressed by these respondents are not new and that similar concerns were highlighted in its endorsement advice on IFRS 9. The Feedback statement of this consultation is accessible here.

54 In January 2020 EFRAG issued its advice to the EC on alternative accounting treatments to measurement at fair value through profit or loss for equity and equity-type instruments held in long-term investment business models. In particular, EFRAG advised that the EC recommend to the IASB an expeditious review of the non-recycling treatment of equity instruments within IFRS 9, testing whether the Conceptual Framework would justify the recycling of FVOCI gains and losses on such instruments when realised. If recycling was to be reintroduced, the IASB should also consider the features of a robust impairment model, including the reversal of impairment losses.

Question (b)

55 EFRAG considered in its advice to the EC whether this option should be extended to equity-like type instruments.

56 On EFRAG consultation most respondents (88%) who support the need for an alternative accounting treatment in the consultation described above, considered that the alternative accounting treatment should be extended to 'equity-type' instruments (i.e. units of funds). Among the concerns reported in the consultation, they considered that:

(a) equity instruments should be treated consistently under IFRS 9, irrespective if they are hold directly or indirectly; and

(b) measuring equity-type instruments at FVPL distorts the depiction of financial performance and would not appropriately reflect the management strategy of the funds.

57 The remaining respondents either did not agree or did not reply.

58 In its advice to the EC in relation to accounting for investments in units of funds under IFRS 9, EFRAG was sympathetic to the concerns on the accounting at FVPL, as opposed to FVOCI. EFRAG supported that similar fact patterns should be treated similarly, and noted that some mutual funds and puttable instruments, respond to movements in market variables in a similar way to equity instruments even though these do not meet the definition of an equity instrument under IAS 32.

59 EFRAG considered that any changes to the accounting for these instruments, aimed at allowing for direct and indirect equity instruments to be treated similarly for accounting purposes, would require careful consideration. It would be necessary to evaluate the challenges of developing an appropriate standard setting solution and considering knock-on effects on the classification and measurement model under IFRS 9. Possible consequences could include structuring opportunities and the ability to assess the nature of the underlying assets and business model at the level of the fund itself.

60 EFRAG considered suggestions of relevant criteria made by stakeholders in the consultation mentioned above, in order to select units of funds that could become eligible to the equity accounting treatment and prevent unintended consequences. As a working assumption, EFRAG considered that the definition of equity-type instruments should be limited to units of funds and puttable instruments that invest in equity instruments, associated derivatives and necessary cash holdings.

Question (c)

61 EFRAG notes that IFRS 9 is substantially still not applied by the insurance sector, so its potential impact on long-term investment cannot be assessed based on actual data. Therefore, no compelling evidence has come to the attention of EFRAG that accounting is an impediment or not to long-term investment.

62 EFRAG notes that asset allocation decisions are driven by a plurality of factors and that it is difficult to disentangle the impact of accounting requirements from that of other factors, such as expectation on future returns by class of assets or other regulations, including taxes and prudential requirements.

63 In the consultation described above, most of respondents (70%) considered that an alternative accounting treatment was relevant to meet the objective to reduce or prevent detrimental effects on long-term investments. However, 30% of respondents did not consider that an alternative accounting treatment is needed.

64 Nearly all respondents from the insurance and asset management industry, together with a large majority of the banks and non-financial corporates, supported the need for an alternative accounting treatment to avoid the unexpected effect of divest in equity and equity like instruments.

Notes to constituents – Summary of proposals in the RFI

65 *The feedback received by the Board when it developed IFRS 9 indicated that the approach to the classification and measurement of financial liabilities in IAS 39 should be retained. The only issue with the IAS 39 requirements for financial liabilities that the Board was told needed reconsideration was the profit or loss effects caused by changes in the fair value of a liability resulting from changes in the risk that the issuer will fail to meet its obligations for that liability*

66 By retaining almost all of the requirements from IAS 39, the issue of credit risk was addressed for most liabilities because most liabilities continue to be subsequently measured at amortised cost or are separated into a host, which would be measured at amortised cost, and an embedded derivative that would be measured at fair value. Liabilities that are held for trading (including all derivative liabilities) would continue to be measured subsequently at fair value through profit or loss.

67 The fair value of an entity's own debt is affected by changes in the entity's own credit risk (own credit). This means that when an entity's credit quality declines the value of its liabilities fall and, if those liabilities are measured at fair value, the entity recognises a gain (and if the entity's credit quality improves, the entity recognises a loss). Many users of financial statements and others found this result counterintuitive and confusing.

68 To address concerns about counterintuitive and confusing results for those financial liabilities voluntarily designated at fair value through profit or loss, IFRS 9 requires changes in the fair value of an entity's own credit risk to be recognised in OCI rather than in profit or loss (unless doing so would create or enlarge an accounting mismatch in profit or loss).

Question 5 – Financial liabilities and own credit

(a) **Are the requirements in IFRS 9 for presenting the effects of own credit in other comprehensive income working as the Board intended? Why or why not?**

Please explain whether the requirements, including the related disclosure requirements, achieved the Board's objective, in particular, whether the requirements capture the appropriate population of financial liabilities.

(b) **Are there any other matters relating to financial liabilities that you think the Board should consider as part of this post-implementation review (apart from modifications, which are discussed in Section 6)?**

Please explain the matter and why it relates to the assessments the Board makes in a post-implementation review.

EFRAG's response

In the endorsement advice of IFRS 9 EFRAG noted that the requirements for presenting the effects of own credit risk in other comprehensive income as improving the relevance of reporting information. EFRAG is of the view the requirements work as intended and has not received information that contradicts this view.

Question (a)

69 EFRAG recalls from its endorsement advice on IFRS 9 *Financial Instruments* the following:

70 "When an entity designates a financial liability to be measured at fair value through profit or loss in its entirety, IFRS 9 requires that the changes in the fair value due to changes in the credit risk of that liability (own credit risk) are presented in other comprehensive income. …

71 This requirement significantly improves the relevance of reported profit or loss. The reason is that it avoids counterintuitive reporting of gains in profit or loss when the own credit standing of entity deteriorates and the reporting of losses when the credit standing improves. …

72 The accumulated change in fair value due to the entity's own credit risk on financial liabilities for which the fair value option has been taken is never reclassified to profit or loss. IFRS 9 argues that, when an entity repays the contractual amount, the cumulative effect of changes in the liability's credit risk over its life will net to zero because the liability's fair value will ultimately equal the contractual amount due. EFRAG recognises that this may be often the case. However, in situations where the repayment differs from the contractual amount (for example, due to early repurchase at fair value), the lack of reclassification may limit the relevance of the information especially if gains resulting from the repurchase of liabilities are perceived as part of the performance of the entity. EFRAG understands these views but also notes that these concerns are mitigated to some extent because the amount of such gains or losses has to be disclosed."

73 EFRAG is of the view that the requirements work as intended and has not received information to the contrary.

Question (b)

74 During its preliminary outreach with regard to the issues to be reported as part of this Post-implementation Review EFRAG has not been informed about existing issues with regard to the accounting of financial liabilities.

Notes to constituents – Summary of proposals in the RFI

75 When contractual cash flows are renegotiated or otherwise modified, the modification could result in the entity derecognising or recalculating the carrying amount (gross carrying amount for financial assets) of the financial instrument.

76 IFRS 9 does not define a 'modification' of a financial asset or financial liability. Paragraph 5.4.3 of IFRS 9 refers to the modification or renegotiation of the contractual cash flows of a financial asset, while paragraph 3.3.2 of IFRS 9 refers to the 'modification of the terms' of a financial liability.

77 When amending IFRS 9 to account for the effects of interest rate benchmark reform, the IASB acknowledged that the omission of a description of a 'modification' in IFRS 9, and that the use of different wording to describe a modification of a financial asset and a financial liability, could lead to diversity in practice. The IASB suggested it might be helpful to clarify the requirements for modifications and to consider making a possible narrow-scope amendment to IFRS 9.

Question 6 – Modifications to contractual cash flows

(a) **Are the requirements for modifications to contractual cash flows working as the Board intended? Why or why not?**

Please explain what changes you consider to be modifications of a financial asset for the purpose of applying paragraph 5.4.3 of IFRS 9 and as a modification of a financial liability for the purpose of applying paragraph 3.3.2 of IFRS 9. Does the application of those paragraphs, and the disclosure requirements related to modifications, result in useful information for users of financial statements?

(b) **Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?**

Please explain whether the requirements enable entities to assess in a consistent manner whether a financial asset or a financial liability is modified and whether a modification results in derecognition. Have the requirements been applied differently to financial assets and financial liabilities?

If diversity in practice exists, please explain how pervasive the diversity is and its effects on entities' financial statements.

EFRAG's response

EFRAG understands that the absence of a definition of "substantial modification" and of derecognition thresholds for financial assets in IFRS 9, has led to some diversity in practice of when a financial asset is derecognised or modified.

However, EFRAG also notes that views are split on whether the IASB should undertake standard setting activities.

Question (a)

78 EFRAG notes that financial instruments may undergo modifications for a number of different reasons, being it market or legislative changes or changes in the credit situation of the counterparty, which creates additional complexity in this area.

79 Paragraph 5.4.3 of IFRS 9 states that when the contractual cash flows of a financial asset are renegotiated or otherwise modified *and such modification does not result in derecognition*, the gross carrying amount of the financial asset shall be recalculated as the present value of the modified contractual cash flows discounted at the original effective interest rate (EIR) and a modification gain or loss recognised in profit or loss.

80 However, the trigger of a derecognition is only defined for financial liabilities in paragraph 3.3.2 as a *"substantial modification of the terms of a financial liability".*

81 A substantial modification is further defined in paragraph B3.3.6 as "the discounted cash flows under the new terms being at least 10% different from the discounted remaining cash flows of the original financial liability".

82 Thus, there is no definition of "substantial modification" or derecognition threshold for financial assets in IFRS 9. In the absence of guidance, the current practice was developed often by applying the rules for financial liabilities to financial assets.

83 However, the 10% threshold for the financial liabilities may not be representative or applicable to financial assets and for that reason banks have developed practical approaches, including to limit as much as possible the scope for derecognition. Sometimes qualitative criteria are also used to determine if the financial assets' terms and cash flows were substantially modified.

84 EFRAG notes that in May 2012 the IFRS IC issued a tentative agenda decision (TAD) on IAS 39 *Financial Instruments: Recognition and Measurement* - Accounting for different aspects of restructuring Greek Government Bonds (GGB). The TAD analysed whether a portion of the old GGBs that was exchanged for twenty new bonds with different maturities and interest should be derecognised, or conversely accounted for as a modification or transfer that would not require derecognition.

85 Even if this issue was analysed under IAS 39 not IFRS 9, the IFRS IC concluded on its September 2012 meeting, that the old GGBs should be derecognised as the terms and conditions of the new bonds were substantially different from those of the old bonds. The changes included many different aspects, such as the change in governing law; the introduction of contractual collective action clauses and the introduction of a co-financing agreement that affected the rights of the new bond holders; and modifications to the amount, term and coupons. The IFRS IC determined that it was not necessary to apply the 10% to derecognise those instruments.

86 An example on a modification of contractual cash flows of a financial assets could be illustrated as follows:

(a) A bank enters into a 15-year loan with a borrower (measured at amortised cost or fair value through other comprehensive income). The loan accrues interest at 4%.

(b) At the end of year 10, as a result of an arm's length renegotiation, the remaining maturity has been modified from 5 years to 10 years (5 additional years), and the coupon has been revised to 2% to maturity.

(c) The borrower is not in any financial difficulty and there is no objective evidence of impairment (under IAS 39). In addition, the loan has not suffered a significant increase in credit risk (under IFRS 9).

87 Under those circumstances different accounting approaches could be used:

(a) The entity has surrendered its rights to the 4% coupon for the next 5 years and the principal repayment in 5 years' time. In this situation, the rights to these cash flows have expired, and, so they should be de-recognised as there has been a substantial modification of the contract terms (and by extension the cash flows). Finally, a new 10-year loan should be recognised at fair value on renegotiation (refinance), comprising a new principal payment in 10 years' time and 2% interest coupons for the next 10 years.

(b) The entity has modified its rights to the 4% coupon for the next 5 years and the principal repayment in 5 years' time. In this situation, the rights to these cash flows have been re-estimated, as there has not been a substantial

modification of the contract terms (and by extension the cash flows). Finally, the old 15-year loan should be re-estimated at fair value comprising a modified principal payment in 20 years' time and 2% interest coupons for the next 10 years. In this case, the cash flows should be modified with the modified coupon and a loss (or profit) should be recognised in the statement of profit or loss and other comprehensive income, as defined in paragraph 5.4.3 of IFRS 9.

88 In current practice, some banks tend to use the option described in paragraph 87(b) to account for changes either in the duration or interest rate (or both) of the loans as they consider that there has not been a substantial modification of the contractual terms of the loan in this case.

89 EFRAG considers that a lack of guidance may result in different interpretations of when a financial asset should be modified or derecognised with an impact on a modification gain or loss recognised in profit or loss.

Question to TEG Members

90 EFRAG Secretariat understands that the request of standard setting activities to address this issue is not considered as a priority by preparers of the banking industry.

91 At the same time, EFRAG Secretariat notes that the absence of guidance may negatively affect the comparability of financial statements and their usefulness to users.

92 Should EFRAG report this issue as deserving standard setting?

Question (b)

93 As described in our answer to Question 6 (a) above, there is no direct guidance regarding modification and derecognition of financial assets and the guidance for financial liabilities is often applied by analogy. Many financial institutions had to develop their accounting policies to deal with a lack of guidance in this area which could lead to a diversity in practice**.**

94 EFRAG also highlights the existence of several regulatory and accounting frameworks[3] in Europe to assess the quality of financial assets and the reasons for their modifications, especially if they relate to a decrease in the credit quality of the counterparty, such as forbearance, for example. EBA issued the guidance on forbearance of loans in October 2018. For that reason, banks should monitor their forborne loans and provision them on a one-to-one basis.

95 Some preparers tend to link the substantial modification to the cases of forbearance, significant increase in credit risk and transfer of a financial asset to Stage 3 level (credit-impaired debt instruments), to make a link between different regulatory and accounting frameworks.

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[3] In Europe there are three sets of rules for categorising forbearance or problem loans:

a) the IFRS 9 rules for allocating credit risk exposure to Stages 2 and 3;

b) the rules on capital definition of default (including article 178 in the CRR and new EBA rules due to come into force by end 2020); and

c) the FINREP definitions, which also underpin the ECB/EBA rules regarding the management and disclosure of non-performing loans.

96 One accounting question that arises in this regard is when does a forbearance event (modification for credit reasons) trigger derecognition (which also means that the new loan does not have any provisioning attached despite being a problem loan).

97 Also, in situations where a modification does not result in a derecognition, differences in application may arise. In the view of some an entity may choose an accounting policy to apply the guidance on floating rate financial instruments to changes in cash flows resulting from the modification of a floating rate component under the original contractual terms to a new rate of interest (whether floating or fixed) that reflects current market terms. Under such a policy the original EIR of the financial asset is revised, based on the new terms, to reflects changes in cash flows that reflect periodic changes in market rates.

98 However, in situations where a modification changes floating cash flows into fixed ones or vice-versa differences in practice are seen on either applying paragraph B5.4.5 (floating rates) or B5.4.6 (fixed rates) of IFRS 9 to the modified cash flows.

Notes to constituents – Summary of proposals in the RFI

99 The effective interest method is the method used to calculate the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

100 The effective interest rate is the rate that exactly discounts estimated future cash flows through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity estimates the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but does not consider the expected credit losses (for financial assets). The calculation includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

101 IFRS 9 provides requirements on using the effective interest method, including requirements to reflect changes in cash flows resulting from:

(a) *modifications;*

(b) *movements in market rates of interest; and*

(c) *other changes in estimates (the so-called ‘catch-up adjustment’).*

Question 7 – Amortised cost and the effective interest method

(a) **Is the effective interest method working as the Board intended? Why or why not?**

Please explain whether applying the requirements results in useful information for users of financial statements about the amount, timing and uncertainty of future cash flows of the financial instruments that are measured applying the effective interest method.

(b) **Can the effective interest method be applied consistently? Why or why not?**

Please explain the types of changes in contractual cash flows for which entities apply paragraph B5.4.5 of IFRS 9 or paragraph B5.4.6 of IFRS 9 (the ‘catch-up adjustment’) and whether there is diversity in practice in determining when those paragraphs apply.

Please also explain the line item in profit or loss in which the catch-up adjustments are presented and how significant these adjustments typically are.

> If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.
>
> In responding to questions (a)–(b), please include information about interest rates subject to conditions and estimating future cash flows (see Spotlight 7).

EFRAG's response

EFRAG considers that the effective interest rate method generally provides useful information and notes that IFRS 9 includes scope limitations or corrections to the method for particular financial instruments. EFRAG further notes that that more and more financial instruments incorporate conditions that may affect the future contractual interest cash flows when being fulfilled or fail to be fulfilled by the reporting entity or a third party. Examples are TLTRO related loans and financial instruments with ESG features. The financial instruments including such conditions are pervasive in Europe. EFRAG notes that for these financial instruments the EIR cannot be reliably applied.

EFRAG is collecting further information from constituents on fact patterns, prevalence and diversity in practice in accounting for such financial instruments.

Question (a)

102 When applying the effective interest method, interest is recognised in profit or loss in the period it accrues, regardless of when it is to be paid. This because an entity generally amortises any fees, points paid or received, particular transaction costs and other premiums and discounts that are included in the effective interest rate over the expected life of the financial instrument. EFRAG is of the view that this method generally provides useful information about the amount, timing and uncertainty of future cash flows.

103 EFRAG notes that IFRS 9 includes scope limitations or corrections to the application of the effective interest method like for purchased or originated credit-impaired financial assets or in relation to modifications of cash flows.

104 EFRAG further notes that more and more financial instruments incorporate conditions that may affect the future contractual interest cash flows when being fulfilled or fail to be fulfilled by the reporting entity or their clients. Examples of this kind are the TLTRO[4] transactions (as discussed by the IFRS Interpretations Committee in June 2021) or financial instruments with ESG-features. This kind of contractual conditions are pervasive in Europe.

Questions to constituents

105 Do you think that when case interest revenue/expense is changed because of the fulfilment (or failure of fulfilment) of specific contractual conditions results in a (or more) specific key performance indicator(s)? If yes, how should such (a) KPI(s) be presented in the statement of comprehensive income? Please explain.

106 In case you agree that fulfilment or failure of fulfilment of specific contractual conditions leads to a specific KPI, which contractual features would be in scope of such a KPI? Please explain.

[4] TLTRO: Targeted Longer-Term Refinancing Operation

Question (b)

Questions to constituents

107 How significant are these catch-up adjustments in accordance with paragraph B5.4.5 or B5.4.6 of IFRS 9 (please provide nominal amounts and expressed as a percentage compared to the interest revenue and expense calculated using the EIR – as disclosed per IFRS 7, 20(b))? Please provide information for the following reporting periods: 2018, 2019 and 2020.

Notes to constituents – Summary of proposals in the RFI

108 Upon their transition to IFRS 9, entities were required to apply the Standard retrospectively, but with reliefs to address difficulties that might have arisen from retrospective application.

109 Applying some of those transition reliefs that relate to classification and measurement, entities:

(a) *assessed whether the objective of an entity's business model was to manage financial assets to collect contractual cash flows based on circumstances at the date of initial application of IFRS 9 rather than at the date the related financial instrument was initially recognised;*

(b) *assessed whether a financial asset or financial liability met the criterion for designation under the fair value option based on the circumstances at the date of initial application rather than at the date the related financial instrument was initially recognised;*

(c) *were permitted but not required to present restated comparative information on initial application of the Standard; and*

(d) *did not apply IFRS 9 to financial instruments derecognised before the date of initial application.*

110 As the Board waived the requirement to present restated comparative information, it instead required entities to disclose the effect on classification of financial instruments of the transition to IFRS 9.

Question 8 – Transition

(a) **Did the transition requirements work as the Board intended? Why or why not?**

Please explain whether the combination of the relief from restating comparative information and the requirement for transition disclosures achieved an appropriate balance between reducing costs for preparers of financial statements and providing useful information to users of financial statements.

Please also explain whether, and for what requirements, the Board could have provided additional transition reliefs without significantly reducing the usefulness of information for users of financial statements.

(b) **Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not?**

Please explain any unexpected effects or challenges preparers of financial statements faced applying the classification and measurement requirements retrospectively. How were those challenges overcome?

EFRAG's response

To be completed.

Question (a)

111 In its endorsement advice of IFRS 9 (September 2015), EFRAG noted that upon transition to IFRS 9 there is no requirement to restate the financial information for previous periods will help contain the costs for preparers in implementing IFRS°9.EFRAG acknowledged that most of the entities did not restate but presented comparatives on the transition year between IAS 39 and IFRS 9 and no issues explicitly arose from that exercise.

112 However, EFRAG noted as stated in our comment below that some issues could arise when IFRS 17 is implemented. EFRAG has no further views on this topic.

Question (b)

113 The IFRS 9 endorsement advice further advocated to implement the insurance contracts standard (which later became IFRS 17 *Insurance Contracts* issued in May 2017 and *the Amendments to IFRS 17* issued in June 2020) and IFRS 9 at the same time. This was achieved through the temporary exemption from applying IFRS 9 (*Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts*, issued in September 2016 – prolonged by *Extension of the Temporary Exemption from Applying IFRS 9* in June 2020), but without aligning the transition measures of both standards. To amend this the IASB has issued the IASB issued in July 2021 the ED Initial application of IFRS 17 and IFRS 9 – Comparative information.

Notes to constituents – Summary of proposals in the RFI

114 The IASB is asking to share any information that would be helpful to them in assessing whether:

(a) *The objectives of the standard-setting project have been met;*

(b) *Information provided by the Standard is useful to users of financial statements;*

(c) *The costs are as expected for preparing, auditing, enforcing or using the information entities provide when applying the Standard;*

(d) *The Standard can be applied consistently.*

Question 9 – Other matters

(a) **Are there any further matters that you think the Board should examine as part of the post-implementation review of the classification and measurement requirements in IFRS 9? If yes, what are those matters and why should they be examined?**

Please explain why those matters should be considered in the context of the purpose of the post-implementation review, and the pervasiveness of any matter raised. Please provide examples and supporting evidence when relevant.

(b) **Considering the Board's approach to developing IFRS 9 in general, do you have any views on lessons learned that could provide helpful input to the Board's future standard-setting projects?**

EFRAG's response

Based upon preparatory work for this consultation EFRAG notes a number of issues prevalent in Europe and deserving standard setting activities.

Most of these topics have already been discussed in our answers to the above questions. Below are additionally discussed: factoring of trade receivables, supply chain financing – reverse factoring and financial guarantees.

Question (a)

115 In preparing for the Post-implementation Review of IFRS 9 EFRAG has heard about diversity in practice for a number of issues. These issues are:

(a) SPP- use of administrative rates (see paragraphs 5 to 7).

(b) Sustainable -finance – SPPI-test (see paragraphs 27 to 31);

(c) Contractually-linked instruments – non-recourse (see paragraphs 32 to 35 and Appendix 2);

(d) Recycling changes in fair value accumulated in OCI for equity and treatment of equity like instruments (see paragraphs 51 to 64);

(e) Modification of cash flows (see paragraphs 78 to 98);

(f) Factoring of trade receivables (paragraphs 117 to 129);

(g) Supply-chain financing – reverse factoring (see paragraphs 130 to 138); and

(h) Financial guarantees (see paragraphs 139 to 149).

116 Most of these issues have already been addressed in previous questions. The ones that were not are discussed below:

Factoring of trade-receivables

117 In a factoring arrangement, an entity that is a supplier of goods or services obtains cash from a bank (the factor) against receivables due from the entity's customers.

118 Factoring of trade receivables is a common form of (potential) off-balance sheet finance in many jurisdictions, but it is not specifically addressed by IFRS 9. This may lead to diversity in current reporting practices. While there may be a consensus on local jurisdictional level how to report on such transactions, such a consensus does not exist cross-border leading potentially to differences in how similar transactions are being reported.

119 As a sole potential source of information on these transactions, IFRS 7 *Financial Instruments: Disclosures*, paragraphs 42A to 42H deal with disclosure requirements relating to transfers of assets; these disclosures requirements are found to be too high level in their description thereby potentially leading to incomplete information.

120 The purpose of trade receivables factoring is to get cash flows from trade receivables quicker than under regular payment terms agreed with customers, by "selling" them to a financial institution. The arrangements are in practice very diverse and it is usually not sufficient to differentiate between a factoring with recourse (no derecognition) and without recourse (full derecognition) - many transactions are somewhere in between and require detailed analysis.

121 The basic accounting question is whether, when and/or to which extend trade receivables subject to a factoring arrangement shall be derecognised. The applicable accounting principles are therefore the ones on derecognition of financial assets. If the trade receivables are not derecognised, the upfront payment received from the factor is recorded as a financing liability.

122 EFRAG has been informed that illustrative examples in IFRS 9 on how to report on these transactions may help in improving the consistency in application of IFRS 9 derecognition principles with respect to such transactions.

123 As an example, a common fact pattern on factoring of trade receivables can be described as follows:

124 "The Factor purchases the Company's receivables from Debtors making a 90% prepayment of the purchase price, less a charge which is equal to an agreed percentage of principal amount. The parties agreed for a pro-rata share of any losses between the Company (10%) and the Factor (90%). The receivables are insured up to 90% of the principal amount. If no payment is made until the initial payment date of each invoice, additional interests are charged by the Factor for the period until 6 months overdue. The Factor can sell the receivables to any other party, however the insurer's approval is necessary to preserve the insurance protection. After the 6 months period passed without payment made by the Debtor, the Factor becomes beneficiary of credit insurance. Credit insurance was obtained by the Company prior to factoring and its costs are recharged to the Company.

125 Considering the above fact pattern, the following aspects of applying IFRS 9 derecognition principles may raise concerns:

(a) How to compare the entity's exposure to the variability of cash flows from the transferred assets before and after the transfer in order to determine whether there was a transfer of substantially all risks and rewards or not? (IFRS 9.3.2.6-8)

(b) Shall the fact that the receivables are subject to insurance protection impact the derecognition analysis? This effectively comes down to interpreting what "similar assets" are in the meaning of IFRS 9.3.2.2.

(c) If substantially all risks and rewards have neither been transferred or retained, how to determine whether the control over the asset was retained or not and whether the answer to (b) above shall impact this analysis.

126 Considering the above, the following information may be missing in current disclosures, which may result from both (i) lack of specific disclosure requirements in IFRS 7 and (ii) insufficient enforceability of existing requirements:

(a) The historical loss rate of factored trade receivables by the reporting entity and how it compares to the division of losses between the reporting entity and the factor under the factoring arrangement (how many losses are borne by each party, and whether the entity covers first losses or whether they are shared pro rata with the factor);

(b) The IFRS 9-trigger that leads to derecognition of the trade-receivables (expiration of the rights involved, continuation to pay the cash flows involved, transfer of substantially all risks and rewards, retention of control); and

(c) When the trade receivables are subject to insurance, a quantitative and qualitative analysis how this has affected the derecognition assessment.

127 EFRAG requests the IASB to provide additional guidance on how the issues with regard to derecognition should be addressed. Also specific disclosures could be considered.

Questions to constituents

128 Would you have other fact patterns with regard to factoring of trade receivables that in your view should be considered and/or have you experienced challenges in other aspects of both accounting and disclosing information on trade receivables factoring? Please explain.

129 Do you agree that additional illustrative examples specifically on trade receivables factoring would be helpful in ensuring consistent application of IFRS 9 derecognition principles?

Supply-chain financing – reverse factoring

130 In a reverse factoring arrangement, a financial institution agrees to pay amounts an entity owes to the entity's suppliers and the entity agrees to pay the financial institution at the same date as or a date later than suppliers are paid.

131 The IFRS IC issued an Agenda Decision on this topic in December 2020. However, it is noted that this Agenda Decision did not resolve all uncertainties, especially with regard to presentation in the statement of cash flows.

132 The Agenda Decision considered the impact of a reverse factoring arrangement on presentation in the balance sheet, the derecognition of a financial liability, presentation in the statement of cash flows and in the notes to the financial statements.

133 Two further issues were identified with regard to supply chain financing - reverse factoring:

(a) Need for additional guidance on the principal-agent area; and

(b) How to apply the derecognition requirements in IFRS 9 when becoming part of a reverse factoring arrangement.

Principal-agent area

134 Differences in views exist between audit firms and inside audit firms on how to reflect reverse factoring transactions in the books of corporates. In particular when a factor is acting as paying agent of the corporate.

135 Some consider that when the factor is paying on behalf of the corporate it is a cash transaction that is done in a fiduciary capacity despite the fact that funds do not come from an account in the name of the corporate. So the payment should be considered as cash outflow by the corporate upon payment to the factor.

136 Others think it is not a cash payment as the cash is not coming from the corporate and the only cash transaction is when the corporate is paying back the cash flows at the very end of the supply chain finance, may be some months later.

137 Hence EFRAG is of the view that this issue may benefit from a clarification in IFRS°9. Fact patterns to be considered here include:

(a) if the reversed factoring arrangement was set up by the bank, the entity or the seller;

(b) whether the payment conditions to the seller were determined in negotiations with the bank and the seller or with the entity and the seller; and

(c) whether use of cash discounts was decided by the bank or the entity.

Derecognition

138 A second clarification that is necessary relates to how to apply the derecognition requirements in IFRS 9.3.3.2 when one become part of a reverse factoring

arrangement: i.e., is the original trade payable legally extinguished and if so, as from which moment?

Financial guarantees

Perspective of the holder of the guarantees

139 EFRAG has heard about diversity in practice for financial guarantee when this is not included in the contractual terms of the debt instrument.

140 EFRAG has determined two perspectives from the holder of the guarantees:

(a) when the entity holds a financial guarantee that is not an integral element of another financial instrument and as a consequence is not in the scope of IFRS°9, could be measured or not at FVPL; and

(b) when the entity holds a financial guarantee that can be considered as an integral element of another financial instrument and as a consequence cannot be recognised separately.

141 In the cases mentioned in the previous paragraph 140, judgement is required to assess whether the financial guarantee is an integral element of the financial instrument. This judgement creates a diversity in practice due to the lack of clarity when applying IFRS 9 requirements.

142 In addition, EFRAG considers this is an issue identify wider on non-financial entities rather than banks and insurance companies EFRAG encourages the IASB to further examinate this issue to harmonise the practice of those financial liabilities not included in the contractual terms of the debt instrument as part of the PIR or as part of a more comprehensive project.

Compensation rights

143 EFRAG has been reported with differences in practice when accounting for compensation rights that relate to non-integral financial guarantees. Differences witnessed were:

(a) Allocation of all or part of the premium paid to acquisition of the recognised compensation right. In this case, all or part of the premium paid is viewed as consideration for acquisition of the recognised compensation right; or

(b) No allocation of any part of the premium paid to acquisition of the compensation right. In this case, the premium and the compensation right are viewed as separate assets. The entire premium is considered as payment for coverage to be provided over the period of the guarantee

144 In the cases mentioned in the previous paragraph 143 EFRAG notes diversity in practice due to lack of clarity in applying IFRS 9 for compensation right. In some cases, compensation rights are considered as part of the premium and those are recognised together with acquisition. However, some cases they are considered as separate assets. EFRAG encourages the IASB to include this issue as part of the PIR or as part of a more comprehensive project, so comparison can be enhanced.

Guarantees issued

145 EFRAG noted that there is no guidance on how the requirements explained in paragraph B2.5 of IFRS 9, should apply if the issuer does not receive all of the premium at initial recognition. For consistency, those contracts should be accounted on:

(a) *Gross basis*: the issuer recognises a liability for its obligations to provide assurance to the holder (the fair value measurement is likely to be equal to the sum of the premium received and the future premiums receivable); or

(b) *Net basis*: the issuer recognises a net amount.

146 EFRAG acknowledges that in those cases where the net basis approach is applied, the amount initially recognised should be increased by any late premium received, so all premiums received are considered when measuring a financial guarantee.

147 Additionally, when account under net basis, the ongoing recognition of income in accordance with the principle of IFRS 15, may cause that the cumulative amount of income recognised, exceeds the cumulative amount of premiums received to date.

148 Under those premises, EFRAG notes that IFRS 9 does not specify how '*the higher of'* as defined in paragraph 4.2.1 c of IFRS 9[5] should be applied under those circumstances and the entity should choose between the accounting policy of:

(a) Excluding the accrued amount for '*the higher* of' measurement and recognise it as a receivable separately from the financial guarantee contract liability; or

(b) Treating the accrued amount as representing a negative balance of 'the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15' (paragraph 4.2.1 (c) (ii) of IFRS 9).

149 In the cases mentioned in the previous paragraph 148 EFRAG notices diversity in practice due to lack of clarity in applying IFRS 9 for guarantees issued. EFRAG encourages including this issue as part of the PIR or as part of a more comprehensive project.

Question to TEG Members

150 EFRAG Secretariat understands that the request of standard setting activities to address this issue is not considered as a priority by preparers of the banking industry.

151 At the same time, EFRAG Secretariat notes that the absence of clear guidance may negatively affect the comparability of financial statements and their usefulness to users.

152 Should EFRAG report this issue as deserving standard setting?

Questions to constituents

153 Would you have other fact patterns with regard to financial guarantees that in your view should be considered? Please explain.

Question (b)

154 EFRAG has no further views on potential lessons learned.

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[5] Exclusions for financial liabilities to be measured at amortised cost at subsequent measurement, the measurement should be the higher of:

(i) the amount of the loss allowance determined in accordance with Section 5.5 a of IFRS 9); and

(ii) the amount initially recognised (see paragraph 5.1.1 of IFRS 9) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.

Appendix 2 – Examples of contractually linked – non-recourse guidance

155 Example A – P has a subsidiary S. S is a trading entity (e.g., in manufacturing). Its share capital is fully held by P but its fair value relative to the intra group loan is not significant. P almost fully funds its investment via a 5-year term loan for CU100M with a fixed interest rate. S has an “enterprise value” of CU101M at time of lending. S is a trading business. The contractual terms do not directly have any non-recourse impact. However in substance, whether the loan is repayable in full might be linked to the enterprise value of S; thus if the “equity” share value of S falls it would be unable to pay the debt.

156 Example B – same as example A except S is a property company, which holds a single asset.

157 Example C – P has an associate with a 30% holding in Y. Y is a manufacturing entity. Y’s shares are listed on a stock market. The market capitalization of Y on 1 Jan X0 is CU5M. In order to allow a significant expansion, P lends CU30M to Y. The loan has a fixed interest rate of 5% and is due for bullet repayment in 5 years-time.

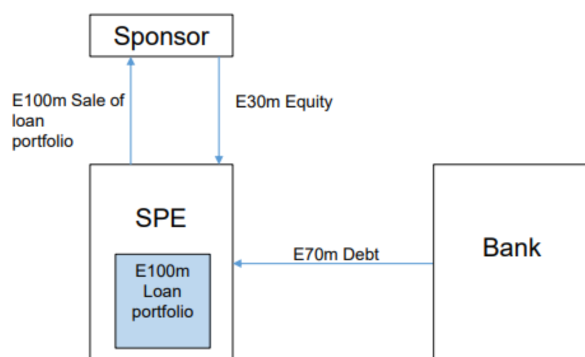
158 It is noted that in example A, there is indirect exposure to the equity value of the borrower (a subsidiary) where subsidiary is mainly funded by intra group borrowings (i.e., with negligible headroom). In this case the subsidiary is just a normal trading entity.

159 Example B is similar except that the subsidiary is a property company holding a single asset. Here the question arises whether the nature of the type of borrower is relevant in particular if the borrower has exposure to particular assets, with the effect that the loan has similar exposure to those assets.

160 In example C, the lender lends to an associate, where that associate is listed on a stock market. In case it is considered that example A is still SPPI, does the principle have any difference if the borrower’s equity prices are traded (i.e., creating a more visible exposure to share prices)

161 EFRAG notes that there exists diversity in views in these areas, in particular where a contract does not directly contain exposure to inputs that would not qualify for the SPPI criterion, but there is indirect exposure to equity prices / pricing of assets. Further examples of this can be seen with intra group loans or loans to associates.

Example 1: Asset Financing through bilateral loan with sponsor investment as equity



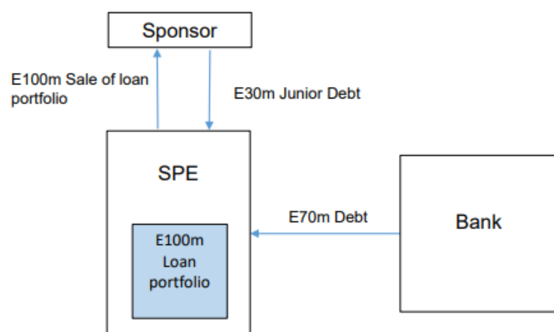
Direction of arrow represent cash flow

- Sponsor originates E100m loans
- Sponsor sells loans to SPE.
- SPE issues equity for E30m back to sponsor. The equity has no maturity and no contractual scheduled payments. The instrument meets equity definition in IAS 32.
- SPE issues E70m debt to Bank at 3mL+2% and is A rated internally. Debt meets definition of liability in IAS 32.
- There is an explicit waterfall of payments in the debt facility agreement ongoing and in default whereby the debt holder is paid prior to any dividends on the equity instrument.
- There are covenants in the debt instrument whereby if the value of the loan portfolio falls such that the Loan to Value (LTV) ratio increases to 80% then there is an Event of Default.
- In an Event of Default the debt holder can enforce on the loan collateral.
- The sponsor is permitted to increase their equity investment so that LTV triggers are not met (cure rights).
- There is no recourse of the debt to the sponsor/originator.
- (Note the same structure exists for financing of commercial real estate and aviation financing)

Accounting Questions:
- Should this be assessed as a Contractually Linked Instrument (IFRS 9 B4.1.20) or a Non Recourse Financing (IFRS 9.B4.1.17)?

Assessment
- Since there is only one debt tranche then the contractually linked instrument definition is not met since B4.1.20 requires multiple tranches of credit risk.
- The debt is assessed in accordance with non recourse financing guidance in IFRS 9.B4.1.17

Example 2: Asset financing with bilateral loan with sponsor investment as debt (1)



Direction of arrow represent cash flow

Structure Description
- Sponsor originates E100m loans
- Sponsor sells loans to SPE.
- SPE issues a E30m junior debt instrument to the sponsor, the instrument has a contractual maturity and a coupon rate. The coupon is Payment in Kind (PIK) meaning if the coupon cannot be paid then it is added to principal and accrues until paid or maturity. Therefore the junior loan cannot have an event of default prior to maturity. The term of the debt instrument is past the maturity date of the underlying loan portfolio and allows a period for credit workout process. The cash flows on the debt instrument are identical to equity in the previous example. Structuring as debt is tax efficient (interest is tax deductible) in certain jurisdictions.
- The SPE also issues a E70m senior debt instrument to the bank at 3mL+2% and is A rated internally.
- There is an explicit waterfall of payments in the senior debt facility ongoing and in default whereby the senior debt holder is paid at each coupon date prior to any interest or principal of the junior debt
- There are covenants in the senior debt instrument whereby if the value of the loan portfolio falls such that the Loan to Value (LTV) ratio increases to 80% then there is an Event of Default on the senior loan. There is also an EOD upon failure to pay.
- In an Event of Default the senior debt holder can enforce on the loan collateral.
- The sponsor has the option to increase their junior debt so that LTV triggers are not met and an event of default is prevented (cure rights). Due to the substantial equity contribution and the LTV trigger levels it is economically rational for the sponsor to do this except in the rare situation of a large and sudden fall in collateral value (gap risk event).
- There is no recourse for the senior debt to the sponsor/originator.

Example 2: Asset financing with bilateral loan with sponsor investment as debt (2)

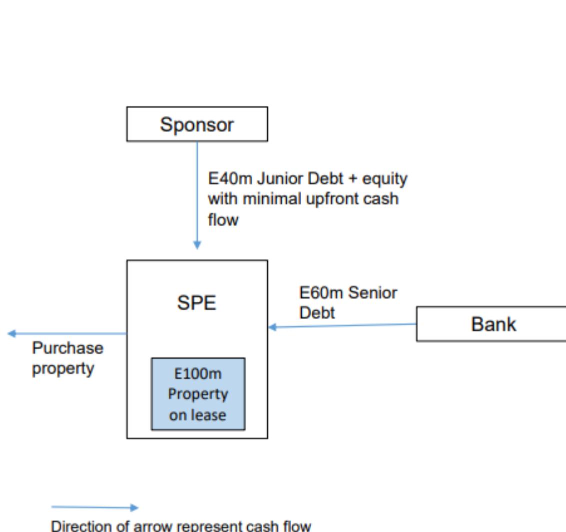
Accounting Analysis:

- The CLI definition is not clear and there is no application guidance. Different conclusions could be reached as to whether the structure is an NRF or CLI

CLI Definition	Arguments for NRF	Arguments for CLI
Issuer may prioritise payments to the holder using multiple contractually linked instruments that create concentrations of credit risk	Condition not met: Whilst there are 2 instruments which meet the financial liability definition in IAS 32 – the junior instrument is 'in substance' equity and has identical cash flows to the previous example. Addtionally, the sponsor consolidates the SPE and so there is only 1 tranche of debt external to the group.	Condition met: There are 2 (i.e. multiple) instruments which meet the definition of IAS 32 liability.
Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche	Condition met – there is a waterfall of payments which allocate both the ongoing and default cash flows to each tranche.	Condition met – there is a waterfall of payments which allocate both the ongoing and default cash flows to each tranche.
The holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher ranking tranches	Condition not met: As the holder of the senior loan may benefit from additional cash flows not initially included in the entity and therefore not generated by the entity, this criteria has not been met. The right to increase the amount invested in the junior loan is a feature akin to a NRF transaction. Although the right is not an obligation, loan covenants are structured with defined LTV trigger levels that make it economically rational for the sponsor to inject more cash in the vehicle to not breach its covenants and protect its investment. If the Sponsor did not invest additional cash into the vehicle, it would lead to an event of default prior to a situation of non-payment of the senior loan and put its junior note at risk.	Condition met: Whilst there is a right for the Sponsor to contribute additional cash or assets to the vehicle, there is no contractual obligation for the sponsor to inject additional junior debt and so the only cash flows may only be those generated by the issuer.
Other considerations	We understood the CLI criteria to be more aimed at public securitisations with many debt tranches than these bilateral senior loan structures. Public securitisations generally have 3+ tranches and do not include rights for the sponsor/junior tranche holder to contribute additional cash flows or assets into the vehicle at a future date. If this is CLI it is unclear what structure would meet the NRF definition as NRF's function in the same manner.	

Impact of decision: CLI more operational effort and more likely to fail SPPI (especially if non financial underlyings).

Example 3: Real Estate Financing with senior loan and sponsor investment as subordinated debt



Structure Description

- Variant on example 2 – but the tranching of the debt instruments is via different mechanism and the underlying is not a financial asset but property on lease.
- SPE purchases a property asset for E100m which is subject to a lease which generates cash inflows.
- The funding for the purchase comes from 2 main instruments into the SPE – senior debt and junior debt. There is also a small injection of cash via equity.
- The sponsors investment into the structure is predominantly via a junior debt instrument (shareholder loan) to SPE. The junior debt will have a high coupon ~15% payment in kind and be long dated maturity e.g. 20 years.
- Bank provides senior lending of 60m 3yr senior to SPE at L+3%. Non payment of interest results in EOD.
- The senior loan agreement has a waterfall for allocation of cash flows. Cash received from the rental agreements comes into a Collection Account. Cash from the collection account is first used to pay operating expenses of the property, then used to pay the interest and principal amortisation on the senior loan, any remaining cash is transferred to a General Account. If the loan is performing and no covenants have been breached then the sponsor can decide upon how cash in the General Account is allocated. They could use cash in the general account to make improvements in the property, pay amounts on the junior debt or pay dividends on the equity (subject to distribution restrictions e.g. Companies Act.) Payments on the junior debt are tax efficient.
- Additionally there is a subordination deed signed by the Sponsor which acknowledges that the junior debt is subordinate to the senior debt. The deed details when cash flows prior to default can be paid to the junior debt – ie from the General Account – it also details that the junior debt is subordinate to the senior debt in EOD. Additionally in an EOD the junior debt is assigned to the senior debt provider.
- There are covenants in the senior debt instrument whereby if the value of the property falls such that the Loan to Value (LTV) ratio increases to 70% then there is an Event of Default on the senior loan.
- The sponsor has the option to increase their junior debt so that LTV triggers are not met and an event of default is prevented (cure rights). Due to the substantial equity contribution and the LTV trigger levels it is economically rational for the sponsor to do this except in the rare situation of a large and sudden fall in collateral value (gap risk event).
- There is no recourse for the senior debt to the sponsor.

Example 3: Real Estate Financing with senior loan and sponsor investment as subordinated debt

Accounting Analysis:

- The CLI definition is not clear and there is no application guidance. Different conclusions could be reached as to whether the structure is an NRF or CLI

CLI Definition	Arguments for NRF	Arguments for CLI
Issuer may prioritise payments to the holder using multiple contractually linked instruments that create concentrations of credit risk	Condition not met: Whilst there are 2 instruments which meet the financial liability definition in IAS 32 – the junior instrument is 'in substance' equity. Additionally, the sponsor consolidates the SPE and so there is only 1 tranche of debt external to the group.	Condition met: There are 2 (i.e. multiple) instruments which meet the definition of IAS 32 liability i.e. the senior debt and the junior debt.
Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche	Condition not met – the waterfall in the senior agreement does not mention the junior debt. Additionally since the facility agreement allows maintenance expenses to be made and also the sponsor can decide on cash flow allocations from the General Account then not ALL cash flows generated by the issuer are allocated between the "tranches"	Condition met – the waterfall in the senior agreement and the subordination deed means that cash flows cannot be paid on the junior debt until the senior loan is paid. Additionally the junior loan is subordinate on default.
The holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher ranking tranches	Condition not met: As the holder of the senior loan may benefit from additional cash flows not initially included in the entity and therefore not generated by the entity, this criteria has not been met. The right to increase the amount invested in the junior loan is a feature akin to a NRF transaction. Although the right is not an obligation, loan covenants are structured with defined LTV trigger levels that make it economically rational for the sponsor to inject more cash in the vehicle to not breach its covenants and protect its investment. If the Sponsor did not invest additional cash into the vehicle, it would lead to an event of default prior to a situation of non-payment of the senior loan and put its junior note at risk.	Condition met: Whilst there is a right for the Sponsor to contribute additional cash or assets to the vehicle, there is no contractual obligation for the sponsor to inject additional junior debt and so the only cash flows may only be those generated by the issuer. The junior loan only gets cash flows once the senior loan is repaid.
Other considerations	We understood the CLI criteria to be more aimed at public securitisations with many debt tranches than these bilateral senior loan structures. Public securitisations generally have 3+ tranches and do not include rights for the sponsor/junior tranche holder to contribute additional cash flows or assets into the vehicle at a future date. If this is CLI it is unclear what structure would meet the NRF definition as NRF's function in the exact same manner.	

Impact of decision: CLI more operational effort and more likely to fail SPPI (especially if non financial underlyings).

Appendix 3 – List of ESG-factors examples

Size	ESG Margin Ratchet
0-500 mln	-10bps if the KPI is achieved +10bps if the KPI is not achieved ESG margin ratchet linked to sustainability KPIs focused on (i) recycling, (ii) producing green products, and (iii) increasing the percentage of employee shareholders Ratchet works both ways, disapplies if EoD (event of default) ongoing
500 mln - 1 bln	-7.5bps if the KPIs are achieved +7.5bps if the KPIs are not achieved
1 bln - 1.5 bln	-10bps if the KPI is achieved +10bps if the KPI is not achieved 'ESG margin ratchet linked to sustainability KPIs focused (i) 2% decrease per annum in Co2 emissions (ii) (ii) Sustainability board champion in place -5bps if the KPIs are achieved +5bps if the KPIs are not achieved +2.5bps if only 1 KPI is met ESG margin ratchet linked to an undisclosed sustainability KPI -10bps if the KPI is achieved +10bps if the KPI is not achieved
1.5 bln - 2 bln	The ESG margin shall be adjusted (on a non-compounding basis) by reference to the Sustainability KPI growth level, defined as the growth in annual installed wind power general capacity in gigawatts (GW) powered by gearboxes supplied by the Target Group in the relevant FY, as follows: Equal to or greater than 5%: 10bps reduction Equal to or greater than 0% but less than 5%: 5bps reduction Less than 0% but equal to or greater than -5%: 5bps uplift Less than -5%: 10bps uplift -7.5bps if the KPI is achieved +7.5bps if the KPI is not achieved KPI focused on a reduction in GHG Emissions compared to the previous Financial Year and a reduction in GHG Emissions of at least 10% compared to the Financial Year immediately before that previous Financial Year ESG margin ratchet linked to sustainability KPIs focused on (i) GHG emissions (Scope 1 and 2) of the Group ≥ 4.2% GHG reduction p.a. versus the baseline: 7.5 bps margin reduction < 4.2% GHG reduction p.a. versus the baseline: 7.5 bps margin uplift Reasonable endeavours to apply 100% of savings towards environmental investments Same ESG ratchet applies to RCF (Remaining Cash Flow)
> 2 bln	ESG margin ratchet applies as long as ESG rating by ESG Rating Agency issued within the last 12 months is equal/ more favourable than the ESG Rating at issue date: 5bps sustainability margin ratchet which works both way Disapplies if EoD ongoing ESG Rating Agency of international repute (e.g., MSCI, Sustain analytics, presently done by S&P) RCF sustainability margin ratchet of 15bps