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Post-Implementation Review of IFRS 9 – TLTRO issue
Issues Paper

Objective

1 This paper describes the agenda decision by the IFRS Interpretations Committee (IFRS IC) of September 2021 in response to a request about accounting for the European Central Bank (ECB)'s Targeted Longer-Term Refinancing Operations (TLTRO).

2 In their meeting of 14-15 July 2021 EFRAG TEG members decided not to include TLTRO III as a separate issue in the draft comment letter to PIR IFRS 9. Instead, the issues that were identified as relevant for the PIR were to be considered for integration into the chapters relating to modifications of cash flows and financial instruments with ESG features.

Description of the issue

3 In June 2021, the IFRS IC published a tentative agenda decision in response to a request about accounting for the European Central Bank (ECB)'s Targeted Longer-Term Refinancing Operations (TLTRO). These operations provide financing to banks with the objective of stimulating lending to the bank's customers. The amount that banks can borrow through the programme and the interest rate applicable to each TLTRO tranche is linked to the volume and amount of loans made to non-financial corporations and households. The submitter identified diversity in the application of the requirements in IFRS 9 Financial Instruments and IAS 20 Accounting for Government Grants and Disclosure of Government Assistance in relation to the accounting for TLTRO transactions by banks. The request asked:

(a) whether the TLTRO III tranches represent loans with a below-market interest rate and, if so, whether the borrowing bank is required to apply IFRS 9 or IAS 20 to account for the benefit of the below-market interest rate;

(b) if the bank applies IAS 20 to account for the benefit of the below-market interest rate:

   (i) how it assesses in which period(s) it recognises that benefit; and

   (ii) whether, for the purpose of presentation, the bank adds the amount of the benefit to the carrying amount of the TLTRO liability.

(c) how the bank calculates the applicable effective interest rate;

(d) whether the bank applies paragraph B5.4.6 of IFRS 9 to account for changes in estimated cash flows resulting from the revised assessment of whether the conditions attached to the liability have been met; and

(e) how the bank accounts for changes in cash flows related to the prior period that result from the bank's lending behaviour or from changes the ECB makes to the TLTRO III conditions.

Comments received

4 The IFRS IC received 15 comment letters by the comment letter deadline and two late letters.

Comments related to IAS 20

5 With respect to whether TLTRO III tranches contain a government grant in the scope of IAS 20, some respondents largely supported the Committee's position in the tentative agenda decision (TAD). These respondents agreed with the Committee's conclusion that judgement is required based on facts and circumstances and the requirements in IAS 20 provide an adequate basis for an entity to determine how to account for the government grant if it concludes that there is a grant. A few of these respondents specifically agreed that the Committee is not in a position to conclude on whether the ECB meets the definition of government in IAS 20 or should not be addressing such complex individual transactions.

6 However, some other respondents said to reduce diversity in the application of IFRS 9 and IAS 20, it would be helpful for the Committee to provide more clarity about the applicability of IAS 20 to TLTRO III transactions. In particular, they suggested further explanation of:

(a) how to determine whether a central bank or other similar body meets the definition of government in IAS 20; and

(b) whether the interest rates on TLTRO III loans represent a below-market rate.

7 Some respondents also questioned whether, and if so how, subsequent changes in cash flow estimates affect the identification and accounting for a government grant applying IAS 20. They were concerned about the application of paragraph 10A in isolation when conditions have to be met for an entity to be eligible for the below market rate of interest, i.e. if contingent rates indexed to specific performance targets result in a grant with a variable amount. This is because they disagree with a reading of IAS 20 that implies an entity can identify and recognise a government grant associated with a loan at a below-market rate only at initial recognition of the loan.

Overall comments related to the effective interest method

8 With respect to the application of the effective interest method to TLTRO III transactions, most respondents said in order to determine the effective interest rate of a TLTRO III transaction, an entity needs to assess whether the instrument has a floating or fixed rate. In this regard, respondents said an entity has to take into consideration that:

(a) the ECB is the market maker that can unilaterally change the rate or could have set an 'all-in' rate from the outset. As a consequence, the contractual provisions of the instrument or subsequent changes are not that relevant when assessing whether the instrument's contractual interest rate is a floating rate. They therefore consider the interest rate of a TLTRO III transaction to be a floating rate that is periodically reset to reflect movements in the market rate of interest, changes of which an entity would account for applying paragraph B5.4.5 of IFRS 9.

(b) subsequent revisions of estimated contractual cash flows depend on an entity's assessment of meeting lending thresholds, which at least two respondents would account for applying paragraph B5.4.6 of IFRS 9. They said if the Committee did not specifically deal with how to treat these entity-specific changes in expectations, it would imply that there is room for interpretation.

9 Only a few respondents commented on how to treat conditions attached to the interest rate when determining the effective interest rate at initial recognition of the financial liability. Those respondents said an entity has to assess whether it will reach the lending threshold over the life the loan. However, they requested further clarity about how to consider such an assessment when determining the effective interest rate.

10 Most respondents implicitly agreed that the methodology applied at initial recognition is relevant for subsequent measurement.

Overall comments related to subsequent measurement of the financial liability

11 Respondents were split in their views on how to account for changes in the interest rate of the TLTRO III liabilities subsequent to initial recognition. Most of the respondents with the view that the whole TLTRO III interest rate is a market floating rate said any change in the interest rate made by the ECB represents a reset to market rates. They are therefore of the view that any change the ECB makes to the interest rate represents a movement in the market rate of interest to which paragraph B5.4.5 of IFRS 9 applies.

12 Only two respondents (PwC, EY) clearly said changes in the interest rate that are subject to meeting lending targets would give rise to an entity revising its estimates of payments to which paragraph B5.4.6 of IFRS 9 applies. In addition, EY said, in a recent market survey conducted, they found that most participants apply (a) paragraph B5.4.5 to changes in the interest rate initiated by the ECB unrelated to lending targets and (b) paragraph B5.4.6 to revisions in original estimates of conditional elements of the interest rate.

Agenda Decision

13 Hereafter the proposed Agenda Decision is presented. However, the topic was not discussed at the November IFRS IC meeting and has been postponed till the next meeting.

Applying the requirements in IFRS Standards

14 The Committee observed that IFRS 9 is the starting point for the borrowing bank to determine its accounting for TLTRO III transactions because each financial liability arising from the bank's participation in a TLTRO III tranche is within the scope of IFRS 9. The bank:

(a) determines whether it bifurcates any embedded derivatives from the host contract as required by paragraph 4.3.3 of IFRS 9;

(b) initially recognises and measures the financial liability, which includes determining the fair value of the financial liability, accounting for any difference between the fair value and the transaction price and calculating the effective interest rate; and

(c) subsequently measures the financial liability, which includes accounting for changes in the estimates of expected cash flows.

15 The Committee noted that the questions the request asks are unrelated to the existence of an embedded derivative and, therefore, this agenda decision does not discuss the requirements in IFRS 9 with respect to the separation of embedded derivatives.

Initial recognition and measurement of the financial liability

16 Applying paragraph 5.1.1 of IFRS 9, at initial recognition a bank measures each TLTRO III tranche at fair value plus or minus transaction costs, if the financial liability

is not measured at fair value through profit or loss. A bank therefore determines the fair value of the liability using the assumptions that market participants would use when pricing the financial liability as required by IFRS 13 *Fair Value Measurement*. The fair value of a financial instrument at initial recognition is normally the transaction price—that is, the fair value of the consideration given or received (paragraphs B5.1.1 and B5.1.2A of IFRS 9). If the fair value at initial recognition differs from the transaction price, paragraph B5.1.1 requires a bank to determine whether a part of the consideration given or received is for something other than the financial liability.

17 The Committee observed that determining whether an interest rate is a below-market rate requires judgement based on the specific facts and circumstances of the relevant financial liability. Nonetheless, a difference between the fair value of a financial liability at initial recognition and the transaction price might indicate that the interest rate on the financial liability is a below-market rate.

18 If a bank determines that the fair value of a TLTRO III tranche at initial recognition differs from the transaction price and that the consideration received is for only the financial liability, the bank applies paragraph B5.1.2A of IFRS 9 to account for that difference.

19 If a bank determines that the fair value of a TLTRO III tranche at initial recognition differs from the transaction price and that the consideration received is for more than just the financial liability, the bank assesses whether that difference is treated as a government grant in IAS 20. An entity makes this assessment only at initial recognition of the TLTRO III tranche. The Committee noted that if the difference is treated as a government grant, paragraph 10A of IAS 20 applies only to that difference. The bank applies IFRS 9 to account for the financial liability, both on initial recognition and subsequently (including when accounting for any subsequent modifications to the liability's terms or changes in estimated cash flows related to the financial liability).

Do TLTRO III tranches contain a benefit of a government loan at a below-market rate of interest in the scope of IAS 20?

20 IAS 20 defines government as referring to 'government, government agencies and similar bodies whether local, national or international'. IAS 20 also defines government grants as 'assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity'.

21 Paragraph 10A of IAS 20 requires an entity to treat as a government grant the benefit of a government loan at a below-market rate of interest and apply IAS 20 to account for that benefit. The benefit of a below-market interest rate is the difference between the initial carrying amount of the loan determined by applying IFRS 9 and the proceeds received. Paragraphs 12 and 20 of IAS 20 specify requirements for the recognition of government grants in profit or loss.

22 The Committee observed that TLTRO III tranches would contain a benefit that is treated as a government grant in the scope of IAS 20 only if it were determined that:

(a) the ECB meets the definition of government in IAS 20;

(b) the interest rate charged on the TLTRO III tranches is a below-market interest rate; and

(c) the TLTRO III transactions with the ECB are distinguishable from the borrowing bank's normal trading transactions.

23 The Committee observed that making these determinations require judgement based on the specific facts and circumstances. The Committee therefore said it is not in a position to conclude on whether the TLTRO III tranches contain a benefit that is treated as a government grant in the scope of IAS 20.

24 The Committee acknowledged that judgement may also be required to identify the related costs for which the grants, if any, are intended to compensate. The Committee nonetheless concluded that IAS 20 provides an adequate basis for the bank to determine whether the TLTRO III tranches contain a benefit that is treated as a government grant and if so, how to account for the benefit.

Calculating the effective interest rate on at initial recognition of the financial liability

25 For the purpose of measuring financial liabilities, Appendix A to IFRS 9 defines both the amortised cost of a financial liability and the effective interest rate. Calculating the effective interest rate requires an entity to estimate the expected cash flows through the expected life of the financial liability In calculating the effective interest rate for a TLTRO III tranche at initial recognition, the question arises as to what to consider in estimating the expected future cash flows and, specifically, how to reflect uncertainty that arises from conditions attached to the interest rate.

26 The Committee noted that the question of what to consider in estimating the expected future cash flows for the purpose of calculating the effective interest rate is also relevant to fact patterns other than that described in the request. The Committee therefore concluded that considering how to reflect uncertainty that arises from conditions attached to the interest rate in calculating the effective interest rate is a broader matter, which it should not analyse solely in the context of TLTRO III tranches. This is because such an analysis could have unintended consequences for other financial instruments, the measurement of which involves similar questions about the application of IFRS Standards. **The Committee is therefore of the view that the Board should consider this matter as part of the post-implementation review of the classification and measurement requirements in IFRS 9, together with similar matters already identified in the first phase of that review.**

Subsequent measurement of the financial liability at amortised cost

27 The contractual terms of the TLTRO III tranches require interest to be settled in arrears on maturity or on early repayment of each tranche. There is therefore only one cash flow on settlement of the instrument.

28 The original effective interest rate is calculated based on estimated future cash flows at initial recognition as required by IFRS 9. The Committee noted that whether a bank adjusts the effective interest rate over the life of a tranche depends on the contractual terms of the financial liability and the applicable requirements in IFRS 9.

29 Paragraphs B5.4.5 and B5.4.6 of IFRS 9 specify requirements for how an entity accounts for changes in estimated future cash flows.

30 Paragraph B5.4.5 applies to floating-rate financial instruments with a floating interest component that is periodically adjusted to reflect the movements in the market rates of interest that alter the effective interest rate. IFRS 9 does not elaborate on what is meant by floating rate. However, the Committee observed that a financial instrument with contractual cash flows— which are periodically adjusted to reflect the movements in the market rates of interest —is a floating-rate financial instrument.

31 When considering how to account for changes in cash flow estimates, the Committee noted that paragraph B5.4.5 of IFRS 9 applies only to the floating interest component that is periodically adjusted to reflect the movements in the market rates of interest and not to other interest rate components of the instrument, (which are typically not reset to reflect movements in the market rates of interest).

32 Paragraph B5.4.6 of IFRS 9 applies to changes in estimated future cash flows of financial liabilities other than those dealt with in paragraph B5.4.5, irrespective of whether the change arises from a modification or another change in expectations. However, when changes in contractual cash flows arise from a modification, an entity assesses whether those changes result in the derecognition of the financial liability and the initial recognition of a new financial liability by applying paragraphs 3.3.2 and B3.3.6 of IFRS 9.

33 The Committee considered a situation in which, as a result of a modification that does not result in derecognition or other changes in expected future cash flows, a bank estimates the final repayment cash flow relating to a TLTRO III tranche to be different from that used in determining the carrying amount. In such a situation, the bank adjusts the carrying amount to reflect the modification or other change in expected future cash flows and recognises the difference immediately in profit or loss. The bank therefore makes no adjustment to interest recognised in prior periods.

34 The Committee also noted that application of paragraph B5.4.6 of IFRS 9 depends on a bank's estimates of expected future cash flows in calculating the effective interest rate at initial recognition of the financial liability. This is because, applying B5.4.6, the original effective interest rate is used to discount the revised cash flows.

35 The Committee observed that the question of how conditions attached to the interest rate should be reflected in the estimates of expected future cash flows when determining the effective interest rate affects both initial and subsequent measurement. As this question is part of a broader matter, the Committee considered that it should not be analysed solely in the context of TLTRO III tranches. The Committee is therefore of the view that the Board should consider this matter as part of the post-implementation review of the classification and measurement requirements in IFRS 9, together with similar matters already identified in the first phase of that review.

Disclosure

36 If a bank determines that the ECB meets the definition of government in IAS 20 and that it has received government assistance from the ECB, the bank needs to provide the information required by paragraph 39 of IAS 20 with respect to government grants and government assistance that does not meet the definition of a government grant.

37 In addition, given the judgements required and the risks arising from the TLTRO III tranches, a bank needs to consider the requirements in paragraphs 117,122 and 125 of IAS 1 Presentation of Financial Statements, as well as paragraphs 7, 21 and 31 of IFRS 7 Financial Instruments: Disclosures. Those paragraphs require a bank to disclose information that includes its significant accounting policies and the assumptions and judgements that management has made in the process of applying the bank's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Conclusion

38 The Committee concluded that IAS 20 provides an adequate basis for the bank to determine whether the TLTRO III tranches contain a benefit that is treated as a government grant in the scope of IAS 20, and, if so, how to account for that benefit.

39 With respect to the question of how conditions attached to the interest rate should be reflected in the estimates of expected future cash flows when determining the effective interest rate at initial recognition or in the revisions of estimated future cash flows upon subsequent measurement of the financial liability, the Committee concluded that the matters described in the request are part of a broader matter that, in isolation, are not possible to address in a cost-effective manner and should

be reported to the Board. The Board should consider this matter as part of the post-implementation review of the classification and measurement requirements in IFRS 9.

40 For these reasons, the Committee decided not to add a standard-setting project to the work plan.

Relevance of the technical debate on TLTRO for the ESG products

41 The EFRAG Secretariat understands that the use of catch-up adjustments (B.5.4.6) could be considered as a possible approach to deal with changes in estimated cash flows for financial instruments with ESG features at the moment of fulfilling (or failure to fulfil) the ESG-related KPI's. In particular, B.5.4.6. could represent the approach to implement the amortised cost for instruments with linkages to ESG targets.

Questions for EFRAG TEG

42 Do you think additional guidance (in addition to paragraphs B.5.4.5 and B.5.4.6 of IFRS 9) is necessary to address current situations of changes in cash flows during the life of a financial instrument? Please explain.

43 So far, the EFRAG DCL do not mention this issue as deserving special consideration by the IASB in the PIR. Would you suggest any changes to EFRAG's DCL? Please explain.

44 Do you have any additional comments?

Appendix : Extracts from EFRAG's draft comment letter

Modifications

Question 6 - Modifications to contractual cash flows

45 Are the requirements for modifications to contractual cash flows working as the Board intended? Why or why not?

46 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?

47 Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?

48 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?

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

EFRAG's response

50 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.

51 However, EFRAG also notes that practice has now been established and some do not consider that undertaking standard-setting activities is appropriate at this stage. EFRAG is consulting its constituents on the need of standard setting for this issue.

Question (a)

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

53 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.

54 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".

55 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".

56 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.

57 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.

58 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.

59 Even if this issue was analysed under IAS 39, not IFRS 9, the IFRS IC noted during its September 2012 meeting, that the old GGBs should be derecognised (both under the assessment of paragraph 17 (a) of IAS 39 relating to extinguishment - current paragraph 3.2.3(a) of IFRS 9 or when assessing the existence of a substantial change in the terms of the asset) 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 decided not to add this issue to its agenda.

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

61 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%.

62 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.

63 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).

64 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.

65 In current practice, some banks tend to use the approach described in paragraph 64(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. Some banks also use the policy described in paragraph 72.

66 EFRAG understands 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. At the same time, practice has now been established and some do not consider that undertaking standard setting activities is appropriate at this stage. EFRAG is consulting its constituents on the need of standard setting for this issue.

Question to constituents

67 Do you think that standard-setting activities from the IASB are required to deal with modifications of the cash flow characteristics? Please explain.

Question (b)

68 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.

69 EFRAG also highlights the interaction of regulatory and accounting frameworks 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. The EBA issued the guidance on forbearance of loans in October 2018. For that reason, banks should monitor their forborne loans and provide for them on a one-to-one basis.

70 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 (credit-impaired debt instruments), to make a link between different regulatory and accounting frameworks.

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

72 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.

73 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.

Financial instruments with ESG features

Question 3 - Contractual cash flow characteristics

74 Is the cash flow characteristic assessment working as the Board intended? Why or why not?

75 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.

76 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:

(a) 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).

(b) 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.)

77 Can the cash flow characteristics assessment be applied consistently? Why or why not?

78 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).

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

80 Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?

81 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.

82 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

83 EFRAG considers that the principle underlying the SPPI requirement generally leads to useful information. However, the SPPI test guidance requires a re-evaluation in the light of specific financial instruments such as financial instruments with ESG features or contractually-linked financial instruments. EFRAG proposes that the issue of financial instruments with ESG features is removed from the IFRS 9 PIR process and treated separately as an urgent issue resulting in potential targeted improvements to IFRS 9.

84 EFRAG considers that the principle underlying the SPPI requirement generally leads to the provision of useful information. However, the cash flow characteristics assessment of IFRS 9 require a re-evaluation in the light of specific financial instruments, such as applying the SPPI test to:

(a) financial instruments with Environment, Social and Governance (ESG) features (i.e., sustainable finance products);

(b) instruments with administrative rates; and

(c) applying the guidance for contractually linked financial instruments.

85 In addition, please refer also to our answer to Question 4 below, where we consider the issue of the requirement to measure at FVTPL puttable instruments and mutual funds.

Question (a)

Financial Instruments with ESG features

Regulatory pressure and market developments

86 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.

87 Banks and insurers should make sustainability considerations as an integral part of their 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.

88 In the coming years, European constituents anticipate a sharp increase in volumes of debt instruments with contractual features that link the cash flows with the ESG profile of the borrower. They 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.

89 These constituents consider such financial instruments as basic lending instruments and anticipate that they will become very prevalent in corporate lending activities or mainstream investments. Therefore, there are concerns that if the default subsequent measurement attribute is FVTPL, this measurement might not be reflective of the amount, timing and uncertainty of the cash flows from such instruments. As a result, financial institutions, insurance companies, funds, etc might be indirectly discouraged from mainstreaming or investing in this type of lending. The current global volume of these issuances is in the size of about 700 billion USD in 2020, and just in H1 2021 a little bit over 500 billion USD of which more than 50% relates to European issuers. As an example, only Germany, France and Spain together issued in H1 2021 a total of USD 60 billion. EFRAG has conducted a survey with financial institutions to collect examples of fact patterns that exist currently on the market. The resulting list of examples is presented in Appendix 3 to this letter.

The application of the SPPI test to financial instruments with ESG features

90 The scope of financial instruments with contractual linkages to ESG targets that are specific to the borrower is potentially broad, e.g., including instruments that allow to take an exposure to sustainable or responsible activities. The issue however relates only to the ESG features that introduce a cash flow variability in the financial instruments when the financial instruments are held in a held to collect or held to collect or sell business model. EFRAG understands that constituents do not see these features as compensating for bearing risks outside those in a basic lending arrangement.

91 EFRAG understands that currently practice is developing and constituents are addressing the SPPI test for these instruments in different ways. For some the current size of the impact of the features is de minimis; for others the ESG-linked interest adjustment is seen as compensating for credit risk (however the link with credit link may be difficult to demonstrate and document); for others the ESG features is part of a profit margin.

92 In addition, the variability introduced by the ESG feature creates issues with the application of the effective interest rate and subsequent measurement.

93 Finally, the ESG features also create issues from the issuer side, in order to assess whether the feature shall be considered an embedded derivative and whether split accounting is applicable, i.e., whether one shall follow different accounting for the financial host and the bifurcated embedded derivative.

94 Given the expected pervasiveness of this issue for European constituents, EFRAG is of the view that this issue should be removed from the Post-implementation Review of IFRS 9. This should rather be addressed separately as an urgent issue, resulting in potential targeted improvements to IFRS 9. EFRAG appreciates the preliminary work of the IASB Staff, but is of the view that further work is needed and is happy to be of assistance to the IASB in this regard.

Questions to constituents - Financial instruments with ESG features

95 When applying the SPPI test to financial instruments held to collect that have contractual cash flow variability linked to ESG targets specific to the borrower, what additional approach could be considered in order to avoid failures of the SPPI test? Approaches used currently include considering the 'de minimis' and the possible link to the credit spread.

96 Do you think that failing the SPPI test (and a resulting measurement at fair value through profit or loss) is an appropriate outcome for these financial instruments? Please specify.

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