EFRAG Secretariat: Didrik Thrane-Nielsen, Didier Andries, Galina Borisova

IFRS 9 Post-implementation Review – Classification and Measurement with focus on ESG

Objective

1 The objective of this paper is to update the EFRAG FR Board on

(a) the current status of the IASB discussions on the post-implementation review classification and measurement and

(b) FIWG and EFRAG FR TEG discussions on ESG and contractually linked instruments.

The current status of the IASB discussions on the post-implementation review

2 In its March and April 2022 meetings the IASB discussed a summary of the feedback received on its consultation and a plan for how to deliberate that feedback. The IASB members did not make any decisions but provided their views on the feedback received.

3 The IASB members welcomed the feedback that in general the classification and measurement principles of IFRS 9 worked well in practice and result in measurement of financial instruments that provides useful information to users of financial statements about the amount, timing and uncertainty of an entity's future cash flows. The IASB has agreed to the following indicative timetable:

Topics for discussion in PIR Phase 2	Expected timing
1. Contractual cash flow characteristics (including financial assets with sustainability-linked features and contractually linked instruments)	April–May 2022
2. Business model assessment	Q2/Q3 2022
3. Equity instruments and OCI	Q2/Q3 2022
4. Modifications to contractual cash flows	Q2/Q3 2022
5. Amortised cost and the effective interest method	At same meeting as topic 4 (interaction between topic 4 and topic 5)
6. Other matters	Q3 2022

4 On topic 1 contractual cash-flow characteristics **the IASB has agreed to undertake standard setting activities on financial assets with sustainability-linked features and contractually linked instruments**. <u>This will be a fast-track project that the IASB Board will continue to discuss in its June meeting</u>. The purpose of the project will be to clarify the existing SPPI principle and possibly add examples, to

support entities to consistently assess the contractual cash flow characteristics of all financial assets.

5 In addition, 6 questions raised in the feedback has been considered. These are:

(a) Question A - whether a financial asset has non-recourse features (i.e., features that limit an entity's claim to specified assets of the debtor), and under what circumstances an entity is required to assess the cash flows from the specified assets;

(b) Question B - whether an entity needs to consider cash flows arising from bail-in legislation when the relevant legal requirements are reproduced or referred to in a contract;

(c) Question C - whether interest rates that are contractually adjusted for inflation introduce leverage;

(d) Question D - whether interest rates that include a government-imposed leverage factor are regulated interest rates as described in IFRS 9;

(e) Question E - whether a prepayment feature includes reasonable compensation for early termination of a contract; and

(f) Question F - whether particular types of interest rates include a modified time value of money element.

6 The IASB has decided to:

(a) Consider Question A with its analysis of contractually linked instruments;

(b) Consider Question B after its Financial Instruments with Characteristics of Equity project has developed further;

(c) Perform outreach with members of ASAF and the IFRS Interpretation Committee to gather further information about Questions C and D; and

(d) Take no further action on Question E and F.

Initial reactions by EFRAG FIWG and FR TEG support the direction of the IASB on the 6 questions above. EFRAG FR TEG members on contractually linked instruments noted that the non-recourse guidance was not developed together with the CLI-requirements, so they cover different contractual instruments. Additional guidance and examples would be welcome because as the current requirements of IFRS 9 stand, it is unclear whether the CLI guidance focuses on specific cases only or needs to be applied in all cases.

7 On the important topics of OCI treatment of equity and equity type instruments. <u>The IASB has indicated that the recycling of OCI shall be considered as part of topic 3 while no indication has been provided that IASB will respond to the EFRAG concerns relating to equity type instruments.</u>

The current thinking of the IASB staff on ESG features

8 As explained in paragraph BC4.188 of the Basis for Conclusions on IFRS 9, in developing the SPPI requirements, the IASB decided to require an entity to assess all contingent features in the same way. In the staff view, ESG-linked features should be treated the same as any other contingent feature in this regard.

9 Therefore, the staff view is that, as noted in the IFRS 9 Project Summary, the IASB intended paragraph B4.1.7A of IFRS 9 to clarify that interest can comprise a return not only for the time value of money and credit risk but also for other components such as a return for liquidity risk, amounts to cover expenses and a profit margin.

10 The key consideration in assessing the contractual cash flows resulting from any contingent feature is whether the resulting cash flows reflect a return for risk (i.e. what is the entity being compensated for) that is unrelated to a basic lending arrangement. For example, an entity would ask if the ESG-linked features introduce

exposure to such risks or variability and therefore are not consistent with a basic lending arrangement.

11 Based on the IASB Staff understanding, for a number of financial assets with ESG-linked features, the ESG-linked adjustments to interest rates are not determined considering the risks or ability of the individual borrower meeting specific ESG targets. The ESG linked features are often not meant to compensate the lender for taking on such risks. Rather, the ESG-adjustment serves as an 'incentive' for the borrower to meet the specified ESG targets. It is common for the same level of adjustment to be made to the contractual interest rate for borrowers across various industries and various ESG targets.

12 **If the contractual cash flows resulting from the ESG-linked feature do not introduce compensation for ESG risks, the staff think that such a financial asset could have contractual cash flows that are not inconsistent with a basic lending arrangement.** However, the IASB Staff acknowledges that this assessment can require considerable judgement and that stakeholders are unsure about what the IASB intention would have been for assessing this type of contractual cash flows. They also acknowledge the feedback from respondents indicating diverse views on this matter.

13 The IASB Staff do not think that it is necessary to create an exception from the SPPI requirements to ensure that useful information about the amount, timing and uncertainty of contractual cash flows are provided to users of the financial statements.

14 They also do not consider there to be a need for fundamental changes to the principles of the SPPI requirements in IFRS 9.

15 In their view, if any standard-setting is undertaken in this area, any potential amendments would **solely focus on clarifying the current requirements and providing additional application guidance** to assist entities in assessing whether a financial asset with ESG-linked features has contractual cash flows that are SPPI.

16 To ensure the maximum benefit to be gained for the lowest cost, any clarifications should **not be specific only to ESG-linked features, but principle-based** and robust enough to be applied to other types of financial instruments that may emerge in the future.

17 The staff agree with respondents that this matter is a priority. A timely solution would be necessary to enable stakeholders to develop and implement any process, model and system changes required for classifying and measuring these financial assets.

18 With regards to what potential clarifications could be made in this regard, the staff think the IASB could consider:

(a) adding application guidance with respect to the characteristics of a basic lending arrangement and its link to amortised cost measurement. In our view, such additional application guidance would not only assist entities with assessing the contractual cash flows of financial assets with ESG-linked features, but would also help more consistent application of the SPPI assessment in general;

(b) clarifying how to assess whether variability arising from contractual terms that change the timing or amount of contractual cash flows are consistent with SPPI; and

(c) considering how the disclosure objectives and principles in IFRS 7 would apply to financial assets with ESG-linked features, including information about an entity's exposure to risks arising from such features and how an entity manages such risks.

FIWG and EFRAG FR TEG discussions on ESG

19 The FIWG and the EFRAG FR TEG discussed the topic in several meetings most recently in a FIWG meeting on 10 May and in a EFRAG FR TEG meeting on 18 May.

Observations of the FIWG members

20 Members were generally supportive about an approach that would clarify the existing principles in IFRS 9 and that was principles-based (including ESG features), as it would not require to define what 'ESG' means in accounting terms.

21 They identified as critical point in the development of the additional guidance the reference to the ESG-linked feature not introducing compensation for ESG risks but only incentives:

(a) distinguishing between an incentive and compensation to ESG risks would be judgemental and more guidance is needed to deal with contingent features, including examples;

(b) what ESG risk means for the borrower is not necessarily what ESG risk means from the perspective of the bank. Looking at how the eventual risk is managed, such as managing it as part of the financial risks of the banking book, could also play a role. For example, if the borrower fails to meet the ESG threshold, the bank cannot remedy the potential damage/impact nor can technically 'manage' the risk;

(c) clauses that would provide linkages to ESG indexes (possible future market development) would not be compatible with basic lending features, however the focus ought to be on the cash flows of the financial instrument and their variability and to the fact that the contingency clause is linked to a predefined threshold which is specific to the borrower;

(d) if the criteria for assessing ESG features as SPPI-compliant are set too strict, it may have an impact on European public good assessment. Hence, this member was in favour of accepting some leverage (both ways) in an amortised cost measurement subject to proper disclosure;

(e) while it is true that in the prevailing market conditions, banks include these features as incentives for companies, but do not introduce compensation for ESG risks, all the current developments including from regulatory authorities go in the direction of treating ESG risks as financial risks and in the future ESG compliance is expected to be visible in credit risk. A solution is needed as long as it is not demonstrable that ESG feature forms part of credit risk. Depending on the market developments, such solution could be of help also beyond the short term. They also noted that:

(i) not meeting ESG targets is expected to affect the credit rating of a company over the longer term, the willingness of investors to put money in the company, its financing capacity and the pricing of [future] financial instruments issued by that company;

(ii) stating that compensation for ESG features would fail SPPI would be a mistake. ESG risks are inherent risks in an entity's business and are included when reviewing the credit quality of the entity, including business risk. Since it is an inherent risk, in pricing; i.e when deciding on the credit spread charged ESG risks will always be included in the same way as inflation is included even though not considered to be separable if not priced separately in a contract.

22 A possible approach could be for the IASB to mention that **adjustments to the interest rate** that are contingent to the failure to meet a **threshold that is specific**

to the borrowers' operations would be consistent with a basic lending arrangement.

Observations of the TEG members

23 EFRAG FR TEG members generally agreed with the intention of the IASB to develop the application guidance for the financial instruments with ESG features without introducing specific exceptions to the existing principles of the SPPI guidance.

24 They noted, however, that the IASB should consider to revise its direction of travel in terms of the intended clarification to the SPPI principle, as it could be too narrow given the market expectation that ESG risks will be considered a part of credit risk. It was noted that in the long-term the variability should compensate the lender for the ESG risk of the borrower.

25 Members noted the importance of defining the ESG risk, as financial instruments with ESG features will become integral part of the lending process. If the ESG risk is considered to be a new risk for financial entities, not part of their regular business, then it should be managed through derivatives market, which is not the case today considering actual liquidity.

26 One EFRAG FR TEG member was of the opinion that if the financial instruments with ESG features would fail SPPI test, they should be measured at FVTPL as it is a proper measurement to reflect the variability in the cash flows; this member acknowledges that his view is different from the view of other EFRAG FR TEG members.

27 Another EFRAG TEG member pointed out that for insurance industry it was important that these instruments could be measured both at amortised cost and FVOCI to deal with their volatility. This member noted that often entities invest in these instruments to respond to public communication and ESG strategy and that there was no additional compensation for credit risk.

Alternative proposal by members of the EFRAG Secretariat to bifurcate non-financial components

28 EFRAG FR TEG members questioned the details for the alternative solution proposed by the EFRAG Secretariat for the ESG instruments by separating the non-financial components. In particular, they noted difficulties in defining a service or a good and with the subsequent measurement of the non-financial components.

29 EFRAG FR TEG members considered the proposed alternative as an interesting conceptual approach but decided not to pursue it for the moment, as the IASB intends to clarify the SPPI principle and develop application guidance, but not to amend the SPPI principle and is seeking an urgent solution at the request of stakeholders (including EFRAG). In addition, ESG risk is considered as a financial risk and thus it may be counterintuitive to note that the ESG-risk is non-financial.

Next steps

30 EFRAG Secretariat, EFRAG FIWG and EFRAG FR TEG will follow closely the IASB deliberation process.

Questions to EFRAG FR Board members

31 Do EFRAG FR Board members have observations on the reactions by EFRAG FIWG and TEG members on the recent directions taken by the IASB?

32 Do EFRAG FR Board members have suggestions for further actions by the EFRAG Secretariat on financial instruments with ESG features?