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Contractual cash flow characteristics
Amendments to IFRS 9
An update

Objective and Introduction

1 In May 2022, the IASB decided to start a standard-setting project to clarify particular aspects of the IFRS 9 requirements for assessing a financial asset's contractual cash flow characteristics (i.e., the 'solely payments of principal and interest' (SPPI) requirements) and to provide further guidance relating to contractually linked instruments (CLIs).

2 The objective of this meeting is to update the EFRAG FR TEG on the latest IASB tentative decisions and EFRAG discussions on the topic.

3 EFRAG FR TEG discussed the proposed project plan for amendments to IFRS 9 *Contractual Cash Flow Characteristics of Financial Instruments* on 29 June 2022, Agenda Paper 06-01.

IASB previous discussions

4 In June 2022 the IASB discussed the objective, scope and indicative timetable for the project. The IASB generally supported the IASB staff recommendations. The IASB staff recommendations were provided to EFRAG FIWG on 21 June 2022, to EFRAG IAWG on 23 June 2022, to EFRAG FR TEG-CFSS and FR TEG on 28 and 29 June 2022 respectively, and to EFRAG FRB on 14 July 2022. A summary of these discussions can be found in the Agenda paper 04-01 for the September EFRAG IAWG meeting.

5 In July IASB had initial discussions on the IASB staff's preliminary analysis (AP 16A) of the following concepts in the SPPI requirements in IFRS 9:

(a) the concept of a basic lending arrangement (paragraph B4.1.7A); and

(b) whether and how the nature of a contingent event (i.e., the trigger for a change in the timing or amount of contractual cash flows) is relevant to determining whether the cash flows are SPPI (paragraphs B4.1.10 and B4.1.11).

6 In addition, the IASB had initial discussions on the IASB staff analysis of financial assets with non-recourse features and contractually CLI (AP 16B) containing:

(a) a reminder of the IFRS 9 requirements for financial assets with non-recourse features and CLIs and the IASB's rationale for those requirements; and

(b) preliminary IASB staff views and analysis.

7 The IASB made no decisions for this project at the July 2022 meeting and generally supported the IASB staff recommendations. The IASB staff recommendations were provided to EFRAG IAWG on 8 September 2022.

September 2022 IASB tentative decisions

8 In September, the IASB tentatively decided, in accordance with the IASB staff's recommendations, how to clarify the contractual cash flow characteristics requirements in IFRS 9 (AP 16A), the application of the SPPI requirements in IFRS

9 to financial assets with non-recourse features and the requirements in IFRS 9 for contractually linked instruments – CLIs (AP 16B).

IASB Staff analysis and recommendations

Basic lending arrangement

9 The IASB staff recommend clarifying that for contractual cash flow to be SPPI, a basic lending arrangement does not give rise to variability in cash flow due to risks or factors that are unrelated to the borrower, even if such terms and conditions are common in the specific market in which the entity operates.

10 Although the objective of the SPPI assessment is to determine whether contractual cash flows are consistent with a basic lending arrangement (paragraph B4.1.7A of IFRS 9), the IASB staff note that in cases where it might be difficult to determine it, it might be helpful to consider whether any contractual cash flows are *inconsistent* with a basic lending arrangement.

11 In addition, the IASB staff believe that for the SPPI assessment it is not relevant how common or widespread a lending arrangement is in a particular market. The concept of a basic lending arrangement is more similar to a generally accepted concept of basic lending regardless of the particular market or jurisdiction the loan is made in.

12 Furthermore, referring to paragraph 4.1.3(b) of IFRS 9, the IASB staff highlight that the key consideration is not whether there is variability in the cash flow but whether the contractual cash flows relate to risks or factors that are not specific to the borrower or the instrument. This is because IFRS 9 requires interest to compensate the lender for risks and costs associated with lending the principal amount to particular borrower for a specific period of time.

Contractual terms that can change the timing or amount of contractual cash flows

13 The IASB staff recommend clarifying that a financial asset that includes contractual terms that change the timing and amount of the contractual cash flows could be consistent with a basic lending arrangement and therefore have SPPI cash flows, if (all four requirements must be met):

(a) The contractual cash flows that could arise from any contingent events are SPPI in all circumstances.

Considering paragraph BC4.189 of the Basis for Conclusions on IFRS 9, the IASB staff believe that the SPPI assessment is not a probability-based assessment. Therefore, entities must assume that the contingent event will occur and all contractual cash flows that could arise over the life of the financial instrument must be considered. Only if the cash flows from all possible outcomes are SPPI, the financial asset has contractual cash flows that are SPPI.

(b) The contingent event is specific to the borrower.

In the IASB staff's view, the nature of the contingent event does not need to be unique to the borrower, but the occurrence (or non-occurrence) of the contingent event must be (e.g., pre-defined reduction in greenhouse gas emissions vs reduction in the industry average of greenhouse gas emissions).

(c) The timing and amount of any variability in contractual cash flows are determinable and specified in the contract.

To conclude that all contractual cash flows that could arise over the life of the instruments are SPPI, all changes to the amount or timing of contractual cash flows arising from contingent events specified in the contract must be determinable at *initial recognition* and specified in the contract.

(d) <u>The contractual cash flows arising from the contingent event does not represent an investment in the borrower or exposure to the performance of the underlying assets</u>.

An example could be a contractual term that increases the interest rate on a loan if the borrower's profitability exceeds a certain threshold.

Illustrative examples

14 The IASB staff propose to include these additional examples in paragraph B4.1.13 and B4.1.14 of IFRS 9 to illustrate how the SPPI requirements are applied to financial assets with ESG-linked features.

Example illustrates contractual cash flows that are SPPI	
Instrument	**Analysis**
Instrument I Instrument I is a loan that pays a fixed interest rate over the life of the loan. The fixed interest rate is periodically adjusted by a set number of basis points to reflect the borrower's achievement of a pre-defined ESG target that is specific to the borrower. If the borrower achieves the target, the contractual interest rate for the next period is reduced by the set number of basis points.	The contractual cash flows of the instrument are solely payments of principal and interest. The contingent event (meeting a pre-defined ESG target) is specific to the borrower and the changes in the contractual cash flows arising from the contingent event are set out in the contractual terms. The contractual cash flows arising over the life of the instrument are solely payments of principal and interest and do not represent an investment in the borrower or the underlying assets.

Example illustrates contractual cash flows that are not SPPI	
Instrument	**Analysis**
Instrument J Instrument J is a loan with a contractual interest rate that is adjusted in accordance with the carbon price index.	The contractual cash flows of the instrument are not solely payments of principal and interest. The contractual cash flows on the instrument vary in response to a market variable (the carbon price index). The contractual cash flows that arise over the life of the instrument do not compensate the lender for the risks and costs associated with lending the principal amount to a particular borrower for a specified period of time and therefore are not consistent with a basic lending arrangement.

15 The IASB staff believe that amortised cost is the most appropriate measurement approach for financial assets with ESG-linked features having the characteristics described in paragraph 13 above. This is because the most useful information about this type of financial asset is the return on the instrument that the lender receives and the cash flows that the lender does not expect to receive. The IASB staff's view

was confirmed by CMAC and ASAF members respectively during their June and July 2022 meetings.

Financial assets with non-recourse features

16 The IASB staff recommend clarifying that in the case of a financial asset with non-recourse features:

(a) the lender is exposed to the performance risk of the underlying asset(s) throughout the life of the instrument <u>both for the payment of the contractual payments as well as in default</u>; and

(b) the lender's <u>contractual right to receive contractual payments</u> over the life of the instrument <u>is restricted to the cash flows generated</u> by the underlying asset.

17 In the IASB staff's view, in the case of a "normal" collateralised debt the creditor might be relying on the collateralised asset for the recovery of the amount lent only to the extent that the borrower is unable to make the contractual payments through other means. In a non-recourse instrument, the lender is exposed to the performance risk of un underlying asset(s) and the creditor's ultimate claims is limited to the value of the underlying asset(s).

18 In addition, in cases where the non-recourse feature is resulting from the substance of the contractual cash flows, the IASB staff believe that the examination of the legal structure of the borrower and the value of the "loan-to-value" ratio could be relevant to determine whether a non-recourse feature gives rise to contractual cash flows that are SPPI or not (e.g., if the loan provided by the lender is acting as quasi-equity or the underlying assets are funded entirely by the loan from the lender – 100% loan-to-value ratio, the contractual cash flows are not SPPI).

19 Therefore, the IASB staff recommend <u>including examples</u> of relevant factors an entity could consider when assessing the particular underlying assets or cash flows, such as:

(a) <u>the legal or capital structure of the borrower</u>;

(b) <u>the extent to which the expected cash flows from the underlying assets exceeds the contractual cash flows on the financial asset</u>; or

(c) <u>whether there are other sources of finance that are subordinated to the loan from the lender</u>.

Contractually linked instruments

20 The IASB staff recommend <u>including distinguishing characteristics of CLIs as part of the application guidance of IFRS 9</u> to assist with the consistent application of the CLI requirements. The unique characteristics of a CLI structure are (all four characteristics must be met):

(a) <u>Use of multiple contractually linked instruments</u>.

In this context, the IASB staff believe that the meaning of "multiple" is consistent with the generally accepted notion of "having more than one and usually several of something" (as defined in the Cambridge Dictionary). It would therefore not be appropriate to clarify or qualify the meaning of "multiple" referring to transactions with 3 or more tranches.

In addition, the IASB staff believe that the phrase "contractually linked" is self-explanatory and does not require further clarification. This sentence refers to a transaction where the relationship, rights and obligations between the different tranches are specified in the transaction's contractual terms and each tranche holder knows these aspects for all the tranches.

(b) <u>Non-recourse features</u>.

The IASB find it useful to clarify that non-recourse is one of the characteristics of a CLI, rather than the only one.

(c) Prioritisation of payments through a waterfall payment structure.

The suggestion of the IASB staff is to clarify that the waterfall structure affects the prioritisation of payments to the tranches on an ongoing basis and not only in a liquidation scenario.

(d) Concentrations of credit risk resulting in a disproportionate reduction in contractual rights in the event of cash flow shortfalls.

The combination of the non-recourse features and a waterfall structure that prioritises the payments of the different tranches involves that in a CLI the tranche holders share disproportionately the losses deriving from the performance of the underlying pool of financial assets.

21 Lastly, the IASB staff recommend clarifying that the reference to “instruments” in paragraph B4.1.23 of IFRS 9 also includes financial instruments that are not fully in the scope of IFRS 9 (such as lease receivables), but that have cash flows that are similar to payments of principal and interest.

22 This is because, according to the IASB’s view, the IFRS 16 requirements result in a measurement of a lease receivable in a manner that is similar to financial assets that are measured at amortised cost (paragraph BC5.131 of the Basis for Conclusions on IFRS 9).

23 Conversely, the IASB staff highlight that this proposed clarification does not mean that any tranche linked to lease receivables will automatically have cash flows that are similar to SPPI, since an entity is still required to assess whether the contractual terms of the lease receivables give rise to cash flows that are similar to SPPI.

September 2022 IASB meeting discussions

24 At its meeting on 21 September 2022, the IASB unanimously tentatively decided to amend and clarify the IFRS 9 in line with the IASB staff’s recommendations.

25 The IASB members were overall supportive on the analysis and conclusions performed by the IASB staff and provided the following comments during the meeting:

(a) One member suggested discussing in future meetings how much level of variability ESG features could be added to the interest rate without hindering SPPI compliance.

(b) Some members suggested adding detailed application guidance on what is the meaning of “specific to the borrower” (e.g., financial instruments linted to “scope 3” GHG or the treatment of the revenues link – down vs up). It was also suggested to clarify that the expression “*risks or factors that are unrelated to the borrower*” does not include market interest rate (e.g., LIBOR, SONIA, etc.).

(c) Answering a question on the meaning of “determinable”, the IASB Staff clarified that to assess whether a contingent event gives rise SPPI cash flows, it is necessary to know at the time of initial recognition how the cash flows will change after the contingent event.

EFRAG recent discussions

26 EFRAG FIWG and EFRAG IAWG discussed the IASB staff’s preliminary analysis on the SPPI requirements in IFRS 9 and financial assets with non-recourse features and CLIs on 6 and 8 September 2022 respectively.

27 EFRAG FIWG and IAWG members generally agreed with the IASB project direction. The following comments were provided:

(a) Members stressed the importance to see the IASB examples in respect of the SPPI analysis for the instruments with ESG features.

(b) They appreciated the rapid development of the project and stressed the importance of keeping the IASB deadlines for delivering the Exposure Draft in the 1Q 2023.

(c) On the CLI and non-recourse instruments, members agreed with the project direction and the need for additional guidance. Members also considered that this part of the project should not be prioritised over the SPPI requirements for financial instruments with ESG features.

28 EFRAG FIWG and EFRAG IAWG discussed the September IASB tentative decisions described in this paper on 27 September and 4 October 2022 respectively.

(a) EFRAG FIWG members noted that the two IASB examples of how the SPPI requirements are applied to financial assets with ESG-linked features were quite simplistic. They suggested to add examples of more complex financial instruments, including contingent events and additional guidance on what “specific to the borrower” means.

(b) One member considered that it would be unrealistic to assume that all contingent events will occur at the same time, especially if the contractual terms are mutually exclusive, and believed that this requirement could lead to difficulties in interpretation and application.

(c) Some members asked to clarify what the IASB means by “risks or factors unrelated to the borrower”. Sometimes general economic conditions are linked to the risk of default of the borrower and at this stage, it is unclear whether this type of contract would be SPPI applying the IASB staff’s clarifications. Further guidance is also needed on how to consider the liquidity risk inherent in a financial instrument.

(d) Members stressed the need for further careful analysis to understand the impact of these clarifications on financial instruments other than those with ESG-linked features, with particular reference to the requirement that the cash flows from all contingent events must be SPPI. Moreover, the IASB discussion could have wider implications on other aspects of IFRS 9, such as the amortised cost, the definition of floating / market rate, and the ECL.

(e) On financial assets with non-recourse features, some members were interested to have an example of the loan-to-value ratio. This parameter could be a discriminating factor for credit impaired loans and collateralised portfolios. In addition, one member asked for further guidance on how the life of the instrument (e.g., of the purchased credit-impaired loan which is initially non-recourse) should be interpreted: from the point of view of the originator or that of the acquirer.

29 Update from the EFRAG IAWG discussion will be provided orally.

The EFRAG Secretariat assessment

30 In general, the EFRAG Secretariat shares the analysis performed by the IASB Staff and the clarifications proposed to amendment the IFRS 9. In this context, some points of attention can be highlighted:

(a) The text reported in paragraph 6 of AP 16A states that “*a financial asset […]* ***could be*** *consistent with a basic lending arrangement […], if […]*”. Nevertheless, in the following analysis the IASB Staff do not specify in which situations the financial asset is inconsistent with a basic lending arrangement when all four characteristics are satisfied.

(b) In contrast to what is mentioned in the July Agenda Paper, the IASB Staff do not refer to the concept of "**de minimis**" and "**not genuine**" (paragraph B4.1.18 of IFRS 9) when specifying that all variability in contractual cash flow over the life of the instruments must be assessed and when it is stated that all contractual cash flows that could arise over the life of the instrument must be SPPI in order to measure the financial instrument at amortised cost or at FVOCI.

(c) About financial assets with non-recourse features, the EFRAG Secretariat believes that the clarification would be more useful if it referred more generally to the cash flows that **could be** generated by the underlying asset. This is because the nature and the timing of the cash flows generated by the underlying asset might not be determinable at the initial recognition, but their amount could be inferred from the fair value of the underlying asset.

(d) Lastly, the EFRAG Secretariat notes the statement that the **lease receivables** are financial instruments requires further clarification due to the different nature of lease receivables in case of operating or financial lease.

Questions for EFRAG FR TEG

31 Does EFRAG FR TEG have any comments on the IASB staff's recommendations for clarifying amendments to IFRS 9 in paragraphs 9 – 15?

32 Does EFRAG FR TEG have any comments on the IASB staff's recommendations for clarifying the application of the SPPI requirements in IFRS 9 to financial assets with non-recourse features in paragraphs 16 – 19?

33 Does EFRAG FR TEG have any comments on the IASB staff's recommendations for clarifying the requirements in IFRS 9 for CLIs in paragraphs 20 – 23?

34 Does EFRAG FR TEG have any comments on the EFRAG Secretariat assessment?

Next steps

35 The EFRAG Secretariat will continue to monitor the IASB discussions and tentative decisions and provide updates to EFRAG FR TEG on this topic.