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IFRS 9 *Contractual Cash Flow Characteristics of Financial Assets* – Disclosure, transition and effective date Issues Paper

Objective

1 To update the EFRAG FR TEG on the latest IASB and EFRAG discussions on *Contractual Cash Flow Characteristics of Financial Assets (Amendments to IFRS 9)* (CCFC) project and to obtain EFRAG FR TEG views on the latest IASB tentative decisions.

2 The previous update was provided to EFRAG FR TEG on 6 October 2022 (Agenda paper 09-01).

Background of the project

3 In May 2022, in the context of the post-implementation review (PIR) of IFRS 9 *Financial instruments – Classification and Measurement*, 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 financial assets with non-recourse features contractually linked instruments (CLIs) (AP 3).

4 In June 2022, the IASB discussed the objective, scope and indicative timetable for the project (AP 16). The objective is to make clarifying amendments to the application guidance in paragraphs B4.1.7 to B4.1.26 of IFRS 9 to enable the consistent application of the SPPI requirements and to consider whether additional disclosure requirements are needed. The publication of the exposure draft is expected by the first quarter of 2023.

5 EFRAG FIWG, EFRAG IAWG, EFRAG FR TEG-CFSS and FR TEG discussed the objective, scope and timetable of CCFC project at their meetings on 21, 23, 28, and 29 June 2022 respectively. A summary of these discussion can be found in the Appendix A.

6 In July 2022, the IASB had initial discussions on the IASB staff's preliminary analysis on the concepts of basic lending arrangement and nature of a contingent event (AP 16A). In addition, the IASB had initial discussions on the IASB staff analysis of financial assets with non-recourse features and contractually CLIs (AP 16B).

7 The IASB staff preliminary analysis were provided to EFRAG FIWG and EFRAG IAWG on 6, 8 and 14 September 2022 respectively. A summary of these discussions can be found in the Appendix A.

8 In September 2022, the IASB tentatively decided in line with the IASB staff's recommendations 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).

9 A detailed analysis of the IASB September tentative decisions was proved to EFRAG FIWG, EFRAG IAWG and EFRAG FR TEG on 27 September 2022, and 4 and 6 October 2022 respectively. A summary of these discussions can be found in the Appendix A.

10 In its October 2022 meeting, the IASB agreed with the IASB staff's recommendations for proposed disclosure of requirements and relating to the transition and effective date (AP 16). The IASB staff's recommendations are described below. EFRAG FIWG and IAWG discussed these topics on their meetings on 25 October 2022 and 3 November, respectively.

Disclosure, transition and effective date (October IASB meeting)

IASB staff's recommendations

11 In October 2022, the IASB was asked to consider the IASB staff's recommendation relating to disclosure requirements and the transition and effective date for the clarifying amendments to the requirements in IFRS 9 (AP 16).

Disclosure requirements

12 The IASB staff noted that the feedback received during the PIR process showed that disclosure was considered crucial in providing useful information about entities exposures to ESG-linked risks, both in terms of amount and prevalence of ESG-linked instruments and potential effects on entity's future cash flows of ESG-linked features.

13 In line with the existing requirements in IFRS 7[1], the IASB staff believed that a description of the nature of the contractual terms that could change the timing or amount of contractual cash flows (e.g., contingent events) combined with the quantification of the potential magnitude of the changes in entity's future contractual cash flows would provide useful information to users of financial statements about the nature and extent of the risks arising from financial instruments.

14 Moreover, the IASB staff believed that disclosing the prevalence of financial instruments with contingent events in relation to the entity's total financial assets and financial liabilities would enable users of the financial statements to better understand the uncertainty of the entity's future cash flows.

15 To limit the potential costs for preparers, the IASB staff recommended not to require a specific sensitivity analysis on how P&L and equity would have been affected, but to request quantitative information on the range of possible changes in contractual cash flows. Furthermore, the IASB staff recommended that this disclosure be based on all possible changes in future cash flows without requiring a probability assessment.

16 Finally, the IASB staff believed that any proposed amendments to IFRS 7 have to cover both financial assets and financial liabilities and should not be limited to ESG-linked financial instruments.

17 Therefore, the IASB staff recommended requiring that, **for each class of financial assets and financial liabilities** not measured at FVTPL, an entity shall disclose:

[1] The overall objective of IFRS 7 is to require entities to provide disclosures that enable users of financial statements to evaluate (i) the significance of financial instruments for entity's financial statements; and (ii) the natura and extent of risks arising from financial instruments to which the entity is exposed (IFRS 7, paragraph 1). Moreover, in general. for risks arising from financial instruments, IFRS 7 requires disclosures that enable users of financial statements to understand the amount, timing and uncertainty of future cash flows (IFRS 7, paragraph 21A, 23A, 24H and 35B).

(a) a **qualitative description of the nature of the contingent events** that could change the timing or amount of contractual cash flows;

(b) quantitative information about the **potential range of changes to contractual cash flows** that could result from the contractual terms; and

(c) the **gross carrying amount** of financial assets and amortised cost financial liabilities subject to these contractual terms.

Transition and effective date

18 Acknowledging that some entities might need to modify their accounting policies when initially applying the amendments, which might require a change in classification for some of their financial instruments, the IASB staff recommended that an entity apply the amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, but should not be required to restate prior periods. Any accounting difference at the transition date will be recognised in the opening retained earnings. This proposal is consistent with the transition requirements for the initial application of IFRS 9.

19 The IASB staff recommended that an entity discloses the following information as at the date of initial application of the amendments:

(a) the previous measurement category and carrying amount determined immediately before applying the clarifying amendments; and

(b) the new measurement category and carrying amount determined after applying these amendments.

20 Finally, the IASB staff recommended allowing the early application of the amendments.

IASB discussions

21 All the 11 IASB members agreed with the IASB staff recommendations.'

22 During the discussion, some members suggested specifying that the quantitative information about the range of possible changes in contractual cash flows is based on all possible cash flows *within the contract*.

23 Some members suggested clarifying the scope of the proposed disclosure requirements with reference to both the type of financial instruments to be excluded (e.g., equity instruments at FVOCI) and what type of variable cash flows not to consider (e.g., variability from benchmark interest rate).

24 One member expressed some concerns that the quantitative disclosure requirement meets the cost – benefit criteria and suggested considering a question about this aspect in the Exposure Draft.

IASB work plan

25 The IASB has expanded the scope of the CCFC project and changed its name to "*Amendments to the Classification and Measurement of Financial Instruments*".

26 The related Exposure Draft is now expected in the first half of 2023 and will also include the amendments related to the IFRS IC TAD on electronic cash transfers and the disclosure for equity instruments measured at FVOCI discussed earlier today (agenda paper 04-04 and 04-05).

EFRAG discussions on IASB's October tentative decisions

EFRAG FIWG on 25 October 2022

27 EFRAG FIWG members received an update on the IASB Contractual Cash Flows Characteristics of Financial Assets (Amendments to IFRS 9) project and discussed the proposed new disclosure requirements.

28 EFRAG FIWG members highlighted the importance of having clear guidance on how broad the scope of the proposed disclosure requirements is in order to estimate the potential application costs. The proposed disclosures may be difficult to provide due to the high volume of loans and debt instruments in the banks' portfolio. In addition, members questioned the usefulness of the new requirements considering that they would be applied to instruments that are SPPI.

29 Some members suggested narrowing the scope of the new requirements to the ESG-linked instruments. On the other hand, one member noted that IASB has decided not to define what "ESG-linked" means, so the IASB is unlikely to limit the new disclosures to such instruments. Another member suggested proposing to limit the scope by excluding indexation related to credit risk.

30 One member expressed concern about the timing for the publication of the Exposure Draft, recalling that the priority should be given for the solution for the ESG instruments.

31 On transition requirements, one member noted that it might be useful to understand how the features in financial instruments are currently being considered in light of the upcoming clarifications on the SPPI requirements to applying them consistently.

EFRAG IAWG on 3 November 2022

32 EFRAG IAWG discussed this topic at its meeting on 3 November 2022. The update from this discussion will be provided to EFRAG FR TEG orally.

The EFRAG Secretariat assessment

33 The EFRAG Secretariat welcomes the effort of the IASB staff to meet the request of the users of financial statements and agrees with the IASB staff's conclusion that the proposed additional disclosures will provide useful information on the nature and extent of the risks arising from financial instruments and will improve the usefulness of financial statements.

34 Nevertheless, the EFRAG Secretariat expresses concerns about the implementation cost of the proposed new disclosure requirements, with specific reference to entities with large and diversified portfolio of financial assets that may not have systematically carried out a census of all contractual terms for all their financial instruments in their accounting systems. In these cases, the implementation of the proposed new disclosure requirements should involve significant efforts and costs for preparers which might outweigh the benefits this new disclosure would provide for the users.

35 The EFRAG Secretariat also noted that the IASB decision to broaden the scope of the CCFC project could delay the final publication of the amendments to IFRS 9 and appears to contradict the fact that the application challenges related to financial assets with ESG-linked features was considered a high priority matter.

Questions for EFRAG FR TEG

36 Does EFRAG FR TEG agree with the IASB tentative decisions for new disclosure requirements?

37 Does EFRAG FR TEG agree with the IASB tentative decisions relating to the transition and effective date?

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

Next steps

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

Appendix A: Previous EFRAG discussions

Objective, scope and indicative timeline of CCFC project (June IASB meeting)

EFRAG FIWG on 21 June 2022

1 The EFRAG FIWG members discussed tentative IASB staff positions on the post-implementation review of classification and measurement requirements in IFRS 9 and provided the following comments:

(a) Members expressed concerns that political challenge of SPPI test is underestimated and that simple clarifications will not be sufficient to cater for the instruments with ESG features.

(b) The project plan looked realistic and more evidence was needed if the modification of the standard is sought. The clarifications to the standard can be applied earlier as there is no need to endorse them, whereas if the standard is modified it might take at least till 2025 before it could be applied, but a solution is already needed for the two coming years.

(c) The priority should be given for a solution for the ESG instruments whereas CLI and non-recourse issues can be dealt with later. There could be a tension between a project plan and political reality.

EFRAG IAWG on 23 June 2022

2 The EFRAG IAWG members discussed tentative IASB staff positions on the post-implementation review of classification and measurement requirements in IFRS 9 and provided the following comments:

(a) One member expressed his agreement and support with the timing, direction, and purpose of the project. He also noted that, from a user perspective in the later stages of the project, it is important to avoid creating uneven playing conditions between asset classes simply because of the concept of ESG.

EFRAG FR TEG-CFSS and EFRAG FR TEG on 28 and 29 June 2022

3 Members generally supported the direction of the project. The following comments were provided:

(a) Members were sceptical that simple clarifications will be sufficient and suggested that if the most of the ESG instruments will fail SPPI test, the IASB will need to reconsider its approach.

(b) It was also noted that financial instruments with ESG-linked features do not present a different credit risk than a senior bond with the same level of guarantees as the credit risk is referred to the counterparty. Compliance with ESG requirements and objectives in the future will affect the credit risk of the counterparty, therefore it will also affect the credit risk of financial instruments without ESG-linked features.

(c) Members noted that at this stage the information about potential clarifications is limited and suggested to wait for the detailed IASB proposals to make any decisions. Members suggested that the definition of “basic lending arrangement” should be more dynamic than static.

(d) Members considered that the project plan looked realistic. If the standard needs modification it might take at least till 2024 (or even later) including EU endorsement before it could be (early) applied, but a solution might already be needed for the two coming years.

(e) Priority should be given to a solution for ESG-linked instruments whereas CLIs and non-recourse issues can be dealt with later. Members welcomed the IASB openness to remove from the fast-track project the potential clarification on

CLIs if during the discussion there is an indication that these proposed clarifications would require more extensive analysis.

EFRAG FRB on 14 July 2022

4 Members generally supported the direction of the project. The following comments were provided:

(a) One FRB member stressed that it was very important that any clarification or new wording proposed by the IASB on SPPI be verified and agreed with the banking sector prior to finalisation to ensure that the proposed amendment adequately covers the production of bonds with ESG features.

(b) It was clarified that the IASB Staff's preliminary views seem to be in line with the market desire to classify most of the ESG linked bonds at amortised cost. A point of attention is that, at this stage, it is not possible to predict whether the evolution of the market and the behaviour of the link between ESG risk and credit risk will be compatible with the SPPI in the future.

IASB staff preliminary analysis (July IASB meeting)

EFRAG FIWG on 6 September 2022

5 EFRAG FIWG members generally agreed with the IASB project direction and stressed the importance to see the IASB examples in respect of the SPPI analysis for the instruments with ESG features.

6 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.

7 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.

EFRAG IAWG on 8 September 2022

8 EFRAG IAWG did not have comments on the update on the project developments in respect of SPPI requirements and CLI.

9 One member questioned whether the mortgage loan with interest rate depending on the housing quality would fit the new IASB Staff clarification about the nature of contingent event and be SPPI compliant.

IASB's September tentative decisions

EFRAG FIWG on 27 September 2022

10 Members generally welcomed the direction of the project and made the following comments:

(a) 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 and whether there is potential interaction with the definition of a derivative.

(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's discussions could have wider implications on other aspects of IFRS 9, such as amortised cost measurement, 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 including a 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.

EFRAG IAWG on 4 October 2022

11 Members suggested that the IASB should clarify whether the variability of all contractual cash flows arising from contingent events should be assessed for the purposes of SPPI test or whether it should be subject to de minimis or non-genuine guidance.

12 Members noted that the IASB examples were representative of many financial instruments with predefined ESG features and provided a clear indication on how to treat the SPPI assessment.

EFRAG FR TEG on 6 October 2022

13 EFRAG FR TEG members, while agreeing on the general principles expressed by the IASB, highlighted the importance of analysing the final wording of the proposed clarifications relating to the SPPI requirements in order to assess potential impact on financial instruments with ESG-linked features and the current practices on other debt instruments. At this stage, the link between the general SPPI principles and the proposed clarifications is not entirely clear, nor is it entirely clear whether the four requirements proposed are sufficient to conclude that the instrument is SPPI or whether further analysis on "what are you compensated for" is needed.

14 It was noted that the proposed clarification that the contractual cash flows arising from the contingent event should not represent an exposure to the performance of the underlying assets could create some application questions and more guidance is needed. Sometimes, the meeting of an ESG target could be linked to the performance of an entity's assets and it is unclear how this requirement interacts with the statement that the cash flows should be "specific to the borrower".

15 On the examples provided by the IASB staff, one member believed that the discussion should focus on whether the variability created by the ESG features could be included in the concept of interest payments as defined by the IFRS 9 (remuneration for the time value of money and credit risk) also considering the concept of "de minimis" and "not genuine". Another member noted that the ESG features could be considered as component of credit risk remuneration. In addition, it was noted that paragraph B4.1.7A of IFRS 9 states that interest can also include consideration for other risks in addition to the time value of money and credit risk (e.g., liquidity risk and administration costs).

16 On financial assets with non-recourse features, one member questioned the IASB staff conclusion according to which "the phrase 'contractually linked' is self-

explanatory and requires no further clarification". The member noted that in some cases the non-recourse features are determined by the structure of an operation rather than from a formalised contract. In addition, this member believed that in practice it is sometimes unclear what a tranche is (e.g., equity type trances and cash and liquidity facilities) and further application guidance on this aspect could be useful. Another member noted that the clarifications proposed by the IASB is a compromise based on how pervasive the issue is and the time constraints of the project.

17 One member agreed with the EFRAG Secretariat's suggestion on lease receivables and welcomed more application guidance on when these instruments meet SPPI requirements.

18 On the EFRAG Secretariat assessment, an IASB observer explained the intention of the IASB to use "could be" for the four SPPI requirements and clarified that the requirements of the paragraph B4.1.18 of IFRS 9 are still valid. On financial assets with non-resource features, the intention of the IASB was to clarify that the cash flows should be generated by the underlying assets without assessing the related uncertainties. Finally, the IASB observer noted that from the IASB perspective there was no difference between the nature of the cash flows generated by financial or operating leases.

19 Some members suggested the IASB to prioritise its work on the clarifications relating to ESG-linked features and the SPPI requirements over the work on the financial assets with non-recourse features and CLIs should they require more extensive analysis. Considering that the IASB is developing guidelines already embedded in the principles of the Standards, one member believed that the clarifications on the SPPI requirements could already be applied by the entities without waiting for the finalisation for the project.