

Budapest, 23rd of June 2023

MBSZ/77/1/2023

Wolf Klinz
Chair of the EFRAG FRB
European Financial Reporting Advisory Group
35 Square de Meeûs
1000 Brussels
Belgium

Subject: EFRAG Draft Comment Letter in relation to IASB ED/2023/2 Amendments to Classification and Measurement of Financial Instruments (Proposed Amendments to IFRS 9 and IFRS 7)

Dear Mr. Klinz,

On behalf of the Hungarian Banking Association (HBA), we are pleased to comment on the Draft Comment Letter of EFRAG published on 3 May 2023 (the 'DCL'), prepared to request feedback from European constituents in relation to the exposure draft Amendments to the Classification and Measurement of Financial Instruments (Proposed Amendments to IFRS 9 and IFRS 7), issued by the IASB on 21 March 2023 (the 'ED'). This has been done with the assistance of the members of the Hungarian Banking Association.

The attached appendix to this letter sets out our view and detailed comments on the issues which are of particular relevance for us.

We remain at your disposal should you need further explanations and input.

Yours sincerely,



Levente Kovács
Hungarian Banking Association
Secretary General

Appendix

EFRAG Draft Comment Letter: IASB ED/2023/2 Amendments to Classification and Measurement of Financial Instruments (Proposed Amendments to IFRS 9 and IFRS 7)

Request for comments issued by EFRAG on 3 May 2023

Comments from the Hungarian Banking Association
June 2023

The Hungarian Banking Association (HBA) was founded in 1989 but its roots go back to 1919. Its members are banks which are registered and operating in Hungary. The HBA's membership include, in line with the development of the Hungarian banking sector, 51 direct members and around 500 indirect members. Also, we have to mention that among the members there are the specialised lending agencies, the financial infrastructure providers, and the associations of financial institutions so the HBA has an umbrella function as well.

The HBA is the professional advocacy body of the Hungarian banking sector, coordinating and representing the view of the banking community. The most important function of the HBA is the representation of its members' interests vis-à-vis third parties. To this end, the HBA establishes committees and working groups involving professionals from member banks.

In representing its members' interests, the HBA participates in the drafting and discussion of laws, statutes and projects that affect the banking sector directly or indirectly. The HBA presents its opinions, developed on a consensual basis, in Parliament, in various government forums and while the legislation is being drafted. It monitors monetary policy and regulatory proposals of the Central Bank of Hungary and maintains close cooperation with one of its bodies, the Hungarian Financial Supervisory Authority (HFSA). One of its important functions is to cooperate with other professional organisations, explaining to them the views of the HBA on current economic, financial, and other relevant issues. More information here: <https://www.bankszovetseg.hu/?lang=en>

Further information about HBA's comments on the matters discussed here can be requested from:

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Introduction

HBA appreciates the work performed by EFRAG in providing the leading voice of Europe in the field of corporate reporting. We welcome the opportunity to comment on the DCL and contribute to your effort. We understand that EFRAG is generally supportive of ED and will raise mainly smaller improvements and perceived inconsistencies in the ED.

Unfortunately, HBA has a different opinion. Due to our technical analysis done together with our members, we do not believe that the proposed amendments relating to the classification and measurement of financial assets with ESG-linked features are technically sounded. Our view is that the new principle proposed in the ED (IFRS 9.B4.1.10A) 'occurrence of the contingent event is specific to the debtor' does not depict the underlying characteristics of ESG features in general.

As our members are particularly concerned with the assessment of contractual terms that change the timing or amount of contractual cash flows, we focused mainly on the issue addressed under Question 2 of the ED.

General remarks

We understand that the aim of the ED was to address the most prominent issue which is the classification and measurement requirements of financial assets with ESG-linked features. We support the efforts of the IASB in this regard. The current version of IFRS 9 has requirements that do not provide clear guidance how these instruments should be classified. Our members see significant increases in the volume of instruments with ESG-linked features and we also expect that these instruments will become more complex going forward. Therefore, it is vital to bring clarity by having clear guidance and principles.

Although we appreciate the effort of the IASB, we believe that the current proposal will not achieve the stated goals. Paragraph B4.1.8A of the ED clarifies the existing requirements in B4.1.7A of IFRS 9 and we think these can be seen as an improvement. However, we do not agree with the interrelated principles included in paragraph B4.1.10A of the ED. We do not believe that the requirement to assess whether the occurrence of the contingent event is specific to the debtor appropriately depicts the underlying characteristics of ESG features.

ESG-linked features are non-financial contractual rights / obligations falling under IAS 32.AG23

Our view is that most financial instruments with ESG-linked features are financial instruments that encompass a non-financial asset in addition to the financial asset. Such instruments are referred by IAS 32.AG23. According to this paragraph, the entire instrument should be treated as a financial instrument, and they should be classified and measured in accordance with the requirements of IFRS 9. However, IFRS 9 does not include guidance how these instruments should be assessed. We are of the opinion that ESG-linked features are non-financial rights / obligations attached to the financial asset that the parties of the instruments have to honor. This is based on the following argumentation.

Paragraph AG23 of IAS 32 provides the following (emphasis added):

"...financial instruments also encompass a contract that gives rise **to a non-financial asset or non-financial liability in addition to a financial asset or financial liability**. Such financial instruments often give one party **an option to exchange** a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising the option will vary from time to time depending on the

fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. **The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument**, regardless of the other types of assets and liabilities also created.”

IAS 32.AG23 provides in the example that the holder may have a right to take physical delivery of the oil rather than the principal. When this occurs, the principal would not be repaid but a physical delivery would take place. We believe that ESG-linked features share significant similarity with this example. When applying the IAS 32 example to the Instrument EA (B4.1.13 of the ED), the following elements can be identified:

1. Financial asset component is the basic lending arrangement. The lender provides the principal to the borrower which in turn has to repay the principal and the contractually stated interest (unadjusted with the impact of the emissions).
2. Non-financial right component is an exchange transaction between the lender and borrower. The borrower has a right to receive cash in exchange of emissions reduction. On the other hand, the lender has an obligation to pay cash for the reduced emissions.

Our view in relation to the second component is based on the characteristics how greenhouse gas emissions are calculated. The greenhouse gas of the borrower constitute also a greenhouse gas emission of the lender in many cases. For example, according to the Greenhouse Gas Protocol Standards ([Standards | GHG Protocol](#)), the borrower may regard its emissions as Scope 1 (Scope 2) but the lender would also need to account for the same emissions as part of its Scope 3 emissions. The Technical Guidance for Calculating Scope 3 Emissions ([Scope3 Calculation Guidance 0.pdf \(ghgprotocol.org\)](#)) defines 15 different categories from which Scope 3 emissions can arise. Category 15 is defined as ‘Investments’ and defines the Scope 3 emissions of companies that provide financial services. Investments are categorized as a Scope 3 emissions because providing capital or financing is a service provided. Therefore, financial institutions are equally interested in the actual emissions of the borrower.

Today, many financial institutions have committed greenhouse gas emissions goal, like reaching carbon neutral loan portfolio by a certain date (e.g.: Net Zero Banking Allowance). As a result, both the borrower and lender have vested interest in the emission reduction. Consequently, the term of the financial instruments creates an exchange of financial asset for a non-financial asset. The lender is willing to pay cash for the reduced emissions so it can account for the reduction as part of its own commitment. Therefore, we believe the characteristics of the features creates a financial liability for the lender and a financial asset for the borrower. Our view is that IFRS 9 should address the impact of this transaction and considering the emission reduction as contingent event is very simplistic and does not depict the underlying characteristics.

Applicability of IAS 23.AG23 to similar non-ESG features

As stated in the previous section, ESG-linked features can create financial asset and financial liability for the lender and the borrower for the exchange non-financial assets which would be in addition to the basic lending arrangement. In our view this is an area where IASB should put effort and address properly the classification of these instruments. The same issue occurs for other instruments and as there is no clear guidance, they present significant issue for the banking sector. We present the issue through another example.

During the project launched by the IASB on Request for Information on its post-implementation review of IFRS 9 Financial Instruments: Classification and Measurement (referred as 'PIR'), we provided examples of State-subsidized loans in Hungary. We believe that this will show also how IAS 32.AG23 is a relevant issue and should be considered by the IASB in the context of ESG but also more broadly.

Since 2016, the Hungarian Government started introducing state-subsidized loans to promote the construction of new flats, housing or improve old flats for families with children and to support the broader policy of increasing childbirth. Under this policy, the government introduced two loan products: Housing subsidy for families (hereinafter „CSOK”) and Baby-waiting loan (hereinafter „Babyloan”).

Both products are popular on the Hungarian market and are currently classified as financial assets measured at fair value through profit or loss under IFRS 9. However, as the Babyloan is more significant, we mainly focus on this. The main characteristics are the following:

- The loan amount is HUF 10 million (approximately 25.000 EUR).
- Maturity can range between 60 and 240 months (usually maximum maturity 20 years is used)
- The interest rate is set at the 5-year zero-coupon government bond rate multiplied by 1.3 and 2% interest premium (decreased to 1% premium as from May 2022 for new applications). The interest period is set for 5 years. Therefore, assuming 20 years maturity there is three interest re-set events: at the 5th, 10th, and 15th anniversary. However, the interest re-set is impacted by the eligibility of the attached government subsidies.
- The product contains two government subsidies: (a) interest subsidy and (b) childbirth allowance.
 - o **Interest subsidy:** In the first 5 years, government provides interest subsidy and pays interest to the bank directly. The continuation of the interest subsidy is subject to the birth (or adoption) of a child within the first 5 year of the loan. If there is no child within 5 years, the interest subsidy received by the debtor should be reimbursed to the government. Further, as the interest subsidy stops the debtor has to pay a floating market-based interest to the financial institutions after year 5.
 - o **Childbirth allowance:** Debtors can receive non-refundable childbirth allowance for their second and third child. The allowance takes the form of waiving 30% of the then outstanding principal when the second child is born. Full waiving of the remaining principal when the third child is born.

The main reason this product is classified as financial assets measured at fair value through profit or loss is due to the assumed leverage included in the interest rate. It should be noted that the interest rate (5-year zero-coupon government bond rate multiplied by 1.3 plus spread) is applicable at inception for a 5-year fixed period in case one child is born within the first 5 years. In case there is no child then the interest rate of the product will be fixed in the first 5 years and thereafter it is floating market based. Therefore, we can see this as the basic lending arrangement.

The eligibility condition of the interest subsidy on the other hand is an exchange transaction between the debtor and the government. The debtor must support the government's policy (childbirth) to benefit from the interest subsidy. When the eligibility is satisfied the government pays the interest of the loan directly to the financial institution on behalf of the debtor. From an economic perspective, this can be seen as an option written by the government. The right is given to debtor with a non-financial variable (childbirth). The cash flow variability of this transaction relates to the childbirth and the change relating to the 5-year zero coupon government bond. For this reason, we believe that this reflects similarity with the example in IAS 32.AG23.

Today, IFRS 9 does not deal with the impact of the non-financial item that are attached to the financial asset. There is no clear guidance how this should be considered in the classification of financial assets. We see this as a significant blackhole in the standard. We do not think that adding B4.1.10A of the ED will provide more clarity. The ESG-linked features and the Babyloan are not contingent event. They depict an exchange transaction between two parties that create financial right or obligation. Consequently, we believe that the IASB should not proceed with the finalisation of the amendments based on the ED on this issue.

Transition requirements

Paragraph 7.2.47 – 7.2.49 of the ED describes the effective date and transition requirements of the Amendments to the Classification and Measurement of Financial Instruments. According to these paragraphs, the application of the Amendments should be done retrospectively but it is not required to restate prior periods.

We noted that these requirements are in line with the initial application of IFRS 9 but we do not believe the proposed transition will provide useful information to the users of the financial statement. A retrospective application requires recalculating the impact since the initial recognition of the financial assets for which the classification is changing. This may require significant work especially in case the instrument contains additional features that were not separately assessed. Therefore the cost of the retrospective approach may outweigh the benefit for the users. Therefore, HBA believes that it would be more practicable to request the transition in accordance with the requirements on reclassification as stated in 5.6.1. – 5.6.7 in IFRS 9 through a prospective approach.