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IFRS 9 PIR – Detailed list of issues assessed as prevalent Issues Paper – background paper

Objective

1 The objective of this paper is to give an overall view to EFRAG Board on the results from the preparatory work and suggestions from EFRAG TEG, EFRAG FIWG and EFRAG IAWG on the issues to be discussed in EFRAG's response to the Request for Information on IFRS 9 *Classification and Measurement*. This paper will be the basis for the preparation of the comment letter in response to the Request for information "RFI".

List of the issues

2 EFRAG TEG has identified the following list of issues to be reported:

(a) Recycling changes in FV accumulated in OC for equity and treatment of equity like instruments;

(b) Sustainable finance – SPPI test;

(c) Supply-chain financing – reverse factoring;

(d) Modification of cash flows

(e) Financial guarantees

(f) Contractually linked instruments – non- recourse

(g) Factoring of trade receivables; and

(h) SPPI – use of administrative rates.

3 In addition, Appendix 2 includes a list of topics that EFRAG TEG decided not to report to the IASB.

4 The following table provides a summary of EFRAG TEG views on prevalence and priority of the selected issues to report in the comment letter as response to the RFI.

Topic	Prevalence in Europe	Priority in Europe
Sustainable finance – SPPI test	Prevalent issue in Europe.	High
Supply chain financing – reverse factoring	Prevalent issue in Europe.	High
Recycling changes in FV accumulated in OCI for equity instruments	Prevalent issue in Europe	High
Investments in equity like instruments	Prevalent issue in Europe	High

Modifications of cash flows	Prevalent issue in Europe.	Medium
Contractually linked instruments – non-recourse	Prevalent issue in Europe.	Medium
Factoring of trade receivables	Prevalent issue in Europe.	Medium
SPPI – use of administrative rates	Prevalent issue in Europe.	Medium
Financial guarantees	Prevalent issue in Europe.	Low

Recycling changes in FV accumulated in OC for equity and treatment of equity like instruments

Recycling changes in FV accumulated in OCI for equity instruments

5 In June 2018, the European Commission (EC) requested EFRAG to consider alternative accounting treatments to measurement at FVPL for equity instruments. Possible accounting treatments should properly portray the performance and risk of long-term investment business models in particular for those equity and equity type investments that are much needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on climate change.

6 In the context of this project, in May 2019 EFRAG launched a public consultation to gather constituents' views on whether alternative accounting treatments to those in IFRS 9 are needed to portray the performance and risks of equity and equity-type instruments held in long-term investment business models. EFRAG received 63 responses: this number confirms that this is a topic that generates considerable interest in Europe, specifically, but not exclusively, for the financial sector. Seventy (70%) of respondents considered that an alternative accounting treatment was relevant to meet the objective to reduce or prevent detrimental effects on long-term investments. However, 30% of respondents did not consider that an alternative accounting treatment is needed. Seventy-eight percent (78%) of those who supported an alternative treatment (corresponding to 52% of the total respondents) favoured a model based on fair value through other comprehensive income (‘FVOCI’) with recycling and impairment, with a scope that is similar to the FVOCI option under IFRS 9. EFRAG notes that the concerns expressed by these respondents are not new and that similar concerns were highlighted in its endorsement advice on IFRS 9. The Feedback statement of this consultation is accessible here.

7 In January 2020 EFRAG issued its advice to the EC on alternative accounting treatments to measurement at fair value through profit or loss for equity and equity-type instruments held in long-term investment business models. In particular, EFRAG advised that the EC recommend to the IASB an expeditious review of the non-recycling treatment of equity instruments within IFRS 9, testing whether the Conceptual Framework would justify the recycling of FVOCI gains and losses on such instruments when realised. If recycling was to be reintroduced, the IASB should also consider the features of a robust impairment model, including the reversal of impairment losses.

Treatment of equity-like type instruments

8 Most respondents (88%) who support the need for an alternative accounting treatment in the consultation described above, considered that the alternative accounting treatment should be extended to ‘equity-type’ instruments (i.e. units of funds). Among the concerns reported in the consultation, they considered that:

(a) equity instruments should be treated consistently under IFRS 9, irrespective if they are hold directly or indirectly; and

(b) measuring equity-type instruments at FVPL distorts the depiction of financial performance and would not appropriately reflect the management strategy of the funds.

9 The remaining respondents either did not agree or did not reply.

10 In its advice to the EC in relation to accounting for investments in units of funds under IFRS 9, EFRAG was sympathetic to the concerns on the accounting at FVPL, as opposed to FVOCI. EFRAG supported that similar fact patterns should be treated similarly, and noted that some mutual funds and puttable instruments, respond to movements in market variables in a similar way to equity instruments even though these do not meet the definition of an equity instrument under IAS 32 *Financial Instruments - Presentation*.

11 EFRAG considered that any changes to the accounting for these instruments, aimed at allowing for direct and indirect equity instruments to be treated similarly for accounting purposes, would require careful consideration. It would be necessary to evaluate the challenges of developing an appropriate standard setting solution and considering knock-on effects on the classification and measurement model under IFRS 9. Possible consequences could include structuring opportunities and the ability to assess the nature of the underlying assets and business model at the level of the fund itself.

12 EFRAG considered suggestions of relevant criteria made by stakeholders, in order to select units of funds that could become eligible to the equity accounting treatment and prevent unintended consequences. As a working assumption, EFRAG considered that the definition of equity-type instruments should be limited to units of funds and puttable instruments that invest in equity instruments, associated derivatives and necessary cash holdings.

Sustainable finance – SPPI test

13 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.

14 Banks and insurers should make sustainability considerations as an integral part of its 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.

15 European constituents anticipate in the coming years a sharp increase in volumes of debt instruments with contractual features that link the cash flows with the ESG profile of the borrower and 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. These stakeholders are concerned that such a classification would not be reflective of the way such instruments are managed (as they are considered as part of the lending business which is measured at amortised cost). Banks might be indirectly discouraged from mainstreaming this type of lending.

16 The current global volume of these emission is in the size of about 700[1] billion in 2020, and just in H1 2021 a little bit over 500 billion of which more than 50% relates

[1] Sustainable Debt Highlights H1 2021

to European issuers. As an example, only Germany, France and Spain together issued in the H1 2021 a total of 60 billion.

17 EFRAG understands that currently the impact of these features is assessed to be minimal, so not resulting in failing the SPPI test. However, in the future, in order to meet the anticipated ambitious sustainability targets offering appropriate incentives, these stakeholders expect a higher impact.

18 Incorporating ESG[2] factors and risks into the business model analysis and definition could improve the long-term business strategies to mitigate and reduce environmental harmful activities and promote environmentally sustainable activities. This could lead also to a better credit quality, so allowing to benefit of lower credit spreads.

19 Preparers also noted that the alignment of the accounting to the business model may have positive effects on long-term sustainable investments.

20 Some additional reasons that justify the prevalence of ESG financial instrument are:

(a) Investors demand more ESG transparency from investee companies and are encouraging them to adopt strategies that support the net-zero carbon targets defined in several international Agreements or initiatives;

(b) The long-term investment focus of some industries leads to a particularly well placed to channel investment into infrastructure projects, notably in the area of renewable energy; and

(c) These investments typically earn an additional return above other equity or debt instruments.

21 EFRAG observes that when the SPPI test was designed, these products were not anticipated to play such a key role in the lending business of banks and other investors. The IASB should accordingly consider the classification of these contracts, which are currently seen to be integral part of the lending business, but may fail to be classified at amortised cost.

Fact patterns concerned

22 From the ***issuer perspective*** an ESG-linked bond is where the amount of interest varies depending on an entity-specific sustainability factor or rating of the issuer. The issuer's accounting treatment depends on whether a contractual linkage of the interest amount to the sustainability factor meets the definition of an embedded derivative that needs to be bifurcated from the host contract and accounted for separately.

23 From an ***investor-perspective*** different fact patterns can arise such as:

(a) *Changes or variability in contractual cash flows* due to linkages to sustainability or ESG factors;

(b) *Green finance arrangements* that do not include varying interest rates with regard to ESG factors, but provide for a *below-market interest rate* or even a zero-interest rate in order to finance green projects (resulting in a day one gain when measured initially at fair value unless the fair value at inception cannot reliably incorporate expectations on the level of performance); and

(c) *Green (securitised) bonds collateralised by one or more specific green assets*. Repayment is made primarily from the cash flows of the green projects or loans to green projects. In the case of asset-backed securities, the holder has a right of recourse to the underlying pool of loans or assets from the green projects that have been pooled as collateral. Covered bonds are securitised

[2] Environmental, Social or Governance characteristics that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual.

bonds in which the holder has a general claim against the issuer and to a pool of the underlying green projects or loans to green projects (i.e. dual-recourse).

Examples of contractual features

24 In preparation of the response to the IASB RFI, EFRAG has collected a number of examples of contractual features that show a linkage of the contractual cash flows to some ESG factors relating to the borrower. These examples are presented in the appendix 1 to this paper.

Supply chain financing -reverse factoring

25 In a reverse factoring arrangement, a financial institution agrees to pay amounts an entity owes to the entity's suppliers and the entity agrees to pay the financial institution at the same date as or a date later than suppliers are paid.

26 The IFRS IC issued an Agenda Decision on this topic in December 2020. However, it is noted that this Agenda Decision did not resolve all uncertainties, especially with regard to presentation in the statement of cash flows.

27 The Agenda Decision considered the impact of a reverse factoring arrangement on presentation in the balance sheet, the derecognition of a financial liability, presentation in the statement of cash flows and in the notes to the financial statements.

28 The first issue raised in this regard is how to apply the derecognition requirements in IFRS 9.3.3.2 when one become part of a reverse factoring arrangement: i.e., is the original trade payable legally extinguished and if so, as from which moment?

29 A more important area that was considered in need for additional guidance was the principal-agent area. Differences in views exist between audit firms and inside audit firms on how to reflect such transactions in the books of corporates. In particular when a factor is acting as paying agent of the corporate.

30 Some consider that when the factor is paying on behalf of the corporate it is a cash transaction that is done in a fiduciary capacity despite the fact that funds do not come from an account in the name of the corporate. So the payment should be considered as cash outflow by the corporate upon payment to the factor.

31 Others think it is not a cash payment as the cash is not coming from the corporate and the only cash transaction is when the corporate is paying back the cash flows at the very end of the supply chain finance, may be some months later.

32 Hence this issue may benefit from a clarification in IFRS 9 on the principal-agent relationship. Factors to be considered here could include if the reversed factoring arrangement was set up by the bank, the entity or the seller. Whether the payment conditions to the seller were determined in negotiations with the bank and the seller or with the entity and the seller and whether use of cash discounts were decided by the bank or the entity.

Modifications of cash flows

33 Paragraph 3.3.2 of IFRS 9 states that a substantial modification of the terms of a financial liability shall be accounted for as the extinguishment of the original financial liability and the recognition of a new financial liability.

34 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.

35 Paragraph B3.3.6 of IFRS 9 states that the terms of a financial liability are substantially different if the discounted cash flows under the new terms are at least 10% different from the discounted remaining cash flows of the original financial liability. However, for financial assets the current Standard does not state when such modification is substantial.

36 For the reasons mentioned above, the guidance on modification of cash flows for financial assets is considered to be insufficient.

37 EBA issued guidance on forbearance of loans in October 2018. For that reason, banks should monitor loans modified after forbearance and provision them on a one-to-one basis.

38 The accounting question that arises is the following: when does a forbearance event (modification for credit reasons) trigger derecognition (which also means that the new loan does not have any provisioning attached despite being a problem loan).

39 The 10% threshold of the liabilities may not be representative or applicable to assess this for that reason, banks have developed practical approaches, including to limit as much as possible the scope of derecognition.

Financial guarantees

40 In accordance with IFRS 9, paragraph B2.5 it is stated that financial guarantee contracts may have various legal forms, such as a guarantee, some types of letters of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form.

41 The IFRS 9 paragraph specifies different appropriate accounting treatments for the issuer [shortened]:

(a) Although a financial guarantee contract meets the definition of an insurance contract in IFRS 17 *Insurance Contracts* if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either IFRS 9 or IFRS 17 to such financial guarantee contracts. If IFRS 9 applies, paragraph 5.1.1 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies, the issuer measures it at the higher of:

    (i) the amount of the loss allowance determined in accordance with Section 5.5 of IFRS 9; and

    (ii) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers*.

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. Such guarantees are derivatives, and the issuer applies IFRS 9 to them.

(c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies IFRS 15 in determining when it recognises the revenue from the guarantee and from the sale of goods.

Contractually linked instruments – non-recourse

42 IFRS 9 contains requirements (paragraph B.4.1.20 and following) for debt instruments issued in tranches whose terms create concentrations of credit risk and a special exception for loans that pay a negative interest rate. The payments on these financial assets are contractually linked to payments received on a pool of other instruments.

43 Diversity in practice is noted with application of the non-recourse guidance and contractually linked instruments. More detailed guidance is needed to resolve these inconsistencies in particular with regard to the scope of applying the "look through to" approach.

Non-recourse vs contractually linked

44 The contractually linked definition could be seen as very broad with no explicit guidance on what constitutes a tranche. In order to distinguish between non-recourse financing and contractually linked, some believe it is necessary to consider the nature and substance of an arrangement.

Interpretation of contractually linked guidance

45 The contractually linked guidance requires the underlying pool to 'contain one or more instruments that give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding'. The key question to some is what constitutes an 'instrument' for the purposes of contractually linked guidance.

46 The issue reported is also related with the reclassification requirements as it is argued by some that a change in processes would also qualify as a change in business model.

47 Also the look-through approach is considered difficult in some cases, as the required details are not available for every line of underlying investments.

48 Constituents note diversity in views in this area, in particular where a contract does not directly contain exposure to inputs that would not qualify for the SPPI criterion, but there is indirect exposure to equity prices / pricing of assets. Further examples of this can be seen with intra group loans or loans to associates.

Factoring of trade receivables

49 Commonly occurring fact pattern description:

50 The Factor purchases the Company's receivables from Debtors making a 90% prepayment of the purchase price, less a charge which is equal to an agreed percentage of principal amount [assumed pro-rata share of any losses between the Company (10%) and the Factor (90%); alternatively it can be that any first losses are borne by the Company and only above the 10% threshold by the Factor]. The historical loss rate is – say – 6%. The receivables are insured up to 90% of the principal amount. If no payment is made until the initial payment date of each invoice, additional interests are charged for the period until 6 months overdue. The Factor can sell the receivables to any other party, however the insurer's approval is necessary to preserve the insurance protection. After the 6 months period passed without payment made by the Debtor, the Factor becomes beneficiary of credit insurance. Credit insurance may have been obtained by the Company prior to factoring (or alternatively later on by the Factor) and costs are recharged to the Company. Alternatively, there can be no insurance.

51 In these cases, one needs to assess historical loss rate and compare it to how the losses are apportioned between the company and the factor under the factoring arrangement (how many losses are borne by each party, and whether the entity covers first losses or whether they are shared pro rata with the factor). If the trade receivables are subject to insurance, one needs to determine whether and how it

shall impact the derecognition assessment depending on specific circumstances. Given the inherent complexity adding illustrative examples to IFRS 9 would be very helpful.

SPPI – use of administrative rates

52 An illustration of these products is found in Sweden, where the loan terms, both fixed and floating refer to “the general interest level”. In practice, that means that a “composite” rate is created using the composition of the actual funding of the bank/mortgage institution.

53 Example 1: Around 60% of the mortgage loans in Sweden are fixed for 3 months. After 3 months the rate is adjusted based on the price list of the mortgage institution. The price list as such has been generated using the average funding profile of the institution.

54 The liquidity in the market is not big enough to allow a refinancing of the institution every 3 months. Therefore, the actual funding is mix of deposits, overnight funding, commercial paper/certificates of deposits with a maturity up to 12 months, covered bonds issued at fixed rates with maturities between 3 to 5 years, senior bond, senior non-preferred, tier 2 and additional tier 1 instruments as well as equity. The actual relative composition will depend on the actual market situation.

55 This means in practice that competition and the formulas used decide the actual interest rate adjustments every 3 months, not changes in 3-month rates observed in the market.

56 Example 2: Fixed rate loans to corporates and retail refer to the general interest level as well. It means that the bank offers a fixed rate without any reference to any index, just a gross rate is offered. The actual funding is the same as in example 1 with the exception that covered bonds are not used in this latter case.

57 The safeguard both for private individuals is that consumer protection laws prevents changes in the interest rates offered above “changes in general interest levels”.

58 About cost of funds pricing mechanisms the following additional information was provided at EFRAG FIWG:

(a) As long as the interest rate is not based on a formula that is substantially linked to elements independent of client credit risk (e.g. inflation indexing on some consumer loans; exchange rate linked premiums; direct inclusion in the formula for cost of funds of substantially all of a bank's CAPEX and OPEX), the SPPI test should be considered passed;

(b) Where the interest rate is set by a third party, or where there is no interest rate but there is a fee structure that reflects risk (which was the case in some "refinancing" transactions) the SPPI test should be passed unless there are clear arguments against;

(c) Interest rate ratchets linked to "not strictly financial" triggers are seen as normal and not limited to ESG - for example minus 50 basis points on expansion to a specific market, or completion of a specific acquisition, or completing a building project, or obtaining a specific permit or license.

Appendix 1: List of ESG-factors examples

Size	ESG Margin Ratchet
0-500 mln	-10bps if the KPI is achieved +10bps if the KPI is not achieved ESG margin ratchet linked to sustainability KPIs focused on (i) recycling, (ii) producing green products, and (iii) increasing the percentage of employee shareholders Ratchet works both ways, disapplies if EoD (event of default) ongoing
500 mln - 1 bln	-7.5bps if the KPIs are achieved +7.5bps if the KPIs are not achieved
1 bln - 1.5 bln	-10bps if the KPI is achieved +10bps if the KPI is not achieved 'ESG margin ratchet linked to sustainability KPIs focused (i) 2% decrease per annum in Co2 emissions (ii) (ii) Sustainability board champion in place -5bps if the KPIs are achieved +5bps if the KPIs are not achieved +2.5bps if only 1 KPI is met ESG margin ratchet linked to an undisclosed sustainability KPI -10bps if the KPI is achieved +10bps if the KPI is not achieved
1.5 bln - 2 bln	The ESG margin shall be adjusted (on a non-compounding basis) by reference to the Sustainability KPI growth level, defined as the growth in annual installed wind power general capacity in gigawatts (GW) powered by gearboxes supplied by the Target Group in the relevant FY, as follows: Equal to or greater than 5%: 10bps reduction Equal to or greater than 0% but less than 5%: 5bps reduction Less than 0% but equal to or greater than -5%: 5bps uplift Less than -5%: 10bps uplift -7.5bps if the KPI is achieved +7.5bps if the KPI is not achieved KPI focused on a reduction in GHG Emissions compared to the previous Financial Year and a reduction in GHG Emissions of at least 10% compared to the Financial Year immediately before that previous Financial Year ESG margin ratchet linked to sustainability KPIs focused on (i) GHG emissions (Scope 1 and 2) of the Group ≥ 4.2% GHG reduction p.a. versus the baseline: 7.5 bps margin reduction < 4.2% GHG reduction p.a. versus the baseline: 7.5 bps margin uplift Reasonable endeavours to apply 100% of savings towards environmental investments Same ESG ratchet applies to RCF (Remaining Cash Flow)
> 2 bln	ESG margin ratchet applies as long as ESG rating by ESG Rating Agency issued within the last 12 months is equal/ more favourable than the ESG Rating at issue date: 5bps sustainability margin ratchet which works both way Disapplies if EoD ongoing ESG Rating Agency of international repute (e.g. MSCI, Sustain analytics, presently done by S&P) RCF sustainability margin ratchet of 15bps

Appendix 2: Topics discussed and not to include in the RFI

Topic	Prevalence in Europe		Priority in Europe	
	FIWG	IAWG	FIWG	IAWG
Business model – sales – COVID 19	Prevalent issue in Europe.		Medium	
FVOCI business model (elimination)	Prevalent issue in Europe		Low	Not to report
Benchmark test for last reset rates due to IBOR reform	Not prevalent issue in Europe.		Low	
Business model – boundary HTC/HTCS (liquidity buffers banks – loan syndicates)	Prevalent issue in Europe		Low	
Reclassification and IFRS 5 – scope of IFRS 9	Not prevalent issue in Europe		Low	
Credit risk	Not prevalent issue in Europe		Low	
Prepayment	Not prevalent issue in Europe		Low	
Reporting gains on gross basis	Not prevalent issue in Europe		Low	
Measurement of derivatives to meet obligations to policyholders	Not prevalent issue in Europe	Prevalent issue in Europe	Low	Out of scope