EFRAG
European Financial Reporting Advisory Group

EFRAG Secretariat: Almudena Alcalá,
Didier Andries (team leader)

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Summary of the comments received on the Interaction of green/sustainable finance and IFRS 9 requirements

Objective

1 This paper is prepared to inform EFRAG TEG about the inputs received from different constituents on interaction of green/sustainable finance and IFRS 9 *Financial Instruments* requirements.

Structure of the paper

2 This issue paper contains:

(a) Background

(b) Summary of inputs received

(c) Appendix 1 – List of examples

Background

3 In the context of preparing for the Request for Information of the Post Implementation Review (PIR) of IFRS 9, the EFRAG Secretariat has collected fact patterns that provide information about the application of IFRS 9 requirements to green or Environmental, social, and governance 'ESG' financial instruments which can lead to difficulties in particular cases, such as:

(a) Failing the solely payment of principal and interest test 'SPPI-test'; and

(b) The 'non-recourse' nature.

4 This limited outreach was done relying on one-to-one contacts with constituents and organisations from the EFRAG Banking Network.

Summary of inputs received

5 EFRAG has received 13 responses from European constituents.

6 The main distinguishing feature of ESG lending is that borrowers with a better ESG score or performance expect to pay a lower interest. The ESG linked feature is becoming prevalent across many common lending products.

7 Many respondents identified a potential problem with the current requirements in IFRS9 of the SPPI-test and considered that the linkage between ESG or green financial instrument and the SPPI-test should be further investigated. One respondent noted that it should be considered that this is a completely new line of strategic business of the banking industry that was not in place when IFRS 9 was developed and issued.

8 The following table provides an overview of commonly used KPI's in the ESG environment and the impact they have on the interest charged:

KPIs
Greenhouse gas 'GHG' emissions level; Green revenues ratio; and Ratio of women in management.
Prevention of corruption; and ESG performance of the borrower.
Percentage of employees working at a subsidiary that is certified as a best employer through the "Great Place to Work" Percentage of women in the group's executive committee; and Percentage of renewable energy out of total electricity consumption at constant scope.
Percentage of total female employees of the borrower; Percentage of the borrower's total electricity consumption sourced from renewable generation; and Having a 0% share or commitment in new greenfield coal projects.
Total CO2e emissions reduction target; BEV (Battery Electric Vehicle) share of sales target; and Tailpipe CO2e emissions reduction target.
Gender equality; Repair indicator; and Durability score.
Use of proceeds to eligible green projects.
Step up/down in rates applicable to the above may range from 2bps to 10bps

Prevalence of ESG / green financial instruments

9 Some respondents reported that ESG issues are increasing world-wide in the leveraged loan market with a number of deals issued in 2021 structured as ESG-linked loans.

Type of debt	2019	2020	Change ($)	Change (%)
Green bonds	$271.1B	$305.3B	$34.2B	12.6%
Sustainability bonds	37.9	68.7	30.8	81.1
Social bonds	18.0	147.7	129.7	720.3
Green loans	93.4	80.3	-13.0	-14.0
Sustainability-linked loans	140.1	119.5	-20.6	-14.7
Sustainability-linked bonds	5.0	10.6	5.6	112.5
Total	565.5	732.1	166.6	29.5

Source: BloombergNEF

Figure 1 : Sustainable debt issuance, 2019 to 2020 [1]

10 One respondent mentioned that there was a rise in ESG-linked TLB[2] issuance in 2021 that have ESG-specific targets in documentation. Furthermore, the number of investors with broader monitoring of ESG policies and screenings is growing and this could potentially be another marketing point for investors and increase potential investor demand.

11 Some of the reasons concerning 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;

12 One respondent mentioned that the contractual features provided for the following possible terms that could impact the SPPI test:

(a) an interest rate indexed to other non-interest variables, or

(b) the limitation of a creditor's claim to specified assets of the debtor or to the cash flows from specified assets.

13 Another respondent emphasized that for the insurance sector the main area of concern could be related to investments carried at held to collect and sell, backing traditional with profits insurance policies. Unit-linked products which are carried at fair value would be less problematic.

14 In addition, some respondents mentioned that in cases of some step-up interest rate bonds, these ESG or green feature provide compensation for basic lending factors. In this case it should be further assessed whether there are sufficient collaterals or guarantees not related to the specific activity of the debtor. ESG-related step-ups are not in opposition to the SPPI test, as long as a link can be demonstrated between

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[1] The Sustainable Debt Market Is All Grown Up

[2] Term loan which has minimal amortization and a balloon payment of principal at maturity.

the ESG criteria on which the step-up/step down is based and the credit quality of the entity. However, this link could be complicated to demonstrate and document.

Fact patterns by issuance

15 The fact patterns identified of ESG or green financial instruments can differ depending on the investor or the issuer perspective.

16 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.

17 To make this assessment, a company should determine whether the definition of a derivative[3] is met and, if so, whether the economic characteristics and risks of the embedded derivative and the host contract can be viewed as closely related. Judgement is required to determine whether the sustainability factor represents a financial or non-financial variable.

18 Similar to the analysis performed by the holder to determine whether a financial asset with ESG-linked interest rates meets the contractual cash flow characteristics test (i.e., whether the variability is consistent with a basic lending arrangement), this assessment by the issuer primarily depends on whether there is a direct influence of the sustainability factors on the issuer's credit risk.

19 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 non-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[4] are securitised 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).

20 On the *changes or variability of contractual cash flows*, it raises the question as to whether a contractual linkage to a sustainability factor would cause the financial asset to fail the SPPI criteria. Sustainability factors are increasingly incorporated

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[3] In accordance with IFRS 9 paragraph 4.3.1 an embedded derivative is a component of a hybrid contract that also includes a non-derivative host – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. In the view of the EFRAG Secretariat the ESG ratchets are an entity-specific performance target, specific to one of the two parties in the contract, they are not an embedded derivative but merely a contractual term

[4] In accordance with IFRS 9, paragraph B4.1.21 for contractually linked instruments, a tranche has cash flow characteristics that are payments of principal and interest if i) the contractual terms of the tranche being assessed give rise to cash flows that are solely payments of principal and interest; ii) the underlying pool of financial instruments has particular cash flow characteristics and iii) the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments.

into credit ratings which could indicate that these factors contribute to the credit risk of the issuer.

21 An entity shall use judgement to determine whether there is a direct influence from the specific sustainability factors referenced in the contractual cash flows of the asset on the issuer's credit risk. If so, to the extent they contribute to credit risk, changes in cash flows that are driven by these factors may not cause a financial asset to fail the SPPI criteria because they reflect a component of credit risk.

22 Some respondents added that conducting the SPPI-test is not straightforward and requires considering, amongst others, the significance of the impact of the ESG triggers (e.g., whether they are de-minimis, as defined under IFRS 9. B4.1.18[5]) and whether the inclusion of such features is consistent with a basic lending arrangement.

23 However other respondents mentioned that the ESG margin is designed to encourage borrowers to meet ESG goals. The potential reduction in margin is not hedged, rather it is helping companies to achieve a wider sustainability, and thus business strategy, targets. Specific ESG features included in companies' contracts can be up to now considered as "vanilla" and that they could be compliant with the definition of basic landing arrangement since they do not include structured features and they do not expose the bank to additional risks.

24 Secondly, some respondents raised concerns on *Green finance arrangements which lead to a below-market interest rate* a "simple" financial instrument without special features in relation to cash flow variability would most likely fulfil the SPPI criteria. Even an interest rate that is below the market rate.

25 However, in some cases, it is possible that there is a difference between the transaction price and the fair value of the financial instrument at initial recognition. This determines how this difference should be accounted for. If the financial instrument was issued under an arm's length transaction and the transaction price is not equal to the fair value at initial recognition, the appropriate accounting for the difference depends on how the fair value is determined:

(a) if the fair value is evidenced by Level 1 inputs or based on a valuation technique that uses only data from observable markets, the difference should be recognised as a gain or loss at initial recognition; and

(b) in all other circumstances, the day one profit or loss is deferred.

26 Finally, on *green (securitised) bonds collateralised by one or more specific green assets* the characteristics of the underlying pool of assets held by the issuer of the green bond can be a determinative factor in the contractual cash flow characteristics test. The requirements on contractually linked instruments apply even if the underlying pool contains only non-financial assets. If the underlying pool of instruments contains only directly the financed wind or solar power plants instead of financial instruments, the contractual cash flow characteristics test is not met because the underlying pool does not contain one or more financial instruments that meet the SPPI criteria.

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[5] A contractual cash flow characteristic does not affect the classification of the financial asset if it could have only a de minimis effect on the contractual cash flows of the financial asset. To make this determination, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument. In addition, if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than de minimis but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset.

27 However, if underlying pool also includes financial instruments that fund green projects (e.g. in the form of loans for projects to increase energy efficiency or loans for electric or hybrid vehicles), the SPPI criterion may be met.

28 Further assessment would be needed if an issuer prioritizes payments to holders of financial assets using multiple contractually linked instruments that create concentrations of credit risks (tranches). If one of the three conditions in IFRS 9 B4.1.21[6] is not met, the contractually-linked subordinated instrument will not meet the contractual cash flow characteristics test and, therefore, the investor will be required to measure the instrument subsequent to initial recognition at fair value through profit or loss (FVPL).

29 Some respondents shared different real-life examples that have been identified when issuing an ESG or green financial instrument such as:

(a) Different bps if the KPI are achieved;

(i) KPI based on the weighted average of the EEOI 'Energy Efficiency Operational Index' for the whole fleet of the borrower's container vessels;

(ii) 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;

(b) ESG margin ratchet linked to sustainability KPIs focused on decrease per annum in Co2 emissions;

(c) ESG margin ratchet linked to sustainability KPIs focused on group sustainability rating, and % reduction in tonnes of carbon dioxide per euro of group turnover of GHG emissions;

(d) 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 financial year.

[6] A tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if: (a) the contractual terms of the tranche being assessed for classification give rise to cash flows that are SPPI on the principal amount outstanding; (b) the underlying pool of financial instruments has the ca cash flow characteristics set out in paragraphs B4.1.23 and B4.1.24; and (c) the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments.

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