EFRAG
European Financial Reporting Advisory Group

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This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

IFRS 9 PIR – Analysis of issues identified
Issues Paper

Objective

1 The objective of this paper is to develop an assessment of the technical merits of the selected issues as input for the PIR of IFRS 9 *Financial Instruments*, i.e., to identify the issues deserving standard setting activities.

Categorisation of the issues

2 EFRAG has divided the list of issues reported into five categories:

(a) Category A: issues where the existing EFRAG position can be repeated;

(b) Category B.I: issues for which standard setting is required as a priority in the PIR (including a possible indication on whether we would suggest to amend the standard or to issue education material, or other actions);

(c) Category B.II: issues for which standard setting is required but which can be addressed later than the PIR of IFRS 9 (including a possible indication on whether we would suggest amending the standard or to issue education material, or other actions);

(d) Category C: issues for which the EFRAG Secretariat has identified some prevalence; and

(e) Category D: issues which are inherently complex and/or standard setting would not necessarily lead to a favourable cost-benefit trade-off.

3 In assessing whether the requirements have improved financial reporting, the IASB will consider the following questions:

(a) are the requirements working as intended?

(b) are the requirements capable of being applied consistently? and

(c) are there any significant unexpected effects, either positive or negative.

Issues categorised as requiring standard setting as a priority in the PIR (Category B.I)

4 The following issues have been put forward by EFRAG TEG:

	Issue	***Criterion***
2	Sustainable finance – SPPI test	Requirements not working as intended
3	SPPI – use of administrative rates	Inability to apply requirements consistently

	Issue	***Criterion***
5	Business model – sales – COVID (merged with issue 18 – COVID moratoria)	Unexpected effects
6	Contractually linked instruments – non-recourse	Inability to apply requirements consistently
20	Supply chain financing – reverse factoring	Inability to apply requirements consistently
9 ***new***	Factoring of trade receivables	Inability to apply requirements consistently

Issue for discussion

10 ***new***	FVOCI business model	Too complex to apply and not conceptually robust

Issues categorised as requiring standard setting but to be addressed later (Category B.II)

5 The following issues have been put forward by EFRAG TEG:

	Issue	***Criterion***
12	Modifications of cash flows – merged with issue 19 (Accounting for TLTRO III)	Inability to apply requirements consistently
21	Financial guarantees	Inability to apply requirements consistently

Assessment of the issues

6 During its meeting of 14-15 July 2021 EFRAG TEG considered the views from EFRAG FIWG. It was suggested to split the list of issues between those that require an urgent treatment and those that can be addressed in a later stage. EFRAG TEG's views on the topics can be summarised as follows:

Nº	**Topic**	**EFRAG TEG View (summary)**
(2)	Sustainable finance – SPPI test	Prevalent issue in Europe. **To be reported to the IASB** in the response to the RFI.
(3)	SPPI – use of administrative rates	Prevalent issue in Europe. **To be reported to the IASB** in the response to the RFI, in connection with a possible broader discussion whether the borderline between amortised cost and fair value is still considered appropriate. EFRAG TEG members were divided whether this issue should be addressed through standard setting or via educational material.
(5)	Business model – sales – COVID 19	It would be very difficult to request standard setting for this issue. More a stress-test situation for the "held to collect and sale" criterion for HTC than an issue per-se. Need to re-discuss the topic.

(6)	Contractually linked instruments – non-recourse	**To be reported to the IASB** in the response to the RFI. IFRS 9 leaves structuring opportunities.
(20)	Supply chain financing – reverse factoring	**To be reported to the IASB** in the response to the RFI. Setting disclosure requirements (as the IASB is proposing) would not solve the issue.
(12)	Modification of cash flows	Prevalent issue in Europe (e.g., forbearance practices in banking). **To be reported to the IASB** in the response to the RFI. Possibly lower priority, however, to be reported as IFRS 9 lacks guidance.
(21)	Financial guarantees	**To be reported to the IASB** in the response to the RFI. Possibly lower priority, however, to be reported as IFRS 9 lacks guidance.
(12)	Accounting for TLTRO III	Not to be included as a separate issue (rather an example of the issue of modification)

(2) Sustainable finance – SPPI test

7 IFRS 9 does not currently specify if sustainable products[1] should be accounted at fair value when they fail the SPPI test. Banks might be indirectly discouraged from mainstreaming this type of lending.

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

9 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;

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

(d) As issuers some groups benefit from a growing interest of investors, that could have the same challenges if their benchmark is to carry at amortised cost these bonds.

10 In order to illustrate the above accounting issue, reference is made to paper 01-03C which contains examples of ESG or green financial assets.

11 In a reaction to paragraph 26 of paper 01-03C one EFRAG FIWG member clarified that project finance structures where the underlying asset is a windfarm are currently accounted by them for as passing the SPPI-test.

[1] Green bonds, green loans, green deposit products etc.

[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.

12 The EFRAG FIWG member noted these structures are considered by them as non-recourse. When the underlying windfarm performs well a fixed or variable interest rate is being paid. In case there would be an underperformance there is sufficient equity to absorb losses.

EFRAG Secretariat analysis

13 The issue of bonds and loans with interest rate or other features linked to the achievement of ESG targets of the issuer or linked to the proceeds of an ESG project was not widespread at the time the C&M criteria were designed by the IASB. From the perspective of the holder, the application of the SPPI test or of the contractual linked test in IFRS 9 may result in these instruments failing to be eligible for classification at amortised cost or at fair value through OCI, unless the entity demonstrates that the feature under investigation has an indirect credit risk nature (e.g., the reduction of interest rates reflects a lower credit risk that accompanies the achievement of the ESG target).

14 The EFRAG Secretariat notes that the following contractual features could impact the SPPI test: interest rate indexed to other non-interest variables or the limitation of a creditor's claim to specified assets of the debtor or to the cash flows from specified assets.

15 In addition, for the insurance industry a pervasive area of concern could relate to investments carried at held to collect and sell (FVOCI), backing traditional with profits insurance policies. Unit-linked products which are carried at fair value would be less problematic.

16 In cases of step-up interest rate bonds where these ESG or green feature provide compensation for basic lending factors 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 necessarily in conflict with the SPPI requirement as long as a link can be demonstrated between 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.

17 The EFRAG Secretariat considers 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[3]) and whether the inclusion of such features is consistent with a basic lending arrangement.

18 In addition, the EFRAG Secretariat understands that, while the impact of such ESG triggers can in many cases still be considered as de minimis today (due to the relative size of the volatility introduced by the incentive), their impact is to increase in the near future as pressure builds for obtaining the climate change related targets.

A possible alternative approach?

19 The EFRAG Secretariat has collected views to explore whether the ESG feature could be separated from the financial asset and treated differently, such as an intangible asset.

 (a) In order to illustrate the above assessment, the EFRAG Secretariat has received the following example: A bank will lend money to an entity for 5 years at 3%. Alternatively, if the entity commits to certain ESG conditions so that the

[3] 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.

bank can classify its lending as ESG compliant it can borrow money for 5 years at 2.92%.

(b) In this example, the bank should classify the 3% interest rate as a basic lending product which will pass the SPPI-test and the net present value of the interest rate reduction of 0.08% should be classify as the cost of an intangible asset (as it is what the bank is "*paying or not earning*" to be able to classify its lending as green and by extension be aligned with the European public good of ''financing the green economy' in the long-term)

(c) The EFRAG Secretariat has analysed the characteristics of this 0.08% gap.

(i) Under paragraph B5.1.1[4] of IFRS 9 the reduced payment of 0.08% is for something other than the financial instrument. As the ESG feature is without physical substance it should be considered for recognition based on IAS 38 *Intangible Assets* Standard.

(ii) Under paragraph 8 of IAS 38 "an intangible asset is an identifiable non-monetary asset without physical substance." To be considered for recognition as an intangible asset the ESG feature must fulfil the definition of an Intangible asset. The important parts of that asset are:

- Identifiable;
- Non-monetary;
- Without physical substance; and
- An asset.

(iii) The ESG feature is contractual and the loan together with the ESG feature is separately transferable for the bank. The identifiability requirements of paragraph 12 in IAS 38 can thus be argued to be fulfilled.

(iv) It could be argued that the ESG feature, based in a financial instrument is a monetary asset and thus not an intangible asset. However, as the ESG feature according to IFRS 9.B5.1.1 is separated from the monetary instrument it can be argued that the ESG feature in not itself a monetary asset and thus passes the non-monetary requirement.

(v) It is rather clear that the ESG feature is without physical substance (i.e., compared to PPE).

(vi) For some of these features, it can be argued that those are an asset to the bank. It might give benefits in the future (cheaper capital requirements, positive public image, among others) and at the present these economic resources are contractually controlled by the bank. Thus, an argument can be made that the ESG feature could qualify as an intangible asset to the bank. The issue thus becomes if it can be recognised as an asset by the bank.

(vii) Under paragraph 21 and 22[5] of IAS 38 the requirement for recognition is that it is probable that the expected future economic benefits that are

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[4] The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph B5.1.2A and IFRS 13). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. […] Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

[5] An intangible asset shall be recognised if, and only if:

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

attributable to the asset will flow to the entity and that the cost of the asset can be measured reliably. In the present example reliable measurement of cost is not an issue. Dependent upon which benefits is being identified from the ESG feature it might or might not be possible to demonstrate that it is probable that the identified expected future economic benefits will flow to the bank.

(viii) In case the requirements for recognition of an intangible asset are not met, payments that relate to the ESG component would result in an expense.

(3) SPPI – use of administrative rates

20 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.

21 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.

22 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.

23 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.

24 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.

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

26 In addition, one FIWG member provided the following outcome of discussions held about cost of funds pricing mechanisms:

(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

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(b) the cost of the asset can be measured reliably.

An entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

"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.

EFRAG Secretariat analysis

27 The EFRAG Secretariat notes the following:

(a) Situations such as in Sweden are not unique, the use of administrative rates occurs also in other jurisdictions;

(b) The use of benchmark rates has the advantage of standardisation, especially when developing a principles-based standard; and

(c) As the underlying components of administrative interest levels can be different from region to region or even from entity to entity, the analysis and standard setting becomes more complex, even rules based. Before standard setting can begin, further outreach on the main components of these rates will be required.

28 Notwithstanding these considerations, the EFRAG Secretariat is of the view that the IASB are to consider the use of administrative rates because using such rates is what is economically happening. The use of administrative rates will also have knock-on effects on the hedge accounting requirements, but these are out of scope of the current PIR.

(5) Business model – sales - COVID

29 Diversity in practice occurs on how to assess “frequent and significant sales” of financial assets under the business model held to collect.

30 In the context of COVID, significant volumes of non-performing loans have been sold to enhance the risk profile of the assets. More guidance is sought on how to assess changes in business models (whether sales of financial assets under the business model held to collect are permitted sales). This raises the question whether the standard should be applied differently in exceptional times compared to “ordinary” times. It has been suggested to address this through a question in the public consultation on the upcoming RFI.

EFRAG Secretariat analysis

31 The EFRAG Secretariat notes that in accordance with paragraphs B.4.1.3A and B.4.1.3B of IFRS 9 that a sale of assets when there is an increase in credit risk as well as for other reasons (such as to manage credit concentration risk) are consistent with a business model to collect contractual cash flows.

32 IFRS 9 requires financial assets to be reclassified between measurement categories when, and only when, the entity’s business model for managing them changes. IFRS 9 ring-fences the circumstances in which a change in the business model has occurred. For example, reclassifications would not be allowed by the mere fact that a market temporarily disappears or when the intention related to a particular financial asset changes in response to market conditions, if there is no evidence that the business model has changed.

33 The EFRAG Secretariat considers that COVID 19 has had an impact on the ability of many companies to pay back their loans. Hence, banks would take measures to protect their loan portfolios, including the sale of some of these loans.

34 However, EFRAG assessed on the IFRS 9 endorsement advice in 2015 that reclassifications triggered solely based on a change in intentions due to market

conditions would create tension in terms of reliability of the information. EFRAG was satisfied that IFRS 9 requires an entity to reclassify financial instruments if a change in business model has been decided in response to a change in market conditions. As a result EFRAG assessed the requirements for reclassification of financial assets as leading to relevant information.

(6) Contractually linked instruments – non-recourse

35 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.

36 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

37 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

38 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.

39 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.

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

41 In order to illustrate the above accounting questions, the EFRAG Secretariat has received a number of examples:

(a) Examples 1, 2 and 3 are explained in paper 01-03A;

(b) Examples 4, 5 and 6 are explained below.

42 One EFRAG FIWG member provided the following examples:

43 Example 4 – P has a subsidiary S. S is a trading entity (e.g., in manufacturing). Its share capital is fully held by P but its fair value relative to the intra group loan is not significant. P almost fully funds its investment via a 5 year term loan for CU100M with a fixed interest rate. S has an “enterprise value” of CU101M at time of lending. S is a trading business. The contractual terms do not directly have any non-recourse impact. However in substance, whether the loan is repayable in full might be linked to the enterprise value of S; thus if the “equity” share value of S falls it would be unable to pay the debt.

44 Example 5 – same as example 4 except S is a property company, which holds a single asset.

45 Example 6 – P has an associate with a 30% holding in Y. Y is a manufacturing entity. Y’s shares are listed on a stock market. The market capitalization of Y on 1 Jan X0 is CU5M. In order to allow a significant expansion, P lends CU30M to Y. The loan has a fixed interest rate of 5%, and is due for bullet repayment in 5 years time.

46 It is noted that in example 4, there is indirect exposure to the equity value of the borrower (a subsidiary) where subsidiary is mainly funded by intra group borrowings (ie with negligible headroom). In this case the subsidiary is just a normal trading entity.

47 Example 5 is similar except that the subsidiary is a property company holding a single asset. Here the question arises whether the nature of the type of borrower is relevant in particular if the borrower has exposure to particular assets, with the effect that the loan has similar exposure to those assets.

48 In example 6, the lender lends to an associate, where that associate is listed on a stock market. In case it is considered that example 4 is still SPPI, does the principle have any difference if the borrower's equity prices are traded (i.e., creating a more visible exposure to share prices)

49 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.

EFRAG Secretariat analysis

50 The EY handbook notes that "*Because of the way the standard is written the outcome of the contractual cash flow characteristics assessment will depend on the form of the arrangement. Arrangements which involve using multiple contractually linked instruments should be assessed under the contractually linked instruments requirements while arrangements with non-recourse features but without multiple tranches should be assessed under the non-recourse requirements.*"[6]

51 Hence the accounting outcome may be different depending on the structure used. This is demonstrated by the examples in paper 01-03A, whereby it is noted by constituents that the CLI criteria seem to be more aimed at public securitisations with many debt tranches.

52 However, the assessments do not stop there. The KPMG handbook notes that *"Judgement is required in assessing whether a non-recourse asset meets the SPPI-criterion. In our view, the underlying purpose of the assessment is to identify cases in which the financial asset is intended to provide the holder with a return based on the performance of specific assets or another variable that does not represent exposure to and compensation for a basic lending arrangement and therefore fails the SPPI-criterion*"[7].

53 The KPMG handbook provides a non-exhaustive list of factors to be considered in applying judgement:

(a) *"Whether the contractual arrangement specifically defines the amounts and dates of the cash payments of the loan;*

(b) *The fair value of the collateral relative to the amount of the secured financial asset;*

(c) *The ability and willingness of the borrower to continue to make contractual payments on the secured financial asset, notwithstanding a decline in the value of the collateral;*

(d) *Whether the borrower is an individual or a substantive operating entity or is a special purpose-entity;*

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[6] EY International GAAP 2019, Volume 3, Chapter 44, paragraph 6.6., page 3639

[7] KPMG Insights into IFRS, 2020/2021 Volume 2, paragraph 7.4.320.70, page 2051.

(e) *The risk of loss on the secured limited financial asset relative to a full-recourse loan to the debtor;*

(f) *Whether another party has contributed sufficient equity to absorb expected losses before affecting the ability of the borrower to make payments on the loan;*

(g) *The manner in which the lender evaluates and manages the risks and benefits of secured financial assets of the same type as part of its business model;*

(h) *Whether the spread is reasonable and similar to other loans that are full-recourse basic lending arrangements;*

(i) *Whether the lender will benefit from any upside from the underlying asset(s); and*

(j) *The extent to which the collateral represents all or a substantial portion of the borrower's assets."*

54 Based on the many potential elements to be considered as illustrated above, the EFRAG Secretariat is of the view this issue should be considered by the IASB as deserving standard setting activity.

(20) Supply chain financing -reverse factoring

55 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.

56 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.

57 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.

58 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?

59 In this regard, IDW in its comment letter to the IFRS IC noted: "…*in our view, a more specific reference to the derecognition guidance in IFRS 9 and an explanation of the interaction with the presentation of the liability in accordance with IAS 1 could provide a basis for a more robust reporting approach for such transactions. It would be necessary to focus on legal extinguishment as well as on substantial modifications. In respect of substantial modifications, the quantitative test would generally not lead to derecognition, whereas a targeted qualitative assessment may nevertheless warrant the derecognition of the trade payables. Any recognised 'new' payable could then not be classified as a 'trade payable'. We recommend some specific guidance be given concerning how the qualitative assessment should be conducted for trade payables –that generally have an effective interest rate of zero. For example, the introduction of an element of interest may lead to the derecognition of the trade payables and trigger the recognition of a payable depicting a financing transaction.*"

60 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.

61 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.

62 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.

63 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.

EFRAG Secretariat analysis

64 In June 2021 the IASB tentatively decided to add a narrow-scope standard setting project with regard to supplier finance arrangements, however not go beyond such arrangements.

65 The IASB tentatively decided to propose amending IAS 7 *Statement of Cash Flows* to add:

(a) An overall disclosure objective: to help users of financial statements understand the nature, timing, and uncertainty of cash flows arising from supplier finance arrangements; and

(b) Specific disclosure objectives:

(i) To provide quantitative information that help users of financial statements determine the effects of supplier finance arrangements on an entity's financial position and cash flows; and

(ii) To provide qualitative information to help users of financial statements understand the risks that arise from supplier finance arrangements.

(9 - new) Factoring of trade receivables

66 Commonly occurring fact pattern description:

67 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.

68 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.

EFRAG Secretariat analysis

69 In June 2021 the IASB tentatively decided to add a narrow-scope standard setting project with regard to supplier finance arrangements, however not go beyond such arrangements.

70 The IASB staff paper leading to that tentative decision noted (IASB staff paper 12A, June 2021, paragraphs 56 and 57):

(a) The input and feedback received revealed no significant investor information concerns about receivables or inventories financing arrangements. Although some investors mentioned a desire for improved information about factoring arrangements, some also said they already obtain information about those arrangements;

(b) IFRS 7 already includes requirements applicable to some types of receivables financing arrangements – paragraphs 42A-42H of IFRS 7 contain disclosure requirements for transfers of financial assets that are not derecognised and for any continuing involvement in a transferred asset.

Issue for discussion

(10 - new) FVOCI business model

71 In the view of some the business model 'held to collect and sell' is an unnecessary variant of the business models held to collect on the one hand and trading on the other hand. As a result, according to those that hold this view, it is difficult to understand what the rationale for such a business model is.

72 Further information on the perceived shortcomings of this business model can be found in Appendix 01-03B.

EFRAG Secretariat analysis

73 IFRS 9, paragraph B4.1.4A provides some background to the FVOCI business model, i.e., a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. There are various objectives that may be consistent with this type of business model. For example, the objective may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding.

74 The EFRAG Secretariat obtained the following statistical information on the use of the FVOCI-model by EU banks.

75 Banks normally use this classification for their liquidity portfolios; as such this business model is considered necessary to represent their banking activity. While there are important differences between banks of different Member States, the average use of the FVOCI-category by banks is around 4% of total assets (on a sample of 93 banks). As confirmed by EFRAG IAWG members in their meeting of 9 September last, the expected use by insurers of the FVOCI business model in IFRS 9 is much higher.

Country	Sample Banks	thereof: No debt instruments at FVOCI	Debt Instruments at FVOCI / Total Assets
			FQ2 - 2021
Lithuania	1	-	*1.56%*
Netherlands	2	-	*6.62%*
Austria	7	-	*5.96%*
Croatia	1	-	*N/A*
Ireland	-	-	*N/A*
Finland	4	-	*8.26%*
Poland	6	-	*16.71%*
Greece	4	-	*N/A*
Estonia	2	1	*0.18%*
Italy	13	-	*5.29%*
Romania	2	-	*25.09%*
Spain	5	-	*5.04%*
Portugal	1	-	*15.16%*
Cyprus	2	-	*N/A*
Malta	-	-	*N/A*
France	10	1	*1.07%*
Bulgaria	3	-	*3.55%*
Sweden	5	3	*0.07%*
Germany	3	-	*5.35%*
Denmark	17	16	*0.18%*
Slovenia	2	-	*16.55%*
Belgium	1	-	*4.49%*
Czechia	1	1	-
Hungary	1	-	*N/A*
AVG (EU)			***4.08%***
# Observations	93	22	*55*

Source: University of Mannheim / Business School (data on quarterly basis)

Issues categorised as requiring standard setting but to be addressed later (Category B.II)

(12) Modifications of cash flows

76 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.

77 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.

78 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.

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

80 EBA issued the guidance on forbearance of loans in October 2018. For that reason, banks should monitor loans modified after forbearance[8] and provision them on a one-to-one basis.

81 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).

82 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.

EFRAG Secretariat analysis

Treatment as non-substantial changes

83 The EFRAG Secretariat notes there is not sufficient guidance as for financial liabilities to determine whether a modification of cash flows for financial assets is substantial.

84 An example on a modification of cash flow could be illustrated as follows:

(a) A bank enters into a 15-year loan with a borrower (measured at amortised cost or fair value through other comprehensive income). The loan accrues interest at 4%.

(b) At the end of year 10, as a result of an arm's length renegotiation, the remaining maturity has been modified from 5 years to 10 years (5 additional years), and the coupon has been revised to 2% to maturity.

(c) The borrower is not in any financial difficulty and there is no objective evidence of impairment (under IAS 39). In addition, the loan has not suffered a significant increase in credit risk (under IFRS 9).

85 Under those circumstances, the EFRAG Secretariat considers that there could be different accounting approaches:

(a) The entity has surrendered its rights to the 4% coupon for the next 5 years and the principal repayment in 5 years' time. In this situation, the rights to these cash flows have ***expired***, and, so they should be ***de-recognised*** as there has been a ***substantial modification of the contract terms (and by extension the cash flows)***.

Finally, A ***new*** 10-year ***loan should be recognised*** at fair value on renegotiation (refinance), comprising a new principal payment in 10 years' time and 2% interest coupons for the next 10 years.

(b) The entity has modified its rights to the 4% coupon for the next 5 years and the principal repayment in 5 years' time. In this situation, the rights to these cash flows have been ***re-estimated***, as there has ***not*** been a ***substantial modification of the contract terms (and by extension the cash flows)***.

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[8] In Europe there are three sets of rules for categorising forbearance or problem loans:

a) the IFRS 9 rules for allocating credit risk exposure to Stage 2 and 3

b) the rules on capital definition of default (including article 178 in the CRR and new EBA rules due to come into force by end 2020); and

c) the FINREP definitions, which also underpin the ECB/EBA rules regarding the management and disclosure of non-performing loans.

Finally, the ***old*** 15-year ***loan should be re-estimated*** at fair value comprising a modified principal payment in 20 years' time and 2% interest coupons for the next 10 years. In this case, the cash flows should be modified with the modified coupon and ***a loss (or profit) should be recognised in the profit or loss,*** as defined in paragraph 5.4.3 of IFRS 9.

86 In current practice, some banks tend to use the option described in paragraph 85 b) to account for changes either on the length or interest rate (or both) of the loans. Banks consider that there has not been a substantial modification of the contractual terms of the loans. However, it is important to mention that in most cases, the loans that underwent a substantial modification are categorised in Stage 3 of ECL, so banks have already recognised a write-off in the profit or loss before the re-estimation of the loan.

10% test

87 The EFRAG Secretariat considers that for financial liabilities, as explained in paragraph 78, the IASB gives guidance on when a substantial modification of cash flows occurred. However, because of the interaction between derecognition and impairment requirements or situations of forbearance, it may not be appropriate to apply the same 10% threshold.

88 On May 2012 the IFRS IC issued a tentative agenda decision (TAD) on IAS 39 *Financial Instruments: Recognition and Measurement* - Accounting for different aspects of restructuring Greek Government Bonds (GGB). The AP analysed whether a portion of the old GGBs that was exchanged for twenty new bonds with different maturities and interest should be derecognised, or conversely accounted for as a modification or transfer that would not require derecognition.

89 Even if this issue was analysed under IAS 39 not IFRS 9, the IFRS IC concluded on its September 2012 meeting, that the old GGBs should be derecognised as the terms and conditions of the new bonds were substantially different from those of the old bonds. The changes included many different aspects, such as the change in governing law; the introduction of contractual collective action clauses and the introduction of a co-financing agreement that affected the rights of the new bond holders; and modifications to the amount, term and coupons. The IFRS IC determined that it was not necessary to apply the 10% to derecognise those instruments.

Floating/fixed rates

90 Also, in situations where a modification does not result in a derecognition differences in application arise. In the view of some an entity may choose an accounting policy to apply the guidance on floating rate financial instruments to changes in cash flows resulting from the modification of a floating rate component under the original contractual terms to a new rate of interest (whether floating or fixed) that reflects current market terms. Under such a policy the original EIR of the financial asset is revised, based on the new terms, to reflects changes in cash flows that reflect periodic changes in market rates.

91 However, in situations where a modification changes floating cash flows into fixed ones or vice-versa differences in practice are seen on either applying paragraph B5.4.5 (floating rates) or B5.4.6 (fixed rates) of IFRS 9 to the modified cash flows.

(21) Financial guarantees

92 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.

93 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.

EFRAG Secretariat analysis

Perspective of the holder of the guarantees

94 The EFRAG Secretariat considers when the entity holds a financial guarantee that is ***not an integral*** *element* of another financial instrument and as a consequence is not in the scope of IFRS 9, could be accounted:

(a) If the financial guarantee contract is ***not measured at FVPL***. By analogy to the guidance of reimbursement in IAS 37, as stated in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 10[9] the following should apply:

(i) If the ***loss has not occurred***. The EFRAG Secretariat considers that the entity should recognised a compensation right when it recognises the related ECL, providing that is almost certain that the compensation will be received in the credit loss is actually suffered; and

(ii) If the ***loss has occurred***. The EFRAG Secretariat considers that there are amounts not covered by the financial guarantee contracts, the asset recognised for the compensation should be limited to the impairment loss covered by the financial guarantee contract.

[9] In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable.

(b) If the financial guarantee contract is ***measured at FVPL***. The EFRAG Secretariat considers that the entity should recognise a compensation right in measuring the fair value of the guarantee.

95 When the entity holds a financial guarantee that can be considered as *an* ***integral*** *element* of another financial instrument and as a consequence cannot be recognised separately.

96 In some of the cases mentioned above, the financial guarantee is not included in the contractual terms of the debt instrument. In those cases, judgement is required to assess whether the financial guarantee is an integral element of the financial instrument.

Compensation rights

97 Differences in practice are reported in accounting for compensation rights that relate to non-integral financial guarantees. Differences witnessed:

(a) Allocation of all or part of the premium paid to acquisition of the recognised compensation right. In this case, all or part of the premium paid is viewed as consideration for acquisition of the recognised compensation right; or

(b) No allocation of any part of the premium paid to acquisition of the compensation right. In this case, the premium and the compensation right are viewed as separate assets. The entire premium is considered as payment for coverage to be provided over the period of the guarantee.

Guarantees issued

98 When an issuer holds a financial guarantee contract, under IFRS 9 should account:

(a) Initial recognition: at fair value if the contract is issued in a standard-alone arm's length transaction to an unrelated party, the initial fair value would be equal to the premium received.

(b) Subsequent measurement: it is one of the exclusions for financial liabilities to be measured at amortised cost (paragraph 4.2.1 c of IFRS 9). In those cases, the measurement should be the higher of:

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

(ii) the amount initially recognised (see paragraph 5.1.1 of IFRS 9) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.

99 However, the EFRAG Secretariat noted that there is no guidance on how the requirements explained in paragraph 93 should apply if the issuer does not receive all of the premium at initial recognition. For consistency, those contracts should be accounted on:

(a) Gross basis: the issuer recognises a liability for its obligations to provide assurance to the holder in line with paragraph 90 (the fair value measurement is likely to be equal to the sum of the premium received and the future premiums receivable); or

(b) Net basis: the issuer recognises a net amount in line with paragraph 91.

100 The EFRAG Secretariat acknowledges that in those cases where the net basis approach is applied, the amount initially recognised should be increased by any late premium received, so all premiums received are considered when measuring a financial guarantee.

101 Additionally, when account under net basis, the ongoing recognition of income in accordance with the principle of IFRS 15, may cause that the cumulative amount of income recognised, exceeds the cumulative amount of premiums received to date.

102 Under those premises, the EFRAG Secretariat considers that IFRS 9 does not specify how 'the higher of' (see paragraph 98 (b) should be applied under those circumstances and the entity should choose between the accounting policy of:

(a) Excluding the accrued amount for '*the higher* of' measurement and recognise it as a receivable separately from the financial guarantee contract liability; or

(b) Treating the accrued amount as representing a negative balance of '*the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15*' (paragraph 4.2.1 (c) (ii) of IFRS 9).

Appendix 1: Short description of remaining issues

103 The paragraphs below provide a short description of issues categorised as C or D.

Category C: Issues for which the EFRAG Secretariat has identified some prevalence

104 The EFRAG Secretariat identified the following issue:

	Issue	***Criterion***
16	*Benchmark test for last-reset rates due to IBOR reform*	*Requirements cannot be applied consistently*

Category C: Issues for which the EFRAG Secretariat has identified some prevalence

Issue 16 – Benchmark test for last-reset rates due to IBOR reform[10]

105 Entities may identify the need to perform the SPPI benchmark test for significance of interest mismatches between:

(a) the last reset rates containing a time lag feature due to being calculated and known in advance at the start of the current interest period as averages of risk-free overnight rates over the previous interest period; and

(b) rates representing time value of money due to being calculated based on the risk-free rates development in the current interest period (known at the end of the period).

106 The issue would arise separately for:

(a) legacy portfolios which are subject to the IBOR rates replacements falling back to the last rest rates; and

(b) new portfolios where entities decide to use the last reset rates.

107 The issue raised is:

(a) whether and to what extent the need to perform the quantitative benchmark test arises and whether this brings any inappropriate burden to entities; and

(b) whether there are any failures in the SPPI benchmark test resulting in non-SPPI financial assets measured at FVPL to the extent which entities would not consider as appropriate since they deem them as basic lending agreements from business perspective.

Category D: Issues which are inherently complex and/or standard setting would not lead to a favourable cost-benefit trade-off

108 The EFRAG Secretariat identified the following issues:

	Issue	***Criterion***
4	*Business model – boundary HTC /HTCS (liquidity buffers banks – loan syndicates)*	*Requirements cannot be applied consistently*
7	*Reclassification and IFRS 5 – scope of IFRS 9*	*Requirements not working as intended*

[10] The issue of application of the SPPI test to particular rates has been discussed at EFRAG TEG and FIWG in the course of drafting the comment letter on the Phase 2 IBOR exposure draft (ED/2020/1). EFRAG concluded that an assessment of such rates would go beyond the scope of the IBOR project and is rather a general issue in the context of SPPI assessment.

8	*Credit risk*	*Requirements cannot be applied consistently*
11	*Prepayments*	*Requirements cannot be applied consistently*
15	*Reporting gains on gross basis*	*Requirements not working as intended*
17	*Measurement of derivatives to meet obligations to policyholders (merged with issue 14 embedded derivatives)*	*Requirements not working as intended*

FIWG feedback

109 EFRAG FIWG members agreed with the descriptions of the issues raised below as well as to submitting these to the IASB without assessment.

Issue 4 – Business model – boundary HTC/HTCS (held to collect/held to collect and sell)

Liquidity buffers of banks

Transfer between banking departments

110 Transfers within a group: in the context of liquidity management, market and investment banking departments happen to purchase financial assets such as securities. Those assets are then resold to the retail departments (of the same group) to meet their day-to-day liquidity management needs and their liquidity portfolio management. At the acquisition date, those assets are held within a business model that is neither HTC nor HTCS and thus, are measured at FVPL. However, after being transferred, those assets are usually held within a HTC business model but their classification cannot be changed to amortised cost. Amortised cost measurement would apply only if the retail departments were to acquire the financial assets directly, but this would be made at a higher cost.

Reclassification in periods of stress

111 In cases of market stress, the classification of these bonds can vary significantly depending on the business model chosen. It was noted that for financial assets – part of a liquidity buffer of a bank – the reclassification requirements in these circumstances are a too high hurdle and the change is very difficult to demonstrate to external parties.

112 It was suggested to identify the HTC business model as a default category, while FVPL would be redefined as trading.

Loan syndications

113 Before the syndication, the entity determines the portion of loans it expects to retain and the portion it expects to sell considering all relevant information at that date. This assessment determines the portion of the loans that are held in HTC and in HTCS business models, and if the loans meet the SPPI criterion, the portions of loans that are measured at fair value or at amortised cost. However, the portion of loans sold may differ from the entity's expectations. Applying paragraph B4.1.2A, this does not change the classification of the financial assets. When the entity sells a lower portion of loans than expected, it is required to continue to measure the excess unsold loans at FVPL while amortised cost would provide useful information in those circumstances.

Issue 7 – Reclassification and IFRS 5 – scope of IFRS 9

Level at which an entity's business model is determined

114 This question arises when an entity also applies the requirements in IFRS 5. For example, a subsidiary holds financial assets within a HTC business model and the subsidiary is also classified as held for sale applying IFRS 5. In those circumstances, there is a question about whether the reporting entity (i.e., the consolidating entity) continues to consider that the financial assets of the subsidiary are held within a HTC business model. In November 2016, the IFRS-IC held the view that an entity assesses its business model for the purpose of classifying financial assets from the group perspective but did not publish any TAD. If the Committee's view were to be applied and if the financial assets were to meet the SPPI criterion, the entity would be required to change the classification of those assets from amortised cost to FVPL. Some stakeholders question whether such reclassification would provide useful information and question whether the benefits of that reclassification would exceed its implementation costs. Those stakeholders think that the Board should consider this matter in the context of the PIR of IFRS 9, rather than in the context of the PIR of IFRS 5—amending IFRS 9 could address the matter.

Business model changes over time

115 Paragraph 4.4.1 of IFRS 9 requires an entity to reclassify financial assets when, and only when, the entity changes its business model for managing those financial assets. In practice, the requirements in IFRS 9 'freeze' the business model within which financial assets are held when they are originated—unless a change in business model occurs (rare in practice). Those requirements may be considered as very stringent in some specific circumstances. Those requirements represent an entity's expectations, at the origination date, about the business model within which it will hold a financial asset but does not necessarily reflect the business model within which that asset is held afterwards.

Issue 8 – Credit risk

116 Diversity in practice is noted how entities disclose their credit risk exposure between financial assets measured at FVPL and those measured at FVOCI.

Issue 11 - Prepayments

117 Diversity in practice was noted in how entities apply the guidance on prepayment features with negative compensation.

Issue 15 – Reporting gains on gross basis

118 The performance of the banks is not reflected when there is an obligation of the banks to allocate gains on gross basis to certain beneficiaries. In addition, those gains on debt instruments sold should be reported on a gross basis in the PL when such gains are not distributable to banks' shareholders.

119 According to some, this information is not useful enough mainly related to insurance activities.

Issue 17 - Measurement of derivatives to meet obligations to policyholders (written input)

120 As an alternative to the application of hedge accounting, the current classification and measurement requirements in IFRS 9 for derivatives could be reviewed to better reflect the risk management, in particular of the interest rate risk, that insurance companies have had in place for a very long time. Measuring all derivatives at FV-PL leads to volatility and is difficult to explain the performance when all the remaining investment portfolios of insurers will be measured at FV-OCI. As an

alternative treatment, a specific scope of derivatives could be measured at FV-OCI if certain conditions are met.