EFRAG
European Financial Reporting Advisory Group

IFRS 9 *Financial Instruments – Classification and Measurement* – Post-implementation Review

You can submit your comments on EFRAG's draft comment letter by using the '<u>Express your views</u>' page on EFRAG's website, then open the relevant news item and click on the 'Comment publication' link at the end of the news item.

Comments should be submitted <u>by 14 January 2022</u>.

International Accounting Standards Board
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

[XX January 2022]

Dear Mr Barckow,

Re: Request for Information – *Post-implementation Review of IFRS 9 – Classification and Measurement*

On behalf of the European Financial Reporting Advisory Group ('EFRAG'), I am writing to comment on the *Request for Information - Post-implementation Review, IFRS 9 Financial Instruments – Classification and Measurement,* issued by the IASB on 28 September 2021 (the 'RFI').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

EFRAG considers that the combination of the cash flow characteristics of the assets together with the assessment of the entity's business model has proved to generally provide an appropriate basis to align the measurement of financial instruments with how they are managed by the entity. However, there are some areas that require attention, illustrated below.

In EFRAG's view, the IASB should re-evaluate whether the classification and measurement principles and the accompanying guidance in IFRS 9 have kept up with e.g., recent market developments (i.e., financial assets with ESG features, the use of administrative rates).

EFRAG has been made aware of some circumstances where the application of the business model concept is challenging. However, EFRAG does not consider that further standard-setting activity is needed, as overall the existing IFRS 9 requirements result in appropriate outcomes.

EFRAG considers that the effective interest rate method generally provides useful information. EFRAG notes that IFRS 9 includes scope limitations or corrections to the method for particular financial instruments. EFRAG also notes that more and more financial instruments incorporate clauses that may affect the future contractual interest cash flows when being fulfilled (or when they fail to be fulfilled) by the reporting entity or a third party. Examples of such financial instruments that are often found in Europe include: Targeted Longer-Term Refinancing Operation ('TLTRO') loans and ratchet loans. The application of the effective interest rate method poses practical challenges for both the initial and subsequent measurement of these kind of financial instruments.

Outreach with constituents and preparatory work to this Draft Comment Letter has led EFRAG to identify a number of issues that arise from the application of the requirements in IFRS 9 to fact patterns that are prevalent in Europe and, as such, deserve standard-setting activities (such as amendments to the standard or educational guidance). Some of those issues are already discussed in the RFI, while others are not.

These issues are (in order of the question of the RFI to which they refer[1]):

(a) Sustainable finance – SPPI test (ref. Spotlight 3.1 and Question 3 of the RFI, High priority, amendments to IFRS 9 requested);

(b) Contractually linked instruments – non-recourse (ref. Spotlight 3.2 and Question 3 of the RFI, Medium priority, amendments to IFRS 9 requested);

(c) SPPI – use of administrative rates (issue not mentioned in the RFI, Medium priority, educational guidance or amendment to IFRS 9 requested);

(d) Recycling changes in FV accumulated in OCI for equity instruments (ref. Spotlight 4 and Question 4 in the RFI, High priority, amendments to IFRS 9 requested);

(e) Treatment of equity-type instruments (issue not mentioned in the RFI, High priority, amendments to IFRS 9 requested);

(f) Modification of cash flows (ref. Question 6 of the RFI, Medium priority. For this issue EFRAG is seeking views from constituents on whether amendments to IFRS 9 should be considered);

(g) Factoring of trade receivables (issue not mentioned in the RFI, Medium priority, educational guidance and amendments to the applicable standard(s) requested);

(h) Supply-chain financing – reverse factoring (issue not mentioned in the RFI, High priority, amendments to the applicable standard(s) requested);

(i) Financial guarantees (issue not mentioned in the RFI, Low priority. For this issue EFRAG is seeking views from constituents on whether educational guidance or amendments to the standard should be considered).

Questions to constituents

The issues of sustainable finance-SPPI test, recycling changes in FV accumulated in OCI for equity instruments, treatment of equity-type instruments and supply chain financing are indicated as high priorities. Modification of cash flows, contractually linked instruments – non-recourse, factoring of trade receivables and use of administrative rates are indicated as medium priorities. Finally, financial guarantees are indicated as a low priority. Do you agree with the issues raised and their prioritisation as indicated above? Please explain.

Do you consider that there are other issues that deserve standard-setting activities? Please provide an illustration.

The Appendices provide detailed feedback on these issues.

EFRAG brings to the attention of the IASB in particular the following, which relates to the some of the issues listed above:

- Application of the SPPI test to sustainable finance products: it is expected that this issue will be so pervasive in Europe that, in EFRAG's view, it should be lifted from

[1] EFRAG has identified the issues raised and their prioritisation based upon a consultation of EFRAG TEG, EFRAG working groups and EFRAG CFSS, as well as of auditors.

the PIR process and treated as an urgent issue separately, so that the IASB can start working on it without waiting for the completion of the RFI process. EFRAG confirms its commitment and willingness to assist the IASB in the assessment of this issue.

- EFRAG considers[2] the IASB should expeditiously review 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.
- EFRAG supports that similar fact patterns should be treated similarly, and notes 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*. EFRAG considers that any changes to the accounting for these instruments, aimed at allowing for equity and equity-type 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. As a working assumption, EFRAG has 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. EFRAG further understands that some constituents would consider a broader scope for such definition.

EFRAG's detailed comments and responses to the questions in the RFI are set out in the Appendices.

If you would like to discuss our comments further, please do not hesitate to contact Didier Andries, Almudena Alcalá, Galina Borisova or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

[2] EFRAG advice to the European Commission on alternative accounting treatments for long-term equity investments, January 2020.

Appendix 1 - EFRAG's responses to the questions raised in the RFI

Question 1 – Classification and measurement

Notes to constituents – Summary of proposals in the RFI

1 The IFRS 9 approach to classifying and measuring financial assets was developed in response to long-standing and widespread stakeholder views that the approach in IAS 39 was too rule-based and complex. IAS 39 had many classification categories for financial assets, each category with its own rules for determining which financial assets were required or permitted to belong in that category, and for identifying and measuring impairment. IFRS 9 provides a principle-based approach that applies to all financial assets. That approach aligns measurement with the contractual cash flow characteristics of the assets and the way the entity manages them. Measurement aligned to both these factors provides users of financial statements with useful information about the amount, timing and uncertainty of the entity's future cash flows.

2 The IASB retained the IAS 39 classification and measurement requirements for financial liabilities substantially unchanged in IFRS 9 because feedback suggested the requirements for financial liabilities in IAS 39 worked well. However, IFRS 9 addressed the one issue consistently raised by constituents regarding financial liabilities—the so called 'own credit issue' relating to gains and losses arising from changes in the credit risk of financial liabilities an entity elected to be measured at fair value through profit or loss.

Question 1 – Classification and measurement

Do the classification and measurement requirements in IFRS 9:

(a) enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?

(b) result in an entity providing useful information to the users of the financial statements about the nature, timing and uncertainty of future cash flows?

Why or why not?

Please provide information about the effects of the classification and measurement changes introduced by IFRS 9, including the ongoing costs and benefits in preparing, auditing, enforcing or using information about financial instruments.

This question aims to help the Board understand respondents' overall views and experiences relating to the IFRS 9 classification and measurement requirements. Sections 2–8 seek more detailed information on the specific requirements.

EFRAG's response

EFRAG is of the view that the classification and measurement requirements in IFRS 9 generally enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how an entity expects to manage them.

Nevertheless, there are areas of attention, such as the use of administrative rates, financial instruments with ESG features, etc, which are described in detail in our response to Question 3.

Question (a)

3 EFRAG is of the view that the classification and measurement requirements in IFRS 9 generally enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how an entity expects to manage them.

4 EFRAG notes that the effects of applying the solely payment of principal and interest ('SPPI') test cannot be assessed in isolation, as the SPPI test is a part of the broader classification exercise jointly with the business model test. The border between where amortised cost and fair value measurement are applicable has always been a highly debated issue. In its endorsement advice for IFRS 9 (September 2015), EFRAG considered that, except for a few cases, i.e. financial assets with interest mismatch features and certain types of subordinated debt instruments, the application of the SPPI test provides a sound basis to separate financial instruments into those that qualify for amortised cost and those that require fair value in the balance sheet.

5 However, EFRAG notes that (i) some economic characteristics of financial instruments were insufficiently considered when IFRS 9 was developed (administrative rates) and (ii) other economic characteristics evolve over time (e.g., financial instruments with ESG features). Some characteristics gain in prevalence, while others lose in prevalence (see our answer to Question 3). Hence, EFRAG welcomes this PIR as the right tool to re-evaluate whether the classification and measurement principles and accompanying guidance in IFRS 9 keep up with market developments.

Question (b)

6 As mentioned in our answer to Question 1 (a), EFRAG is of the view that the classification and measurement requirements of IFRS 9 generally provide useful information. However, EFRAG is also of the view that for some areas (as discussed under Questions 1 (a), 3 and 7) there is a need for improvement.

Question 2 – Business model for managing financial assets

Notes to constituents – Summary of proposals in the RFI

7 *In the context of IFRS 9, a 'business model' refers to how an entity manages its financial assets to generate cash flows — by collecting contractual cash flows, selling financial assets or both. Consequently, classification and measurement based on the business model provides information that is useful in assessing the amounts, timing and uncertainty of an entity's future cash flows*.

8 An entity determines the business model at a level of aggregation that reflects how it manages groups of financial assets to achieve a business objective. An entity's business model is typically observable through the entity's activities to achieve its business objective. An entity considers all available relevant evidence to determine the business model.

9 Changes in the classification and measurement of financial assets subsequent to initial recognition can make financial statements more difficult to understand, particularly when comparing information from period to period. Therefore, the IASB established conditions for reclassification that it intended would be met only on occurrence of a significant event. IFRS 9 requires financial assets to be reclassified between measurement categories when—and only when—the entity's business model for managing them changes. In accordance with IFRS 9, a change in business model is a significant event and is expected to be rare.

Question 2 – Business model for managing financial assets

(a) **Is the business model assessment working as the Board intended? Why or why not?**

Please explain whether requiring entities to classify and measure financial assets based on the business model assessment achieves the Board's objective of entities providing users of financial statements with useful information about how an entity manages its financial assets to generate cash flows.

(b) **Can the business model assessment be applied consistently? Why or why not?**

Please explain whether the distinction between the different business models in IFRS 9 is clear and whether the application guidance on the evidence an entity considers in determining the business model is sufficient.

If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) **Are there any unexpected effects arising from the business model assessment? How significant are those effects?**

Please explain the costs and benefits of the business model assessment, considering any financial reporting or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about reclassification of financial assets (see Spotlight 2).

EFRAG's response

EFRAG considers that the combination of cash flow characteristics of the assets together with the assessment of the entity's business model generally provides an appropriate basis to align the measurement of financial instruments with how they are managed by the entity.

EFRAG has been informed that in some circumstances the business model could not be applied consistently, however EFRAG does not consider that further standard-setting activity is needed as the existing IFRS 9 requirements result in appropriate outcomes.

Question (a)

10 EFRAG is of the view that the business model assessment is generally working as intended.

11 EFRAG noted above that it is impossible to assess the characteristics of the financial asset and the business model in isolation. EFRAG considers that the combination of cash flow characteristics of the asset together with the assessment of the entity's business model generally provides an appropriate basis to align the measurement of financial instruments with how they are managed. However, EFRAG has been informed that in some situations the business model assessment leads to outcomes not reflecting how the entity manages its financial assets. In particular, in the views of the constituents that reported these issues, these situations would require a change in a business model that is currently not allowed under IFRS 9 requirements. These issues are described below for information, however EFRAG does not consider it necessary to undertake further standard-setting activities to address them. Those situations were triggered by the following circumstances:

Liquidity buffers of banks (Transfer between banking departments within the same group).

12 In the context of liquidity management, market and investment banking departments may purchase financial assets such as securities. Those assets are then resold to the internal departments responsible for the banking book (of the same group) and held 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 held to collect nor held to collect and sell and thus, are measured at fair value through profit or loss (FVTPL). The constituents that reported this issue consider that after being transferred to the banking book, those assets are seen as held within an held to collect business model, but their classification cannot be changed to amortised cost[3].

13 These constituents observe that amortised cost measurement would apply only if the internal departments responsible for the banking book were to acquire the financial assets directly, but this would require additional costs. If one wanted to reclassify the asset this should be first sold by the market department to a third party just to re-acquire it through the internal department responsible for the banking book shortly after.

14 In addition to the prohibition to reclassify the asset, EFRAG notes that IFRS 9, paragraph B4.1.4, example 4 notes that "if an entity holds financial assets to meet its everyday liquidity needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's business model is not to hold the financial assets to collect contractual cash flows".

15 Similarly, if the entity is required by its regulator to routinely sell financial assets to demonstrate that the assets are liquid, and the value of the assets sold is significant, the entity's business model is not to hold financial assets to collect contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the analysis.

Reclassification in particular circumstances

16 In particular circumstances, the measurement of bonds can vary significantly depending on the business model applied. EFRAG is aware that IFRS 9, paragraph B4.1.2A notes that the business model assessment is not performed on the basis of worst case or stress case scenarios. In addition, paragraph B4.4.3 of IFRS 9 noted that a change in intention even in circumstances of significant changes in market conditions is not seen as a change in the business model. However, constituents raising the issue note that the effects caused by COVID-19 are of a different nature than what happened during the financial crisis of 2007-2008. In the recent crisis[4] there was regulatory pressure on banks to reduce their exposure to non-performing loans, resulting in the banks engaging in a more systematic de-risking of activities. This included disposal of a significant volume of loans that was initially not foreseen.

17 EFRAG has been informed that this issue is seen by some more as a regulatory than as an accounting issue.

18 In the endorsement advice to IFRS 9 EFRAG noted that reclassifications triggered solely based on a change in intentions due to market conditions would create

[3] In IFRS 9, paragraph B4.4.3 is stated "The following are not changes in business model: […] (c) a transfer of financial assets between parts of the entity with different business models."

[4] This differed to what happened during the 2007-2008 crisis and where intentions change due to market conditions.

tension in terms of the reliability of the information. When concluding the endorsement advice, 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.

Loan syndications

19 Before syndication, the entity may determine 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 at FVTPL (which is not retained) and the portion at a held to collect business model. However, the portion of loans finally sold may differ from the entity's expectations. According to paragraph B4.1.2A of IFRS 9, this does not change the classification of the financial assets. In particular, in situations where the entity sells a lower portion of loans than expected and decides to ultimately retain that unsold portion, it is required to continue to measure the excess unsold loans at FVTPL. However, amortised cost would provide more useful information in those circumstances according to those constituents raising the issue. However, in other circumstances that unsold portion can be sold at the earliest opportunity.

Question (b)

20 EFRAG is of the view that the business model assessment can generally be applied consistently.

21 With regard to the issues mentioned under Question 2 (a), EFRAG considered that accounting should not continuously be adapted for changes in regulation.

Question (c)

22 Please refer to our answer to Question *2 (a) Reclassification in particular circumstances* above.

Question 3 – Contractual cash flow characteristics

Notes to constituents – Summary of proposals in the RFI

23 Amortised cost is a simple measurement technique that allocates interest payments using the effective interest method over the life of a financial instrument. In the IASB's view, amortised cost can provide useful information only if the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement. Therefore, one condition for determining how to classify and measure a financial asset is whether the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (SPPI). Only financial assets with SPPI cash flows are eligible for measurement using amortised cost or fair value through OCI, subject to the business model in which the asset is held.

24 The objective of the effective interest method for financial instruments measured at amortised cost is to allocate interest revenue or expense to the relevant period. Cash flows that are interest are always closely related to the amount advanced to the debtor. The effective interest method, combined with the expected credit loss impairment model, provides relevant information for financial assets with SPPI cash flows. When the Board developed IFRS 9, it noted that the effective interest method is inappropriate for allocating cash flows that are not SPPI.

25 Unlike IAS 39, IFRS 9 does not require or permit embedded derivatives to be separated from financial asset. Accordingly, an entity assesses the contractual cash flow characteristics of a financial asset in its entirety.

Question 3 – Contractual cash flow characteristics

(a) **Is the cash flow characteristic assessment working as the Board intended? Why or why not?**

Please explain whether requiring entities to classify and measure a financial asset considering the asset's cash flow characteristics achieves the Board's objective of entities providing users of financial statements with useful information about the amount, timing and uncertainty of future cash flows.

If, in your view, useful information could be provided about a financial asset with cash flows that are not SPPI applying IFRS 9 (that is, an asset that is required to be measured at fair value through profit or loss applying IFRS 9) by applying a different measurement approach (that is, using amortised cost or fair value through OCI) please explain:

(i) why the asset is required to be measured at fair value through profit or loss (that is, why, applying IFRS 9, the entity concludes that the asset has cash flows that are not SPPI).

(ii) which measurement approach you think could provide useful information about the asset and why, including an explanation of how that approach would apply. For example, please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk). (See Section 7 for more questions about applying the effective interest method.)

(b) **Can the cash flow characteristics assessment be applied consistently? Why or why not?**

Please explain whether the requirements are clear and comprehensive enough to enable the assessment to be applied in a consistent manner to all financial assets within the scope of IFRS 9 (including financial assets with new product features such as sustainability-linked features).

If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) **Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?**

Please explain the costs and benefits of the contractual cash flow assessment, considering any financial reporting effects or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about financial instruments with sustainability-linked features (see Spotlight 3.1) and contractually linked instruments (see Spotlight 3.2).

EFRAG's response

EFRAG considers that the principle underlying the SPPI requirement generally leads to useful information. However, the SPPI test guidance requires a re-evaluation in the light of specific financial instruments such as financial instruments with ESG features or contractually-linked financial instruments. EFRAG proposes that the issue of financial instruments with ESG features is removed from the IFRS 9 PIR process and treated separately as an urgent issue resulting in potential targeted improvements to IFRS 9.

26 EFRAG considers that the principle underlying the SPPI requirement generally leads to the provision of useful information. However, the cash flow characteristics

assessment of IFRS 9 require a re-evaluation in the light of specific financial instruments, such as applying the SPPI test to:

(a) financial instruments with Environment, Social and Governance (ESG) features (i.e., sustainable finance products);

(b) instruments with administrative rates; and

(c) applying the guidance for contractually linked financial instruments.

27 In addition, please refer also to our answer to Question 4 below, where we consider the issue of the requirement to measure at FVTPL puttable instruments and mutual funds.

Question (a)

Financial Instruments with ESG features

Regulatory pressure and market developments

28 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.

29 Banks and insurers should make sustainability considerations as an integral part of their 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.

30 In the coming years, European constituents anticipate a sharp increase in volumes of debt instruments with contractual features that link the cash flows with the ESG profile of the borrower. They 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.

31 These constituents consider such financial instruments as basic lending instruments and anticipate that they will become very prevalent in corporate lending activities or mainstream investments. Therefore, there are concerns that if the default subsequent measurement attribute is FVTPL, this measurement might not be reflective of the amount, timing and uncertainty of the cash flows from such instruments. As a result, financial institutions, insurance companies, funds, etc might be indirectly discouraged from mainstreaming or investing in this type of lending. The current global volume of these issuances is in the size of about 700[5] billion USD in 2020, and just in H1 2021 a little bit over 500 billion USD of which more than 50% relates to European issuers. As an example, only Germany, France and Spain together issued in H1 2021 a total of USD 60 billion. EFRAG has conducted a survey with financial institutions to collect examples of fact patterns that exist currently on the market. The resulting list of examples is presented in Appendix 3 to this letter.

The application of the SPPI test to financial instruments with ESG features

32 The scope of financial instruments with contractual linkages to ESG targets that are specific to the borrower is potentially broad, e.g., including instruments that allow to

[5] Sustainable Debt Highlights H1 2021

take an exposure to sustainable or responsible activities. The issue however relates only to the ESG features that introduce a cash flow variability in the financial instruments when the financial instruments are held in a held to collect or held to collect or sell business model. EFRAG understands that constituents do not see these features as compensating for bearing risks outside those in a basic lending arrangement.

33 EFRAG understands that currently practice is developing and constituents are addressing the SPPI test for these instruments in different ways. For some the current size of the impact of the features is de minimis; for others the ESG-linked interest adjustment is seen as compensating for credit risk (however the link with credit link may be difficult to demonstrate and document); for others the ESG features is part of a profit margin.

34 In addition, the variability introduced by the ESG feature creates issues with the application of the effective interest rate and subsequent measurement.

35 Finally, the ESG features also create issues from the issuer side, in order to assess whether the feature shall be considered an embedded derivative and whether split accounting is applicable, i.e., whether one shall follow different accounting for the financial host and the bifurcated embedded derivative.

36 Given the expected pervasiveness of this issue for European constituents, EFRAG is of the view that this issue should be removed from the Post-implementation Review of IFRS 9. This should rather be addressed separately as an urgent issue, resulting in potential targeted improvements to IFRS 9. EFRAG appreciates the preliminary work of the IASB Staff, but is of the view that further work is needed and is happy to be of assistance to the IASB in this regard.

Questions to constituents – Question 3 (a)

37 In addition to the issue of the application of the SPPI test to financial instruments with ESG features and to the requirement to classify at FVTPL mutual funds and other puttable instruments (see our answer to Question 4 below) that have been identified in this DCL, are there other fact patterns for which you think the cash flow characteristics assessment is not leading to an appropriate measurement outcome? Please consider, in particular, financial assets that are required to be measured at FVTPL, for which a different measurement approach (amortised cost or FVOCI) would be in your view more appropriate. Please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk).

Questions to constituents – Financial instruments with ESG features

38 When applying the SPPI test to financial instruments held to collect that have contractual cash flow variability linked to ESG targets specific to the borrower, what additional approach could be considered in order to avoid failures of the SPPI test? Approaches used currently include considering the ‘de minimis’ and the possible link to the credit spread.

39 Do you think that failing the SPPI test (and a resulting measurement at fair value through profit or loss) is an appropriate outcome for these financial instruments? Please specify.

40 What do you consider the economic nature of the ESG-linked variability to be?

Question (b)

Contractually linked instruments – non–recourse

41 EFRAG understands that diversity in practice is noted with application of the non-recourse guidance and its interaction with the contractually linked instruments guidance.

42 EFRAG has been informed about the issues arising from the application guidance on contractually linked instruments ('CLI') (paragraphs B4.1.20 – B4.1.26) as well as the non-recourse guidance (paragraphs B4.1.16, B4.1.17).

43 In particular, IFRS 9 contains requirements for debt instruments issued in tranches whose terms create concentrations of credit risk. The payments on these financial assets are contractually linked to payments received on a pool of other instruments.

44 EFRAG has been informed that these rules-based requirements may lead to contradictory outcomes (passing SPPI test or not) depending on the nature of the guidance (contractually linked or non-recourse) being applied. However, the two types of structures are considered to be essentially the same by some constituents. EFRAG has been further informed that – due to the "late" introduction of the non-recourse guidance in IFRS 9 at the end of the standard setting process, the interaction between the two sets of requirements have not been fully explored.

45 EFRAG has been informed about the following issues that arise in this regard:

(a) The "look through" approach is considered difficult in some cases, as the required details are not available for every line of underlying investments.

(b) The contractually linked definition could be seen as very broad, absent an explicit guidance on what constitutes a "tranche". In order to distinguish between non-recourse financing and contractually linked, EFRAG has heard that some believe it is necessary to consider the nature and substance of an arrangement.

(c) The IFRS 9 guidance has been developed with public securitisations in mind, but currently there are all sorts of financing in terms of structured finance and corporate real estate financing. An example of such a structure would be a fact pattern where two tranches of a debt could be seen as creating contractually linked instruments. In this structure the junior tranche has the substance of equity but does not meet the IAS 32 definition of an equity instrument.

(d) 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.

(e) An issue reported relates to the reclassification requirements as it is argued by some that a change in processes (i.e., whether to apply the non-recourse guidance or the CLI-guidance) would also qualify as a change in business model.

46 EFRAG suggests the IASB to provide additional guidance to address these issues.

47 Examples of such structures that have been reported to EFRG are provided in Appendix 2.

Question to constituents – Question 3 (b)

48 In addition to financial assets which are in the scope of the contractually linked or non-recourse guidance identified in this DCL, are there other fact patterns to which you think the cash flow characteristics assessment cannot be applied consistently?

Question (c)

Financial instruments with administrative rates

49 EFRAG has been informed that the application of the SPPI test to financial instruments with administrative rates, one issue to which IFRS 9 pays insufficient attention to, is causing unexpected costs. In some jurisdictions the loan terms of financial instruments 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. In other jurisdictions the use of administrative rates occurs sometimes in intra-group loans.

50 EFRAG notes that, while entities are able to achieve the desired classification for these financial instruments, the process for doing so has been unnecessary onerous as the criteria of the SPPI-test, as currently worded, are considered being too strict.

51 EFRAG understands that in practice when administrative rates are compatible with the concept of the lender's cost of funding the instrument may be considered as having the characteristics of a basic lending instrument. EFRAG has been informed that in jurisdictions where administrative rates prevail, they are used in very competitive markets. EFRAG finally notes that IFRS 9 focuses too much on benchmark rates and considers that it would be useful if the IFRS 9 requirements would address this issue explicitly by providing further guidance, as was done for regulated rates.

Question to constituents – Question 3 (c)

In addition to the unexpected costs of applying the SPPI test to instruments with administrative rates identified in this DCL, are there other fact patterns that show unexpected effects arising from the cash flow characteristics assessment?

Question 4 – Equity instruments and other comprehensive income

Notes to constituents – Summary of proposals in the RFI

52 Equity instruments do not have SPPI cash flows and therefore are measured at fair value through profit or loss. As explained in paragraph BC5.22 of the Basis for Conclusions on IFRS 9, in the IASB's view, fair value provides the most useful information about the amount, timing and uncertainty of the cash flows arising from investments in equity instruments.

53 The IASB acknowledged when it developed IFRS 9 that, in a narrow set of circumstances, presenting fair value gains and losses from equity investments in profit or loss may not be indicative of the entity's performance. Therefore, IFRS 9 permits an entity to make an irrevocable election at initial recognition to present in OCI changes in the value of an investment in an equity instrument not held for trading. Those gains and losses are not 'recycled' to profit or loss on disposal of the investment, and the investment is not subject to impairment requirements.

54 Some constituents questioned whether non-recycling for investments in equity instruments in IFRS 9 is consistent with the Conceptual Framework for Financial Reporting. The Conceptual Framework explains that, in principle, income and expenses included in OCI in one period are reclassified into profit or loss in a future *period when doing so results in the statement of profit or loss providing more relevant information or providing a more faithful representation of the entity's financial performance for that future period. However, if, for example, there is no clear basis for identifying the period in which reclassification would have that result, or the amount that should be reclassified, the IASB may, in developing Standards, decide that income and expenses included in OCI are not to be subsequently reclassified.*

Question 4 – Equity instruments and other comprehensive income

(a) **Is the option to present fair value changes on investments in equity instruments in other comprehensive income working as the Board intended? Why or why not?**

Please explain whether the information about investments in equity instruments prepared applying IFRS 9 is useful to users of financial statements (considering both (i) equity instruments measured at fair value through profit and loss; and (ii) equity instruments to which the OCI presentation option has been applied).

For equity instruments to which the OCI presentation option has been applied, please explain whether information about those investments is useful considering the types of investments for which the Board intended the option to apply, the prohibition from recycling gains and losses on disposal and the disclosures required by IFRS 7.

(b) **For what equity instruments do entities elect to present fair value changes in other comprehensive income?**

Please explain the characteristics of these equity instruments, an entity's reason for choosing to use the option for those instruments, and what proportion of the entity's equity investment portfolio comprises those instruments.

(c) **Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in other comprehensive income? How significant are these effects?**

Please explain whether the requirements introduced by IFRS 9 had any effects on entities' investment decisions. If yes, why, how and to what extent? Please provide any available evidence supporting your response which will enable the Board to understand the context and significance of the effects.

In responding to (a)–(c), please include information about recycling of gains and losses (see Spotlight 4).

EFRAG's response

The absence of recycling has created significant constituents' concerns. EFRAG considers the IASB should expeditiously review 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.

EFRAG supports that similar fact patterns should be treated similarly, and notes 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.* Any changes to the accounting for these instruments, aimed at allowing for equity and equity-type 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. As a working assumption, EFRAG considers 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.

Question (a)

55 The absence of recycling when applying the option to present fair value changes of investments in equity instruments in other comprehensive income has created significant constituents' concerns.

56 The option to present fair value changes on investments in equity instruments in OCI has been considered extensively by EFRAG mainly because the changes in fair value cannot be recycled when the instrument is sold. Additionally, EFRAG considered whether this option should be extended to equity-type instruments.

Equity instruments

57 In June 2018, the European Commission ('the EC') requested EFRAG to consider alternative accounting treatments to measurement at FVTPL 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.

58 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. The European industry associations of Insurance, Saving Banks and Asset Managers, in their capacity as investors, responded to this consultation. EFRAG also received letters from the European associations of auditors and financial analysts. European Security and Markets Authority, the European Central Bank, and 8 National Standard Setters (NSS) also shared their positions while responding to the consultation. 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.

59 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. Nearly all respondents from the insurance and asset management industry, together with a large majority of the banks and non-financial corporates, supported the need for an alternative accounting treatment. Users and NSS had split views. The users who supported an alternative treatment (half of the users who responded) mainly supported the FVTPL model for all equity instruments. NSS who supported an alternative prefer FVOCI model with recycling; those NSS who did not support an alternative, mainly believe that more evidence is needed before a change is

proposed. Respondents from the accounting/audit profession and regulators did not consider that an alternative treatment is needed, mainly because at this stage there is no evidence to support such a need. The Feedback statement of this consultation is accessible here.

60 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.

Equity-type

61 EFRAG considered in its advice to the EC whether this option should be extended to equity-type instruments.

62 On EFRAG consultation 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 FVTPL distorts the depiction of financial performance and would not appropriately reflect the management strategy of the funds.

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

64 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 FVTPL, 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.

65 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.

66 EFRAG considered suggestions of relevant criteria made by constituents in the consultation mentioned above, in order to select units of funds that could become eligible to the equity accounting treatment and prevent unintended consequences. As a working assumption[6], EFRAG considered that the definition of equity-type

[6] EFRAG advice to the European Commission on alternative accounting treatments for long-term equity investments, January 2020.

instruments should be limited to units of funds and puttable instruments that invest in equity instruments, associated derivatives and necessary cash holdings.

67 EFRAG was recently made aware that some constituents would consider a broader scope of the definition of equity-type instruments, such as to include funds/puttable instruments investing in both equity and debt instruments and funds/puttable instruments that invest in infrastructure assets, including in the form of limited partnerships.

Question (b)

[to be updated following the consultation, see question to constituents below]

Questions to constituents – Questions 4 (a) and (b)

FVOCI option for equity instruments

68 For which equity instruments has the option to present fair value changes in the OCI been applied? What are the reasons for choosing to use the option for those instruments? What is their proportion of the overall investment portfolio?

69 From a user perspective, do you think the absence of recycling of gains or losses of equity instruments designated at FVOCI provides useful information? Please explain.

Treatment of equity-type financial instruments

70 Please consider paragraphs 65/67 above[7]. If you consider that equity-type financial instruments should be accounted for similarly to equity instruments, how would you define 'equity-type'? What type of underlying investments should be considered? How a classification test could be structured, taking into consideration among other things the need to assess the characteristics of the underlying assets?

71 From a user perspective, do you think that expanding the possibility to use FVOCI for equity-type financial assets provides more useful information? Please explain.

Question (c)

72 At this stage EFRAG is not aware about any unexpected effects arising from the option to present fair value changes on investments in equity instruments in other comprehensive income, in addition to those described in our answer to Question 4 (a) above. This is partly due to the fact that IFRS 9 is substantially still not applied by the insurance sector, so its potential impact on long-term investment cannot be assessed based on actual data. As EFRAG noted in the Advice to the EC issued in January 2020, no compelling evidence has come to the attention of EFRAG that accounting is an impediment or not to long-term investment.

73 EFRAG notes that asset allocation decisions are driven by a plurality of factors and that it is difficult to disentangle the impact of accounting requirements from that of other factors, such as expectation on future returns by class of assets or other regulations, including taxes and prudential requirements.

74 In the consultation described above, most of respondents (70%) 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.

[7] Please refer also to Chapter 4 of the Supporting Material issued by EFRAG together with the Advice to the EC in January 2020.

75 Nearly all respondents from the insurance and asset management industry, together with a large majority of the banks and non-financial corporates, supported the need for an alternative accounting treatment to avoid the unexpected effect of divest in equity and equity type instruments.

Question 5 – Financial liabilities and own credit

Notes to constituents – Summary of proposals in the RFI

76 *When developing IFRS 9, the IASB kept the classification and measurement requirements of financial liabilities in IAS 39 unchanged. The only issue that the IASB was told needed reconsideration was the profit or loss effects caused by changes in the fair value of a liability resulting from changes in the risk that the issuer will fail to meet its obligations for that liability.*

77 By retaining almost all of the requirements from IAS 39, the issue of credit risk was addressed for most liabilities because most liabilities continue to be subsequently measured at amortised cost or are separated into a host, which would be measured at amortised cost, and an embedded derivative that would be measured at fair value. Liabilities that are held for trading (including all derivative liabilities) would continue to be measured subsequently at fair value through profit or loss.

78 The fair value of an entity's own debt is affected by changes in the entity's own credit risk (own credit). This means that when an entity's credit quality declines the value of its liabilities fall and, if those liabilities are measured at fair value, the entity recognises a gain (and if the entity's credit quality improves, the entity recognises a loss). Many users of financial statements and others found this result counterintuitive and confusing.

79 To address concerns about counterintuitive and confusing results for those financial liabilities voluntarily designated at fair value through profit or loss, IFRS 9 requires changes in the fair value of an entity's own credit risk to be recognised in OCI rather than in profit or loss (unless doing so would create or enlarge an accounting mismatch in profit or loss).

Question 5 – Financial liabilities and own credit

(a) **Are the requirements in IFRS 9 for presenting the effects of own credit in other comprehensive income working as the Board intended? Why or why not?**

Please explain whether the requirements, including the related disclosure requirements, achieved the Board's objective, in particular, whether the requirements capture the appropriate population of financial liabilities.

(b) **Are there any other matters relating to financial liabilities that you think the Board should consider as part of this post-implementation review (apart from modifications, which are discussed in Section 6)?**

Please explain the matter and why it relates to the assessments the Board makes in a post-implementation review.

EFRAG's response

EFRAG is of the view that the requirements work as intended and has not received information that contradicts this view.

Questions (a) and (b)

EFRAG is of the view that the requirements work as intended. From the outreach conducted in preparation of this Post-implementation Review, EFRAG has not been informed about existing issues with regard to the accounting of financial liabilities.

Question 6 – Modifications to contractual cash flows

Notes to constituents – Summary of proposals in the RFI

80 When contractual cash flows are renegotiated or otherwise modified, the modification could result in the entity derecognising or recalculating the carrying amount (gross carrying amount for financial assets) of the financial instrument.

81 IFRS 9 does not define a ‘modification’ of a financial asset or financial liability. Paragraph 5.4.3 of IFRS 9 refers to the modification or renegotiation of the contractual cash flows of a financial asset, while paragraph 3.3.2 of IFRS 9 refers to the ‘modification of the terms’ of a financial liability.

82 When amending IFRS 9 to account for the effects of interest rate benchmark reform, the IASB acknowledged that the omission of a description of a ‘modification’ in IFRS 9. The IASB also admitted that the use of different wording to describe a modification of a financial asset and a financial liability, could lead to diversity in practice. The IASB suggested it might be helpful to clarify the requirements for modifications and to consider making a possible narrow-scope amendment to IFRS 9.

Question 6 – Modifications to contractual cash flows

(a) **Are the requirements for modifications to contractual cash flows working as the Board intended? Why or why not?**

Please explain what changes you consider to be modifications of a financial asset for the purpose of applying paragraph 5.4.3 of IFRS 9 and as a modification of a financial liability for the purpose of applying paragraph 3.3.2 of IFRS 9. Does the application of those paragraphs, and the disclosure requirements related to modifications, result in useful information for users of financial statements?

(b) **Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?**

Please explain whether the requirements enable entities to assess in a consistent manner whether a financial asset or a financial liability is modified and whether a modification results in derecognition. Have the requirements been applied differently to financial assets and financial liabilities?

If diversity in practice exists, please explain how pervasive the diversity is and its effects on entities’ financial statements.

EFRAG’s response

EFRAG understands that the absence of a definition of “substantial modification” and of derecognition thresholds for financial assets in IFRS 9, has led to some diversity in practice of when a financial asset is derecognised or modified.

However, EFRAG also notes that practice has now been established and some do not consider that undertaking standard-setting activities is appropriate at this stage. EFRAG is consulting its constituents on the need of standard setting for this issue.

Question (a)

83 EFRAG notes that financial instruments may undergo modifications for a number of different reasons, including market or legislative changes or changes in the credit situation of the counterparty, which creates additional complexity in this area.

84 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.

85 However, the trigger of a derecognition is only defined for financial liabilities in paragraph 3.3.2 as a *"substantial modification of the terms of a financial liability".*

86 A substantial modification is further defined in paragraph B3.3.6 as "the discounted cash flows under the new terms being at least 10% different from the discounted remaining cash flows of the original financial liability".

87 Thus, there is no definition of "substantial modification" or derecognition threshold for financial assets in IFRS 9. In the absence of guidance, the current practice was developed often by applying the rules for financial liabilities to financial assets.

88 However, the 10% threshold for the financial liabilities may not be representative or applicable to financial assets and for that reason banks have developed practical approaches, including to limit as much as possible the scope for derecognition. Sometimes qualitative criteria are also used to determine if the financial assets' terms and cash flows were substantially modified.

89 EFRAG notes that in 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 TAD 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.

90 Even if this issue was analysed under IAS 39, not IFRS 9, the IFRS IC noted during its September 2012 meeting, that the old GGBs should be derecognised (both under the assessment of paragraph 17 (a) of IAS 39 relating to extinguishment – current paragraph 3.2.3(a) of IFRS 9 or when assessing the existence of a substantial change in the terms of the asset) 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 decided not to add this issue to its agenda.

91 An example on a modification of contractual cash flows of a financial assets 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).

92 Under those circumstances different accounting approaches could be used:

(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). 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 statement of profit or loss and other comprehensive income, as defined in paragraph 5.4.3 of IFRS 9.

93 In current practice, some banks tend to use the approach described in paragraph 92(b) to account for changes either in the duration or interest rate (or both) of the loans as they consider that there has not been a substantial modification of the contractual terms of the loan in this case. Some banks also use the policy described in paragraph 100.

94 EFRAG understands that a lack of guidance may result in different interpretations of when a financial asset should be modified or derecognised with an impact on a modification gain or loss recognised in profit or loss. At the same time, practice has now been established and some do not consider that undertaking standard setting activities is appropriate at this stage. EFRAG is consulting its constituents on the need of standard setting for this issue.

Question to constituents

95 Do you think that standard-setting activities from the IASB are required to deal with modifications of the cash flow characteristics? Please explain.

Question (b)

96 As described in our answer to Question 6 (a) above, there is no direct guidance regarding modification and derecognition of financial assets and the guidance for financial liabilities is often applied by analogy. Many financial institutions had to develop their accounting policies to deal with a lack of guidance in this area which could lead to a diversity in practice.

97 EFRAG also highlights the interaction of regulatory and accounting frameworks in Europe to assess the quality of financial assets and the reasons for their modifications, especially if they relate to a decrease in the credit quality of the counterparty, such as forbearance, for example. The EBA issued the guidance on forbearance of loans in October 2018. For that reason, banks should monitor their forborne loans and provide for them on a one-to-one basis.

98 Some preparers tend to link the substantial modification to the cases of forbearance, significant increase in credit risk and transfer of a financial asset to Stage 3 (credit-impaired debt instruments), to make a link between different regulatory and accounting frameworks.

99 One accounting question that arises in this regard is when does a forbearance event (modification for credit reasons) triggers derecognition (which also means that the

new loan does not have any significant provisioning attached despite being a problem loan).

100 Also, in situations where a modification does not result in a derecognition, differences in application may 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.

101 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.

Question 7 – Amortised cost and the effective interest method

Notes to constituents – Summary of proposals in the RFI

102 The effective interest method is the method used to calculate the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

103 The effective interest rate is the rate that exactly discounts estimated future cash flows through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity estimates the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but does not consider the expected credit losses (for financial assets). The calculation includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

104 IFRS 9 provides requirements on using the effective interest method, including requirements to reflect changes in cash flows resulting from:

(a) *modifications;*

(b) *movements in market rates of interest; and*

(c) *other changes in estimates (the so-called 'catch-up adjustment').*

Question 7 – Amortised cost and the effective interest method

(a) **Is the effective interest method working as the Board intended? Why or why not?**

Please explain whether applying the requirements results in useful information for users of financial statements about the amount, timing and uncertainty of future cash flows of the financial instruments that are measured applying the effective interest method.

(b) **Can the effective interest method be applied consistently? Why or why not?**

Please explain the types of changes in contractual cash flows for which entities apply paragraph B5.4.5 of IFRS 9 or paragraph B5.4.6 of IFRS 9 (the 'catch-up adjustment') and whether there is diversity in practice in determining when those paragraphs apply.

Please also explain the line item in profit or loss in which the catch-up adjustments are presented and how significant these adjustments typically are.

> If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.
>
> In responding to questions (a)–(b), please include information about interest rates subject to conditions and estimating future cash flows (see Spotlight 7).

EFRAG's response

> **EFRAG considers that the effective interest rate method generally provides useful information and notes that IFRS 9 includes scope limitations or corrections to the method for particular financial instruments. EFRAG further notes that more and more financial instruments incorporate conditions such as TLTRO related loans and ratchet loans. The financial instruments including such conditions are pervasive in Europe. EFRAG notes that the application of the EIR poses practical challenges both for the initial and subsequent measurement.**
>
> **EFRAG is collecting further information from constituents on fact patterns, prevalence and diversity in practice in accounting for such financial instruments.**

Question (a)

105 When applying the effective interest method, interest is recognised in profit or loss in the period it accrues, regardless of when it is to be paid. This is because of the accrual principle. Applying that principle, an entity shall also amortise any fees, points paid or received, particular transaction costs and other premiums and discounts that are included in the effective interest rate over the expected life of the financial instrument. EFRAG is of the view that this method generally provides useful information about the amount, timing and uncertainty of future cash flows.

106 EFRAG notes that IFRS 9 includes scope limitations or corrections to the application of the effective interest method like for purchased or originated credit-impaired financial assets or in relation to modifications of cash flows.

107 EFRAG further notes that more and more financial instruments incorporate conditions that may affect the future contractual interest cash flows when being fulfilled or fail to be fulfilled by the reporting entity or their clients. Examples of this kind are the TLTRO[8] transactions (as discussed by the IFRS Interpretations Committee in June 2021) and ratchet loans. For example: a ratchet loan that includes a rate reset. In this example the credit spread is increased following a scale of predetermined rates, on the occurrence of one or more predetermined events that are linked to the borrower's financial covenants. According to some accounting guidance, resetting only the credit spread component when the reset is predetermined at inception can be regarded as a change in EIR as it is considered as a component of the market interest rate.

Question (b)

108 EFRAG notes that the application of the EIR to instruments with conditions that may affect the future interest cash flows when being fulfilled (or when they fail to be fulfilled) by the reporting entity or a third party poses practical challenges both for the initial and subsequent measurement. These financial instruments are prevalent in Europe. However, EFRAG is seeking for further information on whether when applying paragraph B5.4.5 of IFRS 9 or paragraph B5.4.6 of IFRS 9 diversity in practice exists.

[8] TLTRO: Targeted Longer-Term Refinancing Operation

Question to constituents

109 How significant are these catch-up adjustments in accordance with paragraph B5.4.5 or B5.4.6 of IFRS 9 (please provide nominal amounts and expressed as a percentage compared to the interest revenue and expense calculated using the EIR – as disclosed per IFRS 7, 20(b))? Please provide information for the following reporting periods: 2018, 2019 and 2020.

Question 8 – Transition

Notes to constituents – Summary of proposals in the RFI

110 Upon their transition to IFRS 9, entities were required to apply the Standard retrospectively, but with reliefs to address difficulties that might have arisen from retrospective application.

111 Applying some of those transition reliefs that relate to classification and measurement, entities:

(a) *assessed whether the objective of an entity's business model was to manage financial assets to collect contractual cash flows based on circumstances at the date of initial application of IFRS 9 rather than at the date the related financial instrument was initially recognised;*

(b) *assessed whether a financial asset or financial liability met the criterion for designation under the fair value option based on the circumstances at the date of initial application rather than at the date the related financial instrument was initially recognised;*

(c) *were permitted but not required to present restated comparative information on initial application of the Standard; and*

(d) *did not apply IFRS 9 to financial instruments derecognised before the date of initial application.*

112 As the IASB waived the requirement to present restated comparative information, it instead required entities to disclose the effect on classification of financial instruments of the transition to IFRS 9.

Question 8 – Transition

(a) **Did the transition requirements work as the Board intended? Why or why not?**

Please explain whether the combination of the relief from restating comparative information and the requirement for transition disclosures achieved an appropriate balance between reducing costs for preparers of financial statements and providing useful information to users of financial statements.

Please also explain whether, and for what requirements, the Board could have provided additional transition reliefs without significantly reducing the usefulness of information for users of financial statements.

(b) **Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not?**

Please explain any unexpected effects or challenges preparers of financial statements faced applying the classification and measurement requirements retrospectively. How were those challenges overcome?

EFRAG's response

EFRAG has no evidence that the Transition requirements of IFRS 9 are not working as intended by the IASB.

Question (a)

113 EFRAG has no evidence that the Transition requirements of IFRS 9 are not working as intended by the IASB.

114 In its endorsement advice of IFRS 9 (September 2015), EFRAG noted that upon transition to IFRS 9 there is no requirement to restate the financial information for previous periods, this will help contain the costs for preparers in implementing IFRS 9. EFRAG acknowledged that most of the entities did not restate but presented comparatives on the transition year between IAS 39 and IFRS 9 and no issues explicitly arose from that exercise.

115 EFRAG notes that only when IFRS 9 is applied together with IFRS 17, issues at transition have arisen, however this discussion is not part of this comment letter.

Question (b)

116 The IFRS 9 endorsement advice further advocated to implement the insurance contracts standard (which later became IFRS 17 *Insurance Contracts* issued in May 2017 and *the Amendments to IFRS 17* issued in June 2020) and IFRS 9 at the same time. This was achieved through the temporary exemption from applying IFRS 9 (*Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts*, issued in September 2016 – prolonged by *Extension of the Temporary Exemption from Applying IFRS 9* in June 2020), but without aligning the transition measures of both standards. To amend this the IASB has issued the IASB issued in July 2021 the ED *Initial application of IFRS 17 and IFRS 9 – Comparative information*.

Question 9 – Other matters

Notes to constituents – Summary of proposals in the RFI

117 The IASB is asking to share any information that would be helpful to them in assessing whether:

(a) *The objectives of the standard-setting project have been met;*

(b) *Information provided by the Standard is useful to users of financial statements;*

(c) *The costs are as expected for preparing, auditing, enforcing or using the information entities provide when applying the Standard; and*

(d) *The Standard can be applied consistently.*

Question 9 – Other matters

(a) **Are there any further matters that you think the Board should examine as part of the post-implementation review of the classification and measurement requirements in IFRS 9? If yes, what are those matters and why should they be examined?**

Please explain why those matters should be considered in the context of the purpose of the post-implementation review, and the pervasiveness of any matter raised. Please provide examples and supporting evidence when relevant.

(b) **Considering the Board's approach to developing IFRS 9 in general, do you have any views on lessons learned that could provide helpful input to the Board's future standard-setting projects?**

EFRAG's response

Based upon preparatory work for this consultation EFRAG notes a number of issues that arise when applying the Classification and Measurement requirements of IFRS 9 to some financial instruments that are prevalent in Europe.

Most of these topics have already been discussed in our answers to the above questions. Below are additionally discussed: factoring of trade receivables, and supply chain financing – reverse factoring (deserving standard-setting activities) and financial guarantees (EFRAG is seeking views on whether standard setting is necessary).

Question (a)

118 As illustrated above, EFRAG has identified a number of issues that arise from the application of the requirements in IFRS 9 to fact patterns that are prevalent in Europe and, as such, deserve standard-setting activities (amendments to the standard or educational guidance). In this section we illustrate the fact patterns not covered in the previous section of this letter, i.e.

(a) Factoring of trade receivables (see paragraphs 119 to 129);

(b) Supply-chain financing – reverse factoring (see paragraphs 132 to 141); and

(c) Financial guarantees (see paragraphs 144 to 145).

Factoring of trade-receivables

119 In a factoring arrangement, an entity that sells goods or services obtains cash from a bank (the factor) against receivables due from the entity's customers.

120 Factoring of trade receivables is a common form of (potential) off-balance sheet finance in many jurisdictions, but it is not specifically addressed by IFRS 9. This may lead to diversity in current reporting practices. While there may be a consensus on local jurisdictional level about how to report such transactions, a consensus does not seem to exist across countries, leading potentially to differences in how similar transactions are being reported.

121 As a sole potential source of guidance for these transactions, IFRS 7 *Financial Instruments: Disclosures*, in paragraphs 42A to 42H deals with disclosure requirements relating to transfers of assets; these disclosure requirements are found to be too high level in their description, thereby potentially leading to incomplete information.

122 The purpose of trade receivables factoring is to get cash flows from trade receivables quicker than under regular payment terms agreed with customers, by "selling" them to a financial institution. The arrangements are in practice very diverse, and it is usually not sufficient to differentiate between a factoring with recourse (no derecognition) and without recourse (full derecognition) - many transactions are somewhere in between and require detailed analysis.

123 The basic accounting question is whether, when and/or to which extend trade receivables subject to a factoring arrangement shall be derecognised. The applicable accounting principles are therefore the ones on derecognition of financial assets. If the trade receivables are not derecognised, the upfront payment received from the factor is recorded as a financing liability.

124 EFRAG has been informed that illustrative examples in IFRS 9 on how to report on these transactions may help in improving the consistency in application of IFRS 9 derecognition principles with respect to such transactions.

125 As an example, a common fact pattern on factoring of trade receivables can be described as follows: “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. The parties agreed for a pro-rata share of any losses between the Company (10%) and the Factor (90%). 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 by the Factor 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 was obtained by the Company prior to factoring and its costs are recharged to the Company."

126 Considering the above fact pattern, the following aspects of applying IFRS 9 derecognition principles may raise concerns:

(a) How to compare the entity's exposure to the variability of cash flows from the transferred assets before and after the transfer to determine whether there was a transfer of substantially all risks and rewards or not? (IFRS 9.3.2.6-8).

(b) Shall the fact that the receivables are subject to insurance protection impact the derecognition analysis? This effectively comes down to interpreting what "similar assets" are in the meaning of IFRS 9.3.2.2.

(c) If substantially all risks and rewards have neither been transferred or retained, how to determine whether the control over the asset was retained or not and whether the answer to (b) above shall impact this analysis.

127 Considering the above, the following information may be missing in current disclosures, which may result from both (i) lack of specific disclosure requirements in IFRS 7 and (ii) insufficient enforceability of existing requirements:

(a) The historical loss rate of factored trade receivables by the reporting entity and how it compares to the division of losses between the reporting entity 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).

(b) The IFRS 9-trigger that leads to derecognition of the trade-receivables (expiration of the rights involved, continuation to pay the cash flows involved, transfer of substantially all risks and rewards, retention of control).

(c) When the trade receivables are subject to insurance, a quantitative and qualitative analysis how this has affected the derecognition assessment.

128 EFRAG acknowledges that the lack of sufficiently granular disclosures is only indirectly related to the PIR of IFRS 9. EFRAG considers that if the IASB were to address the issues about factoring of trade receivables a comprehensive approach should be used. EFRAG considers that standard setting about IFRS 9 could include consequential amendments to other standards such as IFRS 7.

129 EFRAG requests the IASB to provide additional guidance on how the issues about derecognition should be addressed. Also, specific disclosures could be considered through consequential amendments to IFRS 7.

Questions to constituents

130 Would you have other fact patterns about factoring of trade receivables that in your view should be considered and/or have you experienced challenges in other aspects of both accounting and disclosing information on trade receivables factoring? Please explain.

131 Do you agree that additional illustrative examples specifically on trade receivables factoring would be helpful in ensuring consistent application of IFRS 9 derecognition principles?

Supply-chain financing – reverse factoring

132 EFRAG acknowledges that the issue of supply chain financing - reverse factoring is not an issue that relates solely to IFRS 9. It relates also to other standards such as IAS 1 *Presentation of Financial Statements*, IAS 7 *Statement of Cash Flows* and IFRS 7 *Financial Instruments: Disclosures*.

133 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 when the suppliers are paid.

134 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 about presentation in the statement of cash flows.

135 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.

136 Two further issues were identified about supply chain financing - reverse factoring:

(a) need for additional guidance on the principal-agent area; and

(b) how to apply the derecognition requirements in IFRS 9 when becoming part of a reverse factoring arrangement.

Principal-agent area

137 Differences in views exist between constituents on how to reflect reverse factoring transactions in the books of corporates. In particular when a factor is acting as paying agent of the corporate.

138 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 even though 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.

139 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.

140 Hence EFRAG is of the view that this issue may benefit from a clarification in IFRS 9. Fact patterns to be considered here include:

(a) if the reversed factoring arrangement was set up by the bank, the entity or the seller;

(b) 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

(c) whether use of cash discounts was decided by the bank or the entity.

Derecognition

141 This issue relates to how to apply the derecognition requirements in IFRS 9 paragraph 3.3.2 when one becomes part of a reverse factoring arrangement: i.e., under which circumstances should the original trade payable be derecognised and if so, when? More precisely, an assessment is necessary by the customer to decide whether the original financial liability has been substantially modified. How would the requirements for substantial modifications be applied in this specific case?

Questions to constituents

142 How would additional guidance on (i) the principal agent area and (ii) derecognition benefit you in accounting for reverse factoring transactions? Please explain.

143 As users of financial statements, do you currently lack information on reverse factoring transactions? If yes, which information is missing? In your view does the bank act as an agent in these situations or as a debtor? Please explain.

Financial guarantees

144 EFRAG has been made aware that for financial guarantees the IFRS requirements are not always fully clear, leading to diversity in practice in particular areas. However, EFRAG also notes that practice has now been established and some do not consider that undertaking standard-setting activities is appropriate at this stage. EFRAG is consulting its constituents on the need of standard setting for this issue.

145 These areas relate to:

Perspective of issuer or holder	**Area of diversity in practice**
Issuer of the financial guarantee	Accounting and measurement of an issued financial guarantee. Some entities recognise separately an obligation representing the protection provided and a financial asset representing any future premiums receivable. Others recognise a single net amount that represents the net of the protection provided and any future premiums receivable. This in turn has a knock-on impact on the measurement of the financial guarantee as it impacts how entities apply paragraph 4.2.1 (c) of IFRS 9 "the higher of test" (interaction with the accounting under IFRS 15 Revenue from contracts with customers and the accrual of income).
Holder of the financial guarantee	Assessing whether the financial guarantee is an integral element of the guaranteed debt instrument (account for it as part of the debt instrument) or whether it should be accounted for as a separate unit of account. This assessment is subject to judgment and no specific guidance is provided in IFRS to make this judgment.
	When the guarantee is considered not integral it is formally not in scope of IFRS 9 and some entities account for the financial guarantee as a reimbursement right in accordance with (IAS 37 Provisions, Contingent Liabilities and Contingent Assets) while others in certain circumstances apply FVTPL accounting based on IAS 8 and the conceptual framework
	When the financial guarantee is considered not integral and accounts for the guarantee as an IAS 37 reimbursement right, there is divergence. Some entities account for the premium paid and compensation right as separate assets – i.e., the entire premium paid is deferred and recognised in profit or loss over time and the entity recognises a separate compensation right equal to the ECL on the underlying asset against a credit in the impairment line. Others defer

	the difference between the premium paid and the compensation right and recognise the net amount in profit or loss over time.

Question to constituents

146 Do you think that the IASB should provide educational guidance or make amendments to the standard-for financial guarantees? Why or why not?

Question (b)

147 EFRAG has no further views on potential lessons learned.

Appendix 2 – Examples of contractually linked – non-recourse guidance

148 In this Appendix we discuss six different examples, per set of three. The first set of three are referred to as A, B and C, while the second set is referred to as 1, 2 and 3.

149 Example A – P has a subsidiary S. S is a trading entity. 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. 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.

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

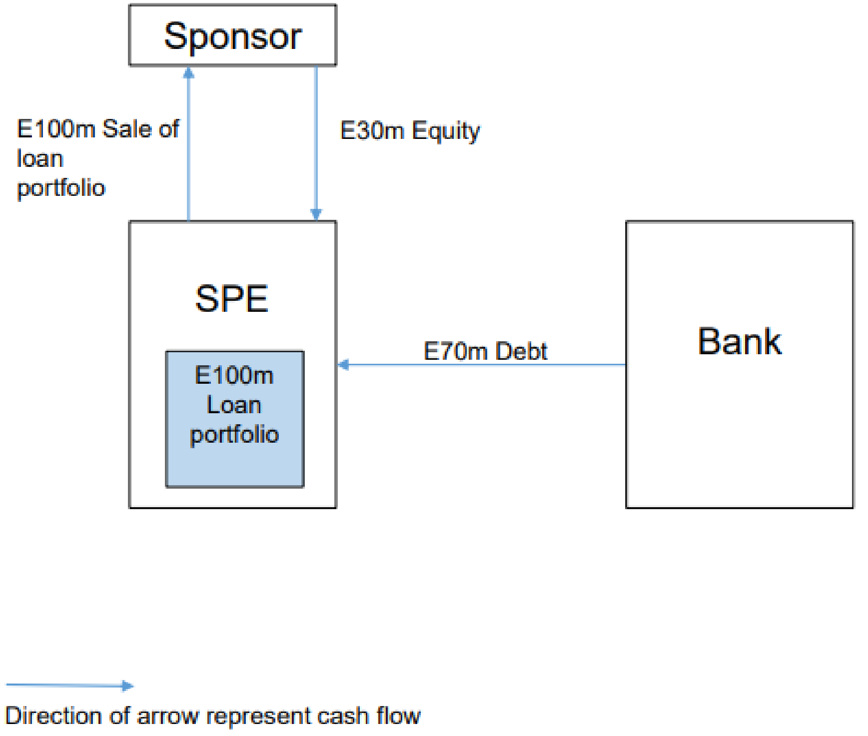
151 Example B – same as example A except S is a property company, which holds a single asset. Here the question arises whether the nature of the type of borrower is relevant in particular if the borrower has exposure to particular assets, with the effect that the loan has similar exposure to those assets.

152 Example C – 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. 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.

153 In example C, the lender lends to an associate, where that associate is listed on a stock market. In case it is considered that example A 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).

154 EFRAG notes that there exists diversity in views in these areas, 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.

Example 1: Asset Financing through bilateral loan with sponsor investment as equity



- Sponsor originates E100m loans
- Sponsor sells loans to SPE.
- SPE issues equity for E30m back to sponsor. The equity has no maturity and no contractual scheduled payments. The instrument meets equity definition in IAS 32.
- SPE issues E70m debt to Bank at 3mL+2% and is A rated internally. Debt meets definition of liability in IAS 32.
- There is an explicit waterfall of payments in the debt facility agreement ongoing and in default whereby the debt holder is paid prior to any dividends on the equity instrument.
- There are covenants in the debt instrument whereby if the value of the loan portfolio falls such that the Loan to Value (LTV) ratio increases to 80% then there is an Event of Default.
- In an Event of Default the debt holder can enforce on the loan collateral.
- The sponsor is permitted to increase their equity investment so that LTV triggers are not met (cure rights).
- There is no recourse of the debt to the sponsor/originator.
- (Note the same structure exists for financing of commercial real estate and aviation financing)

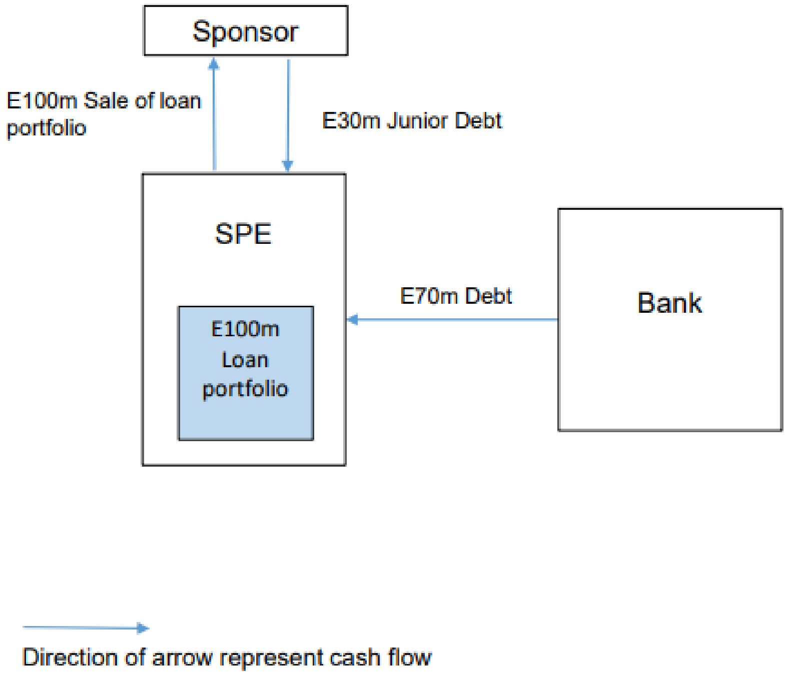
Accounting Questions:

- Should this be assessed as a Contractually Linked Instrument (IFRS 9 B4.1.20) or a Non Recourse Financing (IFRS 9.B4.1.17)?

Assessment

- Since there is only one debt tranche then the contractually linked instrument definition is not met since B4.1.20 requires multiple tranches of credit risk.
- The debt is assessed in accordance with non recourse financing guidance in IFRS 9.B4.1.17

Example 2: Asset financing with bilateral loan with sponsor investment as debt (1)



Structure Description

- Sponsor originates E100m loans
- Sponsor sells loans to SPE.
- SPE issues a E30m junior debt instrument to the sponsor, the instrument has a contractual maturity and a coupon rate. The coupon is Payment in Kind (PIK) meaning if the coupon cannot be paid then it is added to principal and accrues until paid or maturity. Therefore the junior loan cannot have an event of default prior to maturity. The term of the debt instrument is past the maturity date of the underlying loan portfolio and allows a period for credit workout process. The cash flows on the debt instrument are identical to equity in the previous example. Structuring as debt is tax efficient (interest is tax deductible) in certain jurisdictions.
- The SPE also issues a E70m senior debt instrument to the bank at 3mL+2% and is A rated internally.
- There is an explicit waterfall of payments in the senior debt facility ongoing and in default whereby the senior debt holder is paid at each coupon date prior to any interest or principal of the junior debt
- There are covenants in the senior debt instrument whereby if the value of the loan portfolio falls such that the Loan to Value (LTV) ratio increases to 80% then there is an Event of Default on the senior loan. There is also an EOD upon failure to pay.
- In an Event of Default the senior debt holder can enforce on the loan collateral.
- The sponsor has the option to increase their junior debt so that LTV triggers are not met and an event of default is prevented (cure rights). Due to the substantial equity contribution and the LTV trigger levels it is economically rational for the sponsor to do this except in the rare situation of a large and sudden fall in collateral value (gap risk event).
- There is no recourse for the senior debt to the sponsor/originator.

Example 2: Asset financing with bilateral loan with sponsor investment as debt (2)

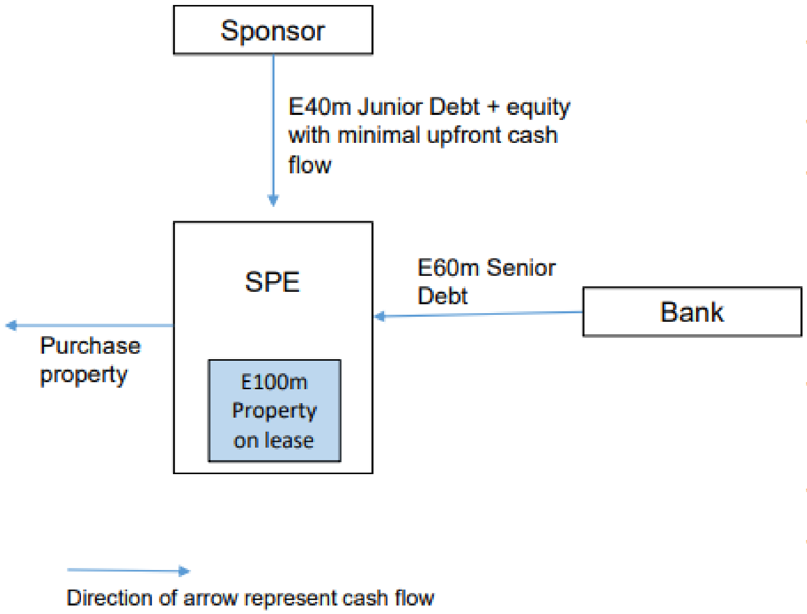
Accounting Analysis:

- The CLI definition is not clear and there is no application guidance. Different conclusions could be reached as to whether the structure is an NRF or CLI

CLI Definition	Arguments for NRF	Arguments for CLI
Issuer may prioritise payments to the holder using multiple contractually linked instruments that create concentrations of credit risk	Condition not met: Whilst there are 2 instruments which meet the financial liability definition in IAS 32 – the junior instrument is 'in substance' equity and has identical cash flows to the previous example. Addtionally, the sponsor consolidates the SPE and so there is only 1 tranche of debt external to the group.	Condition met: There are 2 (i.e. multiple) instruments which meet the definition of IAS 32 liability.
Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche	Condition met – there is a waterfall of payments which allocate both the ongoing and default cash flows to each tranche.	Condition met – there is a waterfall of payments which allocate both the ongoing and default cash flows to each tranche.
The holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher ranking tranches	Condition not met: As the holder of the senior loan may benefit from additional cash flows not initially included in the entity and therefore not generated by the entity, this criteria has not been met. The right to increase the amount invested in the junior loan is a feature akin to a NRF transaction. Although the right is not an obligation, loan covenants are structured with defined LTV trigger levels that make it economically rational for the sponsor to inject more cash in the vehicle to not breach its covenants and protect its investment. If the Sponsor did not invest additional cash into the vehicle, it would lead to an event of default prior to a situation of non-payment of the senior loan and put its junior note at risk.	Condition met: Whilst there is a right for the Sponsor to contribute additional cash or assets to the vehicle, there is no contractual obligation for the sponsor to inject additional junior debt and so the only cash flows may only be those generated by the issuer.
Other considerations	We understood the CLI criteria to be more aimed at public securitisations with many debt tranches than these bilateral senior loan structures. Public securitisations generally have 3+ tranches and do not include rights for the sponsor/junior tranche holder to contribute additional cash flows or assets into the vehicle at a future date. If this is CLI it is unclear what structure would meet the NRF definition as NRF's function in the same manner.	

Impact of decision: CLI more operational effort and more likely to fail SPPI (especially if non financial underlyings).

Example 3: Real Estate Financing with senior loan and sponsor investment as subordinated debt



Structure Description

- Variant on example 2 – but the tranching of the debt instruments is via different mechanism and the underlying is not a financial asset but property on lease.
- SPE purchases a property asset for E100m which is subject to a lease which generates cash inflows.
- The funding for the purchase comes from 2 main instruments into the SPE – senior debt and junior debt. There is also a small injection of cash via equity.
- The sponsors investment into the structure is predominantly via a junior debt instrument (shareholder loan) to SPE. The junior debt will have a high coupon ~15% payment in kind and be long dated maturity e.g. 20 years.
- Bank provides senior lending of 60m 3yr senior to SPE at L+3%. Non payment of interest results in EOD.
- The senior loan agreement has a waterfall for allocation of cash flows. Cash received from the rental agreements comes into a Collection Account. Cash from the collection account is first used to pay operating expenses of the property, then used to pay the interest and principal amortisation on the senior loan, any remaining cash is transferred to a General Account. If the loan is performing and no covenants have been breached then the sponsor can decide upon how cash in the General Account is allocated. They could use cash in the general account to make improvements in the property, pay amounts on the junior debt or pay dividends on the equity (subject to distribution restrictions e.g. Companies Act.) Payments on the junior debt are tax efficient.
- Additionally there is a subordination deed signed by the Sponsor which acknowledges that the junior debt is subordinate to the senior debt. The deed details when cash flows prior to default can be paid to the junior debt – ie from the General Account – it also details that the junior debt is subordinate to the senior debt in EOD. Additionally in an EOD the junior debt is assigned to the senior debt provider.
- There are covenants in the senior debt instrument whereby if the value of the property falls such that the Loan to Value (LTV) ratio increases to 70% then there is an Event of Default on the senior loan.
- The sponsor has the option to increase their junior debt so that LTV triggers are not met and an event of default is prevented (cure rights). Due to the substantial equity contribution and the LTV trigger levels it is economically rational for the sponsor to do this except in the rare situation of a large and sudden fall in collateral value (gap risk event).
- There is no recourse for the senior debt to the sponsor.

Example 3: Real Estate Financing with senior loan and sponsor investment as subordinated debt

Accounting Analysis:

- The CLI definition is not clear and there is no application guidance. Different conclusions could be reached as to whether the structure is an NRF or CLI

CLI Definition	Arguments for NRF	Arguments for CLI
Issuer may prioritise payments to the holder using multiple contractually linked instruments that create concentrations of credit risk	Condition not met: Whilst there are 2 instruments which meet the financial liability definition in IAS 32 – the junior instrument is 'in substance' equity. Additionally, the sponsor consolidates the SPE and so there is only 1 tranche of debt external to the group.	Condition met: There are 2 (i.e. multiple) instruments which meet the definition of IAS 32 liability i.e. the senior debt and the junior debt.
Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche	Condition not met – the waterfall in the senior agreement does not mention the junior debt. Additionally since the facility agreement allows maintenance expenses to be made and also the sponsor can decide on cash flow allocations from the General Account then not ALL cash flows generated by the issuer are allocated between the "tranches"	Condition met – the waterfall in the senior agreement and the subordination deed means that cash flows cannot be paid on the junior debt until the senior loan is paid. Additionally the junior loan is subordinate on default.
The holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher ranking tranches	Condition not met: As the holder of the senior loan may benefit from additional cash flows not initially included in the entity and therefore not generated by the entity, this criteria has not been met. The right to increase the amount invested in the junior loan is a feature akin to a NRF transaction. Although the right is not an obligation, loan covenants are structured with defined LTV trigger levels that make it economically rational for the sponsor to inject more cash in the vehicle to not breach its covenants and protect its investment. If the Sponsor did not invest additional cash into the vehicle, it would lead to an event of default prior to a situation of non-payment of the senior loan and put its junior note at risk.	Condition met: Whilst there is a right for the Sponsor to contribute additional cash or assets to the vehicle, there is no contractual obligation for the sponsor to inject additional junior debt and so the only cash flows may only be those generated by the issuer. The junior loan only gets cash flows once the senior loan is repaid.
Other considerations	We understood the CLI criteria to be more aimed at public securitisations with many debt tranches than these bilateral senior loan structures. Public securitisations generally have 3+ tranches and do not include rights for the sponsor/junior tranche holder to contribute additional cash flows or assets into the vehicle at a future date. If this is CLI it is unclear what structure would meet the NRF definition as NRF's function in the exact same manner.	

Impact of decision: CLI more operational effort and more likely to fail SPPI (especially if non financial underlyings).

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Appendix 3 – List of ESG-factors examples

Size of the issuance in EUR	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) 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 ways

	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