EFRAG FR TEG meeting
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Financial instruments with ESG features – way forward

Objective

1 The objective of this paper is to support the definition of a possible solution, collecting inputs from EFRAG FR TEG members on the April IASB Staff papers and on IASB discussion. This paper refers to the content of the IASB Staff paper 3B.

The IASB Staff observations on the current SPPI guidance

2 Some respondents have interpreted the components of 'interest' explained in paragraph B4.1.7A of IFRS 9 to be an exhaustive list of the only possible elements of interest that is consistent with SPPI. However, the IASB Staff understanding is that this was not the intention of the IASB.

3 As explained in paragraph BC4.182(b) of the Basis for Conclusions on IFRS 9, the IASB noted that interest may include consideration for elements other than time value of money and credit risk and focuses on what the entity is being compensated for, instead of how much the entity receives for a particular element.

4 Therefore, the staff view is that, as noted in the IFRS 9 Project Summary, the IASB intended paragraph B4.1.7A of IFRS 9 to clarify that **interest can comprise a return not only for the time value of money and credit risk but also for other components** such as a return for liquidity risk, amounts to cover expenses and a profit margin.

5 As explained in paragraph BC4.188 of the Basis for Conclusions on IFRS 9, in developing the SPPI requirements, the IASB decided to require an entity to assess all contingent features in the same way. In the staff view, **ESG-linked features should be treated the same as any other contingent feature** in this regard.

6 The key consideration in assessing the contractual cash flows resulting from any contingent feature is whether the resulting cash flows reflect a return for risk (i.e. what is the entity being compensated for) that is **unrelated to a basic lending arrangement.** For example, an entity would ask if the ESG-linked features introduce exposure to such risks or variability and therefore are not consistent with a basic lending arrangement.

7 Based on the IASB Staff understanding, for a number of financial assets with ESG-linked features, the ESG-linked adjustments to interest rates are not determined considering the risks or ability of the individual borrower meeting specific ESG targets. **The ESG linked features are often not meant to compensate the lender for taking on such risks.** Rather, the ESG-adjustment **serves as an 'incentive'** for the borrower to meet the specified ESG targets. It is common for the same level of adjustment to be made to the contractual interest rate for borrowers across various industries and various ESG targets.

8 **<u>If the contractual cash flows resulting from the ESG-linked feature do not introduce compensation for ESG risks, the staff think that such a financial asset could have contractual cash flows that are not inconsistent with a basic lending arrangement.</u>** However, the IASB Staff acknowledges that this assessment can require considerable judgement and that stakeholders are unsure about what the IASB intention would have been for assessing this type of contractual cash flows. They also acknowledge the feedback from respondents indicating diverse views on this matter.

IASB Staff orientation on standard setting

9 The IASB Staff do not think that it is necessary to create an exception from the SPPI requirements to ensure that useful information about the amount, timing and uncertainty of contractual cash flows are provided to users of the financial statements.

10 They also do not consider there to be a need for fundamental changes to the principles of the SPPI requirements in IFRS 9.

11 In their view, if any standard-setting is undertaken in this area, any potential amendments would **solely focus on clarifying the current requirements and providing additional application guidance** to assist entities in assessing whether a financial asset with ESG-linked features has contractual cash flows that are SPPI.

12 To ensure the maximum benefit to be gained for the lowest cost, any clarifications should **not be specific only to ESG-linked features, but principle-based** and robust enough to be applied to other types of financial instruments that may emerge in the future.

13 The staff agree with respondents that this matter is a priority. A timely solution would be necessary to enable stakeholders to develop and implement any process, model and system changes required for classifying and measuring these financial assets.

14 With regards to what potential clarifications could be made in this regard, the staff think the IASB could consider:

(a) adding application guidance with respect to the characteristics of a basic lending arrangement and its link to amortised cost measurement. In our view, such additional application guidance would not only assist entities with assessing the contractual cash flows of financial assets with ESG-linked features, but would also help more consistent application of the SPPI assessment in general;

(b) clarifying how to assess whether variability arising from contractual terms that change the timing or amount of contractual cash flows are consistent with SPPI; and

(c) considering how the disclosure objectives and principles in IFRS 7 would apply to financial assets with ESG-linked features, including information about an entity's exposure to risks arising from such features and how an entity manages such risks.

<u>IASB discussions</u>

15 IASB members were overall supportive to the staff proposal to clarify and expand the IFRS 9 application guidance rather than make fundamental changes to the SPPI principles. IASB members understood that no fundamental changes to the principles should be made and no exception for ESG features would be created. Instead, the issue around ESG features should be addressed by clarifying the SPPI principles.

16 One IASB member, whilst agreeing with the staff proposition in general, was not supportive of the idea of addressing specifically ESG features and creating exceptions to the SPPI principles. In his view, the ESG feature may be used as an example.

17 Another IASB member conditionally agreed with the staff analysis but would like to understand what the proposition in a scenario would be where the majority of the instruments fail SPPI.

18 The IASB Staff clarified that the proposition is that the cash flows should be assessed according to the SPPI principles, regardless of whether the instrument has an ESG label or not, and that no changes to or exceptions from the SPPI principles would be suggested.

<u>The EFRAG Secretariat observations</u>

19 The EFRAG Secretariat understands that the IASB may soon open a project to amend IFRS 9 in order to add application guidance with respect to the characteristics of a basic lending arrangement and its link to amortised cost measurement, including guidance on how to assess variability due to contingent features and disclosure about the risks arising from such variability. There would be no exceptions nor temporary solution and the new guidance would be general and not limited to ESG features.

20 On the basis of the IASB Staff paper, one of the key elements in the possible new application guidance could be to require that the cash flows resulting from the contingent feature do not reflect a return for risk the ESG risk. **If the ESG-linked features introduce exposure to ESG risks/introduce compensation for ESG risks,** it would not be consistent with a basic lending arrangement and thus would trigger the classification and measurement at FVTPL.

21 The EFRAG Secretariat understands that this possible new application guidance would address the issue for those instruments that introduce an incentive but do not transfer an exposure to the ESG risk onto the lender and/or where the adjustment to the interest rate does not reflect a quantification of the exposure to ESG risks or the probability of missing the target.

Questions to EFRAG FR TEG members

22 What do EFRAG FR TEG members think about the approach described in paragraph 19 above?

23 What do EFRAG FR TEG members think about the requirement described in paragraph 21 above? Do they agree that this approach would address the issue with the financial instruments currently on balance sheet? Would this requirement represent a risk that future planned production of ESG lending may fail the SPPI test?

24 Do EFRAG FR TEG members have additional suggestions to make for the possible clarification to the SPPI requirements?