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Financial instruments with ESG features – proposals for clarifications to paragraphs B5.1.1 and B4.1.7A of IFRS 9

Objective

1 The objective of this paper is, based on the background material provided in paper 08-03, to propose two possible clarifications to IFRS 9, to introduce a simplified decision tree; and to apply those to some very simplified descriptions of rachet loans, green loans and ESG loans.

2 EFRAG FR TEG members will be asked to provide their views on the proposed approach.

Two possible clarifications to IFRS 9

<u>On the separation of non-financial components</u>

3 Paper 08-03 introduced the issue of combined contracts with a non-financial component in a contract where a financial instrument is considered the main component.

4 A financial instrument as defined in IAS 32 is a pure exchange of a financial asset against a financial liability and or an equity instrument. It follows directly or indirectly from IFRS 2 that if a contract obliges one party to deliver a good or a service the counterparty has received a good or a service when and if the delivery takes place.

5 A contract for which the obligations under the contract may fully or partly be discharged by the delivery of goods (non-financial assets) or services is a non-financial contract or contains a non-financial component. The accounting for such a contract would be expected to be fully or partly found outside the requirements for the accounting for financial instruments in IFRS 9. However explicit guidance may point to IFRS 9 (e.g., IFRS 9.2.1(b), IFRS 9.2.1(j), IFRS 9.2.5-2.7 and IFRS 9.4.3.5).

6 Many contracts involving the providing of credit require the borrower to conduct actions that have no additional benefit for the lender besides securing the credit provided by the lender. As the borrower, to release its obligations to the lender, is contractually required to conduct actions in addition to delivery of financial assets it may be claimed that there is something more than only a financial instrument present.

7 For the avoidance of doubt the following clarification related to paragraph B5.1.1 of IFRS 9 may be suggested: "*Delivery of a service in a contract that has no alternative value to the receiver than to affect the fair value of a financial component of the same contract shall be considered integral to the financial instrument and not separated from that financial instrument*."

<u>On cash-flow variability caused by non-financial component integral to the financial instrument</u>

8 Many financial instruments include obligations on the borrower related to measures aimed at limiting the credit risk for the credit provider. Such obligations may include pledge of identified assets, presentation of financial statements, limits on key figure ratios, limits on the use of funds etc. These obligations are considered integral to the financial instrument and thus not separated from the financial instrument.

9 Normally the obligations that are considered integral to the financial instrument determine the level of the cash flows in the financial instrument, but do not add to the variability of the cash flows of the instrument. However, sometimes the contract stipulates variability in the cash flows dependent upon fulfillment, level of fulfilment or non-fulfilment of non-financial conditions considered integral to the financial instrument.

10 Paragraph B4.1.7A of IFRS 9 describes the concept of a basic lending arrangement and some components of cash-flows that are compatible with a basic lending arrangement. For the avoidance of doubt the following clarification related to paragraph B4.1.7A of IFRS 9 may be suggested: *"Variability in cash flows caused by delivery of a service considered integral to the financial instrument that at initial recognition of the financial instrument is not expected to be more than the changes in fair value of the credit risk of that financial instrument is consistent with a basic lending arrangement."*

A possible decision tree

11 Having introduced the two clarifications related to scope of IFRS 9 and the SPPI requirements, the coworking of the two clarifications can be shown in a possible decision three as shown in the next paragraph.

12 Is there a non-financial component involved in the transaction?

(a) Is there a non-financial <u>good</u> to be delivered or can the size of the obligation be influenced by the delivery or non-delivery of a non-financial <u>good</u>?

(i) Yes => A non-financial component is to be separated (B5.1.1). The remaining host instrument is subject to SPPI-test. After the separation, please continue to next question to assess the existence of a service.

(ii) No => Next question

(b) Is there a <u>service</u> to be delivered or can the size of the obligation be influenced by the delivery or non-delivery of a <u>service</u>?

(i) Yes => Next question

(ii) No => No non-financial component to be separated

(c) Does the delivery of the service in the contract has a value to the receiver other than to affect the fair value of [the credit risk] of the financial component of the same contract?

(i) Yes => A non-financial component is to be separated (B5.1.1)

(ii) No => Service is integral to the financial instrument, no non-financial component to be separated.

How may the thinking about combined contracts be applied to rachet loans, green loans and ESG financing?

13 <u>Characteristics of a rachet loan</u>. A loan for which the interest rate is adjusted as and when the borrower delivers or not delivers a set of predetermined key financial ratios specific to the entity[1].

14 Analysis of a rachet loan. A rachet condition does not in isolation imply delivery of a good. For a rachet loan the size of the obligation will be influenced by the delivery or

[1] Changes in cash flows from changes in financial variables and non-financial variables not specific to the entity may indicate the presence of an embedded derivative.

non-delivery of a service (the entity delivering actions influencing its entity specific key financial ratios). It is not foreseeable that the credit provider receives any benefit from the service other than the impact on the fair value of the loan provided.

15 Based on this one can conclude that:

(a) A rachet loan only consists of a financial instrument component as the service delivered is integral to the financial instrument.

(b) When assessing the SPPI condition the clarification relating to basic lending arrangement will be applicable.

(c) A rachet loan may or may not be SPPI compliant.

16 Characteristics of a green loan. A loan that can only be used for approved (environmentally friendly) purposes.

17 Analysis of a green loan. It must be decided on a case-by-case basis if the green loan includes delivery of a good. For a green loan the size of the obligation will generally not be influenced by the delivery or non-delivery of a service (as the use of the proceeds is predetermined and it does not create further variability in the cash flows). It should be decided on a case-by-case basis if the credit provider receives any benefit from the service (the borrower investing in the approved purpose) other than the impact on the fair value of the loan provided.

18 Based on this one can conclude that:

(a) A green loan may, but is not expected to, include a non-financial component. To the extent a non-financial component is identified, it shall be separated based on the paragraph B5.1.1 of IFRS 9.

(b) When assessing the SPPI condition, after having allocated cash flows to any identified non-financial component, the clarification relating to basic lending arrangement may be applicable.

(c) The characteristics defining a green loan are SPPI compliant.

19 Characteristics of an ESG loan. A loan for which the interest rate is adjusted as and when the borrower delivers or not delivers a set of predetermined ESG measures specific to the entity2.

20 Analysis of an ESG loan. It must be decided on a case-by-case basis if the ESG loan includes delivery of a good. For an ESG loan the size of the obligation will be influenced by the delivery or non-delivery of a service (the entity delivering actions influencing this entity specific ESG measures). It should be decided on a case-by-case basis if the credit provider receives any benefit from the service other than the impact on the fair value of the loan provided.

21 Based on this one can conclude that:

(a) An ESG loan may include but is not expected to include a non-financial component. To the extent a non-financial component is identified, it shall be separated based on the requirement in paragraph B5.1.1 of IFRS 9.

(b) When assessing the SPPI condition, after having allocated cash flows to any identified non-financial component, the clarification relating to basic lending arrangement may be applicable.

(c) An ESG loan may or may not be SPPI compliant.

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[2] Changes in cash flows from changes in financial variables and non-financial variables not specific to the entity may indicate the presence of an embedded derivative.

Questions for EFRAG FR TEG

22 Does EFRAG FR TEG have any comments on the proposed approach to separate non-financial components of a financial host contract?

23 Does EFRAG FR TEG have any comments on the proposed approach to consider variabilities in cash flows caused by non-financial components integral to a financial instrument?