EFRAG
European Financial Reporting Advisory Group

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Post-implementation Review of IFRS 9 – comments received from EFRAG FIWG, IAWG and User Panel

Objective

1 The objective of this paper is to reflect the comments received from EFRAG FIWG, IAWG and User Panel with regard to the Post-Implementation Review of IFRS 9 in their respective meetings (EFRAG FIWG - 2 December 2021, EFRAG IAWG - 7 December 2021 and EFRAG User Panel - 7 December 2021).

2 During these meetings the EFRAG Secretariat collected views in particular with regard to (i) financial instruments with ESG features and (ii) equity-type financial instruments. Members of the EFRAG User Panel were also asked for their views with regard to factoring of trade receivables and supply chain financing.

Questions for EFRAG Board and TEG members

3 Does EFRAG Board and TEG members have questions about the inputs provided?

Financial instruments with ESG features

EFRAG FIWG meeting

4 Members discussed the possibility to pass the SPPI test based on a demonstrated link between the adjustment to cash flows and credit risk: if the adjustment is a fixed spread and is a fraction of the total interest payment, this link could, at least in theory, be demonstrated. This would help to overcome the issue for scenarios where this link can be demonstrated, but not for all the ESG links that will emerge. Also, the current correlations between the features and the pricing are still low. Developments are expected in market practices, such as incorporation of ESG factors in credit rating systems.

5 It was noted that more information from banks was needed to answer most of the questions raised. The inclusion of ESG features in financial instruments was a moving target. The expectation was that the contractual clauses would change/be influenced by the forthcoming regulatory reporting to make a link between the ESG feature and the credit risk of the borrower (reference was made to recent proposals by EBA).

6 Preparers from the banking industry provided two examples:

(a) They made margin adjustments in their products that considered the long-term sustainability objectives of the borrower. While noting a direct link to credit risk, he noted there were currently no methods available to calculate the effects. However, the margin reduction was considered smaller than the effects on credit risk. There is no speculative intent, the asset is seen as a basic lending instrument, and it passes the SPPI test thanks to the de-minimis

clause. The adjustment is not considered as part of the interest rate risk management.

(b) ESG features were considered in the credit risk assessment of borrowers. However, proving that relationship was difficult, in particular for features that relate to the categories “Social” and “Governance”. They accepted a lower profit margin in order to be able to participate in sustainable finance deals: the adjustment to the profit margin is considered as a commercial decision, it was defined in a competitive bidding process reflecting how much reduction of profit a bank was ready to accept in order to be able to meet its green volumes target. Para. B4.1.7A of IFRS 9 allows to consider profit margin as a basic lending component and this approach could be an alternative to the demonstration of a link to credit risk.

7 As for the reduction of profit margin that a bank is ready to accept, another possible economic justification could be the liquidity capacity, i.e., anticipating a higher demand for these products in the secondary market, a bank could be willing to accept a lower profit today. Also, often the reduced margin on the asset is accompanied by a lower cost of liabilities issued to fund these assets, or the collateral e.g., real estate development projects provide better protection for credit risk.

8 Several EFRAG FIWG members repeated that such financial instruments were by nature basic lending instruments and should be measured at amortised cost. Day 2 accounting was important too, as in order to propose any revision to the SPPI guidance, a satisfactory approach was needed to deal with the subsequent cash flow variability from the ESG feature using amortised cost. Some EFRAG FIWG members noted that the change in cash flow variability could be addressed through catch-up adjustments (i.e., B5.4.6 require to discount the revised cash flow estimates at the original EIR and recognise the adjustment to the carrying amount in profit or loss). However, this approach would result in important operational complexities in case of a large number of loans, resulting in significant costs, but has technical merits under the current framework in IFRS. In addition, depending on how the expected changes in contractual cash flows are treated at initial recognition, it may result in increased volatility of banks’ results and equity. It was also noted that the IFRS IC is currently dealing with a similar issue with an interpretation for TLTRO 3 loans and the developments in that interpretation may have an impact on possible solutions for this issue. This also shows that accounting for cash flow variations is not an issue limited to ESG-linked financial instruments.

9 Members noted that at present day, almost all ESG features fitted within the “de minimis” assessment and they were genuine.

10 The question was raised whether a derivative market was likely to emerge on ESG features. This was noted to be unlikely as the features currently seen are entity-specific.

EFRAG IAWG meeting

11 Some EFRAG IAWG members did not consider that “green” bonds had different credit risk compared to other financial instruments as their holders will not be paid earlier. However, they considered that a possible failure of the SPPI test should not be a factor prohibiting these instruments to be accounted for at amortised cost.

12 Other members noted that “green” bonds did not have a variability in the interest rate, as they had a fixed rate and therefore there was no issue on that side. However, they acknowledged the increasing volume of mortgage loans with an interest rate dependant on the energy rating of the house or apartment, the banks were providing and noted that insurance companies might be affected as well. They expressed doubts that all of such investments in the future will pass the SPPI test

and noted that the link to credit risk or pricing mechanism is difficult to prove at this stage.

13 One EFRAG IAWG member noted that the credit risk of environmental investments was lower than others, and that although the mathematical models were not yet developed, there was an opportunity to try to calculate the connection of the impact of an ESG rating on the price of bonds. In his view, it should be possible to find a quantitative impact.

User Panel meeting

14 Mixed views were provided on the issue of some of the ESG linked instruments failing the SPPI test, ranging from adjusting the test to allow them to be accounted for at amortised cost, to not changing the test (i.e., if an ESG feature makes instrument fail SPPI it has to be measured at FVTPL as required by current IFRS 9 rules).

15 When looking at the link with the credit risk, some users saw the green bonds as being no different from other bonds as their holders do not get paid earlier than others, the impact on credit risk is difficult to prove. They are issued because the underlying funding is cheaper.

16 These users considered that “green” reporting was more normative than financial reporting. For the investors the financial assets with “green” features are not different from other financial assets where the change in interest rate can be treated as a step-up for example. For an investor, not reaching a commitment to a certain “green” covenant is not different from not reaching any other commitment and the information about that should be better placed in the management report and not in the financial report.

Recycling of gains or losses on equity-type instruments

EFRAG FIWG meeting

17 One EFRAG FIWG member shared data from a research report from the European Banking Institute on the “*Accounting for financial instruments under IFRS 9 – First time application effects on European Banks's Balance Sheets*”. He noted that banks considered in this study held 0.2% of total assets as equity instruments and of those only 24% were held at FVOCI.

18 Several EFRAG FIWG members noted that the treatment of equity-type instruments was not a pressing issue for the banking community.

EFRAG IAWG meeting

19 Some EFRAG IAWG members noted the importance of broadening the definition of equity-type instruments (i.e., those for which the IASB should explore a solution to allow them to be designated at FVOCI) to different investments funds. One of these EFRAG IAWG members highlighted for insurance companies the need to have a broader application of the FVOCI option for equity-type instruments backing some insurance contract liabilities (other than contracts under variable fee approach) where the OCI option in IFRS 17 will be used for the disaggregation of finance income and expense.

20 One EFRAG IAWG member proposed to check the definition of equity-type instruments that was proposed by the ANC in the letter sent in January 2020 to EFRAG in response to the consultation on the EFRAG draft advice top the EC on possible alternative accounting treatments to FV measurement for long-term investment (LTI) portfolios of equity and equity-type instruments.

EFRAG User Panel meeting

21 EFRAG User Panel views had not changed since EC request for technical advice on possible alternative accounting treatments to FV measurement for long-term investment (LTI) portfolios of equity and equity-type instruments published on 30 January 2020.

22 Hereafter we recall the views as published in the [Feedback statement – Survey on Alternative accounting treatments for long-term equity investments – January 2020]

23 In line with survey responses, EFRAG User Panel members provided mixed views and referred to different measurement approaches (even if there was a slight preference for the first approach described below):

(a) *fair value through profit or loss: such an approach helps users assessing the entities' risk exposure to equity instruments. In addition, disclosures about the methodologies used to calculate fair value are fundamental for users;*

(b) *fair value through other comprehensive income ('FVOCI') with recycling: such an approach provides information about realised and unrealised gains and losses. The ability to identify realised vs. unrealised gains or losses is fundamental and highly relevant to the users of financial statements to assess the performance of an entity;*

(c) *adjusted cost – Equity Method: such an approach is particularly useful for situations where entities are currently applying level 3 fair value calculation under IFRS 13 Fair Value Measurement; and*

(d) *an approach that provides information about the future value of equity (i.e., reflecting the full potential of the business) rather than focusing on the point-in-time fair value (market perspective) of the equity instrument.*

Factoring of trade receivables

EFRAG User Panel meeting

24 Factored receivables distort the performance of assets and operational flows in cash flow statement, therefore, the disclosures helping to estimate how the accounts would look like without financing arrangements would improve the comparability with peers not using such arrangements. Companies that make significant use of factoring may have more liquidity issues during a slowdown scenario; users need to be able to assess this risk. For example, having a requirement to disclose the amount of trade payables adjusted for/not distorted by supply chain financing arrangements would be useful.

25 It was noted that the existing variety of financing arrangements (e.g., with or without recourse) makes the analysis of their impacts even more difficult.

26 The information about historical loss rate on factored receivables would be useful.

Supplier Finance Arrangements

EFRAG User Panel meeting

27 In order to provide overlap in the discussions the issue on supply chain financing was linked to the discussion of the IASB's exposure draft on supplier finance arrangements.

28 EFRAG User Panel members were broadly supportive of the direction of the project to require entities to provide specific disclosures related to supplier finance arrangements.

29 Project scope – members expressed support for the IASB's approach to describe rather than define what supplier finance arrangements were. They considered the

approach to be practical and less prone to structuring opportunities. However, it was noted that it might capture wider range of arrangements than anticipated. Furthermore, members commented that focusing the scope on supplier finance arrangements that lengthen the payment period would simplify the project.

30 Proposed disclosures – members expressed general supports for the proposed disclosure requirements under the ED and further made the following comments on:

(a) presentation of supplier finance arrangements - members considered that further improvements were necessary with respect to presentation, classification and measurement of liabilities under such arrangements. In particular:

(i) Some members supported the IASB approach to start first by requiring disclosures about supplier finance arrangements and later consider improvements to the presentation and classification on the balance sheet and cash flow statements of these arrangements in other related projects in the future. This will result in a timely completion of the project and provide users with information about such arrangements.

(ii) On the contrary, some members considered that the presentation of cash flows under supplier finance arrangements was important and warranted consideration by the IASB at this stage of the project.

(b) comparability - members commented that they wanted to be able to understand how account payables would look like if supplier finance arrangements were not used.

(c) range of payment due dates - users considered that contractual payment terms between the entity and the finance provider should be the starting point for disclosures related to due payment dates (e.g., disclosing the average number of days for the two classes when these arrangements exist and when they do not exist). This will provide users with information about when it has to pay the finance provider.

31 Timeliness - members highlighted that completing the project in a timely matter was important and considered that adding presentation to the current stage of the project might affect its completion.