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Post-implementation Review of IFRS 9 – Outreach December 2021 – January 2022

Objective

1 The objective of this paper is to provide an overview of the inputs received during the December 2021-January 2022 outreach with various constituents relating to i) financial instruments with ESG features and ii) equity-type instruments.

Questions for EFRAG Board and TEG members

2 Do EFRAG Board and TEG members have comments on the inputs provided?

Meetings with constituents

3 EFRAG had a number of meetings with constituents belonging to the following categories: associations of preparers/preparers of the banking and insurance industries, auditors, national standard setters, banking regulators.

Financial instruments with ESG features

Introduction

4 As a way to deal with the push for a greener economy, banks integrate ESG features in their lending instruments. The fulfilment (or failure of fulfilment) the ESG targets affects the variability in cash flows in these otherwise basic lending instruments, potentially leading to fail the SPPI-requirement. The inclusion of these features does not change the business model which is held to collect.

5 The collection of data on sustainability characteristics (e.g., on energy performance or carbon footprint) is relatively recent. Because of the lack of historical statistical data (the availability of data depends on the jurisdiction), difficulties arise to introduce ESG features in the ratings used by banks, especially in proving the link between credit risk and failure of fulfilling the ESG features. At this stage, the assumptions taken are rather general and the models based on the assumptions are not yet subject to supervisory scrutiny.

6 Banks generally apply a de minimis approach to ESG features today, but this is not considered a long-term solution as the relative size of these features is expected to rise. An urgent solution is needed from the IASB; there is a need to separate this issue from the Post-implementation Review of IFRS 9 with the aim to speed up the search for a solution.

7 The nature of these features is thought to be ‘psychological’, even if small they aim to incentivise the borrower to fulfil a particular ESG target. Some consider the ESG features as part of the profit margin, while others consider the link to credit risk.

8 In case the change in cash flows caused by the ESG features goes beyond the effect of change in credit risk, the value of the financial instrument increase, when

the ESG target is not met. These features figure on a spectrum towards/of credit risk. Their fulfilment (or failure to fulfilment) is an indicator of the transition success of the borrower, thereby indicating whether/to which extent the borrower will be able to gather sufficient cash flows in the future to pay back the loan. In a society that transitions to a green economy, successful transitions will permit entities to continue to gather cash flows sufficient to pay back loans, whereas entities with unsuccessful transitions will see business go down or underlying collateral decrease in value. Given this, failure of an ESG feature is considered indicative of having an impact on default of the loan, but there is no one to one relationship. As a result, credit risk increases on clients who fail their own ESG targets.

9 Some noted that there are different ways to structure a financial instrument in order to invest in ESG activities; embedding them in otherwise basic lending instruments is only one of the ways to do so. Alternative structuring approaches could avoid the SPPI issue. If the ESG feature is embedded in an otherwise basic lending instrument that is accounted for at amortised cost, there is a risk that the variability is not captured or valued. ECL impairment models currently do not capture this variability.

10 Others noted that financial instruments with ESG features are basic lending instruments, and that amortised cost measurement provides more useful information than a fair value measurement. Amortised cost provides information on the growth of the portfolio, credit provisioning and the possibility to recover the provisioning. Fair value incorporates all these features without specification. Fair value creates measurement uncertainty valuation challenges (these instruments being generally level 3) and results in reporting that is less relevant than amortised cost, considering the business model.

Profit margin approach

11 Proponents of the profit margin approach argue that lower profit margins are accepted by banks as they have a specific interest in increasing the volume of business in this area.

(a) The pricing of the debt instruments is linked to pre-defined and measurable sustainability performance targets. The margin is composed of a base margin and a margin adjustment (a discount or premium in case the sustainability performance target is achieved or missed).

(b) For bonds, the pricing effects are indirect as there is an influence from supply and demand of the instruments.

(c) Some banks are using the following to determine the size of "E"/"ESG" related features in loans:

(i) Margin adjustment based on risk grids - determination of positive/negative adjustments on top of the credit rate (different methodologies exist);

(ii) Margin adjustment - change in ESG score or CO2 emissions (this method is similar to the first except that it refers to an ESG score, not an E score in isolation);

(iii) Inclusion of ESG related fees - discount or premium - depending on whether the sustainability goal is achieved.

(d) It was noted that for short term loans banks would accept to have a lower profit margin (as it brings benefits in the area of regulation or public image), but not so for longer term loans.

12 Demonstration of the link with the profit margin can start with the existence of a step-down which is seen as renouncing part of the margin. While internal calculations exist on the calculation of the margin, these are not public.

Credit risk approach

13 Proponents of the credit risk approach note that they do not loose margin on green lending. Instead, they note that the funding for those loans is cheaper, so both sides of the margin move.

14 In addressing the ESG features, it was suggested that the IASB should consider a caveat whether jurisdictions push enforcement of ESG criteria.

B5.4.6 and day 2

15 The use of a catch-up adjustment, relying on IFRS 9 B5.4.6 is seen as a possible approach to capture the ESG features in the amortised cost. In particular, when at inception a good estimate of the (probability-weighted) ESG-linked cash flows can be provided, then the subsequent catch-up adjustment would be expected to be reasonably small, if any. This would mitigate the concerns of how to deal with the P&L variability due to the ESG features in calculating the amortised cost.

"E"-type, "S"-type and "G"-type features

16 Climate or green risk is the most important risk type in current financial instruments (the "E" within ESG). However, a solution is required also for the social and governance features as they are expected to grow in importance soon. Some investors already abstain from investing in case of insufficient gender equality measures taken by a company.

17 A qualitative link can be established between "E" type features and credit risk, but it may be harder to do so for the "S" and "G" type features. For "E" type instruments, borrowers get "punished" when not fulfilling the feature, for example the value of the collateral is lowered; they are excluded from participation in future tenders, or they are taxed additionally for non-compliance. Based on regulatory incentives, the climate risk would be included in the liquidity risk as a component of a basic lending agreement. Cost of capital will depend on a company's ability to tackle climate risk, and this will be reflected in the pricing of loans to that company.

Equity-type instruments

Users

18 EFRAG met a group of international users. Most of them were in favour of a FVPL measurement of equity instruments. One of them was in favour of FVOCI measurement with recycling.

Preparers

19 The possibility to measure equity instruments at FVOCI with recycling is a priority for the insurance industry. In absence of recycling mismatches would occur for the insurance activities.

20 Banks are divided about this issue. For a commercial bank equity is not a significant part of the portfolio and when active in private equity, one uses fair value through profit or loss.

21 Other banks (with insurance activities) do not see why dividends and realised gains should be treated differently.

22 Finally, it was noted that when fair value is not reliable, keeping equity at cost (IAS 39) or at the net asset value (US GAAP) was better than having a recycling solution.

Extension of the definition of equity-type instruments

23 Preparers from insurance industry expressed a need to extend FVOCI treatment to equity-type instruments which should cover structured finance, real estate,

infrastructure and investments in windfarms for example. Generally, some noted that equity-type instruments should be described as:

(a) Any form of financial instrument that entitles the holder to a return based on the net assets of the fund. It was noted that this definition would require some ringfencing though.

(b) Puttable instruments with the following underlying: equity instruments or equity-type instruments, cash or cash equivalent to meet the liquidity constraints of the funds and potentially instruments that reduce the cash flow variability and/or manage operational issues related to the fund management.

24 For investment funds with underlying debt instruments some added that – based on a look through – if all the underlying debt instruments meet SPPI, then also the fund can meet the SPPI criterion. However, a problem remains for funds that capitalise as the only way to realise cash flows is to sell unit of funds. In this case it was questioned which measurement would be better: fair value through profit or loss or dividends in profit or loss and changes in fair value through OCI. For funds that distribute a FVOCI measurement could work however.