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Amendments to the Classification and Measurement of Financial Instruments - Feedback analysis – Assessment of contractual cash flows

Objective

1 The objective of this paper is to provide the EFRAG FR TEG with a summary of the feedback analysis on the assessment of contractual cash flows performed by the IASB staff and the IASB staff proposals to address the respondents' concerns.

Detailed feedback analysis

Overall approach

2 Almost all respondents appreciated the IASB's intention to address this issue especially for financial assets with ESG-linked features.

3 Although many respondents (mostly preparers) considered the proposed clarifications helpful, they nevertheless asked for more refinements.

4 Specifically, some respondents said that it is not clear why contingent events that are specific to the debtor (as stated in paragraph B4.1.10A of the ED), are consistent with the concept of basic lending risks and costs as discussed in paragraphs B4.1.7A and B4.1.8A of the ED.

5 A few respondents recommended clarifying that:

(a) the core principle for assessing contractual cash flows is articulated in paragraph B4.1.7 of IFRS 9;

(b) paragraphs B4.1.7A–B4.1.10A of IFRS 9 (as amended by the ED) should be considered sequentially; and

(c) no paragraph should be considered in isolation.

6 A few respondents were concerned that if paragraph B4.1.10A of the ED was applied in isolation, it could result in some financial assets being considered to have SPPI cash flows even though the instruments are not currently considered to be consistent with a basic lending arrangement, for example a loan with an interest rate that is linked to the debtor's sale targets.

Concept of a basic lending arrangement

7 Most respondents generally supported the clarifications to the elements of interest that are consistent with a basic lending arrangement proposed in paragraph B4.1.8A of the ED. However, some respondents considered that they do not contain sufficient guidance to identify the types of features that would be consistent with a basic lending arrangement (e.g., some ESG-linked features).

8 Many respondents raised concerns about the statement in the last sentence in that paragraph that 'a change in contractual cash flows is inconsistent with a basic

lending arrangement if it is not aligned with the direction and magnitude of the change in basic lending risks or costs.', such as:

(a) inconsistencies with other statements in IFRS 9 on whether or not a quantitative assessment of compensation is required;

(b) uncertainty about how to apply this requirement in the case of common ESG-linked features where the change in contractual cash flows cannot be linked directly to a change of basic lending risks or costs; and

(c) the view that this statement should not be part of the clarification of the concept of a basic lending arrangement but should be incorporated into the guidance on contractual terms that change the timing or amount of contractual cash flows.

9 Respondents also provided several suggestions how to clarify what constitutes a 'basic lending arrangement', such as adding 'cost of capital' and 'ESG-linked features' to the list of elements of interest; clarifying that compensation for 'basic lending risks and costs' may include a profit margin; including a rebuttable assumption that ESG risk is a basic lending risk, etc.

Considering the size of changes in contractual cash flows

10 Many respondents noted a contradiction between the following two statements in paragraph B4.1.8A of the ED:

(a) the assessment of interest focuses on *what* an entity is being compensated for, rather than *how much* compensation an entity receives; and

(b) a change in contractual cash flows is inconsistent with a basic lending arrangement if it is not aligned with the *direction and magnitude* of the change in basic lending risks or costs.

11 Many respondents expressed concerns with the use of the term 'magnitude', including that:

(a) the meaning of the term is unclear, because it is not defined and is not used elsewhere in IFRS 9;

(b) it is unclear how the term relates to the concept of leverage in paragraph B4.1.9 of IFRS 9; and

(c) such a requirement could result in diversity in practice developing around whether a 'punitive' increase in interest rates in response to an event such as missed payments, is aligned with the magnitude of a change in credit risk.

12 Suggestions for addressing the concerns with the word 'magnitude' included: removing the requirement to consider the size of the change in contractual cash flows; rewording the requirement using terms such as 'order of magnitude', 'level of magnitude', 'consistent with the economic rationale', 'commensurate to the risks' or 'proportionate'; including additional application guidance.

Contractual terms that change the timing or amount of contractual cash flows

Scope and application of paragraph B4.1.10A of the ED

13 Many respondents were concerned that the proposed clarifications in paragraph B4.1.10A of the ED could result in contractual terms that are currently widely considered to be consistent with a basic lending arrangement to no longer represent SPPI cash flows (for example, in case of 'increased cost clauses').

14 Some respondents also said that it is not clear whether paragraph B4.1.10A of the ED is intended to apply to all contractual terms that change the timing or amount of contractual cash flows, or only those terms that are contingent on events that are not directly linked to basic lending risks or costs.

15 Some respondents asked to define the term ‘contingent event’. A few respondents suggested including in the main Standard the statement in paragraph BC69 of the Basis for Conclusions on the ED that the ‘contingent events’ referred to in paragraph B4.1.10 of IFRS 9 excludes those associated with the time value of money or prepayment features.

Contingent events specific to debtor

16 Many respondents observed that this requirement would preclude any instruments where the ESG-linked targets are set at a consolidated level or for a group entity other than the legal debtor, from being considered consistent with a basic lending arrangement.

17 Respondents asked whether the following targets would be considered ‘specific to the debtor’:

(a) scope III emissions;

(b) emissions of a sector of which the lender is a part;

(c) where the target is relative to a benchmark, for example the debtor is in the top X% of sustainability leaders for a particular industry or group; and

(d) certain levels or ratios of expenses or revenues (for example, from ‘green business activities’) where changes in expenses or revenues depend on both the specific activities of the borrower and changes in market prices.

Investment in the debtor and performance of specified assets

18 Some respondents expressed concerns with the statement in paragraph B4.1.10A of the ED that the resulting cash flows must represent neither an investment in the debtor nor an exposure to the performance of specified assets, including that:

(a) the wording in this paragraph differs from paragraph B4.1.16 of IFRS 9 which refers to ‘an investment in particular assets or cash flows’;

(b) it is not clear what is meant by the term ‘an investment in the debtor’ in this context (one respondent suggested referring to ‘an equity-like investment in the debtor’);

(c) there is a potential for structuring opportunities if the target is only indirectly linked to cash flows generated by the debtor, such as a reference to the market share of the debtor or the number of store openings; and

(d) the requirement to achieve a particular ESG-target could be based on the ‘performance of specified assets’ and the IASB should therefore clarify whether it intended to refer to financial performance only.

19 A few respondents asked to clarify whether financial instruments with some particular clauses would be consistent with a basic lending arrangement.

IASB staff analysis

Overall approach

20 The IASB staff acknowledge respondents’ concerns that the proposals to clarify the existing general application guidance could unintentionally disrupt existing practice and considers that they can be effectively addressed by refining the originally proposed clarifications.

21 On the concerns about unintended consequences of interaction of the proposals with the existing requirements, the IASB staff highlights that the **IASB’s intention was to clarify the application guidance and not to fundamentally change the assessment of contractual cash flows**. The proposed clarifications do not change the basic principles behind the assessment of contractual cash flows of financial

assets, described in paragraphs 4.1.2 and 4.1.2A, 4.1.3 and application guidance and examples in paragraphs B4.1.7–B4.1.26 of IFRS 9.

22 The IASB staff also highlights that the relevant application **guidance** for the SPPI assessment **should be considered holistically**; **no specific paragraph or requirement takes precedence or can be applied in isolation** and neither does the order in which paragraphs are located in the Standard affect whether cash flows are SPPI or not.

Concept of a basic lending arrangement

23 As mentioned in paragraph BC47(a) of the Basis for Conclusions on the ED, the IASB reconfirmed that the elements of interest specified in paragraph B4.1.7A of IFRS 9 do not constitute an exhaustive list of the elements that are consistent with a basic lending arrangement.

24 The IASB staff notes that there is no requirement in IFRS 9 for the compensation for basic lending risks and costs to be fixed, or calculated on the same basis, throughout the life of the financial asset. As a result, instrument EA in paragraph B4.1.13 of the ED can be viewed as a combination of a basic lending arrangement with an interest rate that applies if the greenhouse gas emission targets are met and a basic lending arrangement with a higher interest rate if the greenhouse gas emission targets are not met.

25 The IASB staff acknowledges that statement in paragraph B4.1.8A of the ED that ‘a change in contractual cash flows is inconsistent with a basic lending arrangement if it is not aligned with the direction and magnitude of the change in basic lending risks or costs’ could be **less categorical**.

26 The IASB staff further agrees with respondents that it is not helpful to include such an unconditional statement as part of the clarified description of what constitutes a basic lending arrangement and that the principles articulated in this statement **should be considered together with the requirements relating to contractual terms that change the timing or amount of contractual cash flows**.

Considering the size of changes in contractual cash flows

27 The IASB staff agrees with the feedback received that **it is not helpful to imply that the ‘magnitude’** of changes in contractual cash flows **needs to be considered without being more specific** about what such a consideration would require.

28 In the IASB staff’s view, the application guidance in paragraphs B4.1.9A-B4.1.26 of IFRS 9 is consistent with the principle proposed in paragraph B4.1.8A of the ED (based on paragraph BC4.182(b) of the Basis for Conclusions on IFRS 9) that ‘[t]he assessment of interest focuses on *what* an entity is being compensated for, rather than *how much* compensation an entity receives.’

29 However, in practice, there may not be a perfect one-to-one relationship between the risks and the spread calculated for each element of interest. There are different approaches to pricing the different elements of interest in a basic lending arrangement and **the IASB did not intend to prescribe a particular approach**.

30 In the IASB staff’s view, in cases where it is not clear whether a contractual term that may change the timing or amount of contractual cash flows is consistent with a basic lending arrangement, a helpful consideration might be **whether the fair value of a such contractual feature is insignificant**.

Contractual terms that change the timing or amount of contractual cash flows

Scope and application of paragraph B4.1.10A of the ED

31 It was **not the IASB’s intention to disrupt the existing market practice** in applying paragraph B4.1.10 of IFRS 9 and the other requirements in IFRS 9 to

assess whether common contractual terms such as credit ratchet clauses or increased costs clauses are consistent with a basic lending arrangement. It was only intended to provide additional guidance.

32 The IASB staff are of the view that the core principle articulated in paragraph B4.1.10 of IFRS 9 is that **the cash flows before and after a change in contractual cash flows should represent SPPI.**

33 Paragraph B4.1.10 of IFRS 9 further states that an entity 'may need to assess the nature of any contingent event' but that the '**nature of the contingent event in itself is not a determinative factor'**.

34 The IASB attempted to give more definitive guidance by proposing that the occurrence of a contingent event should be 'specific to the debtor', but given the shortcomings of this guidance, now suggests a different approach described below (see paragraph 37).

Contingent events specific to the debtor

35 In the IASB staff view, the requirement that the occurrence of a contingent event must be 'specific to the debtor' does not provide sufficient guidance in the following circumstances:

(a) factors that impact basic lending risks and costs but are not specific to the borrower (such as the profit margin or administrative costs included in the interest rate);

(b) factors that are specific to the borrower, but unrelated to basic lending risks and costs (such as profit-sharing arrangements or targets linked to the debtor's revenue); and

(c) factors such as ESG-targets included in instruments that would otherwise appear to be consistent with a basic lending arrangement but are set at a level other than the legal debtor (such as group-wide ESG-targets or targets for Scope III emissions).

36 The IASB staff believes that for the purposes of classifying a financial asset in accordance with IFRS 9, **the intention** behind including a contractual term in a financial asset **is less important than** whether this contractual term changes the timing or amount of contractual cash flows in such a way that **amortised cost would no longer provide useful information** to users.

37 The IASB staff believe that the requirements in paragraph B4.1.10 of IFRS 9 can be further clarified that if a financial asset, that would otherwise have cash flows that are SPPI, contains a contractual feature that would change the timing or amount of contractual cash flows based on the occurrence of a contingent event and the nature of this contingent event does not clearly indicate that the contractual cash flows over the life of the financial asset are SPPI, the instrument could nevertheless **have SPPI cash flows if**:

(a) the contractually specified changes in cash flows following the occurrence (or non-occurrence) of any contingent event would give rise **to cash flows that are SPPI when considered in isolation**; and

(b) **the fair value of this contractual feature at initial recognition is insignificant**.

38 The IASB staff considers that fair value could be a good indicator of whether an entity is being compensated for something other than basic lending risks and costs and that a consideration of the significance of the **fair value of the contractual feature may be more useful than focusing on whether the contingent event is specific to the debtor.**

39 Nevertheless, the IASB staff reminds that the entity will still need to make a **holistic assessment** of whether the contractual cash flows on the financial asset represent SPPI by taking into account the other requirements in IFRS 9, including that the resulting cash flows should not represent an investment in particular assets or cash flows.

Investment in the debtor and performance of specified assets

40 Considering the concerns raised by respondents on the terminology used in the proposals, the IASB staff suggest aligning the wording of the clarification with that in **paragraph B4.1.16 of IFRS 9** - that is that the resulting cash flows **should not represent 'an investment in particular assets or cash flows'.**

41 Since the IASB proposed in paragraph B4.1.8A of the ED that a share of revenue or profits of the debtor is an example of a risk not typically considered a basic lending risk or cost, the IASB staff do not believe that further application guidance is needed.

The IASB members discussion

42 The IASB discussed the feedback and the IASB staff proposals at its October meeting. Members generally expressed support for the direction of travel and the IASB staff proposals.

43 However, members noted that 'insignificant' is not a notion defined in IFRS 9 and questioned how this insignificance should be demonstrated and whether a quantitative assessment would be necessary. Some members were concerned that estimating fair value at initial recognition of an instrument measured at amortised cost could be difficult.

44 An IASB member questioned if the feature is 'insignificant' what would be the economic reason to have this feature in the financial instrument. This member was concerned that insignificance could be too loosely interpreted and result in green washing.

45 The IASB staff noted that in most cases it would be more qualitative rather than quantitative assessment and that 'insignificance' should not be assessed and isolation, the nature of the contingent event and the cash flows before and after the event should also be taken into account. The term 'insignificant' is already used in IFRS 9 for the purposes of SPPI assessment.

46 One IASB member suggested to make it very clear in the Basis for Conclusions, that the IASB is not asking for quantitative assessment of non-significance of these features in a way similar to the one described in paragraph BC 69 of IFRS 15 portfolio approach.

The EFRAG Secretariat assessment

47 The EFRAG Secretariat have concerns that the logic applied by IASB staff as described in paragraph 24 may be applied to a number of conditions currently not considered consistent with SPPI.

48 The EFRAG Secretariat is concerned that the interpretation by IASB staff described in paragraph 32 is a serious misinterpretation of the core principle in paragraph B4.1.10 as it shifts the focus from the contractual cash flows that could arise (the core principle in B4.1.10) to looking in isolation on the cash flows before and after the change (a new principle that applies to "all" possible cash flows and is thus not useful in describing if something is or is not SPPI).

49 The EFRAG Secretariat is concerned that the IASB staff argument presented in paragraph 33 that the 'nature of the contingent event in itself is not a determinative factor' may be misinterpreted when it is not read in connection with the rest of the

same sentence in paragraph B4.1.10 which reads "[however], it may be an indicator".

50 The EFRAG Secretariat shares the IASB members concerns about the potential need to quantify in some cases the insignificance of the fair value of a contractual feature that would change the timing or amount of contractual cash flows at initial recognition, especially for existing instruments.

51 The EFRAG Secretariat acknowledges, however, that the requirement with similar wording already exists in IFRS 9 in relation to the financial assets with a prepayment feature (paragraph B4.1.12(c) of IFRS 9) and is effectively applied.

52 The EFRAG Secretariat notes that the wording 'an investment in particular assets or cash flows' from paragraph B4.1.16 of IFRS 9 is more general than the original proposal and highlights the importance of careful drafting to avoid unintended consequences.

EFRAG discussions

53 EFRAG FIWG and IAWG discussed this topic at its meetings on 20 and 21 November 2023, respectively. Their feedback is provided below.

EFRAG FIWG

54 EFRAG FIWG members generally welcomed the IASB refined proposals, considered that they would provide a sensible outcome and that judgement will always be required.

55 However, members noted that it was an important change, expressed concerns about quantification of the insignificance of a contingent feature and questioned how it could be done in a qualitative way.

56 Members discussed several alternatives of how to quantify a fair value with different directions of changes of the interest rate and came up with some practical difficulties. Members questioned how to compare the cash flows, including probabilities of the contingent event and determination of fair value, as it could render a delta between the two cash flows insignificant due to discounting. Some members argued that even if the delta is significant, the resulting instrument could still be SPPI.

57 Some members further questioned whether and how they should estimate a fair value of a loan with and without a contingent feature if currently there is no requirement to do so.

58 Members noted that the ESG features start taking different forms, sometimes going beyond the simple interest rate changes, like for example linking the tenor of the facility to meeting certain ESG target. In their view, it is impossible to capture all the possible contractual features at this stage and, therefore, the IASB's proposed solution goes into the right direction.

59 Some members asked whether introduction of a fair value assessment could be seen as a replacement of de-minimis requirement and expressed their hope the relation between the proposed approach and the existing de-minimis guidance would be clarified in the final amendments.

EFRAG IAWG

60 EFRAG IAWG members expressed concerns about the change in the IASB approach to require to estimate a fair value of the contractual feature that may change the timing or amount of contractual cash flows at initial recognition is insignificant. They considered it to be a significant change compared to original proposals in ED. In some members view it can be disruptive to current practice as it should be applied to all financial instruments and not only to the instruments with

ESG-linked features. One member questioned whether, given the significance of a change, the IASB would re-expose the ED.

61 A member noted that a requirement in paragraph B4.1.10A that the SPPI assessment shall be done irrespective of the probability of the contingent event occurring contradicts with the requirement to assess the fair value, as the fair value, in this member view, includes probability in it.

62 Members noted that the term 'insignificance' is already present in IFRS 17 and involves quantitative estimation. It was suggested that the IASB makes it very clear that the quantitative assessment is not required and that further illustrative examples are developed which show how the IASB expects this assessment to be done qualitatively.

Questions for EFRAG FR TEG

63 Does EFRAG FR TEG have any comments on the IASB staff proposed clarifications to the paragraph B4.1.10 of IFRS 9 described in paragraph 37?

64 Does EFRAG FR TEG have any comments on the IASB staff recommendation to replace the wording of paragraph B4.1.10A of the ED ‘investment in the debtor and an exposure to the performance of specified assets’ by the wording from paragraph B4.1.16 of IFRS 9 ‘an investment in particular assets or cash flows’?