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Comment letter on the EFRAG Draft Comment Letter on Request for Information - Post-implementation Review, IFRS 9 Financial Instruments – Classification and Measurement

Dear Mr Gauzès,

Thank you for the opportunity to comment on the EFRAG draft comment letter. In line with the EFRAG tentative position, we would like to highlight urgency of the need that the IASB addresses the issue of accounting treatment of ESG features. The topic should be removed from the IFRS 9 PIR process since a more timely solution is needed.

Please find our answers to the questions to constituents raised by EFRAG below.

Yours sincerely,

Gabriele Tauböck
Head of Group Accounting

Questions to constituents

The issues of sustainable finance-SPPI test, recycling changes in FV accumulated in OCI for equity instruments, treatment of equity-type instruments and supply chain financing are indicated as high priorities. Modification of cash flows, contractually linked instruments – non-recourse, factoring of trade receivables and use of administrative rates are indicated as medium priorities. Finally, financial guarantees are indicated as a low priority. Do you agree with the issues raised and their prioritisation as indicated above? Please explain.

Do you consider that there are other issues that deserve standard-setting activities? Please provide an illustration.

We agree with the issues and their prioritisation except for the items of administrative rates and modification. We consider that these two issues are not candidates for standard setting for reasons which we discuss in the answers to specific questions below.

Questions to constituents – Question 3 (a)

37 In addition to the issue of the application of the SPPI test to financial instruments with ESG features and to the requirement to classify at FVTPL mutual funds and other puttable instruments (see our answer to Question 4 below) that have been identified in this DCL, are there other fact patterns for which you think the cash flow characteristics assessment is not leading to an appropriate measurement outcome? Please consider, in particular, financial assets that are required to be measured at FVTPL, for which a different measurement approach (amortised cost or FVOCI) would be in your view more appropriate. Please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk).

Questions to constituents – Financial instruments with ESG features

38 When applying the SPPI test to financial instruments held to collect that have contractual cash flow variability linked to ESG targets specific to the borrower, what additional approach could be considered in order to avoid failures of the SPPI test? Approaches used currently include considering the ‘de minimis’ and the possible link to the credit spread.

39 Do you think that failing the SPPI test (and a resulting measurement at fair value through profit or loss) is an appropriate outcome for these financial instruments? Please specify.

40 What do you consider the economic nature of the ESG-linked variability to be?

Except for the cases discussed in our comment letter below we do not consider that there are other cases which would be candidates for reconsideration of application of the SPPI test.

Regarding financial assets with ESG features, Erste Group reacts to a rapidly changing environment where sustainability objectives are essential and acts as an active player in this field. Its lending and investing activities are being adapted accordingly.[1]

In our comment letter we focus on features which adjust the interest rate based on fulfilling certain ESG targets or ESG score changes. Financial assets with ESG-linked features raise the issue of how to apply the SPPI assessment.

The ESG-linked interest is normally based on long-term targets (KPIs) publicly disclosed in sustainability reports of borrowers or their ESG score (provided by a third party, often also called ESG rating). Meeting these targets or positive ESG score changes are beneficial for their business. From lenders' perspective, interest rate reductions are substantiated when borrowers act in a positive manner. From business point of view, such instruments are viewed as basic lending agreements without any speculative elements.

We firmly believe that financial assets with ESG-linked features should be measured at amortised cost (if, as normally is the case, the hold-to-collect business model is applied to them). We consider that the amortised cost is much more appropriate measurement compared to the fair value through profit or loss alternative.

The fair value through profit or loss measurement (which would result if these features were considered not to be SPPI) would lead to unsubstantiated profit or loss volatility resulting from:

- changes in benchmark interest yield curves (a reasonably possible interest change of 1.00% for an instrument with a duration of 5 years would lead to a P/L hit of close to 5% of the outstanding amount); and
- market-based measurement of credit and other spreads. For products like loans these often cannot be derived from observable inputs. Own estimates and their adjustments to market-based data bring subjective elements in the volatile valuation. This is incomparable to the P/L volatility resulting from the expected credit losses inherent in

[1] As part of the European Green Deal the European Commission proposed in September 2020 to raise the net greenhouse gas emission reduction target to at least 55 % compared to 1990. In addition, plans to earmark substantial funds to support the vision of a European Union becoming climate-neutral by 2050 were announced, and it was decided that 30 % of the combined EU Budget multiannual financial framework (MFF) 2021-2027 and the EU Next Generation funds are to be allocated to climate-related expenditure. Erste Group believes that the aspirations of the European Commission will have a profound transformative impact on European economies and societies in the years to come and that this transformation is necessary and the right thing to do. Such a transition should be executed in a socially fair manner, and equally high attention needs to be paid to environmental, social and governance objectives.

Against the backdrop of the increasing importance of overarching societal challenges to cope with social imbalances and climate change, Erste Group has reinforced its commitment and formulated a transparent set of the sustainability objectives and their relation to the 17 UN Sustainable Development Goals (SDGs). These sustainability objectives are an elementary and clear value set to be consistently activated in Erste Group's business strategies, products and services and, consequently, also in its sustainability risk management principles and in the supplier management principles.

In this regard Erste Group has introduced the Sustainable Finance Framework (SFF) in March 2021. The SFF has been designed as an umbrella framework that will allow Erste Group to issue sustainable finance instruments to finance new and/or refinance existing loans to its clients and projects with environmental and/or social benefits.

The Sustainable Finance Guideline outlines the various approaches and options that are available to define and identify assets that can be considered as environmental and/or social eligible to mobilize funds for a transition towards a low carbon economy.

the amortised cost measurement for which sophisticated measurement models were developed during IFRS 9 implementation and they are subject to robust disclosures.

We acknowledge that the fair value through profit or loss measurement would capture the fair value volatility resulting from ESG-linked features which might be viewed as appropriate. But the extent of the ESG-linked cash flow adjustments and their impact on the measurement is much smaller than the inappropriate volatility resulting from the above-mentioned valuation components.

As a result, we conclude that the fair value through profit or loss measurement method is not appropriate for financial assets with ESG-linked features which are held to collect contractual cash flows (or in the 'hold to collect and sell' business model). The profit or loss volatility which market-based valuation inputs bring is not relevant for this kind of business model. Another argument is that these instruments are generally viewed as basic lending agreements by lenders.

The variable ESG-linked interest cash flows would be captured by the amortised cost measurement either as catch-up adjustments (IFRS 9.B5.4.6) or, if the ESG-linked adjustments could be viewed as being part of movements in the market rate of interest, as a floating rate element (IFRS 9.B5.4.5). This distinction is addressed in a separate question of the PIR and, in our view, it does not affect the conclusion on the appropriate measurement.

To pass the SPPI assessment the ESG-linked features must be viewed as being part of basic lending risks. Paragraphs 4.1.3(b) and B4.1.7A of IFRS 9 SPPI discuss components of basic lending agreements. The ESG-linked features can possibly be viewed as being related to (i) credit risk or (ii) profit margin components.

Regarding (i), Erste Group has developed internal procedures for considering ESG behaviour and risks of its customers in credit decisions as also required by recent regulatory guidance[2]. This can also influence loan pricing which reacts to potential ESG rating improvements (by ESG rating agencies) or fulfilment of ESG-linked KPIs.

However, in most cases a direct quantification of what is the effect of fulfilling ESG targets on the actual credit risk change is not straightforward. In this regard we note that paragraph BC4.182(b) of IFRS 9 does not require an exact calculation of what the credit risk component or its changes would be.[3] As a result, it may be sufficient if entities could prove a positive correlation between the target fulfilment and the credit risk improvement and that the positive margin adjustment does not clearly overstate this improvement.

As to (ii), viewing the ESG-linked interest adjustment as part of the profit margin would be in line internal performance measurement of these instruments. ESG-linked risks are not managed as part of the interest rate risk in the banking book by ALM at our bank. Any ESG-linked changes in the interest affect the profit of the business unit entering in the transaction.

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[2] EBA Report on management and supervision of ESG risks for credit institutions and investment firms issued in June 2021 as well as EBA Guidelines on loan origination and monitoring issued in May 2020
ECB Guide on climate-related and environmental risks issued in November 2020

[3] "The IASB also noted that the assessment of interest focuses on what the entity is being compensated for (ie whether the entity is receiving consideration for basic lending risks, costs and a profit margin or is being compensated for something else), instead of how much the entity receives for a particular element."

Currently we do not perform the SPPI assessment for ESG-linked features if they are below the de-minimis threshold defined by the bank (IFRS 9.B4.1.18). So far, all the interest adjustments in our business have been within this threshold. But ESG-linked instruments are expected to increase in volume. Also, the extent of the adjustments is likely to exceed the threshold. As a result, we do not consider the de-minimis relief will work from longer-run perspective.

The most viable solution for meeting the SPPI could be to acknowledge that ESG-linked interest adjustments are a new phenomenon in the world focused on sustainability. There is an important public good aspect in these features. Lenders of funds which support sustainable behaviour in the economy should not be penalised by volatile fair value through profit or loss measurement of such assets. As a result, we consider that the IASB should think about introducing the ESG-linked interest adjustments as a separate basic lending arrangements component. At the same time, qualitative boundaries could be set. Outside such boundaries a simple qualitative assessment of the features would no longer be viewed as sufficient for a positive SPPI assessment.

The issue of accounting treatment of ESG features has emerged recently and does not directly relate to the IFRS 9 post-implementation review. We fully support the EFRAG position that it should be removed from the IFRS 9 PIR process and addressed as a separate issue urgently.

Question to constituents – Question 3 (b)

48 In addition to financial assets which are in the scope of the contractually linked or non-recourse guidance identified in this DCL, are there other fact patterns to which you think the cash flow characteristics assessment cannot be applied consistently?

Regarding the guidance for non-recourse assets its drafting should be improved. Paragraph B4.1.16 of IFRS 9 mentioning the non-recourse asset starts with an example of a financial asset where the cash flows increase as more automobiles use a particular toll road. We note that such a feature would be non-SPPI in general and does not have to be mentioned in connection with discussing non-recourse assets.

Despite the fact that accounting practice has evolved in assessing the non-recourse features and we are not aware of inconsistent application it would be helpful to improve the guidance. IFRS requirements should also address “in substance” non-recourse financial assets which do not relate to explicit contractual terms but result e.g. from funding provided to special purpose entities, investments in funds or project financing loans.

Regarding the scope of the contractually linked and non-recourse guidance we agree with the EFRAG analysis and the need for additional guidance.

Question to constituents – Question 3 (c)

In addition to the unexpected costs of applying the SPPI test to instruments with administrative rates identified in this DCL, are there other fact patterns that show unexpected effects arising from the cash flow characteristics assessment?

Our bank uses administrative rate in its loan business. Based on the existing guidance in the IFRS literature we do not consider that there should be problems with the SPPI assessment for usual cases of their application. A positive SPPI conclusion can be generally reached without a significant effort. We consider this as an irrelevant issue for the PIR.

Questions to constituents – Questions 4 (a) and (b)

FVOCI option for equity instruments

68 For which equity instruments has the option to present fair value changes in the OCI been applied? What are the reasons for choosing to use the option for those instruments? What is their proportion of the overall investment portfolio?

69 From a user perspective, do you think the absence of recycling of gains or losses of equity instruments designated at FVOCI provides useful information? Please explain.

Treatment of equity-type financial instruments

70 Please consider paragraphs 65/67 above[7]. If you consider that equity-type financial instruments should be accounted for similarly to equity instruments, how would you define 'equity-type'? What type of underlying investments should be considered? How a classification test could be structured, taking into consideration among other things the need to assess the characteristics of the underlying assets?

71 From a user perspective, do you think that expanding the possibility to use FVOCI for equity-type financial assets provides more useful information? Please explain.

In the past our bank participated in all the outreaches performed by EFRAG regarding the treatment of equity instruments:

- Request for Feedback – Questionnaire, Equity Instruments – Research on Measurement in 2019;
- EFRAG Discussion Paper: Equity Instruments – Impairment and Recycling in 2018; and
- EFRAG's Request for Evidence on Equity Investments Held by European Constituents and Possible Effects of IFRS 9 in 2017;

As a result, we refer to the detailed answers to these consultations. In short, we see merits in introducing the recycling for investments equity instruments measured at FVOCI. We also consider that a viable impairment model could be developed for them. When saying this, we also note that Erste Group is not a typical long-term equity investor and the existing measurement requirements for equity instruments do not affect our investment decisions. As a result, we do not have a strong preference for changing the requirements. But we also

understand that the IFRS 9 requirements may not fit the business model of typical long-term equity investors and the need for the change should be assessed from their perspective.

At Q3 2021 ultimo equity instruments measured at FVOCI accounted for 27% of the overall equity investment portfolio in total amount of EUR 430 million (i.e. non-trading equity investments). Erste Group uses the FVOCI option for strategic, significant banking business relationship (except insurance) investments.

Regarding treatment of equity-type financial instruments we quote our answer to question 7 of the 2019 EFRAG questionnaire.
"The primary distinguishing factor should be the 'puttable exception' in IAS 32. However, the type of assets factor should also play a role. The alternative non-FVPL treatment should be available for funds which invest in equity instruments without material derivative positions which could leverage the returns. However, if the measurement alternative was FVOCI with recycling and impairment, which as such could be suitable for all non-trading equity-type investments, we consider that the fund assets could also include debt instruments and non-financial assets without material leverage positions. As a result, mutual funds investing in simple debt instruments or real estate funds could also be measured at FVOCI."

We also note that any changes in the treatment of equity-type instruments are not vital for us and Erste Group could continue with their FVPL measurement.

Question to constituents

95 Do you think that standard-setting activities from the IASB are required to deal with modifications of the cash flow characteristics? Please explain.

We do not consider that any standard-setting activities are necessary for modifications of the cash flow characteristics. There is a lack of guidance in IFRS 9 on when modifications of contractual cash flows of financial assets result in derecognition but the issues have been addressed in the accounting practice. We observe that IFRS literature by audit firms brings a sufficient guidance in this respect and entities were able to develop their own policies. Erste Group has dedicated a lot of effort for establishing clear criteria for determining what cash flow modification events lead to derecognition of financial assets. Based on our discussion with auditors we consider that the policies are applied in a consistent manner by entities.

Question to constituents

109 How significant are these catch-up adjustments in accordance with paragraph B5.4.5 or B5.4.6 of IFRS 9 (please provide nominal amounts and expressed as a percentage compared to the interest revenue and expense calculated using the EIR – as disclosed per IFRS 7, 20(b))? Please provide information for the following reporting periods: 2018, 2019 and 2020.

The most significant case of booking catch-up adjustments in Erste Group's history was for the TLTRO III funding from the ECB in the amount of EUR 92.4 million recognised in 2021 (=

0.44% in terms of the TLTRO III notional amount of EUR 21.0 billion; = 2.5% of overall net interest income in the amount of EUR 3 670 million for the first three quarters of 2021) due to positive revisions in expectation of fulfilling the eligibility criteria for -50bps interest reduction in the TLTRO III additional special interest rate period.

We consider that it would be helpful if the IASB provided some guidance for cases when it is not straightforward to decide whether changes in contractual interest rates are treated under paragraph B5.4.5 or B5.4.6 of IFRS 9. In this regard we confirm that credit spread adjustments which are linked to changes of borrowers' financial ratios are treated under B5.4.5 by our bank, i.e. they result in the EIR recalculation (as mentioned in paragraph 107 of the EFRAG DCL). Moreover, Erste Group applies similar treatment for so called commercial renegotiations of interest rates. They arise when borrowers with fixed interest loans are in position to enforce reduction in the interest rate due to existence of cheap prepayment options and effectively functioning loan refinancing market. We interpret that such circumstances result in an implicit floating rate feature in the contract. The floating rate treatment of such cases is supported in some IFRS literature published by audit firms since these interest rate adjustments lead to changes in the market rate of interest or its component. Thus, they warrant the EIR recalculation approach based on the logic of paragraph B5.4.5 of IFRS 9.

We consider that any guidance by the IASB should confirm this established practice. Further, the guidance could be beneficial for entities to decide about the appropriate treatment in more contentious cases (such as European banks experienced in assessing whether the extraordinary 50bps interest rate reduction for TLTRO III by the ECB was part of the market rate of interest).

Questions to constituents

130 Would you have other fact patterns about factoring of trade receivables that in your view should be considered and/or have you experienced challenges in other aspects of both accounting and disclosing information on trade receivables factoring? Please explain.

131 Do you agree that additional illustrative examples specifically on trade receivables factoring would be helpful in ensuring consistent application of IFRS 9 derecognition principles?

We do not have other fact patterns to consider.

We agree that additional guidance on trade receivables factoring would be helpful. A general accounting practice for accounting treatment of factoring has evolved but there may be inconsistencies in how the derecognition requirements apply.

Questions to constituents
142 How would additional guidance on (i) the principal agent area and (ii) derecognition benefit you in accounting for reverse factoring transactions? Please explain.
143 As users of financial statements, do you currently lack information on reverse factoring transactions? If yes, which information is missing? In your view does the bank act as an agent in these situations or as a debtor? Please explain.

Being in the factor's position we do not face issues in applying the requirements. But an additional guidance could be helpful for example in communicating the reverse factoring transactions with our customers.

Question to constituents
146 Do you think that the IASB should provide educational guidance or make amendments to the standard-for financial guarantees? Why or why not?

We consider that additional guidance which would bring more clarity in accounting for financial guarantees could be helpful. While practice has been established it comes to some application inconsistencies as also in noted paragraph 145 of the DCL.