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28 January 2022

Dear Board Members,

Invitation to comment – Request for Information - *Post-implementation Review* - IFRS 9 *Financial Instruments* — Classification and Measurement

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on Request for Information – *Post-implementation Review* – IFRS 9 *Financial Instruments* – Classification and Measurement (the PIR) from the International Accounting Standards Board (IASB or Board).

In summary, we believe that the Classification and Measurement rules in IFRS 9 generally work well, and as intended by the IASB. However, we draw to your attention the following points in our response:

i) There is diversity in how the occurrence of sales affects the application of the "hold-to-collect" business model, specifically what is meant by 'insignificant in value' and 'infrequent'. More guidance and examples would help drive greater consistency of application.

ii) There are a number of interpretation questions raised in practice as to the scope of the Contractually Linked Instrument guidance. Some clarification on the points raised in our letter would help drive greater consistency of application.

iii) The SPPI test does not deal well with the increasing number of debt instruments that are being issued with certain features linked to the Environmental Social and Governance goals of a borrower. By default, these features risk causing the instrument to be recorded at fair value through profit or loss. As such features become standard elements of normal loans, it would be helpful to add extra guidance to differentiate when such features would be consistent with a basic lending arrangement (in accordance with B4.1.7A) and when they introduce a risk unrelated to a basic lending arrangement. This issue is probably sufficiently urgent to justify an accelerated project, separate from the remainder of the PIR.

iv) While the IASB has divided the PIR into three phases, none of these cover the numerous issues that have arisen relating to challenges applying the derecognition

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rules or on the scope of the standard. We strongly encourage the IASB to address these issues (some of which we set out in Appendices 2and 3 to this response) as part of the PIR.

Our detailed responses to the Board's questions are set out in the Appendices to this letter.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +31 88 407 5035.

Yours faithfully,

Ernst & Young Global Limited

Appendix 1 – Responses to specific questions raised in the Request for Information – *Post-implementation Review* – IFRS 9 *Financial Instruments* – Classification and Measurement

Question 1—Classification and measurement

Do the classification and measurement requirements in IFRS 9:

(a) enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?

(b) result in an entity providing useful information to the users of the financial statements about the amount, timing, and uncertainty of future cash flows? Why or why not?

Please provide information about the effects of the classification and measurement changes introduced by IFRS 9, including the ongoing costs and benefits in preparing, auditing, enforcing, or using information about financial instruments.

This question aims to help the Board understand respondents' overall views and experiences relating to the IFRS 9 classification and measurement requirements. Sections 2–8 seek more detailed information on the specific requirements.

See our responses to questions 2 to 8 below.

Question 2—Business model for managing financial assets

(a) Is the business model assessment working as the Board intended? Why or why not?

Please explain whether requiring entities to classify and measure financial assets based on the business model assessment achieves the Board's objective of entities providing users of financial statements with useful information about how an entity manages its financial assets to generate cash flows.

The business model test generally works as we believe the Board intended, both as to the classification of assets and the constraints on their reclassification. However, certain key terms in the guidance such as 'infrequent' and 'insignificant' (in B4.1.3B) are undefined, and so there is inevitably a range of interpretations and hence diversity of application in practice. This is also one of the areas of concern highlighted by the EBA in their November 2021 Monitoring Report.

It would be very helpful if the Board could add more guidance to the standard to help clarify how these terms should be understood.

With respect to the first criterion, 'insignificant in value', guidance would be helpful on issues such as: i) whether it should be assessed based on a percentage of the portfolio that may be sold and, if so, the range of percentages deemed consistent with this criterion; (ii) whether

any test of insignificance should be performed only period by period, or also by considering sales over the entire life of the portfolio; (iii) whether the percentage of the portfolio that may be sold depends on the duration of the assets (given that a level of sales per year will result in a greater overall turnover for assets with longer duration); and iv) whether the profit or loss impact of a sale is relevant (such that sales with a large profit or loss are given greater weighting than those where the impact is small).

With respect to the second criterion, 'infrequent', more guidance could usefully be added on the kinds of stressed conditions in which sales may be excepted, beyond the 'run on the bank' scenario illustrated in the Application Guidance. Further, what might be viewed as a stress scenario may change over time. If a stress scenario that was previously not reasonably expected to occur becomes more probable due to new facts and circumstances, an entity will presumably need to re-assess whether the scenario continues to constitute a stress scenario for the purpose of classifying new financial assets. For example, when sales have recently occurred as a result of unanticipated funding needs, an entity may assess that such a scenario is currently no longer reasonably expected not to (re-)occur within this portfolio, resulting in newly originated or newly purchased financial assets in this portfolio no longer being classified in a hold to collect business model.

Another issue that needs to be resolved is whether the business model assessment should be made from the viewpoint of the business or the reporting entity. The distinction matters if financial assets are originated or acquired in a business that the entity may or intends to sell. The IFRS IC discussed this question in November 2016 and noted that, in its consolidated financial statements, an entity assesses the business model test from a group perspective. But the IFRS IC did not make a decision on this matter and the discussion was referred to the Board.

For when the IASB moves to the hedge accounting phase of the PIR, we note that this issue also has significance for determining whether a forecast cash flow is 'highly probable' for hedge accounting purposes at a consolidated level, when the business applying hedge accounting is due to be sold.

Question 2—Business model for managing financial assets *(continued)*

(b) Can the business model assessment be applied consistently? Why or why not?

Please explain whether the distinction between the different business models in IFRS 9 is clear and whether the application guidance on the evidence an entity considers in determining the business model is sufficient. If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements

The diversity in practice described under (a) is best evidenced by the recent EBA IFRS 9 monitoring report. When assessing whether a sale is 'insignificant in value', institutions in the sample report the use of many different thresholds and methodologies and no clear trends are observed in the type of assessment that institutions are running. The situation is similar for the assessment of the frequency of sales where a multiplicity of practices is also

observed. Many entities sell *some* hold to collect assets every year, so this is a widespread issue. We expect this issue to become even wider when insurers apply IFRS 9.

There is also diversity due to different judgements made on 'the viewpoint from which the assessment is made', as referred to above.

Question 2—Business model for managing financial assets *(continued)*

(c) Are there any unexpected effects arising from the business model assessment? How significant are these effects?

Please explain the costs and benefits of the business model assessment, considering any financial reporting or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about reclassification of financial assets (see Spotlight 2).

Given that IFRS 5 excepts financial instruments from the scope of its measurement requirements, it is unhelpful that IFRS 9 doesn't allow expected fair value losses to be recognized if the entity is in the process of selling it. Unless the asset is already impaired, the entity is not permitted to record a fair value loss that it expects to incur, even if it has contracted to make the sale.

Question 3—Contractual cash flow characteristics

(a) Is the cash flow characteristics assessment working as the Board intended? Why or why not?

Please explain whether requiring entities to classify and measure a financial asset considering the asset's cash flow characteristics achieves the Board's objective of entities providing users of financial statements with useful information about the amount, timing and uncertainty of future cash flows. If, in your view, useful information could be provided about a financial asset with cash flows that are not SPPI applying IFRS 9 (that is, an asset that is required to be measured at fair value through profit or loss applying IFRS 9) by applying a different measurement approach (that is, using amortised cost or fair value through OCI) please explain:

(i) why the asset is required to be measured at fair value through profit or loss (that is, why, applying IFRS 9, the entity concludes that the asset has cash flows that are not SPPI).

(ii) which measurement approach you think could provide useful information about the asset and why, including an explanation of how that approach would apply. For example, 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). (See Section 7 for more questions about applying the effective interest method.)

(b) Can the cash flow characteristics assessment be applied consistently? Why or why not?

Please explain whether the requirements are clear and comprehensive enough to enable the assessment to be applied in a consistent manner to all financial assets within the scope of IFRS 9 (including financial assets with new product features such as sustainability-linked features). If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?

Please explain the costs and benefits of the contractual cash flow assessment, considering any financial reporting effects or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about financial instruments with sustainability-linked features (see Spotlight 3.1) and contractually linked instruments (see Spotlight 3.2).

For the most part the contractual cash flows assessment works as we believe the Board intended. However, there are problems in two main areas:

i) Contractually Linked Instruments

ii) Financial assets with ESG[1] features

Contractually Linked Instruments

The guidance set out in paragraphs B4.1.20 to B4.1.26 can be applied successfully to many of the kinds of structures for which they were drafted, that is, securitisations of loans/receivables. However, it isn't clear as to the scope of the requirements, since transactions involving more than one investor, with varying levels of subordination, are used in many other fact patterns. In many cases, structures are designed not to share the credit risks of receivables with multiple investors, but simply to finance assets on a collateralised basis, while in some instances the underlying assets are not financial instruments at all.

The Basis for Conclusions, in discussing the development of the guidance, states that it was revised so as to focus on the economic characteristics rather than the form and legal structure *(BC4.29)* and is not based solely on the contractual features (*BC4.33).* Further, to make the judgement about whether an instrument has the required features to be to be considered to be contractually linked, an entity must understand the characteristics of the underlying issuer (*BC4.34).* One of the challenges in applying the guidance is that, despite the desire of the Board not to focus on legal form, the wording, including the title, 'contractually linked', frequently refers to the contractual form.

Commonly asked questions for which it would be helpful to publish further guidance, include:

a) What does 'multiple contractually linked instruments' mean in paragraph B4.1.20? Would only two tranches count as 'multiple', or does there need to be at least three, for an arrangement to be covered by the guidance?

b) What counts as a tranche?

1. Would it include over-collateralisation, whereby an entity whose assets are funded provides collateral, the value of which is returned if unused?

2. Does an issued note count as a tranche if non-payment of amounts due would result in a breach of contract and hence an event of default, such that the structure must be restructured or liquidated? A focus on legal form would suggest not, while the Basis for Conclusions (BC4.28) notes that subordination, in itself, does not preclude amortised cost measurement.

3. Would an issued note count as a tranche if it qualifies to be classified as equity under IAS 32?

[1] Environmental, Social, Governance

4. Conversely, would an issued note that is equity in legal form count as a tranche if it does not qualify to be classified as equity under IAS 32? Such an instrument may not be contractually linked to the other tranches, but there may be an indirect linkage, such that the equity behaves as a junior tranche, especially if the structure has a limited life. As such, if a structure is funded by such a note and, say, one other (more senior) debt instrument, would it be in the scope of the guidance?

c) Given that B4.1.21 (b) refers to 'the underlying pool of ***financial instruments'***, does this mean that any structure where the underlying assets are not financial instruments in the scope of IFRS 9 (such as, for instance, operating leases) are not within the scope of the CLI guidance? If they are in scope, then no issued note would satisfy the SPPI criterion since the underlying pool of assets would themselves not normally satisfy the criterion.

d) How much additional complexity can be added to a structure before it is no longer within the scope of the CLI guidance? For instance, are any of the following not within the scope of the guidance?

1. If a manager of the structure is paid a variable fee linked to the level of recovery of cash flows on the underlying assets?

2. (If the scope of the CLI guidance does include structures where the underlying assets are not financial instruments) if a parent establishes an SPE to develop and operate a property, and finances it by the SPE issuing two or more contractually linked tranches of debt finance?

Or

3. A parent finances the acquisition of an operating entity by establishing an SPE in which it invests an equity stake (classified as equity under IAS 32 *Financial Instruments – Presentation* - but see d) and e) above) and arranges for two or more contractually linked debt tranches to provide more senior finance?

Also, a practical problem arises when a portfolio of underlying loans includes a small number of loans that would fail SPPI. From a strict reading of B4.1.21 (b), this would cause all the tranches to fail SPPI, which would, arguably, seem a strange answer if any variability due to the feature that leads to this failure would be fully absorbed by junior tranches of the structure. While such a feature would not be *de minimis* for the individual loan, or even necessarily for the pool, it may be in the context of the exposure of the tranche being assessed. It would be helpful if the Board would reconsider the wording of B4.1.21(b).

Financial assets with ESG features

Banks are increasingly being asked by clients, regulators and others to help promote improvements in their clients' environmental and social impact, through differential pricing of loans. This has led to a huge increase in the volume of loans with ESG features, where the

interest rate typically increases or decreases by a number of basis points, based on the obligor's compliance with some pre-specified criteria.

The issue is whether the inclusion of such features in loans would cause them to fail the SPPI criterion. If a significant portion of a bank's loan portfolio were required to be recorded at FVPL, it would be unlikely to provide useful information to users and would significantly expand the population of level 3 assets at FVPL, creating valuation challenges for the lenders and their auditors.

At least at the moment, these pricing adjustments are only indirectly related to the credit risk of the obligor. First, the loans are often relatively short term compared to the period over which failure to meet the criteria might affect the obligor's credit risk; and second, credit risk management doesn't normally get involved in these price adjustments, which are currently relatively small. Hence, it is not at present possible in many cases to argue that the feature is consideration for credit risk.

Many of the pricing adjustments we have seen would probably be viewed as *de minimis*, and as such, permitted to be ignored in the SPPI assessment, but they are steadily increasing in size (now frequently double-digit basis points) and this view is becoming increasingly difficult to hold.

As such features become standard elements of normal loans, it would be helpful to add extra guidance to help differentiate when such features would be consistent with a basic lending arrangement (in accordance with B4.1.7A) and when they introduce a risk unrelated to a basic lending arrangement.

We attach, as Appendix 2, the section of International GAAP[2] we have written as guidance on this topic.

Other

The articulation between certain paragraphs of IFRS 9 could be improved to make it clear that the 'de minimis' guidance in paragraph B4.1.18 also applies to non-recourse loans, as described in paragraph B4.1.17. Paragraph B4.1.17 refers to where "the terms of the financial asset give rise to ***any*** other cash flows…" (emphasis added) and does not contain the cross reference to B4.1.18 contained in the CLI guidance (paragraph B4.1.25).

[2] International GAAP 2022

Question 4—Equity instruments and other comprehensive income

(a) Is the option to present fair value changes on investments in equity instruments in OCI working as the Board intended? Why or why not?

Please explain whether the information about investments in equity instruments prepared applying IFRS 9 is useful to users of financial statements (considering both

(i) equity instruments measured at fair value through profit and loss; and

(ii) equity instruments to which the OCI presentation option has been applied).

For equity instruments to which the OCI presentation option has been applied, please explain whether information about those investments is useful considering the types of investments for which the Board intended the option to apply, the prohibition from recycling gains and losses on disposal and the disclosures required by IFRS 7.

The option is working as we believe the Board intended, although several issues have arisen from its application:

i) Should any difference between the consideration paid for an equity investment classified at FVOCI and its initial fair value be recorded in OCI or in profit or loss? This question arises, for example, whenever the volume purchased includes a block discount or surplus.

   Whether a day 1 gain or loss should be recognised in profit or loss or rather in OCI is unclear due to the lack of a clear articulation between the guidance on Day 1 gains or losses and the measurement of FVOCI equity instruments. On one hand, paragraph B5.1.2A. states that "An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss." On the other hand, paragraph 5.7.1 (part of section 5.7 'Gains and losses') states that, "A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in profit or loss unless: (…) (b) it is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in other comprehensive income in accordance with paragraph 5.7.5." Meanwhile, 5.1.1 would require transaction costs incurred on acquisition to be recognised in OCI.

ii) A similar question arises if an equity investment classified at FVOCI is sold for a value that varies from P*Q due to a block discount or premium.

   This is due to the lack of a clear articulation between the derecognition rules and the measurement of FVOCI equity investments. Paragraph 3.2.12 states that "On derecognition of a financial asset in its entirety, the difference between the carrying amount (measured at the date of derecognition) and the consideration received (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss", while 5.7.1 states that "A gain or loss on a financial

asset or financial liability that is measured at fair value shall be recognised in profit or loss unless: (…) (b) it is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in other comprehensive income in accordance with paragraph 5.7.5."

iii) How should disposal costs be recorded for an equity investment at FVOCI?

Although the accounting for transaction costs on initial recognition is clearly set out in 5.1.1., the accounting for similar costs incurred on disposal is not specified. For similar reasons as mentioned in ii), it is unclear whether such costs should be recognised in profit or loss as suggested by paragraph 3.2.12 on derecognition, or rather in OCI, consistent with transaction costs incurred on original recognition.

Question 4 – Equity instruments and other comprehensive income *(continued)*

(b) For what equity instruments do entities elect to present fair value changes in OCI?

Please explain the characteristics of these equity instruments, an entity's reason for choosing to use the option for those instruments, and what proportion of the entity's equity investment portfolio comprises those instruments.

Practice varies, with, at one extreme, some entities using the category for equity investments that are not held in a trading book while, at the other, the category is used for investments that the entity never expects to sell. This reflects differences in entities' business model for holding such assets, which vary both by industry and by geographical location.

Question 4 – Equity instruments and other comprehensive income *(continued)*

(c) Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in OCI? How significant are these effects?

Please explain whether the requirements introduced by IFRS 9 had any effects on entities' investment decisions. If yes, why, how and to what extent? Please provide any available evidence supporting your response which will enable the Board to understand the context and significance of the effects.

In responding to (a)–(c), please include information about recycling of gains and losses (see Spotlight 4).

We have no additional comments.

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Question 5– Financial liabilities and own credit

(a) Are the requirements for presenting the effects of own credit in OCI working as the Board intended? Why or why not?

Please explain whether the requirements, including the related disclosure requirements, achieved the Board's objective, in particular, whether the requirements capture the appropriate population of financial liabilities.

(b) Are there any other matters relating to financial liabilities that you think the Board should consider as part of this post-implementation review (apart from modifications, which are discussed in Section 6)?

Please explain the matter and why it relates to the assessments the Board makes in a post-implementation review.

We believe that the requirements for presenting the effects of own credit in OCI are generally working as the Board intended, although we note two issues where the wording could be reconsidered:

i) Paragraph B5.7.16 (a) allows the amount of the change in fair value of a financial liability that is attributable to changes in credit risk of that liability, to be determined as the amount of change in fair value that is not attributable to changes in market conditions that give rise to market risk. Paragraph B5.7.17 states that changes in market conditions that give rise to market risk include changes in a benchmark interest rate. The IBOR reform project has highlighted that some benchmarks, such as LIBOR, include an element of credit risk. It is therefore unclear whether the amount of change attributable to changes in credit risk should be measured relative to a risk-free rate (and so represents 'absolute' credit risk) or to a benchmark rate such as LIBOR (and so represents 'relative' credit risk, i.e., the credit risk specific to the obligor).

ii) It is unclear whether, for debt denominated in a foreign currency, the own credit risk portion of changes in fair value should be recorded in OCI as they arise, or whether the amount to be recorded in OCI should be a cumulative amount, based on current exchange rates.

In the following simple example, we assume that the exchange rate for a period is the same as at period end. An entity with sterling as its functional currency issues a liability with an initial fair value of $100 (recorded at an exchange rate of 1.4, i.e., £71.43). In period 1, the liability changes in fair value to $103 (at a period end rate of 1.42, i.e., £72.54), of which $2 represents a decline in interest rates and $1 a reduction in the instrument's credit risk. The change in fair value is accordingly recorded as:

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		Dr £	Cr £
Cr	Change in fair value of liability		1.10[3]
Cr	Foreign exchange revaluation - p/l		1.01[4]
Dr	Revaluation due to market risk - p/l	1.41[5]	
Dr	Revaluation due to credit risk - OCI	0.70[6]	

In period 2, assume there is no change in the dollar fair value of the liability, while the exchange rate increases to 1.5. The entries would therefore be:

		Dr £	Cr £
Dr	Change in fair value of liability	3.87[7]	
Cr	Foreign exchange revaluation - p/l		3.87[8]
Dr	Revaluation due to market risk - p/l	0	
Dr	Revaluation due to credit risk - OCI	0	

The problem that arises is that the cumulative amount that has been recorded in OCI for the instrument's change in credit risk is a debit of £0.70, whereas the cumulative dollar change in the instrument's credit risk in sterling terms is now £0.679. Applying this approach, while the dollar value of the change in credit risk will revert to nil before the note is repaid, there will likely be a balance left in the sterling amount recorded in OCI.

It could be useful for the Board to clarify whether retranslation of the component of the fair value of liabilities which relates to credit risk should itself be accumulated in OCI or recorded in profit or loss.

[3] ($100/1.4) – ($103/1.42)
[4] ($100/1.4) – ($100/1.42)
[5] $2/1.42
[6] $1/1.42
[7] ($103/1.42) – ($103/1.5)
[8] ($103/1.42) – ($103/1.5)
[9] $1/1.5

Question 6— Modifications to contractual cash flows

(a) Are the requirements for modifications to contractual cash flows working as the Board intended? Why or why not?

Please explain what changes you consider to be modifications of a financial asset for the purpose of applying paragraph 5.4.3 of IFRS 9 and as a modification of a financial liability for the purpose of applying paragraph 3.3.2 of IFRS 9. Does the application of those paragraphs, and the disclosure requirements related to modifications, result in useful information for users of financial statements?

(b) Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?

Please explain whether the requirements enable entities to assess in a consistent manner whether a financial asset or a financial liability is modified and whether a modification results in derecognition. Have the requirements been applied differently to financial assets and financial liabilities? If diversity in practice exists, please explain how pervasive the diversity is and its effects on entities' financial statements.

We have for many years highlighted the need to develop guidance on the modification of financial assets and when it would lead to derecognition.

We would be supportive of applying the guidance for modification of liabilities, that a 'substantial modification' would result in derecognition. However, if a lender grants a concession to a troubled obligor, this should be treated as an impairment trigger rather than a possible derecognition. It follows that we suggest that the 10% test is either not applied for stage 2 and 3 assets (as the modification is likely to form part of an impairment workout strategy), or else it is adapted to address concessions due to credit risk, otherwise most modifications of troubled assets would result in derecognition. One of the problems with derecognising such assets is that the 'new' asset would be classified as stage one for ECL purposes (which could be misleading, and we are aware is of concern to regulators) or, possibly, POCI, which would distort comparability between credit-impaired assets which have been substantially modified and derecognised and other credit-impaired assets.

Because the assessment of whether a modification might result in derecognition is likely to be, primarily, a qualitative judgement, it would be helpful for the standard to include some examples of where a modification would be viewed as substantial. Possible scenarios would include: i) if the currency of the instrument is changed; ii) the remaining maturity is extended from, say, two years to ten; iii) the loan switches from floating to fixed (and hence the original EIR is no longer relevant); or iv) a new feature is added that would affect the SPPI assessment if it were present at origination.

We also note several application issues arising from the current modification guidance:

1. Paragraph 5.4.3 states that modification gains and losses should be accounted for in a similar manner to changes in estimates (as set out in B5.4.6) but does not specify

where in profit or loss such an adjustment should be recorded. Many entities argue that if the modification is of an impaired asset, the adjustment should be recorded as part of the ECL charge. To do otherwise distorts the reporting of an entity's credit-related losses and the level of such losses would depend on whether the lender has previously written off some of the amounts due. However, a summary of the April 2015 meeting of the Transition Resource Group for Impairment of Financial Instruments (ITG), published on the IASB's website, suggests this would not be appropriate. Instead, it says that if disclosing gains and losses from impairments and modifications on a net basis would provide relevant information (for example, if the reason for the modification was credit-related), this could be dealt with through additional disclosure in the notes. The summary also says that modification gains and losses should be presented separately if considered appropriate. It would be helpful if the Board would reconsider the ITG's discussion on this topic, so as to require such modifications to be reported together with impairment losses.

2. The requirements for the treatment by the lender for modification fees charged to the borrower are not clear (in contrast with the treatment of fees incurred which would adjust the carrying amount of the modified financial asset as per paragraph 5.4.3). One view could be that they should be included in the modification gain or loss as they are part of the modified contractual cash flows and do not represent 'fees incurred'. Alternatively, one might argue that the fees charged to the borrower would adjust the carrying amount of the loan. This would be consistent with the principle in paragraph B5.4.2 of IFRS 9, which explains that origination and commitment fees are an integral part of the EIR and, therefore, amortised over the term of the financial asset in accordance with the effective interest method.

3. Also, it is not clear how to apply the substantial modification guidance to derivatives, especially those where there is cash settlement of the difference in fair value. While this is not relevant for measuring the derivative, derecognition would result in a de-designation of a hedge relationship.

Question 7—Amortised cost and the effective interest method

(a) Is the effective interest method working as the Board intended? Why or why not?

Please explain whether applying the requirements results in useful information for users of financial statements about the amount, timing and uncertainty of future cash flows of the financial instruments that are measured applying the effective interest method.

The EIR method is well established and most constituents are used to the 'AG8' (i.e., paragraph B5.4.6) 'catch up' approach for changes in estimates. However, it can sometimes be difficult to interpret whether a change in expected cash flows should be accounted for under B5.4.5 or B5.4.6. A good example of this is the issue of TLTRO loans, as discussed by the IFRS IC, as to whether conditions attached to the interest rate should be reflected in the estimates and revisions of expected future cash flows when determining the EIR. In the TAD, the Committee observed that this is part of a broader matter and should be covered in the PIR.

Another example is where an initial low 'teaser' rate is charged on a loan which is prepayable at the borrower's option, that adjusts to a 'standard' rate after, say, one year. We observe diversity in practice, based on different readings of the guidance:

1. Some entities consider that, in accordance with B5.4.4, a teaser discount should be included in the calculation of the EIR applied over the expected life of the loan, giving a blended rate. Changes in expectations of prepayment would result in B5.4.6 adjustments.

2. Other entities believe that the initial teaser rate is itself a market rate and so a reversion to a standard rate should be accounted for in accordance with B5.4.5.

Question 7—Amortised cost and the effective interest method *(continued)*

(b) Can the effective interest method be applied consistently? Why or why not?

Please explain the types of changes in contractual cash flows for which entities apply paragraph B5.4.5 of IFRS 9 or paragraph B5.4.6 of IFRS 9 (the 'catch-up adjustment') and whether there is diversity in practice in determining when those paragraphs apply. Please also explain the line item in profit or loss in which the catch-up adjustments are presented and how significant these adjustments typically are. If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

In responding to questions (a)–(b), please include information about interest rates subject to conditions and estimating future cash flows (see Spotlight 7).

See our comments under a) above.

Question 8—Transition

(a) Did the transition requirements work as the Board intended? Why or why not?

Please explain whether the combination of the relief from restating comparative information and the requirement for transition disclosures achieved an appropriate balance between reducing costs for preparers of financial statements and providing useful information to users of financial statements. Please also explain whether, and for what requirements, the Board could have provided additional transition reliefs without significantly reducing the usefulness of information for users of financial statements.

(b) Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not?

Please explain any unexpected effects or challenges preparers of financial statements faced applying the classification and measurement requirements retrospectively. How were those challenges overcome?

The transition rules included concessions to make it easier, in theory, for preparers to implement the standard in 2017. However, because it is not permitted to apply IFRS 9 to financial instruments that were derecognised prior to the transition date, a preparer could never report meaningful comparative information on an IFRS 9 basis. Since special relief has been provided to insurers and no other entity will now transition to IFRS 9, there is no need to amend the standard, but we make reference to this issue again under question 9(b), in the context of ‘lessons learned’.

Question 9—Other matters

(a) Are there any further matters that you think the Board should examine as part of the post-implementation review of the classification and measurement requirements in IFRS 9? If yes, what are those matters and why should they be examined?

Please explain why those matters should be considered in the context of the purpose of the post-implementation review, and the pervasiveness of any matter raised. Please provide examples and supporting evidence when relevant.

The PIR programme

The PIR programme has been split into three sections, to cover Classification and Measurement, Impairment and Hedge Accounting. This leaves out both scope and derecognition, which was arguably one of the most challenging part of IAS 39 in terms of application and interpretation, and which was incorporated into IFRS 9 without amendment. We attach in Appendix 3 a list of issues relating to scope and, in Appendix 4, examples of problems with the derecognition model.

IAS 20 – forgivable loans and other forms of grants embedded in loans

As illustrated by the IFRS IC discussion on TLTRO instruments, there is lack of clarity as to how IFRS 9 and IAS 20 interact and hence how forgivable loans should be accounted for. The IFRS IC discussion does not cover all the related issues and the IFRS IC has chosen to refer to the PIR the issue of how conditions attached to the interest rate should be reflected in estimates and revisions of future expected cash flows when determining the effective interest rate (see Question 7, above).

We also refer to our response of 16 August 2021 to the IFRS IC TAD, in which we highlighted a number of concerns with the wording, as drafted. Apart from the question as to whether the ECB is a government agency or similar body, that is not relevant to the PIR, the first relates to the TAD's apparent focus on constraining the amount of government grant at inception, as opposed to varying it depending on subsequent progress in meeting the conditions and so does not appear consistent with the definition of a government grant or the principles of IAS 20.

For example, in measuring the fair value of the loan at initial recognition, the entity would need to assess the value at which it could be transferred to a market participant, and hence how market participants would probability-weight the likelihood of meeting their lending targets and, therefore, receiving the more favourable rate. Unless it is either 0% or 100% likely that the participants would meet the targets (both when the tranche is drawn and in the final outcome), the difference between the fair value of the liability and the transaction price will not be the same as the ultimate amount of benefit that the bank receives from the ECB. Even if there is reasonable assurance and the full benefit is subsequently received, the amount of the grant as measured under paragraph 10A on initial recognition will not be equal to the benefit that is ultimately received. It seems inconsistent with the definition of a government grant in paragraph 3 of IAS 20 not to update the measurement of the

government grant to include the full transfer of resources to the entity, especially as the definition considers that the transfer of resources may be in return for past or future compliance with certain conditions (which an entity may not be certain of meeting at inception).

The second concern relates to possible changes in the rate. Consider an on-market loan that is given by a government agency or similar entity and the interest or principal obligations are subsequently reduced. Unless this modification results in derecognition of the original loan, the wording in the TAD suggests that paragraph 10A, being only applicable at initial recognition of the loan, would not apply. Judgement would then need to be exercised in determining whether the reduction is within the scope of IAS 20 or IFRS 9, using other paragraphs and the general definition of a government grant in IAS 20. We provided an example in our 16 August 2021 response of how this judgement could be made by using the guidance in paragraph 10 of IAS 20 below. We see little reason to have different treatment for subsequent reductions based on whether the initial loan did, or did not, contain a government grant. Therefore, we believe that the TAD is too restrictive in not allowing for judgement to be exercised for events that occur after initial recognition of government loans.

We believe that the Board should consider the accounting for such loans more broadly as part of the PIR.

Regular-way trades

Paragraph B3.1.5 states that "generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes" while paragraph B3.1.6 defines the settlement date as "the date that an asset is delivered to or by an entity". In practice, while settlement is often delayed beyond its due date, interest or coupon usually accrues from the ***due*** settlement date, rather than the date that settlement actually occurs. It would be helpful to clarify if this difference in fact pattern would lead to settlement date accounting being based on when the transaction is due to settle rather than when it actually does.

Question 9-Other matters *continued*

(b) Considering the Board's approach to developing IFRS 9 in general, do you have any views on lessons learned that could provide helpful input to the Board's future standard-setting projects?

We appreciate that the IASB sought to replace IAS 39 with IFRS 9 with a degree of urgency, but one area that suffered from this was the guidance on Contractually Linked Instruments, as discussed above in our response to Question 3, where the final version published by the Board differed significantly from the one that had been exposed for comment and has since given rise to many issues of interpretation. A second issue is that the transition rules, although originally designed to assist entities in transitioning to IFRS 9 made it impossible to prepare meaningful comparative information under IFRS 9 (see Question 8).

Appendix 2 - Extract from International GAAP 2022 Chapter 43 Financial instruments: Classification – ESG loans

5.4.7 Environmental, social and governance (ESG) linked loans

ESG loans are structured such that the interest rate varies based on whether the borrower achieves pre-determined ESG targets defined in the loan agreement. For example, the terms may include a reduction or increase in the interest rate if the borrower does or doesn't attain a certain rating on a type of green-building rating system for an agreed number of the borrower's manufacturing buildings. ESG targets can also include diversity-related targets such as gender representation targets at a defined level of management.

The contingent rate adjustments may introduce additional variability to the cash flows of the loan which is linked to the underlying ESG performance of the borrower, that may not be consistent with a basic lending arrangement. Careful analysis of the terms of ESG loans is required to assess whether the cash flows represent solely payments of principal and interest.

Loans with ESG, green or sustainability-linked features that can cause changes to their contractual cash flows are different from what are commonly called "green loans". Green loans may refer to loans granted to borrowers who operate in environmentally friendly sectors such as solar power or to loans that are granted to finance activities that are 'green'. However, crucially, they do not include any terms which can cause their contractual cash flows to change due to 'green' targets after the loan has been issued.

In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. However, contractual terms that introduce exposures to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as an exposure to changes in equity prices or commodity price, do not give rise to contractual cash flows that are solely payments of principal and interest. *[IFRS 9.B4.1.7A].*

How we see it

There is no bright line to determine whether ESG features cause an instrument to fail the SPPI test. It is important to consider whether they provide commensurate compensation for basic lending risks such as credit risk (see 5.4.7A below) or whether they introduce compensation for new risks that are inconsistent with basic lending arrangements (see 5.4.7C below). Some features may be de minimis or non-genuine (see 5.4.7B below). It is important to exercise sound judgement based on facts and circumstances.

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5.4.7A Compensation for credit risk

Instruments are more likely to meet the SPPI requirements if the attainment of the target resulting in a decrease (or a decrease) in the interest rate is likely to result in the improvement (or the deterioration) of the borrower's credit risk during the life of the loan such that the change in interest rate is commensurate with the change in credit risk of the borrower. IFRS 9 acknowledges that clauses which allow changes to the timing and amount of contractual cash flows may not fail the SPPI test if there is a relationship between the changes and an increase in credit risk.

It is often difficult to demonstrate a commensurate link between the interest rate change due to the attainment of an ESG target and the credit risk of the borrower. This may be easier to prove if the entity can demonstrate that it takes the ESG metric into account when pricing and monitoring the credit risk on the loan. This could be the case if there is a link between the feature and the value of the collateral pledged against the loan (see illustration 5.21 below); or if there is a link between the feature and the probability of default on the loan (see illustration 5.22 below). If the link to credit risk is too indirect (see illustration 5.23 below), the feature will have to be further assessed (see 5.4.7B and 5.4.7.C below).

Some ESG features may affect the credit risk of the borrower over the long-term but not necessarily the credit risk of the loan. For example, some ESG features may affect the credit risk of the borrower over a long-term period and continuous failure to meet ESG targets in the long-term might lead to the borrower's business becoming unsustainable and ultimately lead to its demise, but this may have very little effect on the borrower's ability to repay the loan (i.e. credit risk) over the expected remaining life of the loan.

If there is a link between the feature and the credit risk of the loan, the lender should also establish whether the magnitude of the change in the contractual cash flows due to the feature is commensurate with the anticipated change in credit risk. If the feature gives rise to leveraged exposure to the resulting credit risk, the loan is likely to fail the SPPI test. The exception to this is where the feature gives rise to non-commensurate changes in interest rates, not in an attempt to introduce leverage to the contract, but in an attempt to introduce a punitive interest rate to act as a disincentive against the borrower allowing its credit risk to deteriorate. In such cases, the objective of the non-commensurate change in interest is to reduce the lender's risk, similar to other common features of basic lending arrangements such as default penalties, rather than increasing its risk by introducing leverage.

This exception regarding punitive rates is not specific to ESG loans. In September 2013, the IASB Staff noted that even if an interest rate could be described by some as 'punitive' in the sense that the terms of the instrument require a significant increase in the interest rate upon a credit event and such feature is intended, in part, to discourage a specific behaviour (such as missing payments on a credit card), the increased rate could still be commensurate with the consideration for credit risk of the instrument if such behaviour occurs[10].

[10] Agenda paper 6D for the September 2013 IASB meeting on Contractual Cash Flow Characteristics: The Meaning of 'Interest'

The following examples illustrate these considerations.

Illustration 5-21: ESG-linked loans

A bank grants a loan to fund the acquisition of a new fleet of vessels. The loan is collateralised by that fleet. In addition, the loan contains an ESG feature that reduces or increases the interest rate based on the borrower's performance against a commonly used metric in the industry for carbon emissions. The metric is based on the carbon emissions of the entity's fleet after factoring in the distance travelled by the fleet and the ships' size.
 	
In this scenario, there may be a link between the emissions targets and the value of the collateral (the fleet). The bank would need to consider:
 	
• Whether the value of the collateral (the fleet) is linked to the attainment of the carbon emission targets:
  ○ This might be the case, as, all things being equal, a better maintained and therefore more efficient fleet should attract a higher resale value than a less efficient fleet.
  ○ However, better efficiency may not necessarily indicate that the fleet is in a better condition. Efficiency will depend on other factors such as the ships' payloads, the skill of the crews in operating it, the time spent waiting to dock at busy ports and weather conditions.
  ○ Judgement would need to be exercised in determining the strength of the link based on the facts and circumstances.
• Whether the change in value of the fleet would affect the entity's assessment of the credit risk on the loan:
  ○ In this scenario, the fleet has been pledged as collateral on the loan. A more valuable fleet could therefore reduce the loss given default on the loan and therefore decrease the entity's assessment of the loans' credit risk.
  ○ However, if the loan is not collateralised, or if the metric considers the performance of additional ships that have not been pledged as collateral against the loan, the link with credit risk may be harder to demonstrate.
• Whether the change in the interest rate in response to the attainment of the emissions target can be considered appropriate compensation for the associated change in credit risk.

Illustration 5-22: ESG-linked loans

A ten-year loan is granted to a power generating entity to finance an overhaul of a coal-fired power plant. Operating this power plant is the entity's sole business. New local legislation will prohibit the power plant from continuing to operate if a specified CO_2 emissions target is not met on or after a date in 3 years' time. Therefore, the bank has included a series of annual targets in the loan terms, building up to the final deadline. If the power plant does not meet these contractual emissions targets, the interest rate on the loan increases.

The lender is likely to be able to demonstrate a link between the ESG feature and the credit risk of the loan. If the final emissions target is not met, the plant will not be able to operate. As this is the borrower's sole business, it would be unlikely that it will be able to repay the loan if that was to happen. The contractual emissions targets are designed to incentivise the borrower to incrementally work towards meeting the overall legislative target. The closer the borrower gets to the legislative deadline and the further it is from achieving it, the higher its credit risk becomes. The contractual features increase the interest rate in response to this increase in credit risk. Therefore, there is a clear link between the contractual targets and the credit risk on the loan.

The lender would also need to establish whether the magnitude of the change in the interest rate is commensurate with the change in credit risk. If the change is not commensurate, it should consider whether the feature is designed as a punitive feature to disincentivise against the borrower allowing its credit risk to increase by making slow progress towards the important legislative deadline.

In practice, this link to credit risk may not be so clear. For example, the link may be blurred when the entity's credit risk is a function of multiple comingled businesses, but the loan and the ESG-feature relate to a single business or portion thereof or when the cost of attaining the ESG target is high and could out-weight the benefits.

Illustration 5-23: ESG-linked loans

A short-term loan is granted to a food group. The interest rate on the loan varies depending on the performance of the group against an ESG scorecard. The scorecard includes three targets

a) one based on the reduction in the Group's CO_2 emissions,

b) one based on the percentage of new hires that are female, and

c) one based on the number of training hours in sustainable food production provided to previously underprivileged people.

The group's performance against each target is weighted and used to determine an overall score. The interest rate will be reduced if the Group achieves a score above a predetermined level.

In this illustration, achievement of the ESG target benefits the entity in a broader, intangible manner. For example, the Group could achieve the training target by providing training as a corporate social initiative to people who are not employed by the Group and have no contractual or financial relationship with the Group. While this may improve its reputation, and therefore possibly improve its business performance and credit risk in the long-term, such a link is indirect and, most likely, weak. Additionally, the loan is a short-term loan and therefore it will be difficult to demonstrate a link between the feature and the credit risk on the loan.

5.4.7B De minimis or non-genuine ESG features

Lenders or holders should also consider whether the ESG feature is de minimis (see 5.4.1A above) or non-genuine (see 5.4.1B above). A lender may decide, as an operational simplification, to introduce a quantitative threshold below which features would be considered 'de minimis' without a detailed analysis. There is judgment to be exercised in determining what the appropriate threshold is. This is especially relevant in a low-interest environment, whereby sustainability-linked discounts or penalties could easily become significant in relative terms.

5.4.7C Compensation for other basic lending risks

In some markets, the presence of ESG features within certain types of lending arrangements is becoming increasingly common because of lenders being expected to support the transition towards greener business. In these cases, if the ESG feature is not de minimis and introduces cash flows that are not commensurate with the change in the credit risk on the loan, further analysis will be necessary to assess whether the feature causes the loan to fail the SPPI test.

In July 2021, the IASB Staff considered the classification of loans with sustainability-linked features. They noted that the key question to ask in analysing these loans is what the entity (the holder) is being compensated for. The nature of the contingent event (i.e. the trigger) of sustainability-linked adjustments is the borrower's performance against specified sustainability targets but this does not automatically mean that the adjustments represent compensation for the entity's exposure to an actual sustainability risk of the borrower and therefore cause the loan to fail the SPPI test [11].

Key to this argument was the feedback from stakeholders that many ESG-linked adjustments of these loans are a standardised fixed spread and represent a relatively small fraction of the total interest of the loans. They are standardised in a sense that they are not determined based on the assessment of the specific risks of the borrower meeting or not meeting the ESG targets. Although the ESG targets are bespoke to the individual borrower, the size and

[11] Agenda paper 3B for the July 2021 IASB meeting on the Post-implementation Review of IFRS 9 – Classification and Measurement

design of the ESG-linked adjustments are often standardised, regardless of what the ESG targets are and how likely it is they will be met. Where this is the case, it could indicate that the ESG features do not introduce compensation for bearing a specific ESG risk that is unrelated to a basic lending arrangement (like equity prices or commodity prices). Therefore, the feature would not cause the loan to fail the SPPI assessment.

In contrast, the Staff highlighted that they were not implying that ESG-linked adjustments may be SPPI because their size is small or because they are standard or common features. A small or common feature may well be inconsistent with a basic lending arrangement and contractual cash flows that are SPPI. But, while the size of the adjustment is not a determinative factor of the assessment, the Staff observed that the larger the adjustments are relative to the total interest of a loan, the more it might be an indication that adjustments represent compensation for a particular type of risk or exposure. In such cases, the borrower and the lender would have a stronger incentive to ensure that a large ESG-linked adjustment reflects the compensation for the relevant ESG risks assumed. If a financial asset compensates an entity for its exposure to ESG risks of the borrower, in the staff's preliminary view, such compensation is often unlikely to be consistent with contractual cash flows that are SPPI.

In addition to the size of the feature, as a further step in the analysis of ESG features that are not *de minimis* and which introduce cash flows that are not commensurate with the change in the credit risk on the loan, we believe that the following considerations may clarify whether the ESG feature introduces compensation for a new risk that is inconsistent with a basic lending arrangement:

- The record of contract negotiations between the borrower and the lender

  The negotiations between the counterparties may indicate whether the feature was included as a necessary concomitant to a basic lending arrangement; in response to one of the more traditional basic lending risks such as credit risk; or to introduce ESG risk and compensation into the loan.

- The nature of the ESG feature. Paragraph 4.182 of the Basis for Conclusions to IFRS 9 expands on this concept of a basic lending arrangement and emphasizes the importance of the pricing approach:

  If the ESG feature is priced to compensate the lender for a specific lending risk, such as credit risk, rather than to incentivize common "good corporate citizen" behaviour, it would be more appropriate to assess the feature against the credit risk guidance in 5.4.7A above.

- The lender's pricing decisions

  The lower the level of precision used by the lender to measure and price the risks and volatility arising from the ESG feature, the greater an indication it is that the lender has not attempted to introduce compensation for an ESG risk and is simply trying to conclude a basic lending arrangement.

- The extent to which the counterparties monitor and manage the resulting ESG risk

  The less prominence that the counterparties give to measuring and managing the resulting ESG volatility and risk on the loan, the greater an indication it is that they were trying to conclude a basic lending arrangement rather than introducing compensation for a separate risk.

- The level and frequency of data on the ESG feature that the borrower is required to report to the lender

  Similar to the previous point, if the parties intended to introduce compensation for ESG risk, the borrower would be expected to provide more granular, frequent updates to the lender in respect of the ESG feature to enable the lender to monitor and manage its exposure.

The Board is currently considering the contractual cash flow test in the context of sustainability-linked loans as part of the post-implementation review of IFRS 9 (see section 10 below). It is possible that additional guidance will emerge during, or as a result of these discussions.

Appendix 3 - Scope issues

Loan commitments

The accounting for the draw-down of loans on loan commitments would benefit from clearer guidance. Paragraph 5.1.1 requires such a loan to be accounted for on original recognition at fair value, but this is not consistent with the treatment of loan commitments under paragraph 4.2.1 (d), which requires application of the expected credit loss guidance, as if the loan were treated as a continuation of the loan commitment. Current practice is not to treat the date of draw-down on a loan commitment as the date of initial origination for the purposes of applying paragraph 5.1.1 to a loan that meets the SPPI criterion, but instead the date of the original loan commitment. This avoids the need to reverse the ECL allowance on drawdown and to record an immediate fair value gain or loss. It would be helpful if the Board provided guidance to support this approach.

If it is accepted that the accounting for a loan commitment should be consistent with the subsequent accounting for the loan once drawn down, the requirements for loan commitments would usefully be updated to reflect the introduction of the SPPI criterion. While it is clear from paragraph 2.3(a) that a loan commitment is in the scope of IFRS 9 if the entity has a past practice of selling the resulting assets shortly after origination, there is no guidance on how to account for commitments to acquire or originate an asset that will fail the SPPI criterion once drawn down. If the Board agrees with the treatment suggested in the previous paragraph, it would be counterintuitive to record the loan commitment in accordance with paragraph 4.2.1(d) but then record the loan when drawn down at fair value through profit or loss, since this would mean having to reverse the ECL allowance and take an immediate fair value gain or loss. It would make more sense to require that such a loan commitment be recorded at FVPL.

Designation of hybrid contracts not in the scope of IFRS 9 at FVPL

The annotated version of IFRS 9 notes that "The IFRS Interpretations Committee recommended, and the Board proposed, to clarify paragraph 11A of IAS 39 (now paragraph 4.3.5 of IFRS 9) as part of Improvements to IFRSs in August 2008. The Board proposed to specify whether it applies only to contracts with embedded derivatives that have financial hosts, or whether the fair value option can be applied to all contracts with embedded derivatives. The Board did not finalise its proposal".

We continue to receive questions from preparers, about whether the FVPL designation can be applied to hybrid contracts where the host is not an instrument in the scope of IFRS 9. Examples include insurance contracts within the scope of IFRS 17 and lease contracts within the scope of IFRS 16. The question is whether IFRS 9.4.3.5 can be applied to allow such contracts to be recorded at FVPL and, if so, whether that affects only the measurement of the contract or also the presentation and disclosure of the contract.

Own use contracts

A number of submissions were made to the IFRS IC in 2009/2010 regarding own use contracts. At the time, the staff noted that, "the issue of the submission (forward contracts with volumetric optionality on non-financial items that are readily convertible to cash) is only one of many practice issues with respect to the scope provisions in IAS 39.5-7. These paragraphs, which are based on US GAAP (but which do not include the many detailed implementation guidance), are difficult to apply in practice. For example, there is divergence in practice not only over when a commodity is readily convertible to cash but also how that notion is to be applied to the parties to the contract (as the staff have observed in its outreach – see paragraph 9(b) of this paper). Consequently, the staff believe that the best course of action is for the IFRS IC to recommend to the IASB that it should comprehensively address the issues experienced in practice concerning the scope of IAS 39 as part of the replacement of that standard".

However, the guidance was carried through to IFRS 9 without changes. If there is scope to reconsider this area as part of the PIR, this could help to reduce complexity and diversity in practice.

Appendix 4 - Derecognition issues

There are a number of practical issues when applying the derecognition rules, that were imported directly from IAS 39 without reconsideration. Further, a 2009 project to amend IAS 39 in this area was abandoned. In a number of places, the standard is unclear and, as a result, there is a potential for diversity in its application. It should be clear that we are not advocating a fundamental re-write of this part of the standard, rather clarification as to how it should be applied.

We divide this appendix into two sections:

A. Areas where we believe that because of uncertainty there is diversity in practice; and

B. Areas where we believe that practice is broadly consistent, but the guidance could be clearer (not least to help guide accounting and audit regulators).

Some of the items have previously been flagged by the IASB or the IFRS IC as in need of improvement and so may be thought of as 'work in progress'.

<u>A. Areas where there is potential diversity in practice</u>

1. *Dilution risk and the de-recognition assessment for trade receivables*

The financial asset derecognition guidance would appear to have been written primarily with loans and bonds in mind, and so do not address some of the specific features of trade receivables. These are not 'purely' loans but are affected by the broader relationship between a supplier and its customers. For instance:

i) the amount due may be affected by the performance of the receivable after it is first recognised, such as where there is a return clause exercised or a commercial dispute affecting the goods or service delivered after the receivable has been billed, or where there is guarantee by the seller of the future performance of an item that has been sold; or

ii) The amounts due may be reduced through subsequent volume discounts or because of a right of set off against amounts owed by the supplier to the customer.

If such trade receivables are sold or otherwise transferred (such as in a factoring arrangement) and, if any of these circumstances occur, the transferor would be required to repurchase the receivable or compensate the transferee, what effect does this have on the assessment of transfer of risks and rewards?

The IFRIS IC and the IASB discussed this issue in 2006 in relation to when conditions attached to a transfer include provisions ensuring the existence and value of transferred cash flows at the date of transfer, but the IFRS IC withdrew its views on this topic in 2007. In the absence of guidance, there is diversity in application.

2. *'Similar' assets in the context of assessing potential de-recognition of a group of assets*

If a package of non-derivative financial assets, such as loans, are transferred in conjunction with derivative financial instruments, or guarantees, is the reference to 'similar financial assets' in 3.2.2(a) meant to require a single derecognition test for the whole 'package' as a whole; or is it necessary to make individual derecognition assessments for each type of instrument (e.g., loans, interest rate swaps, guarantees or credit insurance) transferred? This issue (together with issue 1, above) was raised in the IFRS IC/IASB 2006/2007 deliberations on the topic as well as the 2009 ED, but never resolved. Applying one approach or the other significantly affects the analysis of the transfer of cash flows (paragraph 3.2.2) as well as the extent to which the risks and rewards have been transferred (3.2.6), and there is diversity in practice.

3. *Securitisations – assessment of control*

The derecognition rules raise a number of issues when SPEs are involved. For instance, the control test refers to the transferee's ability to sell but, if the transferee is an SPE, how should this be assessed? An SPE frequently operates under the control of another party, such as a specialist servicer, and has no independent autonomy. The servicer may, in turn, be subject to potential kick out, or is constrained, by a representative of certain tranches of the issued notes not held by the transferor. Thus, the servicer and/or the representative may determine which assets can be sold and how. Should references to the 'transferee' be read in such cases to extend to whichever party or parties have control over the SPE or can constrain it? Since an SPE may not have the practical ability to do anything on its own, a strict reading of B3.2.7 suggests that this could preclude the transferor from derecognising the assets even though it has, for all practical purposes, lost control of them.

4. *Securitisations – accounting for continuing involvement by the transferor and transferee*

If a transferor cannot derecognise an asset because it holds a tranche of a securitisation and is deemed to have retained control, should it record both the underlying assets and the tranche, or should it follow the example for derivatives (paragraph B3.2.14) and so ignore the tranche, since grossing up would involve 'recognising the same rights or obligations twice'? We believe that this is the approach that is often followed, but the treatment for derivatives would usefully be expressed as a principle to be applied more broadly.

The accounting by the transferee in these circumstances is less clear. If it is accepted that the transferor would not recognise both the underlying assets and the tranche it holds, should the transferee record both the 'failed sale' asset and the tranche liability separately? And can they be offset (as this virtual asset will be virtually settled net against the liability)? There is diversity of views on this subject and further guidance on this issue would be valuable.

5. *Continuing involvement – accounting treatment*

We have a general concern regarding the required accounting treatment for a continuing involvement, namely that IFRS 9 provides examples of how to deal with certain specific transactions rather than clear underlying principles. It can be difficult to determine the appropriate treatment for a continuing involvement that does not correspond fairly exactly to one of the examples in IFRS 9. For instance, how should continuing involvement be measured if the transferor retains exposure to a fixed rate of interest, or to pre-payment risk, or an 'excess spread'? We also have some reservations concerning the derecognition example set out in B3.2.17. The fact pattern is not one that we have ever encountered, so the value of this example would be to illustrate principles that may be applied to other fact patterns, but these principles are not clearly explained.

First, it is unclear why it is appropriate to apply the derecognition criteria to part of an asset where the part that is retained provides credit enhancement for the transferee. Paragraph 3.2.2 (b) is clear that if an entity transfers the rights to the first 90% of cash flows, or the rights to 90% of the cash flows but provides a guarantee to compensate the buyer for any credit losses up to a specified percentage, the derecognition rules are applied to the asset in its entirety. If the example in B3.2.17 is retained, it would be helpful to make it clear why the analysis differs from that in 3.2.2(b).

Second, we do not understand the basis of the treatment of the excess spread. The example simply asserts that it is part of the consideration received for providing the subordination, although it is unclear that it forms any more or any less part of the consideration for the subordination than the interest and principal on the 10% that is retained and, instead, would seem to from part of the continuing involvement.

An alternative analysis might be:

- The entity has disposed of not 90% of the whole portfolio, but 90% of the principal balances and 9.5% interest on that 90%, and
- The consideration for the subordination is still CU65, on the basis that if:
    a) The fair value of the consideration for a fully proportionate share of 90% (i.e., including 10% interest) is CU9,090; and
    b) The fair value of the excess spread of 0.5% interest is CU40, then

the fair value of the consideration for a fully proportionate share less the excess spread is CU9,050 (i.e., CU9,090 less CU 40). This in turn means that the balance of the payment made by the transferee of CU 9,115 (i.e., CU65) relates to the subordination.

Further, if the excess spread is regarded as part of the asset retained, rather than the consideration received, it should be accounted for as part of the continuing involvement. As already mentioned above, it is unclear how a continuing involvement in the form of an excess spread should be accounted for, but it would presumably be on a basis consistent

with the accounting treatment of the original transferred asset (typically amortised cost) rather than at fair value.

6. *Valuation of servicing assets or liabilities*

Paragraphs 3.2.10 and B3.2.10 explain the measurement of servicing assets or liabilities. Unfortunately, the standard does not go on to provide examples of what exactly is meant here. Illustrative examples would be useful to drive consistency in application. We have developed an example (e.g., 52.8 in IGAAP Chapter 52) that outlines our understanding.

7. *The pass-through assessment and equity instruments*

It is not clear if, or how, the pass-through test guidance in paragraph 3.2.5(b) should be applied to equity instruments. For instance, if the future cash flows on an equity instrument are passed on to the transferee in perpetuity, and the transferor has a right to sell the underlying equity at its own discretion provided that it passes on the proceeds of the sale to the transferee, would this satisfy the test?

This requirement is that the transferor should be prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows. Strict reading of the paragraph implies that this situation – where the transferor may sell the equity instrument and pass the proceeds to the transferee - would fail de-recognition. If this is the case, then it would mean that the transferor would have to continue to hold the instrument into perpetuity, or until the instrument is sold – is that correct?

B. Areas where the guidance could helpfully be clearer

1. *Equitable transfers*

In many jurisdictions the law recognises two types of title to property: (a) legal title; and (b) equitable or beneficial title. In many securitisation and similar arrangements, the transfer of contractual rights to receive cash flows are achieved via an equitable or beneficial transfer of title in that asset (for instance, if a transfer of legal title would not be possible without the express consent of the debtor). The question is whether an equitable transfer would qualify as a transfer for the purposes of paragraph 3.2.3 (b) of the derecognition assessment, or whether the 3.2.5 pass through criteria would also need to be met. In 2006, the IASB expressed a tentative view that an equitable transfer would be treated like a transfer of legal title rather than as a pass though where it transfers all the legal rights to specifically identified cash flows. This view was also repeated in the 2009 ED, and we believe it has since been generally applied, but it has never been formally published.

2. *Continuing involvement – transfer of control*

Paragraphs B3.2.7 and 8 set out guidance on how to evaluate whether there has been a transfer of control, in scenarios where there has been neither a transfer nor a retention of substantially all risk and rewards. The phrase, "A transferee has the practical ability to sell the transferred asset if it is traded in an active market" is not clear since it can be read to mean that it ***only*** has the practical ability to sell the asset if it is actively traded. The example that immediately follows this is of where the transferor has a call option over the transferred asset or has issued a guarantee or put option in respect of the transferred asset that is sufficiently valuable that it would practically restrict the transferee's ability to sell the asset. As a result, we assume that the 'active market' requirement relates only to these circumstances, but it is not clear.

In contrast, if the transferor's continuing involvement is in the form of a holding a note issued by a securitisation vehicle, presumably it should not matter whether the underlying assets are actively traded. Is this correct? As paragraph B3.2.8, appears to confirm, all that should matter is that the transferee has the practical ability to sell the transferred asset, and this would not be constrained by the assets not being actively traded. In practice, there are many securitisations of non-performing assets which are not traded in active market, but it is intended that the assets held by the securitisation vehicle will be sold. Also, if lack of an active market means that the transferee doesn't have the practical ability to sell the assets, this would have been equally true for the transferor. We recommend that the Board provides clarity that the reference to 'active market' is intended to be an example.

More examples of items that would or would not pass the current control test wording would be helpful.

3. *Disclosures*

Whether or not the guidance regarding derecognition of financial assets is unamended, the disclosure requirements should be reviewed, as suggested by the Board in 2008. For

instance, given the guidance issued by IFRS IC in relation to supplier finance arrangements, there would be merit in strengthening the guidance on disclosure of transactions that result in derecognition, so as to provide more information on the potential liquidity and other risks.

4. *De-recognition of derivatives*

The main text of IFRS 9 is not clear whether derivatives should be assessed for de-recognition using the asset or liability guidance or both. While the question is covered in BC6.333, this important guidance would be better positioned within the main body of the standard. It would also be helpful to clarify that the 10% test would not be relevant to assess whether a modification is substantial, since a derivative has no EIR.

We also raised a comment on how modifications of derivatives should be assessed, in response to Question 6.

5. *Novations*

We continue to receive questions about whether the guidance contained in the novations to central clearing counterparties (CCPs) amendments and the related staff papers applies in other scenarios.

Paragraph BC6.334 stated that "through novation to a CCP, a party (Party A) to the original derivative has new contractual rights to cash flows from a (new) derivative with the CCP, and this new contract replaces the original contract with a counterparty (Party B). Thus, the original derivative with Party B has expired and, as a consequence, the original derivative through which Party A has engaged with Party B meets the derecognition criteria for a financial asset".

In the underlying fact pattern, parties A & B signed two new contracts with a new party C in replacement of the original contract. The conclusion was clear for the fact pattern considered.

However, in other situations (which are also regarded as legal novations in some jurisdictions), the logic behind expiry and de-recognition is less clear. For example, consider an original contract between Parties A and B. B is then replaced by a new party (C) in its contractual rights and obligations under the original contract. Assume that this is a legal novation and legal analysis confirms that the original contractual rights haven't expired; the transaction represents a replacement of the counterparty under the original contract. It is not clear if the BC6.334 conclusion can be forced.

Some argue that the guidance in the BC was developed with a different case in mind and is not applicable. Others look at paragraph 26 of the staff paper that supported the amendment. It stated that, "the novation to a CCP constitutes a 'substantial modification of terms' as referred in paragraph 40 of IAS 39 because the counterparty is a crucial element in terms and conditions of an agreement and the counterparty changes due to the novation". However, this guidance did not make its way into the final amendment.

This issue is also linked to the question of when modification of a derivative gives rise to derecognition, as raised in our response to Question 6.

We recommend that the standard be updated to provide clearer guidance on the assessment of de-recognition in general, but in particular, on changes in counterparties. In addition, we recommend that the guidance contained in this BC and in the related footnote where novation is defined be moved to the body of the main standard.