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PIR IFRS 9 – Assessment of selected issues

Issues Paper

Objective

- 1 The objective of this paper is to develop an assessment of the technical merits of the selected issues as input for the PIR of IFRS 9 *Financial Instruments*, i.e., to identify the issue deserving standard setting activities.

Categorisation of the issues

- 2 EFRAG has divided the list of issues reported into four categories:
 - (a) Category A: issues where the existing EFRAG position can be repeated;
 - (b) Category B: issues for which standard setting is required (including a possible indication on whether we would suggest to amend the standard or to issue education material, or other actions);
 - (c) Category C: issues for which the EFRAG Secretariat has identified some prevalence; and
 - (d) Category D: issues which are inherently complex and/or standard setting would not necessarily lead to a favourable cost-benefit trade-off.
- 3 In assessing whether the requirements have improved financial reporting, the IASB will consider the following questions:
 - (a) are the requirements working as intended?
 - (b) are the requirements capable of being applied consistently? and
 - (c) are there any significant unexpected effects, either positive or negative.

Issues categorised as requiring standard setting

- 4 The following issues have been put forward by EFRAG TEG:

	<i>Issue</i>	<i>Criterion</i>
2	Sustainable finance – SPPI test	Requirements not working as intended
3	SPPI – use of administrative rates	Inability to apply requirements consistently
5	Business model – sales – COVID (merged with issue 18 – COVID moratoria)	Unexpected effects

PIR IFRS 9 – Assessment of selected issues

	<i>Issue</i>	<i>Criterion</i>
6	Contractually linked instruments – non-recourse	Inability to apply requirements consistently
12	Modifications of cash flows	Inability to apply requirements consistently
19	Accounting for TLTRO III – and broader aspects on determining the effective interest rate (merged with issue 9 – variable rates)	Requirements not working as intended
20	Supply chain financing – reverse factoring	Inability to apply requirements consistently
21	Financial guarantees	Inability to apply requirements consistently

Assessment of the issues

(2) Sustainable finance – SPPI test

- 5 IFRS 9 does not currently specify if sustainable products¹ should be accounted at fair value when they fail the SPPI test. Banks might be indirectly discouraged from mainstreaming this type of lending.
- 6 Incorporating ESG² factors and risks into the business model analysis and definition could improve the long-term business strategies to mitigate and reduce environmental harmful activities and promote environmentally sustainable activities. Preparers noted that the alignment of the accounting to the business model may have positive effects on long-term sustainable investments.
- 7 Some of the reasons concerning the prevalence of ESG financial instrument are:
 - (a) As investors demand more ESG transparency from investee companies and are encouraging them to adopt strategies that support the net-zero carbon targets defined in several international Agreements or initiatives;
 - (b) The long-term investment focus of some industries leads to a particularly well placed to channel investment into infrastructure projects, notably in the area of renewable energy;
 - (c) These investments typically earn an additional return above other equity or debt instruments; and
 - (d) As issuers some groups benefit from a growing interest of investors, that could have the same challenges if their benchmark is to carry at amortised cost these bonds.
- 8 In order to illustrate the above accounting issue, reference is made to paper 03-02 which contains examples of ESG or green financial assets.

¹ Green bonds, green loans, green deposit products etc.

² Environmental, Social or Governance characteristics that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual.

EFRAG Secretariat analysis

- 9 The issue of bonds and loans with interest rate or other features linked to the achievement of ESG targets of the issuer or linked to the proceeds of an ESG project was not widespread at the time the C&M criteria were designed by the IASB. From the perspective of the holder, the application of the SPPI test or of the contractual linked test in IFRS 9 may result in these instruments failing to be eligible for classification at amortised cost or at fair value through OCI, unless the entity demonstrates that the feature under investigation has an indirect credit risk nature (e.g., the reduction of interest rates reflects a lower credit risk that accompanies the achievement of the ESG target).
- 10 The EFRAG Secretariat notes that the following the contractual features could impact the SPPI test: interest rate indexed to other non-interest variables or the limitation of a creditor's claim to specified assets of the debtor or to the cash flows from specified assets.
- 11 In addition, for the insurance industry the main area of concern could be related to investments carried at held to collect and sell, backing traditional with profits insurance policies. Unit-linked products which are carried at fair value would be less problematic.
- 12 In cases of step-up interest rate bonds where these ESG or green feature provide compensation for basic lending factors should be further assessed whether there are sufficient collaterals or guarantees not related to the specific activity of the debtor. ESG-related step-ups are not in opposition to the SPPI test as long as a link can be demonstrated between the ESG criteria on which the step-up/step down is based and the credit quality of the entity. However, this link could be complicated to demonstrate and document.
- 13 The EFRAG Secretariat considers the SPPI-test is not straightforward and requires considering, amongst others, the significance of the impact of the ESG triggers (e.g., whether they are de-minimis, as defined under IFRS 9. B4.1.18³) and whether the inclusion of such features is consistent with a basic lending arrangement.
- 14 In addition, the EFRAG Secretariat understands that, while the impact of such ESG triggers can in many cases still be considered as de minimis today (due to the relative size of the volatility introduced by the incentive), their impact is to increase in the near future as pressure builds for obtaining the climate change related targets.
- 15 The EFRAG Secretariat wants to collect views on whether this issue should be considered by the IASB as deserving standard setting activity.**

FIWG feedback

- 16 EFRAG FIWG members agreed that this issue should be reported to the IASB without delay and maybe not to wait for the PIR due process to address and potentially resolve this issue.
- 17 Some EFRAG FIWG members noted that the increase of this type of instrument is expected to be material in volume and in conditions in the next two years. For that reason, the practical expedient offered by the “de minimis” rule currently used may not work anymore in the future to avoid FVTPL for those instruments.

EFRAG FIWG members generally agreed that ESG / green financial instruments do not belong to a new business model category. However, they encourage the IASB

³ A contractual cash flow characteristic does not affect the classification of the financial asset if it could have only a de minimis effect on the contractual cash flows of the financial asset. To make this determination, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument. In addition, if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than de minimis but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset.

to consider whether these ESG / green financial assets are aligned with the SPPI criteria as some FIWG members wondered whether a fair value measurement would provide relevant information. They also noted that measurement at fair value might create challenges as many ESG were very specific to the entity.

- 18 Some FIWG members suggested the IASB exploring an extension of what constituted basic lending features. The issue was more related to the definition of what constituted a basic lending arrangement and what basic loan features should be included in SPPI criteria. There was often no direct correlation between ESG factors and credit risk. However, moving the borrower's business to a more sustainable way would potentially improve credit risk. However, the impact on credit risk might only materialise in periods beyond the maturity of the loan assessed for SPPI.
- 19 One FIWG member considered that the useful references to of de minimis and the link with credit risk should not be abandoned, but at a certain point in time too much pressure would be put on those indicators and there would have to be another solution. ESG was more a characteristic of the contract rather than the business model.
- 20 The SPPI test was designed to avoid hiding volatility in an amortised cost business model, but the definition of a derivative with a non-financial variable that was specific to the entity was a tool in the embedded derivative world that could be a potential way to address the issue with the SPPI test.

(3) SPPI – use of administrative rates

- 21 An illustration of these products is found in Sweden, where the loan terms, both fixed and floating refer to “the general interest level”. In practice, that means that a “composite” rate is created using the composition of the actual funding of the bank/mortgage institution.
- 22 Example 1: Around 60% of the mortgage loans in Sweden are fixed for 3 months. After 3 months the rate is adjusted based on the price list of the mortgage institution. The price list as such has been generated using the average funding profile of the institution.
- 23 The liquidity in the market is not big enough to allow a refinancing of the institution every 3 months. Therefore, the actual funding is mix of deposits, overnight funding, commercial paper/certificates of deposits with a maturity up to 12 months, covered bonds issued at fixed rates with maturities between 3 to 5 years, senior bond, senior non-preferred, tier 2 and additional tier 1 instruments as well as equity. The actual relative composition will depend on the actual market situation.
- 24 This means in practice that competition and the formulas used decide the actual interest rate adjustments every 3 months, not changes in 3-month rates observed in the market.
- 25 Example 2: Fixed rate loans to corporates and retail refer to the general interest level as well. It means that the bank offers a fixed rate without any reference to any index, just a gross rate is offered. The actual funding is the same as in example 1 with the exception that covered bonds are not used in this latter case.
- 26 The safeguard both for private individuals is that consumer protection laws prevents changes in the interest rates offered above “changes in general interest levels”.

EFRAG Secretariat analysis

- 27 The EFRAG Secretariat notes the following:
 - (a) Situations such as in Sweden are not unique, the use of administrative rates occurs also in other jurisdictions;

- (b) The use of benchmark rates has the advantage of standardisation, especially when developing a principles-based standard; and
- (c) As the underlying components of administrative interest levels can be different from region to region or even from entity to entity, the analysis and standard setting becomes more complex, even rules based. Before standard setting can begin, further outreach on the main components of these rates will be required.

28 Notwithstanding these considerations, the EFRAG Secretariat is of the view that IFRS are to consider the use of administrative rates as their use are what is economically happening. The use of administrative rates will also have knock-on effects on the hedge accounting requirements, but these are out of scope of the current PIR.

29 Considering the feedback of FIWG members (below), EFRAG Secretariat proposes that this issue is not to be considered by the IASB as deserving standard setting activity.

FIWG feedback

30 The application of such rates, including blended rates, is common in certain jurisdictions (Sweden, Austria) but not in others (France). The issue with such rates is the burden of proof required to demonstrate that such rates fit into the SPPI test of IFRS 9 which relies on benchmark rates.

31 EFRAG FIWG members from affected jurisdictions advocated a relaxation of the SPPI criteria for such rates unless the blended rate contains elements that do not fit with a basic lending instrument. They indicated that educational material would be useful.

32 Other EFRAG FIWG members cautioned against standard setting and noted that if banks replicate their funding costs in the interests they charge, this would possibly fit within the SPPI test.

(5) Business model – sales - COVID

33 Diversity in practice occurs on how to assess “frequent and significant sales” of financial assets under the business model held to collect.

34 In the context of COVID, more guidance is sought on how to assess changes in business models (whether sales of financial assets under the business model held to collect are permitted sales).

EFRAG Secretariat analysis

35 The EFRAG Secretariat notes that in accordance with paragraphs B.4.1.3A and B.4.1.3B of IFRS 9 that a sale of assets when there is an increase in credit risk as well as for other reasons (such as to manage credit concentration risk) are consistent with a business model to collect contractual cash flows.

36 The EFRAG Secretariat considers that COVID 19 has had an impact on the ability of many companies to pay back their loans. Hence, banks would take measures to protect their loan portfolios, including the sale of some of these loans.

37 **Considering the feedback of FIWG members (below), EFRAG Secretariat proposes that this issue is not to be considered by the IASB as deserving standard setting activity.** The topic will be re-discussed again in September FIWG, so this indication is still tentative.

FIWG feedback

38 This issue will be brought back to September FIWG meeting.

- 39 It was noted that following the COVID situation, banks have been under regulatory pressure not to hold onto non-performing loans on the balance sheet for too long.
- 40 EFRAG FIWG members noted this was not an accounting issue and cautioned against a direction where accounting would have to catch up with regulation for every change.
- 41 In addition, IFRS 9 sets a high hurdle before changing the business model (in the view of the IASB for the reasons established in BC 4.116 of IFRS 9) and already contains elements how to consider the sale of non-performing loans.

(6) Contractually linked instruments – non-recourse

- 42 IFRS 9 contains requirements (paragraph B.4.1.20 and following) for debt instruments issued in tranches whose terms create concentrations of credit risk and a special exception for loans that pay a negative interest rate. The payments on these financial assets are contractually linked to payments received on a pool of other instruments.
- 43 Diversity in practice is noted with application of the non-recourse guidance and contractually linked instruments. More detailed guidance is needed to resolve these inconsistencies in particular with regard to the scope of applying the "look through to" approach.

Non-recourse vs contractually linked

- 44 The contractually linked definition could be seen as very broad with no explicit guidance on what constitutes a tranche. In order to distinguish between non-recourse financing and contractually linked, some believe it is necessary to consider the nature and substance of an arrangement.

Interpretation of contractually linked guidance

- 45 The contractually linked guidance requires the underlying pool to 'contain one or more instruments that give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding'. The key question to some is what constitutes an 'instrument' for the purposes of contractually linked guidance.
- 46 The issue reported is also related with the reclassification requirements as it is argued by some that a change in processes would also qualify as a change in business model.
- 47 Also the look-through approach is considered difficult in some cases, as the required details are not available for every line of underlying investments.

EFRAG Secretariat analysis

- 48 In order to illustrate the above accounting questions, the EFRAG Secretariat has received a number of examples but has not (yet) received permission to share these.
- 49 In the view of EFRAG Secretariat this issue should be considered by the IASB as deserving standard setting activity. The topic will be re-discussed again in September FIWG, so this indication is still tentative.

FIWG feedback

- 50 This issue will be brought back to September FIWG meeting.
- 51 EFRAG FIWG members agreed that the guidance on contractually linked instruments and non-recourse lacks clarity in some situations, especially on the application of the look-through approach. Some FIWG members called for additional guidance or educational material. Although this was an area of structured finance FIWG members agreed this lack of guidance needs to be addressed.

(12) Modifications of cash flows

- 52 Paragraph 3.3.2 of IFRS 9 states that a substantial modification of the terms of a financial liability shall be accounted for as the extinguishment of the original financial liability and the recognition of a new financial liability.
- 53 Paragraph 5.4.3 of IFRS 9 states that when the contractual cash flows of a financial asset are renegotiated or otherwise modified and such modification does not result in derecognition, the gross carrying amount of the financial asset shall be recalculated as the present value of the modified contractual cash flows discounted at the original effective interest rate (EIR) and a modification gain or loss recognised in profit or loss.
- 54 Paragraph B3.3.6 of IFRS 9 states that the terms of a financial liability are substantially different if the discounted cash flows under the new terms are at least 10% different from the discounted remaining cash flows of the original financial liability. However, for financial assets the current Standard does not state when such modification is substantial.
- 55 For the reasons mentioned above, the guidance on modification of cash flows for financial assets is considered to be insufficient.
- 56 EBA issued the guidance on forbearance of loans in October 2018. For that reason, banks should monitor loans modified after forbearance⁴ and provision them on a one-to-one basis.
- 57 The accounting question that arises is the following: when does a forbearance event (modification for credit reasons) trigger derecognition (which also means that the new loan does not have any provisioning attached despite being a problem loan).
- 58 The 10% threshold of the liabilities may not be representative or applicable to assess this for that reason, banks have developed practical approaches, including to limit as much as possible the scope of derecognition.

EFRAG Secretariat analysis

Treatment as non-substantial changes

- 59 The EFRAG Secretariat notes there is not sufficient guidance as for financial liabilities to determine whether a modification of cash flows for financial assets is substantial.
- 60 An example on a modification of cash flow could be illustrated as follows:
- (a) A bank enters into a 15-year loan with a borrower (measured at amortised cost or fair value through other comprehensive income). The loan accrues interest at 4%.
 - (b) At the end of year 10, as a result of an arm's length renegotiation, the remaining maturity has been modified from 5 years to 10 years (5 additional years), and the coupon has been revised to 2% to maturity.
 - (c) The borrower is not in any financial difficulty and there is no objective evidence of impairment (under IAS 39). In addition, the loan has not suffered a significant increase in credit risk (under IFRS 9).

⁴ In Europe there are three sets of rules for categorising forbearance or problem loans:

- a) the IFRS 9 rules for allocating credit risk exposure to Stage 2 and 3;
- b) the rules on capital definition of default (including article 178 in the CRR and new EBA rules due to come into force by end 2020); and
- c) the FINREP definitions, which also underpin the ECB/EBA rules regarding the management and disclosure of non-performing loans.

- 61 Under those circumstances, the EFRAG Secretariat considers that there could be different accounting approaches:
- (a) The entity has surrendered its rights to the 4% coupon for the next 5 years and the principal repayment in 5 years' time. In this situation, the rights to these cash flows have **expired**, and, so they should be **de-recognised** as there has been a **substantial modification of the contract terms (and by extension the cash flows)**.
- Finally, A **new** 10-year **loan should be recognised** at fair value on renegotiation (refinance), comprising a new principal payment in 10 years' time and 2% interest coupons for the next 10 years.
- (b) The entity has modified its rights to the 4% coupon for the next 5 years and the principal repayment in 5 years' time. In this situation, the rights to these cash flows have been **re-estimated**, as there has **not** been a **substantial modification of the contract terms (and by extension the cash flows)**.
- Finally, the **old** 15-year **loan should be re-estimated** at fair value comprising a modified principal payment in 20 years' time and 2% interest coupons for the next 10 years. In this case, the cash flows should be modified with the modified coupon and **a loss (or profit) should be recognised in the profit or loss**, as defined in paragraph 5.4.3 of IFRS 9.
- 62 In current practice, some banks tend to use the option described in paragraph 61 b) to account for changes either on the length or interest rate (or both) of the loans. Banks consider that there has not been a substantial modification of the contractual terms of the loans. However, it is important to mention that in most cases, the loans that underwent a substantial modification are categorised in Stage 3 of ECL, so banks have already recognised a write-off in the profit or loss before the re-estimation of the loan.
- 10% test*
- 63 The EFRAG Secretariat considers that for financial liabilities, as explained in paragraph 54, the IASB gives guidance on when a substantial modification of cash flows occurred. However, because of the interaction between derecognition and impairment requirements or situations of forbearance, it may not be appropriate to apply the same 10% threshold.
- Floating/fixed rates*
- 64 Also, in situations where a modification does not result in a derecognition differences in application arise. In the view of some an entity may choose an accounting policy to apply the guidance on floating rate financial instruments to changes in cash flows resulting from the modification of a floating rate component under the original contractual terms to a new rate of interest (whether floating or fixed) that reflects current market terms. Under such a policy the original EIR of the financial asset is revised, based on the new terms, to reflects changes in cash flows that reflect periodic changes in market rates.
- 65 However, in situations where a modification changes floating cash flows into fixed ones or vice-versa differences in practice are seen on either applying paragraph B5.4.5 (floating rates) or B5.4.6 (fixed rates) of IFRS 9 to the modified cash flows.
- 66 Further uncertainty with regard to the calculation of the effective interest rates can be found in paragraphs 74 to 79 of this paper.
- 67 **Considering the feedback of FIWG members (below), EFRAG Secretariat proposes that this issue is not to be considered by the IASB as deserving standard setting activity.**

FIWG feedback

- 68 Some EFRAG FIWG members acknowledged that the IASB decided when IFRS 9 was issued not to specifically define when a modification of financial assets is seen as a derecognition event (there is some guidance on the liability side) as this was a broader issue. This leaves stakeholders with very limited guidance on the asset side and requires relying on second-level literature.
- 69 Some EFRAG FIWG members noted that some of the difficulties to define whether a modification was significant or not derived from the interaction with the non-performing loans (NPL) regulatory requirements. In particular, when a re-estimation or a derecognition of the cash flows of a NPL interacted with ECL calculations.
- 70 EFRAG FIWG members mentioned that diversity in practice exists. However, some members mentioned that banks have implemented some internal guidance and invest a lot of resources to decide whether those modification were significant or not and see not merit in started a standard setting process.

(19) Accounting for TLTRO – and broader aspects on determining the effective interest rate

- 71 The IFRS IC discussed in June 2021 a request from the European Securities and Markets Authority on the accounting for the European Central Bank's (ECB) provision of financing to credit institutions under the ECB's third targeted longer-term refinancing operations (TLTROs) programme.
- 72 The amount that banks can borrow under the TLTRO programme is linked to their loans to non-financial corporations and households. By offering banks long-term funding at attractive conditions, they stimulate bank lending to the real economy. Upon meeting certain lending performance thresholds bank can receive loan at reduced interest rates. ESMA observed a diversity in practice regarding the accounting for a variety of issues that accompany such a transaction and invited the IFRS IC to clarify the applicable requirements.
- 73 In its tentative agenda decision, the IFRS IC noted, amongst others, that the matter should be considered as part of the Post-Implementation Review of IFRS 9.

EFRAG Secretariat analysis

- 74 The accounting analysis of the TLTRO transactions touches upon a number of wider issues – applicable to financial instruments beyond TLTRO-transactions - within IFRS 9.
- 75 In the case of the TLTRO transactions, the interest rate on the main refinancing operations (MRO) contains a variable element (the MRO-rate) and a fixed element (the contingent 50 basis points reduction in the MRO-rate).
- 76 This is not a unique situation, in many other cases interest rates such as IBOR + x basis points are used. However, what differs is the *nature of the add-on*. In the case of IBOR + x basis points, this fixed add-on refers to credit risk, while in the TLTRO example it refers to a *contingent reduction based on achieving predefined lending performance thresholds (non-financial variable)*.
- 77 In the TLTRO analysis this raises the question on how to calculate the effective interest rate of the financial instrument and on whether to apply paragraph B.5.4.5 of IFRS 9 (for the variable interest rate element) and/or paragraphs B5.4.6 of IFRS⁹ (relating to changes in estimated cash flows, both from modifications or another change in expectations).
- 78 In accordance with IFRS 9 embedded derivatives are separated from the financial liability host contract, but in contrast hybrid financial host asset contracts are assessed entirely for fulfilment of the SPPI-criteria.
- 79 For modifications this chapter refers to paragraphs 59 to 66 of this paper.

FIWG feedback

80 EFRAG FIWG members suggested to wait for the reactions of constituents on the Tentative Agenda Decision of the IFRS IC before proceeding with this topic⁵.

(20) Supply chain financing -reverse factoring

81 In a reverse factoring arrangement, a financial institution agrees to pay amounts an entity owes to the entity's suppliers and the entity agrees to pay the financial institution at the same date as or a date later than suppliers are paid.

82 The IFRS IC issued an Agenda decision on this topic in December 2020. However, it is noted that this Agenda decision did not resolve all uncertainties, especially with regard to presentation in the statement of cash flows.

83 The Agenda Decision considered the impact of a reverse factoring arrangement on presentation in the balance sheet, the derecognition of a financial liability, presentation in the statement of cash flows and in the notes to the financial statements.

84 The issue raised in this regard is how to apply the derecognition requirements in IFRS 9.3.3.2 when ones become part of a reverse factoring arrangement: i.e., is the original trade payable legally extinguished and if so, as from which moment?

85 In this regard, IDW in its comment letter to the IFRS IC noted: *"...in our view, a more specific reference to the derecognition guidance in IFRS 9 and an explanation of the interaction with the presentation of the liability in accordance with IAS 1 could provide a basis for a more robust reporting approach for such transactions. It would be necessary to focus on legal extinguishment as well as on substantial modifications. In respect of substantial modifications, the quantitative test would generally not lead to derecognition, whereas a targeted qualitative assessment may nevertheless warrant the derecognition of the trade payables. Any recognised 'new' payable could then not be classified as a 'trade payable'. We recommend some specific guidance be given concerning how the qualitative assessment should be conducted for trade payables –that generally have an effective interest rate of zero. For example, the introduction of an element of interest may lead to the derecognition of the trade payables and trigger the recognition of a payable depicting a financing transaction."*

EFRAG Secretariat analysis

86 The EFRAG Secretariat agrees it is unlikely that current paragraph B.3.3.6 of IFRS 9 which requires a difference from at least 10% in discounted cash flows is unlikely to be realistic in many cases. Unless this is the underlying message the IASB wants to convey. If that is the case, a confirmation from the IASB side would be considered informative.

87 The EFRAG Secretariat further notes that the IASB staff has indicated to submit to the IASB Board input and feedback for considering whether to add a narrow-scope standard setting project to the work plan on supply chain financing arrangements, and, if so, the possible scope of the project.

88 In the view of the EFRAG Secretariat and considering this background information, this issue should not be considered as part of the PIR IFRS 9 but rather be included and commented upon in the EFRAG answer to the IASB Agenda Consultation (due for late September/early October 2021).

FIWG feedback

89 EFRAG FIWG members acknowledged there were still issues to clarify in the cash flow statement but added there was already a lot of existing guidance (IAS 1, IFRS

⁵ The IFRS IC is expecting comment letter by 16 August 2021 to the TAD on TLTRO III.

7) that is useful in addressing the other issues raised and suggested not to deal with this topic in the PIR of IFRS 9. They also noted that the IASB has taken on a project on disclosures around supply chain financing.

(21) Financial guarantees

- 90 In accordance with IFRS 9, paragraph B2.5 it is stated that financial guarantee contracts may have various legal forms, such as a guarantee, some types of letters of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form.
- 91 The IFRS 9 paragraph specifies different appropriate accounting treatments for the issuer [shortened]:
- (a) Although a financial guarantee contract meets the definition of an insurance contract in IFRS 17 *Insurance Contracts* if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either IFRS 9 or IFRS 17 to such financial guarantee contracts. If IFRS 9 applies, paragraph 5.1.1 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies, the issuer measures it at the higher of:
 - (i) the amount of the loss allowance determined in accordance with Section 5.5 of IFRS 9; and
 - (ii) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers*.
 - (b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. Such guarantees are derivatives, and the issuer applies IFRS 9 to them.
 - (c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies IFRS 15 in determining when it recognises the revenue from the guarantee and from the sale of goods.

EFRAG Secretariat analysis

Perspective of the holder of the guarantees

- 92 The EFRAG Secretariat considers when the entity holds a financial guarantee that is ***not an integral element*** of another financial instrument and as a consequence is not in the scope of IFRS 9, could be accounted:
- (a) If the financial guarantee contract is ***not measured at FVPL***. By analogy to the guidance of reimbursement in IAS 37, as clear in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 10⁶ the following should apply:

⁶ In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable.

- (i) If the **loss has not occurred**. The EFRAG Secretariat considers that the entity should recognise a compensation right when it recognises the related ECL, providing that it is almost certain that the compensation will be received in the credit loss is actually suffered; and
 - (ii) If the **loss has occurred**. The EFRAG Secretariat considers that there are amounts not covered by the financial guarantee contracts, the asset recognised for the compensation should be limited to the impairment loss covered by the financial guarantee contract.
- (b) If the financial guarantee contract is **measured at FVPL**. The EFRAG Secretariat considers that the entity should recognise a compensation right in measuring the fair value of the guarantee.
- 93 When the entity holds a financial guarantee that can be considered as **an integral element** of another financial instrument and as a consequence cannot be recognised separately.
- 94 In some of the cases mentioned above, the financial guarantee is not included in the contractual terms of the debt instrument. In those cases, judgement is required to assess whether the financial guarantee is an integral element of the financial instrument.

Compensation rights

- 95 Differences in practice are reported in accounting for compensation rights that relate to non-integral financial guarantees. Differences witnessed:
- (a) Allocation of all or part of the premium paid to acquisition of the recognised compensation right. In this case, all or part of the premium paid is viewed as consideration for acquisition of the recognised compensation right; or
 - (b) No allocation of any part of the premium paid to acquisition of the compensation right. In this case, the premium and the compensation right are viewed as separate assets. The entire premium is considered as payment for coverage to be provided over the period of the guarantee.

Guarantees issued

- 96 When an issuer holds a financial guarantee contract, under IFRS 9 should account:
- (a) Initial recognition: at fair value if the contract is issued in a stand-alone arm's length transaction to an unrelated party, the initial fair value would be equal to the premium received.
 - (b) Subsequent measurement: it is one of the exclusions for financial liabilities to be measured at amortised cost (paragraph 4.2.1 c of IFRS 9). In those cases, the measurement should be the higher of:
 - (i) the amount of the loss allowance determined in accordance with Section 5.5 a of IFRS 9); and
 - (ii) the amount initially recognised (see paragraph 5.1.1 of IFRS 9) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.
- 97 However, the EFRAG Secretariat noted that there is no guidance on how the requirements explained in paragraph 96 should apply if the issuer does not receive all of the premium at initial recognition. For consistency, those contracts should be accounted on:
- (a) Gross basis: the issuer recognises a liability for its obligations to provide assurance to the holder in line with paragraph 96 (the fair value measurement is likely to be equal to the sum of the premium received and the future premiums receivable); or

- (b) Net basis: the issuer recognises a net amount in line with paragraph 96.
- 98 The EFRAG Secretariat acknowledges that in those cases where the net basis approach is applied, the amount initially recognised should be increased by any late premium received, so all premiums received are considered when measuring a financial guarantee.
- 99 Additionally, when account under net basis, the ongoing recognition of income in accordance with the principle of IFRS 15, may cause that the cumulative amount of income recognised, exceeds the cumulative amount of premiums received to date.
- 100 Under those premises, the EFRAG Secretariat considers that IFRS 9 does not specify how ‘the higher of’ (see paragraph 96 b) should be applied under those circumstances and the entity should choose between the accounting policy of:
- (a) Excluding the accrued amount for ‘*the higher of*’ measurement and recognise it as a receivable separately from the financial guarantee contract liability; or
 - (b) Treating the accrued amount as representing a negative balance of ‘*the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15*’ (paragraph 4.2.1 (c) (ii) of IFRS 9).
- 101 **Considering the feedback of FIWG members (below), EFRAG Secretariat proposes that this issue is not to be considered by the IASB as deserving standard setting activity.**

FIWG feedback

- 102 EFRAG FIWG members noted that in practice there was a lack of guidance for financial guarantees that are an integral element of another financial instrument in IFRS. However, the accounting firm’ books have dealt with this issue and EFRAG FIWG members recommended not to include this issue on the list to report in the RFI.

Questions to EFRAG TEG members

- 103 Do EFRAG TEG members agree with the advice of EFRAG FIWG and the EFRAG Secretariat? Please explain.

Appendix 1: Short description of remaining issues

104 The paragraphs below provide a short description of issues categorised as C or D.

Category C: Issues for which the EFRAG Secretariat has identified some prevalence

105 The EFRAG Secretariat identified the following issue:

	<i>Issue</i>	<i>Criterion</i>
16	<i>Benchmark test for last-reset rates due to IBOR reform</i>	<i>Requirements cannot be applied consistently</i>
<i>new</i>	<i>Factoring of trade receivables</i>	<i>Requirements cannot be applied consistently</i>

Category C: Issues for which the EFRAG Secretariat has identified some prevalence

Issue 16 – Benchmark test for last-reset rates due to IBOR reform⁷

106 Entities may identify the need to perform the SPPI benchmark test for significance of interest mismatches between:

- (a) the last reset rates containing a time lag feature due to being calculated and known in advance at the start of the current interest period as averages of risk-free overnight rates over the previous interest period; and
- (b) rates representing time value of money due to being calculated based on the risk-free rates development in the current interest period (known at the end of the period).

107 The issue would arise separately for:

- (a) legacy portfolios which are subject to the IBOR rates replacements falling back to the last rest rates; and
- (b) new portfolios where entities decide to use the last reset rates.

108 The issue raised is:

- (a) whether and to what extent the need to perform the quantitative benchmark test arises and whether this brings any inappropriate burden to entities; and
- (b) whether there are any failures in the SPPI benchmark test resulting in non-SPPI financial assets measured at FVPL to the extent which entities would not consider as appropriate since they deem them as basic lending agreements from business perspective.

FIWG feedback

109 One EFRAG FIWG member noted this issue was not so urgent anymore as practical solutions had been found in between to deal with it. Another one noted the PIR IFRS 9 process was seen as too late to deal with this topic - by the time there is new guidance to IFRS 9, the major parts of the benchmark reforms would be finished.

⁷ The issue of application of the SPPI test to particular rates has been discussed at EFRAG TEG and FIWG in the course of drafting the comment letter on the Phase 2 IBOR exposure draft (ED/2020/1). EFRAG concluded that an assessment of such rates would go beyond the scope of the IBOR project and is rather a general issue in the context of SPPI assessment.

- 110 Some EFRAG FIWG members saw similarities with the assessment of interest rates that contain ESG-components and the difficulties that arise in comparing such rates with rates that represent SPPI elements only.

Factoring of trade receivables

- 111 Commonly occurring fact pattern description:
- 112 The Factor purchases the Company's receivables from Debtors making a 90% prepayment of the purchase price, less a charge which is equal to an agreed percentage of principal amount [assumed pro-rata share of any losses between the Company (10%) and the Factor (90%); alternatively it can be that any first losses are borne by the Company and only above the 10% threshold by the Factor]. The historical loss rate is – say – 6%. The receivables are insured up to 90% of the principal amount. If no payment is made until the initial payment date of each invoice, additional interests are charged for the period until 6 months overdue. The Factor can sell the receivables to any other party, however the insurer's approval is necessary to preserve the insurance protection. After the 6 months period passed without payment made by the Debtor, the Factor becomes beneficiary of credit insurance. Credit insurance may have been obtained by the Company prior to factoring (or alternatively later on by the Factor) and costs are recharged to the Company. Alternatively, there can be no insurance.
- 113 In these cases, one needs to assess historical loss rate and compare it to how the losses are apportioned between the company and the factor under the factoring arrangement (how many losses are borne by each party, and whether the entity covers first losses or whether they are shared pro rata with the factor). If the trade receivables are subject to insurance, one needs to determine whether and how it shall impact the derecognition assessment depending on specific circumstances. Given the inherent complexity adding illustrative examples to IFRS 9 would be very helpful.

FIWG feedback

- 114 EFRAG FIWG members were cautious about putting this topic on the list and noted that disclosures should be used to provide information about the factoring operations.

Category D: Issues which are inherently complex and/or standard setting would not lead to a favourable cost-benefit trade-off

- 115 The EFRAG Secretariat identified the following issues:

	<i>Issue</i>	<i>Criterion</i>
4	<i>Business model – boundary HTC /HTCS (liquidity buffers banks – loan syndicates)</i>	<i>Requirements cannot be applied consistently</i>
7	<i>Reclassification and IFRS 5 – scope of IFRS 9</i>	<i>Requirements not working as intended</i>
8	<i>Credit risk</i>	<i>Requirements cannot be applied consistently</i>
11	<i>Prepayments</i>	<i>Requirements cannot be applied consistently</i>
15	<i>Reporting gains on gross basis</i>	<i>Requirements not working as intended</i>
17	<i>Measurement of derivatives to meet obligations to policyholders (merged with issue 14 embedded derivatives)</i>	<i>Requirements not working as intended</i>

FIWG feedback

- 116 EFRAG FIWG members agreed with the descriptions of the issues raised below as well as to submitting these to the IASB without assessment.

Issue 4 – Business model – boundary HTC/HTCS (held to collect/held to collect and sell)

Liquidity buffers of banks

Transfer between banking departments

- 117 Transfers within a group: in the context of liquidity management, market and investment banking departments happen to purchase financial assets such as securities. Those assets are then resold to the retail departments (of the same group) to meet their day-to-day liquidity management needs and their liquidity portfolio management. At the acquisition date, those assets are held within a business model that is neither HTC nor HTCS and thus, are measured at FVPL. However, after being transferred, those assets are usually held within a HTC business model but their classification cannot be changed to amortised cost. Amortised cost measurement would apply only if the retail departments were to acquire the financial assets directly, but this would be made at a higher cost.

Reclassification in periods of stress

- 118 In cases of market stress, the classification of these bonds can vary significantly depending on the business model chosen. It was noted that for financial assets – part of a liquidity buffer of a bank – the reclassification requirements in these circumstances are a too high hurdle and the change is very difficult to demonstrate to external parties.
- 119 It was suggested to identify the HTC business model as a default category, while FVPL would be redefined as trading.

Loan syndications

- 120 Before the syndication, the entity determines the portion of loans it expects to retain and the portion it expects to sell considering all relevant information at that date. This assessment determines the portion of the loans that are held in HTC and in HTCS business models, and if the loans meet the SPPI criterion, the portions of loans that are measured at fair value or at amortised cost. However, the portion of loans sold may differ from the entity's expectations. Applying paragraph B4.1.2A, this does not change the classification of the financial assets. When the entity sells a lower portion of loans than expected, it is required to continue to measure the excess unsold loans at FVPL while amortised cost would provide useful information in those circumstances.

Issue 7 – Reclassification and IFRS 5 – scope of IFRS 9

Level at which an entity's business model is determined

- 121 This question arises when an entity also applies the requirements in IFRS 5. For example, a subsidiary holds financial assets within a HTC business model and the subsidiary is also classified as held for sale applying IFRS 5. In those circumstances, there is a question about whether the reporting entity (i.e., the consolidating entity) continues to consider that the financial assets of the subsidiary are held within a HTC business model. In November 2016, the IFRS-IC held the view that an entity assesses its business model for the purpose of classifying financial assets from the group perspective but did not publish any TAD. If the Committee's view were to be applied and if the financial assets were to meet the SPPI criterion, the entity would be required to change the classification of those assets from amortised cost to FVPL. Some stakeholders question whether such reclassification would provide useful information and question whether the benefits

of that reclassification would exceed its implementation costs. Those stakeholders think that the Board should consider this matter in the context of the PIR of IFRS 9, rather than in the context of the PIR of IFRS 5—amending IFRS 9 could address the matter.

Business model changes over time

- 122 Paragraph 4.4.1 of IFRS 9 requires an entity to reclassify financial assets when, and only when, the entity changes its business model for managing those financial assets. In practice, the requirements in IFRS 9 ‘freeze’ the business model within which financial assets are held when they are originated—unless a change in business model occurs (rare in practice). Those requirements may be considered as very stringent in some specific circumstances. Those requirements represent an entity’s expectations, at the origination date, about the business model within which it will hold a financial asset but does not necessarily reflect the business model within which that asset is held afterwards.

Issue 8 – Credit risk

- 123 Diversity in practice is noted how entities disclose their credit risk exposure between financial assets measured at FVPL and those measured at FVOCI.

Issue 11 - Prepayments

- 124 Diversity in practice was noted in how entities apply the guidance on prepayment features with negative compensation.

Issue 15 – Reporting gains on gross basis

- 125 The performance of the banks is not reflected when there is an obligation of the banks to allocate gains on gross basis to certain beneficiaries. In addition, those gains on debt instruments sold should be reported on a gross basis in the PL when such gains are not distributable to banks’ shareholders.
- 126 According to some, this information is not useful enough mainly related to insurance activities.

Issue 17 - Measurement of derivatives to meet obligations to policyholders (written input)

- 127 As an alternative to the application of hedge accounting, the current classification and measurement requirements in IFRS 9 for derivatives could be reviewed to better reflect the risk management, in particular of the interest rate risk, that insurance companies have had in place for a very long time. Measuring all derivatives at FV-PL leads to volatility and is difficult to explain the performance when all the remaining investment portfolios of insurers will be measured at FV-OCI. As an alternative treatment, a specific scope of derivatives could be measured at FV-OCI if certain conditions are met.

