STAFF PAPER

July 2021

IASB® meeting

Project	Post-implementation Review of IFRS 9—Classification and Measurement	
Paper topic	Feedback on financial assets with sustainability linked features	
CONTACT(S)	Uni Choi	uchoi@ifrs.org
	Laura Kennedy	lkennedy@ifrs.org
	Riana Wiesner	rwiesner@ifrs.org

Purpose of this paper

1. This paper summarises feedback from outreach in phase 1 of the post-implementation review (PIR) of the classification and measurement requirements in IFRS 9 *Financial Instruments* that relate to financial assets with sustainability-linked features. Given the significant amount of feedback we have received on this topic, this paper is provided to supplement the feedback summarised in Agenda Paper 3A. Also included in this paper are the staff's preliminary views on some of the key factors an entity needs to consider in its analysis to determine how to apply particular requirements in IFRS 9.

2. In this paper, the staff ask whether Board members have any views, comments or questions about the staff analysis in this paper and whether Board members have any additional views on this matter that are relevant to this PIR for the purpose of gathering feedback from stakeholders through a Request for Information.

Structure of this paper

3. This paper is structured as follows:

   (a) Summary of feedback.

   (b) Staff analysis:

(i) Objective of the cash flow characteristics assessment in IFRS 9;

(ii) Preliminary staff views on the application of the SPPI requirements;

(iii) Effective interest rate; and

(iv) Impairment.

(c) Question for Board members.

Summary of feedback

4. Recent market developments have given rise to a variety of financial instruments that are linked to sustainability initiatives, indices or targets. The financial instruments with such features raised by stakeholders can be broadly categorised into the following types:

(a) green loans and bonds: loans or bonds of which the purpose is exclusively to finance or re-finance, in whole or in part, new or existing 'green projects' specified in the contract. The contractual cash flows of these instruments do not vary with sustainability-linked targets and are generally similar to those of plain vanilla loans.

(b) structured instruments linked to green indices: financial instruments with contractual cash flows that are linked to a green index that is not specific to a party to the contract, such as the Euronext CDP Environment World EW Index.[1] The contractual cash flows of such instruments vary with changes in the relevant index similar to those of any indexed instruments.

(c) loans with environmental, social or governance (ESG) features: the interest rate of these loans is linked to pre-determined ESG targets that are specific to the borrower. The interest rate of such loans is

[1] The Euronext CDP Environment World EW index is a global index selecting the highest-ranked 20 North American and 20 European companies, from a universe composed of the 200 largest North American and 200 largest European stocks on the Euronext 500 index. The companies are ranked on their environmental score.

adjusted periodically to reflect changes in the borrower's performance relative to the specified ESG targets (ESG-linked adjustments). For example, a loan bears a coupon of a benchmark interest rate plus a margin of 240 bps. The loan includes two ESG targets relating to water usage and CO2 emissions. If both of the targets are met, the margin reduces for the next year to 235 pbs. If one of the targets is met, then the margin stays at 240 bps. If none of the targets are met, then the margin increases to 245bps.

5. Most of the questions raised by stakeholders relate to the type of features described in paragraph 4(c) of this paper. Stakeholders explained that the terms and features of these loans vary, and the types and number of ESG targets are specific to the borrower. At present, the most common ESG targets in these loans are environmental targets, but many loans increasingly include social and governance-focused targets such as gender equality and employee work life balance. Although the size of the ESG-linked adjustments is relatively small at present (typically ranges between 2.5bps to 10bps), many stakeholders said that they believe the size of the ESG-linked adjustments is likely to grow in the future.

6. Many stakeholders said that, at present, practice is developing with regards to how to assess whether a loan with ESG-linked adjustments has cash flows that are solely payments of principal and interest (SPPI). Some stakeholders observed that these loans were not prevalent when IFRS 9 was developed and there is uncertainty about what the Board's intention was in this regard and how to apply the IFRS 9 requirements to these features. Some other stakeholders said that ESG-linked loans are priced and managed in the same way as other loans that do not have ESG features and therefore they would like to be able to classify the ESG loans at amortised cost. They acknowledged that pricing for ESG features is at a very early stage of development and it is currently not possible to equate the quantum of an ESG adjustment precisely to measurable changes in credit risk. Stakeholders requested the Board provide either additional application guidance on how to assess whether ESG-linked loans have cash flows that are SPPI or a specific exception from the SPPI assessment that would permit entities to classify these loans at amortised cost.

7. In analysing whether loans with ESG features described in paragraph 4(c) of this paper have cash flows that are SPPI, the staff understand that some stakeholders have formed a view, while others are questioning whether, the ESG-linked adjustments are considered:

   (a) as part of the consideration for credit risk;

   (b) as part of a profit margin; and

   (c) de minimis or non-genuine.

8. In addition, some stakeholders suggest that considering whether the ESG features would be an embedded derivative is a way to determine whether the ESG features result in cash flows that are SPPI. Some other stakeholders argue that a common, standard or widespread feature in loan contracts is consistent with what they believe to be a basic lending arrangement and therefore give rise to contractual cash flows that are SPPI.

Staff analysis

Objective of the cash flow characteristics assessment in IFRS 9

9. The staff acknowledge that these types of instruments were not prevalent and was not specifically considered when the Board developed IFRS 9. However, IFRS 9 requirements are principles-based and are designed to be able to deal with new types of financial instruments as they emerge.

10. IFRS 9 requires an entity to classify financial assets as subsequently measured at amortised cost or at fair value through other comprehensive income if '*the contractual terms of the financial assets give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding*' (and they are held in a business model described by paragraphs 4.1.2 and 4.1.2A of IFRS 9 respectively). In accordance with paragraph 4.1.4 of IFRS 9, if a financial asset has contractual cash flows that are not SPPI, an entity is required to measure the financial asset at fair value through profit or loss.

11. As the Board consistently stated during the development of IFRS 9, amortised cost is a simple measurement technique that allocates interest over time using the effective interest rate. Amortised cost measurement provides useful information only for financial instruments with 'simple' contractual cash flows. The Board's long-held view is that the effective interest method, which underpins amortised cost measurement, is not an appropriate method for allocating 'complex' contractual cash flows. The objective of the contractual cash flow characteristics assessment in IFRS 9 is to identify instruments for which the effective interest method results in relevant and useful information, that is, financial assets with 'simple' contractual cash flows that represent solely payments of principal and interest.[2]

12. Paragraph B4.1.7A of IFRS 9 states:

> Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. 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. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. […] However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. […]

[2] Paragraphs BC4.171–BC4.172 of the Basis for Conclusions on IFRS 9

Preliminary staff views on the application of the SPPI requirements

13. In relation to green loans or bonds described in paragraph 4(a) of this paper, the staff note that their contractual cash flows do not include any sustainability-linked adjustments. Therefore, such financial assets do not present a new challenge in assessing the contractual cash flows characteristics because the purpose of a financial asset does not affect the SPPI assessment.

14. In relation to structured instruments linked to green indices described in paragraph 4(b) of this paper, the staff note that the cash flows that are based on the performance of a specified market index do not represent a return that is consistent with a basic lending arrangement. The staff think that this type of exposure is similar in nature to exposure to changes in equity prices or commodity prices, which, as stated in paragraph B4.1.7A of IFRS 9, does not give rise to contractual cash flows that are SPPI.

15. The rest of this paper focuses on loans with ESG targets described in paragraph 4(c) of this paper. As there are loans with many different types of ESG features and the market is actively developing, it is unlikely there is a one-size-fits-all answer. In the staff's view, it is not possible or appropriate to conclude whether or not all loans with ESG features have contractual cash flows that are SPPI. Similarly, the staff think that it is not appropriate to conclude that all ESG features in all loans always belong to one particular component of interest as described in IFRS 9. Rather, the staff think that entities need to assess the contractual cash flow characteristics based on the contractual terms and features of the loans. The staff analysis in this paper refers to 'loans' but the same would apply to financial assets other than loans that have similar features, for example, bonds.

Consideration for credit risk

16. Based on the phase 1 outreach, many stakeholders are considering whether it is appropriate to deem the ESG-linked interest adjustments as consideration for credit risk. Stakeholders suggested that this could be appropriate because generally there is a link between sustainable business practice, the credit worthiness and going concern of the business over the long-term. They also mentioned that some of the rating agencies are starting to include some ESG

assessments or ESG scores when determining the credit rating of entities in particular industries.

17. Paragraph 4.1.3(b) of IFRS 9 states that:

> interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin. […]

18. The staff think it is clear from paragraph 4.1.3(b) of IFRS 9 that the consideration for the credit risk of a financial asset is for the credit risk associated with the principal amount of that particular financial asset. Further to that, impairment requirements in IFRS 9, which accompany the amortised cost measurement, require expected credit losses to be recognised based on the credit risk assessment for individual financial instruments, rather than the borrower, through their expected life.

19. In order to demonstrate that an ESG target in a loan represents consideration for the credit risk of the loan, the key questions would be whether the ESG targets specified in a loan affect the probability of the borrower defaulting on that particular loan, and if so, whether the ESG-linked adjustments in the loan have been determined considering the effects of meeting (or not meeting) the ESG targets on the credit risk of the loan.

20. Many ESG targets in these loans—especially if they include a broader set of sustainability targets—may not have direct effects on the credit risk of the borrower or the loan. Some ESG factors 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 (ie credit risk) over the expected remaining life of the loan.

21. On the other hand, there may be ESG factors that do affect the credit risk of the loan such that ESG-linked adjustments would indeed represent the consideration

for changes in the credit risk of the loan. However, in such cases we would expect the adjustment to the interest rate to be more specific to the borrower and indicative of the changes in the credit risk associated with the principal amount outstanding of the loan.

Profit margin

22. Paragraph B.4.1.10 of IFRS 9 acknowledges that in a basic lending arrangement the interest rate can include a profit margin component that is consistent with a basic lending arrangement and that is not inconsistent with contractual cash flows being SPPI.

23. ESG features may be described as being part of a profit margin for reasons other than applying IFRS 9. However, the staff do not think the way features are described or labelled changes whether the contractual cash flows are SPPI. IFRS 9 requires entities to analyse the nature of the contractual cash flows, regardless of how they are described or labelled. Paragraph B.4.1.15 of IFRS 9 states:

> In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.1.2(b), 4.1.2A(b) and 4.1.3 of this Standard.

24. The staff observe that the profit margin component is usually a small fixed spread included in the overall interest rate that a customer is paying. In such cases, the profit margin in itself does not result in any variability in the contractual cash flows on a financial asset.

25. Paragraph B4.1.10 of IFRS 9 states:

> If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows […], the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and

> after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (ie the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator. For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding because of the relationship between missed payments and an increase in credit risk. (See also paragraph B4.1.18.)

26. The staff do not think a statement that the adjustment to the interest rate is considered part of the profit margin is sufficient to conclude that the contractual cash flows are SPPI. Any contractual term that could give rise to variability in the contractual cash flows need to be assessed to determine whether they are SPPI as required by paragraph B4.1.10 of IFRS 9.

De minimis effects or non-genuine terms

27. The staff are aware that some stakeholders question whether the contractual cash flows of ESG-linked loans could be considered to be de minimis or non-genuine. On the other hand, we heard from some preparers that they do not consider these features to be de minimis or non-genuine because that would be inconsistent with the reason for including the ESG features in loans to customers, ie to have a meaningful purpose and impact by incentivising customers to transition their businesses to more ESG-conscious businesses.

28. Paragraph B4.1.18 of IFRS 9 states:

> 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 (either in a single reporting period or cumulatively) but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

29. The staff note that when developing IFRS 9, the Board considered that for a contractual feature to have a de minimis effect on the contractual cash flows of the financial asset, the feature must have a de minimis effect in all possible scenarios.[3] Having an effect that is not material or significant does not mean having a de minimis effect. Also, what is considered de minimis for one financial instrument or in one reporting period would not automatically be considered the same for another. The Board also considered that a contractual feature is considered to be genuine unless the event or trigger that gives rise to the variability is extremely rare, highly abnormal and unlikely to occur.

[3] Paragraph BC4.182(c) of the Basis for Conclusions on IFRS 9

Embedded derivatives and a common feature

30. The embedded derivative requirements in IFRS 9 do not apply to hybrid contracts with a host that is an asset within the scope of IFRS 9. This is because a single classification approach applies to all financial assets including hybrid contracts. The staff acknowledge that embedded derivative features often do not have contractual cash flows that are SPPI, and that as part of the cash flow characteristics assessment, an entity may consider whether the feature would have been an embedded derivative that had to be separated from the host contract. However, the inverse in not true and it would be inappropriate to conclude that a financial asset has contractual cash flows that are SPPI only because it does not have an embedded derivative that had to be separated from the host contract.

31. A basic lending arrangement is a concept the Board considered in discussing the elements of interest and the overall objective of the assessment of a financial asset's contractual cash flows. Paragraph B4.1.7A of IFRS 9 describes what constitutes basic lending arrangements and provides examples of what is inconsistent with a basic lending arrangement. The term basic lending arrangement was not intended to imply a common or widespread lending arrangement. In the staff's view, it is inappropriate to conclude a financial asset has contractual cash flows that are SPPI only because it has features of a lending arrangement that is common or widespread.

Preliminary staff views

32. As reproduced in paragraph 25 of this paper, paragraph B4.1.10 of IFRS 9 contains requirements that apply to contractual terms that change the timing or amount of contractual cash flows.

33. In developing the SPPI requirements, in discussing the elements of interest in particular, the Board noted that 'the assessment of interest focuses on what the entity is being compensated for (ie whether the entity is receiving consideration for basic lending risks, costs and a profit margin or is being compensated for

something else), instead of how much the entity receives for a particular element'.[4]

34. In the staff view, the key question to ask in analysing ESG-linked adjustments is therefore what the entity is being compensated for. The nature of the contingent event (ie the trigger) of ESG-linked adjustments is the borrower's performance against specified ESG targets but this does not automatically mean that the adjustments represent compensation for the entity's exposure to the ESG risk of the borrower.

35. According to stakeholders, 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 risks of the borrower meeting or not meeting the ESG targets. Although the ESG targets are bespoke to individual borrower, the size and 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.

36. It is important to note that the staff do not imply that the ESG-linked adjustments may be SPPI because its size is small or because it is a standard or common feature. A small or a common feature may well be inconsistent with a basic lending arrangement and contractual cash flows that are SPPI.

37. Although the staff do not imply that the size of the adjustment is a determinative factor of the assessment, it is perceivable that the larger the ESG-linked 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 a case, the borrower and the lender would have 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 particular 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. We acknowledge that the assessment will require judgement

[4] Paragraph BC4.182(b) of the Basis for Conclusions on IFRS 9

and the conclusion will vary depending on the contractual terms of the financial assets.

Effective interest rate

38. In addition to the SPPI requirements, many stakeholders asked how to apply the effective interest rate requirements in IFRS 9 to these loans. Questions include:

    (a) whether and, if so, how an entity should take into account the probability of the borrower meeting the ESG targets specified in the loan when determining the effective interest rate at initial recognition. For example whether an entity should determine a rate by weighting the probability of the borrower meeting the ESG targets, or whether the initial effective interest rate should be the minimum interest rate that the entity is entitled to receive; and

    (b) whether the entity applies paragraph B5.4.5 or B5.4.6 of IFRS 9 when the interest rate is adjusted based on whether the entity has met the ESG targets.

39. These questions however are not specific to loans with the ESG features but are equally relevant to other financial assets and financial liabilities with a possible variability in the timing or the amount of the contractual cash flows. For example, in its June 2021 meeting, the IFRS Interpretations Committee discussed questions with respect to accounting for Targeted Longer-Term Refinancing Operations (Agenda Paper 4). The questions discussed include how to determine the effective interest rate at initial recognition and how to account for subsequent changes in the estimated cash flows. The Interpretations Committee tentatively decided not to conclude on these questions but to refer it to the Board for consideration in the PIR of the classification and measurement requirements in IFRS 9.

Impairment

40. The Board has not yet started the PIR of the impairment requirements of IFRS 9. However, the staff note that it is important to consider the interaction between the considerations for amortised cost measurement, such as the cash flow

characteristics assessment and the effective interest rate (discussed in paragraphs 9–39 of this paper) and application of the impairment requirements of IFRS 9 for financial assets that are classified as subsequently measured at amortised cost or at fair value through other comprehensive income.

41. In particular, an entity must consider the effects of the ESG features in determining the contractual cash flows that are due to the entity and the cash flows that it expects to receive. In addition, paragraph B5.5.44 of IFRS 9 requires an entity to discount expected credit losses using the original effective interest rate or an approximation thereof. The way an entity determines the effective interest rate at initial recognition and in subsequent periods will have implications on how an entity applies the impairment requirements.

42. However, as the purpose of this PIR is to consider the classification and measurement requirements, and not the impairment requirements, the staff do not think the Board should analyse the impact of ESG-linked features on the application of the impairment requirements in the upcoming RFI.

Question for Board members

Question for Board members
Do Board members have any views, comments or questions about the staff analysis in this paper? In particular, do Board members have any additional views on this matter that are relevant to this PIR for the purpose of gathering feedback from stakeholders through the RFI?