IFRS

STAFF PAPER

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IASB® meeting

Project	**Post-implementation Review of IFRS 9—Classification and Measurement**
Paper topic	Contractual cash flow characteristics assessment—ESG-linked features

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Introduction

1. This paper provides a summary of the feedback and preliminary staff analysis on applying the contractual cash flow characteristics assessment in IFRS 9 *Financial Instruments* to financial assets with ESG-linked features. We are not asking the IASB for any decisions at this meeting, but welcome questions and suggestions for further analysis. The staff will consider those suggestions when preparing the analysis and recommendations for the May 2022 IASB meeting.

2. This paper is structured as follows:

   (a) IFRS 9 requirements;

   (b) summary of feedback; and

   (c) staff analysis and preliminary views.

Question for IASB
Do you have questions or comments about the feedback summarised or the preliminary staff views in this paper?

IFRS 9 requirements

3. Agenda Paper 3A for this meeting summarises the IFRS 9 requirements for assessing whether the contractual cash flows of a financial asset are solely payments of principal and interest on the principal outstanding (SPPI). This paper specifically analyses what is considered to be 'interest' in the SPPI cash flows and how to assess contractual terms that change the timing or amount of contractual cash flows.

IFRS 9 requirements
IFRS 9 provides application guidance on assessing whether the contractual cash flows are SPPI. Paragraph B4.1.7A of IFRS 9 explains that contractual cash flows that are SPPI 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, 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. In contrast, 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 SPPI. Paragraph B4.1.10 of IFRS 9 explains that if a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are SPPI. 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 SPPI, it may be an indicator.

Summary of feedback

Financial assets with contractual cash flows with ESG-linked features

4. Most respondents provided feedback about accounting for a particular type of financial assets with interest rates linked to environmental, social or governance (ESG) targets. These financial assets typically provide general funding to a borrower, but have a contractual interest rate that is adjusted depending on the borrower achieving pre-determined ESG targets that are specific to the borrower (hereafter referred to as financial assets with ESG-linked features). These financial assets are different from other forms of sustainability-linked finance products such as ‘green finance’.

5. ‘Green finance’ typically refers to loans or bonds that are used to finance an environmentally friendly activity (ie they are subject to ‘use of proceeds restrictions’). Although ‘green finance’ instruments can only be used for a particular purpose, their contractual cash flows do not necessarily include ESG adjustments. Consistent with the IASB’s understanding, a few respondents explicitly stated that ‘green’ loans or bonds do not raise particular challenges when applying IFRS 9, because the requirements of IFRS 9 are not based on the purpose of the proceeds.

6. Respondents provided the following as examples of ESG-linked features in loans:

   (a) adjustments to the contractual interest rate ranging between 2.5 to 10 basis points. Many of the adjustments work in both directions (ie the interest rate increases if the ESG target is not met and decreases if the ESG target is met);

   (b) environmental targets related to CO2 emission reduction, producing green products and recycling;

   (c) social and governance targets related to employee gender and ethnic diversity, and to increasing the percentage of employee shareholders;

   (d) some features that are based on changes in the borrower’s ESG score from an ESG rating agency; and

   (e) some features that disapply in the event of default.

7. One respondent quoted an academic study that shows significant global development in ESG lending activity over the past five years, with the nominal value of loans increasing from $6 billion in 2016 to $322 billion in September 2021. According to the study, this increase is mainly attributable to loans with ESG-linked features.[1] The respondent further noted that the issuance of ESG-linked bonds has also increased over time, but this increase is less than that of ESG-linked loans.[2]

8. Some respondents raised a concern that if entities were required to measure loans with ESG-linked features at fair value through profit or loss this could discourage investments in such financial instruments as this would lead to volatility in profit or loss.

Does IFRS 9 provide sufficient application guidance for entities to make the required assessment?

9. Most respondents shared the view that there is not enough application guidance in IFRS 9 to assess whether the contractual cash flows of financial assets with ESG-linked features are SPPI. Many reported diverse views on how the SPPI requirements should be applied, with some saying that their strict reading of the IFRS 9 requirements is that the contractual cash flows are not SPPI unless the ESG-linked feature is de minimis or has a demonstrable link to the credit risk of the asset.

10. Many respondents noted that although at present the size of the adjustments is small enough to be considered as de minimis, they expect the size of the adjustments to grow in the future such that they would no longer be considered de minimis.

11. Some respondents said that considerations of the borrower's exposure to ESG risks, in particular environmental risks, are increasingly becoming part of their overall credit risk management process but it is difficult to quantitatively demonstrate the link between the borrower's ESG performance and the credit risk of the financial assets for the remaining term of the assets. These respondents asked if an entity is expected to demonstrate such a quantitative link in order to conclude that the contractual cash flows are SPPI. One respondent quoted academic studies on the link between ESG

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[1] Such loans with ESG-linked features make up 90% of all ESG lending activity whereas the remainder related to 'green' loans.

[2] Kim, S., Kumar, N., Lee, J., & Oh J. (2021). *ESG Lending*. Working paper

performance of an entity and the entity's overall credit risk, which reported mixed findings. There are a number of studies that indicate that higher ESG performance is associated with lower credit risk of the entity while other studies found weak or no evidence of such a link.[3]

12. A few respondents said that they consider ESG-linked features to be part of the profit margin on a financial instrument that is consistent with a basic lending arrangement if the interest rate on these instruments is comparable to the interest rate on comparable loans without such a feature. These respondents noted that banks often accept lower profit margins on financial assets with ESG-linked features especially for short-term instruments.

13. On the other hand, a few respondents said that they consider that the ESG-linked features are part of the cost of what they consider to be a basic lending arrangement, in other words, costs associated with holding the financial asset for a particular period of time.

14. Some respondents provided feedback on the accounting for financial liabilities with ESG-linked features. A few of them said that questions exist about whether an entity is required to separate such features as an embedded derivative, however they generally considered the questions related to financial assets with such features to be a priority. On the other hand, a few other respondents observed that they consider ESG-linked features in financial liabilities to be non-financial variables specific to a party to the contract and therefore are not embedded derivatives that need to be separated from the financial liability. As such, the financial liabilities are measured at amortised cost without any significant application challenges.

[3] Chava, S. (2014). Environmental externalities and cost of capital. *Management Science*; Jiraporn, P., Jiraporn, N., Boeprasert, A., & Chang, K., (2014). Does corporate social responsibility (ESG) improve credit ratings? Evidence from geographic identification. *Financial Management*; Menz, K.M. (2010). Corporate social responsibility: Is it rewarded by the corporate bond market? A critical note. *Journal of Business Ethics*; Stellner, C., Klein, C., & Zwergel, B. (2015). Corporate social responsibility and Euro-zone corporate bonds: The moderating role of country sustainability. *Journal of Banking and Finance;* Barth, F., Hübel, B., & Scholz, H. (2019). *ESG and corporate credit spreads.* Working paper; Merton, R.C. (1974). On the pricing of corporate debt: The risk structure of interest rates. *Journal of Finance*.

Does amortised cost provide useful information about financial assets with ESG-linked features?

15. Regardless of their views on whether financial assets with ESG-linked features have contractual cash flows that are SPPI, many respondents asked the IASB to permit such financial assets to be measured at amortised cost. Most of these respondents said that amortised cost provides more useful information about the future cash flows on these financial instruments compared to fair value, because:

    (a) interest revenue based on the effective interest method along with the impairment requirements and associated disclosures provide the most useful information about the amount, timing and uncertainty of the future cash flows of these financial instruments. Some respondents said this is the case particularly when the assets are within the 'held to collect' business model, the size of the ESG-linked feature is small and all other features are consistent with a basic lending arrangement.

    (b) amortised cost is capable of providing useful information about variabilities in the contractual cash flows arising from the ESG-linked feature because such variabilities can be accounted for applying paragraph B5.4.6 or B5.4.5 of IFRS 9. These respondents acknowledged that there are application questions about those requirements as highlighted in their feedback on the RFI (see Section 7 of Agenda Paper 3A for the March 2022 IASB meeting).

    (c) the issuers of financial instruments with ESG-linked features often measure the financial liability at amortised cost (see paragraph 14 of this paper). Some of these respondents argued that this indicates that amortised cost can provide useful information about the financial asset for the holder. They consider it important to align the accounting for the issuer and the holder of the same financial instruments.

16. In these respondents' view, measurement at fair value through profit or loss would not provide useful information because:

    (a) most of the fair value and changes therein would reflect changes in interest rate and credit risk rather than the risk associated with the ESG-linked features. They questioned whether measuring such instruments at fair value through profit or loss would provide useful information considering comparable financial assets without such features that are managed in the same business model (of 'held-to-collect') are measured at amortised cost.

(b) there is a general lack of market consensus on how to measure these ESG-linked features given that they are relatively new to the market, leading to difficulty in reliably measuring the fair value of such features.

17. Regardless of the measurement basis applied, some respondents considered disclosure to be critical in providing useful information about entities' exposures to ESG-linked risks arising from financial instruments. They suggested the IASB consider adding disclosure requirements along with the classification and measurement requirements.

Specific suggestions made by respondents

18. Many respondents made suggested possible amendments to IFRS 9 to support entities in applying the requirements to financial assets with ESG-linked features. They include:

(a) enhancing the description of 'interest' and 'basic lending arrangement' so that at least some ESG-linked features are described as another 'building block' of what constitutes 'interest' in a basic lending arrangement;

(b) allowing measurement of financial assets at amortised if the ESG-linked feature is a non-financial variable specific to a party to the contract;

(c) adding specific requirements similar to the requirements with respect to regulated interest rate in paragraph B4.1.9E of IFRS 9; and

(d) adding specific requirements similar to those on modified time value of money in paragraphs B4.1.9B–B4.1.9D of IFRS 9 which include qualitative and quantitative assessments.

19. A few respondents who made suggestions described in paragraph 18(b) of this paper acknowledged that given the variety of ESG-linked features and that the market is continuing to develop, it would be challenging to robustly define such features. They therefore suggested that the IASB only broadly describe such features. On the other hand, there were other respondents that suggested the IASB consider specific

requirements that apply to only some types of ESG-linked features rather than broadly to all types of ESG-linked features.

20. A few respondents specifically requested that in addressing the matter, the IASB maintain the principle-based classification and measurements requirements in IFRS 9, rather than adding a special rule or exception. They observed that principle-based approach enables consistent application of the requirements, and this is particularly important for enabling the requirements to remain applicable to new types of financial instruments as the market for financial instruments with ESG-linked features are evolving.

Staff analysis and preliminary views

Does IFRS 9 enable consistent application of the SPPI requirements to sustainability-linked financial assets?

21. As noted at the IASB July 2021 meeting, the staff think assessing whether financial assets with ESG-linked features have SPPI cash flows requires an entity to consider what an entity is being compensated for and whether the ESG-linked features introduce exposure to risks or volatility/variability in the contractual cash flows that is inconsistent with a basic lending arrangement. Also, in making this assessment, we think it is important to bear in mind the objective of the SPPI condition, which is to identify financial assets for which amortised cost provide useful information about the amount, timing and uncertainty of future cash flows of the assets.[4] Amortised cost is a relatively simple measurement technique that allocates interest over time using the effective interest method. [5]

22. Some respondents have interpreted the components of ‘interest’ explained in paragraph B4.1.7A of IFRS 9 to be an exhaustive list of the only possible elements of interest that is consistent with SPPI. However, our understanding is that this was not the intention of the IASB.

[4] See paragraph BC4.172 of IFRS 9
[5] See paragraph BC4.171 of IFRS 9

23. In developing the application guidance in that paragraph, the IASB considered the importance of maintaining a principle-based approach and the difficulty of identifying every possible element of interest that would be consistent with SPPI. The IASB instead focused on the notion of a basic lending arrangement to explain what could be and what would not be present in such an arrangement. As explained in paragraph BC4.182(b) of the Basis for Conclusions on IFRS 9, the IASB noted that interest may include consideration for elements other than time value of money and credit risk and focuses on what the entity is being compensated for, instead of how much the entity receives for a particular element.

24. Therefore, the staff view is that, as noted in the IFRS 9 Project Summary, the IASB intended paragraph B4.1.7A of IFRS 9 to clarify that interest can comprise a return not only for the time value of money and credit risk but also for other components such as a return for liquidity risk, amounts to cover expenses and a profit margin.

25. As explained in paragraph BC4.188 of the Basis for Conclusions on IFRS 9, in developing the SPPI requirements, the IASB decided to require an entity to assess all contingent features in the same way. For example, there is no distinction between contingent prepayment and extension features and other types of contingent features. In the staff view, ESG-linked features should be treated the same as any other contingent feature in this regard.

26. As stated in paragraph 3 of this paper, paragraph B4.1.10 of IFRS 9 provides application guidance with respect to contractual terms that change the timing or amount of contractual cash flows. It states that to determine whether a financial asset with such terms has SPPI cash flows, an entity must assess the contractual cash flows that could arise both before, and after, the change in 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 SPPI, it may be an indicator.

27. Paragraph B4.1.10 of IFRS 9 compares the following two examples to illustrate the interaction between the nature of the contingent event and the resulting contractual cash flows, and explains that it is more likely in example 1 that the contractual cash flows over the life of the instrument will be SPPI because of the relationship between missed payments and an increase in credit risk:

(a) example 1—a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments; and

(b) example 2—a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level.

28. The IASB further explained in paragraph BC4.188 of the Basis for Conclusions on IFRS 9 that although the nature of a future event in itself does not determine whether a financial asset's contractual cash flows are SPPI, there is often an important interaction between the nature of the future event and the resulting contractual cash flows. For example, if the nature of the future event is unrelated to a basic lending arrangement (for example, a particular equity or commodity index reaches or exceeds a particular level), it is unlikely that the resulting contractual cash flows are SPPI, because those cash flows are likely to reflect a return for equity or commodity price risk.

29. Therefore, in the staff view, the key consideration in assessing the contractual cash flows resulting from any contingent feature is whether the resulting cash flows reflect a return for risk (ie what is the entity being compensated for) that is unrelated to a basic lending arrangement. For example, an entity would ask if the ESG-linked features introduce exposure to such risks or variability and therefore are not consistent with a basic lending arrangement.

30. Based on our understanding, for a number of financial assets with ESG-linked features, the ESG-linked adjustments to interest rates are not determined considering the risks or ability of the individual borrower meeting specific ESG targets. The ESG-linked features are often not meant to compensate the lender for taking on such risks. Rather, the ESG-adjustment serves as an 'incentive' for the borrower to meet the specified ESG targets. It is common for the same level of adjustment to be made to the contractual interest rate for borrowers across various industries and various ESG targets.

31. If the contractual cash flows resulting from the ESG-linked feature do not introduce compensation for ESG risks, the staff think that such a financial asset could have contractual cash flows that are not inconsistent with a basic lending arrangement. However, we acknowledge that this assessment can require considerable judgement and that stakeholders are unsure about what the IASB intention would have been for

assessing this type of contractual cash flows. We also acknowledge the feedback from respondents indicating diverse views on this matter.

Is standard-setting needed?

32. The staff view is that the contractual cash flow characteristics assessment in IFRS 9 is as relevant to financial assets with ESG-linked features as it is to other financial assets. In our view, the SPPI requirement is an appropriate basis to determine whether a financial asset with ESG-linked features is measured at amortised cost or fair value through profit or loss. Therefore, we do not think that it is necessary to create an exception from the SPPI requirements to ensure useful information about the amount, timing and uncertainty of contractual cash flows are provided to users of the financial statements.

33. We also do not consider there to be a need for fundamental changes to the principles of the SPPI requirements in IFRS 9. This is consistent with the feedback on the RFI that generally the contractual cash flow characteristics assessment works as intended and achieves the IASB's objective of providing users of financial statements with useful information.

34. In our view, if any standard-setting is undertaken in this area, any potential amendments would solely focus on clarifying the current requirements and providing additional application guidance to assist entities in assessing whether a financial asset with ESG-linked features has contractual cash flows that are SPPI.

35. In general, the staff are sympathetic towards the questions from stakeholders about how to apply the SPPI requirement to financial assets with ESG-linked features, especially in the context of new financial products developed in recent years and ESG-linked features in particular becoming more widespread and prevalent in the market. However, an important consideration in any standard-setting decision, is the costs to be incurred including the cost of changing practice and unintended consequences vs. the benefits to be derived from the clarifications.

36. On balance, we think there is a need for standard-setting in this regard because as discussed in paragraphs 9–13 of this paper, diversity in practice on how to assess the contractual cash flows of financial assets with ESG-linked features already seems to

be developing. The staff think IFRS 9 can be clarified by adding application guidance to support the consistent application of the SPPI condition. To ensure the maximum benefit to be gained for the lowest cost, we are of the view to any clarifications should not be specific only to ESG-linked features, but principle-based and robust enough to be applied to other types of financial instruments that may emerge in the future.

37. With regards to what potential clarifications could be made in this regard, the staff think the IASB could consider:

(a) adding application guidance with respect to the characteristics of a basic lending arrangement and its link to amortised cost measurement. In our view, such additional application guidance would not only assist entities with assessing the contractual cash flows of financial assets with ESG-linked features, but would also help more consistent application of the SPPI assessment in general.

(b) clarifying how to assess whether variability arising from contractual terms that change the timing or amount of contractual cash flows are consistent with SPPI.

(c) considering how the disclosure objectives and principles in IFRS 7 would apply to financial assets with ESG-linked features, including information about an entity's exposure to risks arising from such features and how an entity manages such risks.

38. The staff agree with respondents that this matter is a priority. The market for this type of financial instruments is growing rapidly globally. The staff therefore think there is a benefit of providing clarity as soon as possible before diverse practice becomes embedded. A timely solution would be necessary to enable stakeholders to develop and implement any process, model and system changes required for classifying and measuring these financial assets.