IFRS

STAFF PAPER

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IASB® meeting

Project	**Contractual Cash Flow Characteristics of Financial Assets (Amendments to IFRS 9)**	
Paper topic	General requirements	
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Introduction

1. In May 2022, the IASB decided to start a standard-setting project to clarify particular aspects of the IFRS 9 requirements for assessing a financial asset's contractual cash flow characteristics (ie the 'solely payments of principal and interest' (SPPI) requirements). The decision was taken in response to feedback received on the *Request for Information Post-implementation Review of IFRS 9—Classification and Measurement*, as discussed during the March 2022 and April 2022 meetings.

2. In June 2022, the IASB discussed the objective, scope and indicative timeline for the project.

3. This paper provides the staff's preliminary analysis of the following concepts in the SPPI requirements in IFRS 9:

   (a) the concept of a basic lending arrangement (paragraph B4.1.7A); and

   (b) whether and how the nature of a contingent event (ie the trigger for a change in the timing or amount of contractual cash flows) is relevant to determining whether the cash flows are SPPI (paragraphs B4.1.10 and B4.1.11).

4. Agenda Paper 16B for this meeting provides the staff's analysis of the characteristics of financial assets with non-recourse features and contractually linked instruments (CLIs).

5. The analysis presented in these papers will serve as the basis for proposed clarifying amendments to the IFRS 9 requirements to be discussed at future meetings.

6. The following topics will also be discussed at future meetings:

   (a) consideration of the need to assess the underlying assets of non-recourse financial assets;

   (a) consideration of the need to assess the underlying assets of non-recourse financial assets;

   (b) the requirements for the underlying pool of instruments for a CLI to meet the SPPI requirements (paragraphs B4.1.23 and B4.1.25);

   (c) whether additional disclosure requirements are needed regarding contractual terms that could affect the timing or amount of contractual cash flows; and

   (d) whether any transitional requirements are needed for entities applying the amended application guidance.

7. This paper is structured as follows:

   (a) a reminder of the IFRS 9 requirements for the SPPI assessment and the IASB's rationale for those requirements; and

   (a) preliminary staff views and analysis.

8. The paper is accompanied by an appendix setting out the background to the IFRS 9 requirements in more detail.

9. This paper does not ask the IASB to make decisions but invites IASB members' questions and comments on the preliminary staff views and analysis.

Question for IASB
Do you have any questions or comments about the preliminary staff views and analysis?

IFRS requirements

Contractual cash flow characteristics

References
- Section 4.1 of IFRS 9
- Paragraphs B4.1.7 to B4.1.26 of IFRS 9
- Paragraphs BC4.3-BC4.8, BC4.22-BC4.35 and BC4.170-BC4.172 of the Basis for Conclusions on IFRS 9

10. IFRS 9 *Financial Instruments* (IFRS 9) requires an entity to classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

    (a) the entity's business model for managing the financial assets; and

    (b) the contractual cash flow characteristics of the financial asset.

11. A financial asset is required to be measured at fair value through profit or loss if its cash flows are not SPPI.

12. Paragraphs BC4.6 and BC4.171 of the Basis for Conclusions on IFRS 9 notes that both fair value and amortised cost can provide useful information to users of financial statements for particular types of financial assets in particular circumstances, but that the effective interest method used for financial assets measured at amortised cost (or fair value through other comprehensive income) is a relatively simple method and is only suitable for instruments with 'simple' cash flows that represent SPPI.

Concept of a basic lending arrangement

References
- Paragraph B4.1.7A of IFRS 9
- Paragraphs BC4.181-2 of the Basis for Conclusions on IFRS 9

13. Paragraph B4.1.7A of IFRS 9 introduces the concept of a 'basic lending arrangement' in discussing the characteristics of cash flows that are SPPI. The rationale behind this paragraph is explained in BC4.182(b) of the Basis for Conclusions on IFRS 9:

    > … the consideration for the time value of money and the credit risk are typically the most significant elements of interest; however, they may

> not be the only elements. In discussing the elements of interest (and indeed the overall objective of the assessment of an asset's contractual cash flows), the IASB considered the concept of a 'basic lending arrangement' (the form of which need not be that of a loan). In such an arrangement, the IASB noted that interest may include consideration for elements other than the time value of money and credit risk. Specifically, interest may include consideration for risks such as liquidity risk and costs associated with holding the asset (such as administrative costs) as well as a profit margin. But elements that introduce exposure to risks or variability in the contractual cash flows that are unrelated to lending (such as exposure to equity or commodity price risk) are not consistent with a basic lending arrangement. The IASB also noted that the assessment of interest focuses on *what* the entity is being compensated for (ie whether the entity is receiving consideration for basic lending risks, costs and a profit margin or is being compensated for something else), instead of *how much* the entity receives for a particular element. For example, the IASB acknowledged that different entities may price the credit risk element differently.

14. Although IFRS 9 does not include a definition of what constitutes a basic lending arrangement as such, the application guidance provides detailed guidance and examples of contractual cash flows that are or are not consistent with a basic lending arrangement (see paragraphs B4.1.9E, B4.1.13, B4.1.14 and B4.1.16 of IFRS 9).

Contractual terms that can change the timing or amount of contractual cash flows

References

- Paragraphs B4.1.10—B4.1.14 and B4.1.18 of IFRS 9
- Paragraphs BC4.183—195 of the Basis for Conclusions on IFRS 9

15. Paragraph B4.1.10 of IFRS 9 provides guidance on assessing whether contractual cash flows are SPPI if the financial asset contains a contractual term that could change the timing or amount of these contractual cash flows. By way of example, the paragraph notes that a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments is more likely to have cash flows that

are SPPI than a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level.

16. Paragraph B4.1.11 of IFRS 9 provides further examples of contractual terms that result in contractual cash flows, namely certain variable interest rates as well as certain options to prepay or extend the contractual term of a debt instrument.

17. The rationale behind this application guidance is discussed in BC4.188 of the Basis for Conclusions on IFRS 9:

> … for all contingent features, the nature of the future event in itself does not determine whether a financial asset's contractual cash flows are solely payments of principal and interest. However, the IASB noted that there often is an important interaction between the nature of the future event and the resulting contractual cash flows. Consequently, it is often helpful (or perhaps even necessary) for the entity to consider the nature of the future event to determine whether the resulting contractual cash flows are solely payments of principal and interest.
>
> 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 solely payments of principal and interest, because those cash flows are likely to reflect a return for equity or commodity price risk.

18. Paragraph B4.1.10 of IFRS 9 also refers to paragraph B4.1.18 of IFRS 9 which states that contractual terms that are either de minimis or non-genuine do not affect the SPPI assessment.

Preliminary staff views and analysis

Contractual cash flow characteristics

19. As reported in Agenda Paper 3A for the March 2022 IASB meeting, most respondents to the *Request for Information Post-implementation Review of IFRS 9—Classification and Measurement* (the PIR) expressed the view that generally the SPPI assessment is working as intended, notwithstanding a few application challenges.

20. Many respondents to the PIR asked the IASB to permit financial assets with ESG-linked features to be measured at amortised cost. Some of these respondents suggested that the IASB should develop specific requirements for assessing whether financial assets with ESG-linked features have cash flows that are SPPI.

21. The IASB agreed with the staff view in Agenda Paper 16 for June 2022 that consistent application will be best achieved, not through the development of specific SPPI requirements for financial assets with ESG-linked features, but by clarifying the following aspects of the SPPI application guidance:

    (a) the concept of a basic lending arrangement (paragraph B4.1.7A of IFRS 9);

    (a) whether and how the nature of a contingent event (ie the trigger for a change in the timing or amount of contractual cash flows) is relevant to determining whether the cash flows are SPPI (paragraphs B4.1.10 and B4.1.11 of IFRS 9); and

    (b) examples in paragraphs B4.1.13 and B4.1.14 of IFRS 9 of applying the SPPI requirements to specific fact patterns (including adding additional examples for financial assets with ESG-linked features).

Amortised cost as a measurement basis[1]

22. Amortised cost of a financial instrument is calculated using the effective interest method. This method is essentially a spreading mechanism that allocates interest revenue or interest expense over a relevant period, and in doing so, amortises or accretes the carrying amount recorded on initial recognition to the ultimate contractual cash flows. This results in the recognition in profit or loss over time of the effective return on a financial instrument as the difference between the amount recorded on initial recognition and the ultimate contractual cash flows.

23. Amortised cost is a cost-based measure. The carrying value of a financial asset recorded in the statement of financial position at any given point in time does not — nor is it intended to—provide information about the fair value of the future cash flows.

[1] Paragraphs 22–26 were previously included in Agenda Paper 6B for the September 2013 joint IASB-FASB meeting

This is reflected in the fact that the effective interest rate is established at initial recognition. Rather, it is a measure of the amount invested in the financial asset at any given point in time that provides a constant link between the amount recorded on initial recognition and future contractual cash flows. In doing so, the measure reflects the value of the expected contractual cash flows discounted at the applicable effective interest rate (EIR).

24. As an allocation mechanism, amortised cost works best for financial assets with contractual cash flows that are fixed (ie those that are known at contract inception and that are not contingent) both in timing and amount.

25. Mechanically, amortised cost could also allocate the effective return for financial assets with variable contractual cash flows as long as those cash flows are determinable. For financial assets with variable cash flows, it is important to consider both the degree and the source of variability in the contractual cash flows in order to determine whether the amortised cost allocation mechanism would work well and provide useful information.

26. However, as the variability in contractual cash flows increases and is driven by factors unrelated to a basic lending type return, amortised cost essentially ceases to allocate the effective return and increasingly becomes a fair value-like measure. In such cases, amortised cost does not provide superior information compared to fair value measurement. For such instruments, amortised cost loses the benefit of being a simple measurement technique and becomes increasingly more difficult to apply.

Concept of a basic lending arrangement

27. The application questions raised during the PIR related mostly to interest, especially the components of interest other than the time value of money. Respondents did not raise many application challenges relating to the meaning of 'principal' in the context of the SPPI assessment.

28. As discussed in Agenda Paper 3B for the April 2022 IASB meeting, 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.

29. However, the staff do not believe it was the IASB's intention to limit the components of interest to only those components mentioned or for those components to become a 'save haven' from the SPPI requirements, ie as long as something is labelled 'credit risk' or 'profit margin' no further analysis is needed (see paragraphs 37-38 of this paper). In our view, the description of interest in this paragraph of IFRS 9 was intended to simply identify the most significant components that are typically included in a basic lending-type return.

30. The concepts of a 'basic lending arrangement' and 'basic lending-type return' has been discussed extensively as part of the IASB's deliberations when developing IFRS 9. It is the underlying rationale for the SPPI assessment and the necessary characteristics of a financial asset in order for amortised cost to provide complete and useful information (see Agenda Paper 6D for the September 2013 joint IAS-FASB meeting).

31. The staff therefore believe that it would be useful to include further guidance on what is intended with a 'basic lending arrangement' to encourage a principle-based and holistic assessment of the characteristics of a financial asset's contractual cash flows.

32. In the staff's view, IFRS 9 uses the term 'basic lending arrangement' to refer to an agreement whereby the lender lends a principal amount to the borrower for a specified term (which may be shortened or extended at the option of the lender or the borrower). In exchange, the lender has the contractual right to receive payments of principal and interest on the principal outstanding, representing compensation for risks and costs associated with lending the principal amount outstanding to the borrower during the term of the instrument. A basic lending arrangement does not represent an investment in or exposure to particular assets or cash flows that are not SPPI.

33. In some cases, cash flows that are contractually labelled as 'interest' may not be consistent with a basic lending arrangement, for example in the case of a profit-share arrangement where the lender contractually receives a lower interest rate during the life of the loan in return for a share of the profit of the entity. In contrast, cash flows may be described as 'fees' but form part of the lender's compensation for the time value of money, credit risk and other basic lending risks and costs. This principle is articulated in paragraph B4.1.15 of IFRS 9:

> 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.

34. As noted in Agenda Paper 6D for the September 2013 joint IASB-FASB meeting, the IASB did not intend to challenge how entities price financial assets. In other words, the notion of the 'appropriate' consideration for the time value of money and the credit risk is not intended to scrutinise entities' pricing approaches.

35. The assessment of whether the contractual terms of a financial asset constitute a basic lending arrangement is based on the lender's overall compensation (ie *what* the lender is being compensated for), rather than the descriptions of various components of this compensation or *how much* the lender receives for a particular element (see paragraph BC4.182(b) of the Basis for Conclusion on IFRS 9).

36. Furthermore, as noted in Agenda Paper 3B discussed at the July 2021 IASB meeting, a basic lending arrangement does not simply refer to a lending arrangement that is common or widespread in a particular market. Although the staff believe that as a general proposition, the market is relevant—for example, in a particular jurisdiction it might be common to reference interest rates to a particular benchmark rate—just because something is 'normal' in the market, that should not necessarily be accepted as SPPI.[2] In our view, the concept of a basic lending arrangement is more akin to a generally accepted notion of basic lending regardless of the particular market or jurisdiction the loan is made. For example, while it may be 'normal' in a particular market to include an adjustment to interest rates dependent on the price of a particular commodity, such an arrangement is not likely to be considered a basic lending arrangement in other markets.

Contractual terms that can change the timing or amount of contractual cash flows

37. In the PIR feedback, many respondents suggested that more guidance is needed on whether and how the nature of a contingent event impacts the SPPI assessment. It

[2] This is consistent with the discussion in Agenda Paper 6D for the September 2013 joint IASB-FASB meeting

appears that some entities have inferred from the example given in B4.1.10 of IFRS 9 of a change in contractual cash flows triggered by a change in the credit risk of the borrower that the nature of the event must be associated with one of the components of interest listed in paragraph B4.1.7A of IFRS 9 for the cash flows of the financial asset to represent SPPI.

38. On the other hand, it appears that some respondents understood the requirements in paragraph B4.1.10 of IFRS 9 to imply that any variability in cash flows associated with the components of interest in paragraph B4.1.7A of IFRS 9 are automatically deemed to be SPPI and no further consideration or analysis would be needed. In other words, as long as the variability is associated with one of the 'permissible' components of interest, it can be assumed to be SPPI without any further analysis.

39. As discussed in paragraphs 25-26 of this paper, amortised cost can be an appropriate measurement basis for certain types of financial assets with variable cash flows. Paragraph B4.1.10 of IFRS 9 states 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 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 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, it may be an indicator…

40. Paragraph B4.1.10 of IFRS 9 includes two examples of how the source of variability in contractual cash flows could affect the SPPI assessment. The first example is of a financial instrument where the interest rate is reset to a higher rate if the debtor misses a number of payments. The second example is of a financial instrument where the interest rate is reset to a higher rate if a specified equity index reaches a particular level. The paragraph states that it is more likely in the first example 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.

41. The staff continues to agree with the statement in paragraph B4.1.10 of IFRS 9 that an adjustment to the contractual interest associated with an increase in the equity index is not consistent with what would generally be considered a basic lending arrangement. This is because an equity index for example, is a general market variable that reflects changes in market conditions affecting all entities and/or all financial instruments in the same way rather than being specific to the borrower or the financial instrument for which the interest rate is adjusted.[3]

42. Furthermore, we think this rebuts the interpretation that some respondents have as described in paragraph 38 of this paper. This is because in the second example in paragraph B4.1.10 of IFRS 9, the variability is in the contractual interest rate, which some regard as ‘safe component’. However, this example makes it clear that IFRS 9 requires all variability in contractual cash flows over the life of the instrument to be assessed and that variability cannot be disregarded simply because it affects one of the components of interest mentioned in paragraph B4.1.7A of IFRS 9.

43. Similarly, the staff also do not believe that paragraph B4.1.10 of IFRS 9 requires any variability in cash flows to be associated with the specified components of interest in order for the contractual cash flows to be SPPI. IFRS 9 specifically requires the cash flows before and after the trigger event to be assessed to determine whether the contractual cash flows over the life of the instrument are SPPI.

44. The degree of variability is also an important factor to consider. In our view, this degree of variability must have the ability to have more than a ‘de minimis’ effect on the contractual cash flows because paragraph B4.1.18 of IFRS 9 states that a contractual cash flow characteristic that could have only a de minimis effect on the contractual flows of a financial asset over the life of the instrument, does not affect the classification of the financial asset.

45. This then leads to the question of which variability in contractual cash flows will be consistent with a basic lending arrangement and result in contractual cash flows that are SPPI.

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[3] This is consistent with the discussion in Agenda Paper 6E for the September 2013 joint IASB-FASB meeting.

46. Based on the feedback received both before and as part of the PIR we became aware that financial instruments are frequently issued with conditionality attached to the interest rate. In other words, the contractual terms specify the base ('unconditional') interest rate that applies, as well as a conditional interest rate that would apply if the entity meets contractually specified conditions. Such a conditional interest rate could be either higher or lower than the base interest rate. For example, the interest rate on a loan could be increased by a pre-specified number of basis points if the borrower fails to meet a contractually specified ESG-linked target.

47. Although these financial assets appear to be similar to the second example in paragraph B4.1.10 of IFRS 9, in that the contractual interest rate is adjusted upon the occurrence (or non-occurrence) of a future event, we think there is an important difference that needs to be considered.

48. In the case of financial assets described in paragraph 46 of this paper, the contingent event is not a financial or market variable that reflect general market conditions, but a variable that is specific to the borrower, for example meeting a specified ESG-linked target. We think this is an important distinction because as explained in paragraph 13 of this paper, the underlying principle of the cash flow characteristics assessment is to assess what risks or costs associated with the borrower and specific financial instrument the lender is being compensated for.

49. However, since paragraph B4.1.10 of IFRS 9 currently provides no requirements or guidance in this regard, we think it would be useful to clarify that a financial asset that includes contractual terms that change the timing and amount of the contractual cash flows could be consistent with a basic lending arrangement and therefore have SPPI cash flows, if:

    (a) the contractual cash flows before and after the reset point represents SPPI;

    (b) the contingent event is specific to the borrower and specified in the contract; and

    (c) the contractual terms do not represent an investment in or exposure to particular assets or cash flows that are not SPPI applying paragraph B4.1.16 of IFRS 9.

50. In the staff's view, it would not be appropriate to introduce a quantitative threshold to assess whether contractual terms that changes the timing or amount of contractual cash flows are SPPI. This is because, other than the de minimis requirements, there is no general quantitative threshold to assess whether contractual cash flows are SPPI because as stated in paragraph 35 of this paper, the focus of the SPPI requirements is on what the entity is being compensated for and not how much.

51. We also think it would be helpful to include additional examples of contractual terms that change the timing or amount of contractual cash flows that would be compatible with a basic lending arrangement (under paragraph B.4.1.13 of IFRS 9) and contractual terms that would not be consistent with a basic lending arrangement (under paragraph B.4.1.14 of IFRS 9). The staff's recommendations for applicable examples will be discussed at a future meeting.

Appendix—Background to the IFRS requirements

Concept of a basic lending arrangement

A1. The Exposure Draft *Financial Instruments: Classification and Measurement* published in July 2009 (the 2009 Exposure Draft) proposed that a financial asset or financial liability shall be measured at amortised cost if both of the following conditions are met:

(a) the instrument has only basic loan features; and

(b) the instrument is managed on a contractual yield basis.

A2. Paragraph B1 of the 2009 Exposure Draft described 'basic loan features' as follows:

> Basic loan features are contractual terms that give rise on specified dates to cash flows that are payments of principal and interest on the principal outstanding. For the purposes of this [draft] IFRS, interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time. Contractual terms that change the timing or amount of payments of principal or interest on the principal outstanding are not basic loan features unless they protect the creditor or debtor (see paragraph B3(c)). Other contractual features that result in cash flows that are not payments of principal and interest are not basic loan features.

A3. In *IFRS 9 Financial Instruments* issued in October 2010 (IFRS 9 (2010)), the term 'basic loan features' was replaced by the current language in paragraph 4.1.2(b) of IFRS 9: 'the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.'

A4. The Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* published in November 2012 (the 2012 Exposure Draft) proposed the addition of paragraph B4.1.8A, which implied a narrow interpretation of the SPPI assessment:

> If the contractual cash flows include payments that are unrelated to principal, the time value of money and the credit risk, the contractual cash flows do not represent solely payments of principal and interest.

Accordingly, such financial assets must be measured at fair value through profit or loss.

A5. In the feedback to the 2012 Exposure Draft many respondents asked whether other components—such as profit margin, compensation for servicing costs or consideration for the entity's funding costs— are consistent with the SPPI condition (see Agenda Paper 6D for the September 2013 joint IASB-FASB meeting).

A6. In response to this feedback, the IASB decided to remove paragraph B4.1.8A and added the discussion of a 'basic lending arrangement' in paragraph B.4.1.7A, as discussed in paragraph 13 of this paper.

Contractual terms that can change the timing or amount of contractual cash flows

A7. The 2009 Exposure Draft contained specific examples of contractual terms that are 'basic loan features' including

(a) contractual provisions that permit the issuer (the debtor) to prepay a debt instrument (eg loans or bonds) or permit the holder (the creditor) to put a debt instrument back to the issuer before maturity and are not contingent on future events;

(b) changes in the return to the holder attributable to changes in the timing of cash flows; and

(c) pre-specified resets of interest rates in response to changes in the credit quality of the financial asset or financial liability.

A8. According to paragraph B4.1.12 of IFRS 9 (2010), only the following contractual terms that change the timing or amount of payments of principal and interest would result in contractual cash flows that are SPPI:

(a) a variable interest rate that is consideration for the time value of money and the credit risk (which may be determined at initial recognition only, and so may be fixed) associated with the principal amount outstanding;

(d) a prepayment option meeting particular conditions; and

(e) an extension option meeting particular conditions.

A9. Stakeholders questioned why specific guidance is provided for prepayment and extension options but not for other types of contingent features and whether (and if so, why) it is necessary to consider the nature of the contingent event if the resulting cash flow is SPPI (see Agenda Paper 6E for the September 2013 joint IASB-FASB meeting).

A10. In response to the feedback received, the IASB revised paragraphs B4.1.10 and B4.1.11 for reasons outlined in paragraph BC4.1.188 of the Basis for Conclusions on IFRS 9 (see paragraph 17 of this paper).