STAFF PAPER

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IASB® meeting

Project	**TLTRO III Transactions (IFRS 9 and IAS 20)**
Paper topic	Finalisation of agenda decision

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Introduction and purpose

1. At its February 2022 meeting, the IFRS Interpretations Committee (Committee) decided not to add a standard-setting project to the work plan in response to a submission about accounting for the European Central Bank (ECB)'s Targeted Longer-Term Refinancing Operations (TLTRO). The Committee instead decided to finalise an agenda decision.

2. The purpose of this meeting is to ask Board members whether they object to the agenda decision, as required by paragraph 8.7 of the IFRS Foundation *Due Process Handbook*.

Background

3. The submission explained that TLTRO operations provide financing to banks with the objective of stimulating lending to the bank's customers. The amount that banks can borrow through the programme and the interest rate applicable to each TLTRO tranche is linked to the volume and amount of loans made to non-financial corporations and households.

4. The submission identified diversity in the application of the requirements in IFRS 9 *Financial Instruments* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* in relation to the accounting for TLTRO transactions by banks. The request asked:

   (a) whether the TLTRO III tranches represent loans with a below-market interest rate and, if so, whether the borrowing bank is required to apply IFRS 9 or IAS 20 to account for the benefit of the below-market interest rate;

   (b) if the bank applies IAS 20 to account for the benefit of the below-market interest rate:

      (i) how it assesses in which period(s) it recognises that benefit; and

      (ii) whether, for the purpose of presentation, the bank adds the amount of the benefit to the carrying amount of the TLTRO liability;

   (c) how the bank calculates the applicable effective interest rate;

   (d) whether the bank applies paragraph B5.4.6 of IFRS 9 to account for changes in estimated cash flows resulting from the revised assessment of whether the conditions attached to the liability have been met; and

   (e) how the bank accounts for changes in cash flows related to the prior period that result from the bank's lending behaviour or from changes the ECB makes to the TLTRO III conditions.

5. In June 2021 the Committee discussed the submission and decided to publish a tentative agenda decision, having observed that IFRS 9 is the starting point for the borrowing bank to determine its accounting for TLTRO III transactions because each financial liability arising from the bank's participation in a TLTRO III tranche is within the scope of IFRS 9.

6. With respect to whether the TLTRO III tranches contain a government grant as defined in IAS 20, the Committee observed the following:

   (a) TLTRO III tranches would contain a government grant in the scope of IAS 20 only if it were determined that:

(i) the ECB meets the definition of government in IAS 20;

(ii) the interest rate charged on the TLTRO III tranches is a below-market interest rate; and

(iii) the TLTRO III transactions with the ECB are distinguishable from the borrowing bank's normal trading transactions.

(b) making the determinations in (a) require judgement based on the specific facts and circumstances and, therefore, the Committee is not in a position to conclude on whether the TLTRO III tranches contain a government grant in the scope of IAS 20.

(c) judgement may also be required to identify the related costs, if any, for which the grants are intended to compensate.

7. The Committee concluded that if the TLTRO III tranches contain a government grant in the scope of IAS 20, the requirements in IAS 20 provide an adequate basis for the bank to determine how to account for that government grant.

8. With respect to the application of the effective interest method to a TLTRO III tranche, the Committee observed the following:

(a) a question arises when calculating the effective interest rate at initial recognition as to what to consider in estimating the expected future cash flows and, specifically, whether the expected future cash flows reflect an assessment of whether the bank will satisfy the conditions attached to the liability.

(b) paragraph B5.4.5 of IFRS 9 applies to floating-rate financial liabilities and paragraph B5.4.6 of IFRS 9 applies to changes in estimated future cash flows other than those dealt with in paragraph B5.4.5.

(c) the application of paragraph B5.4.6 depends on a bank's estimate of expected future cash flows in calculating the effective interest rate on initial recognition of the financial liability. This is because, applying paragraph B5.4.6, the original effective interest rate is used to discount the revised estimated contractual cash flows.

9. The Committee concluded that the question as to what to consider in estimating the expected future cash flows and, specifically, whether the expected future cash flows reflect an assessment of whether the bank will satisfy the conditions attached to the liability is part of a broader matter, which it should not analyse solely in the context of TLTRO III tranches. The Committee was therefore of the view that this matter should be considered as part of the post-implementation review of the classification and measurement requirements in IFRS 9, together with similar matters already identified in the first phase of that review.

Overview of the feedback on the tentative agenda decision

10. The Committee received 15 comment letters on its tentative agenda decision (TAD) by the comment letter deadline of 16 August 2021.

11. Respondents generally agreed with some aspects of the Committee's analysis and conclusions in the TAD but disagreed with other aspects of the TAD or asked for clarifications.

Comments related to IAS 20

12. With respect to whether TLTRO III tranches contain a government grant in the scope of IAS 20, some respondents largely supported the Committee's analysis and conclusions in the TAD. These respondents agreed with the Committee's conclusion that judgement is required based on facts and circumstances to determine whether a TLTRO III tranche contains a government grant and, if there is a grant, that the requirements in IAS 20 provide an adequate basis for an entity to determine how to account for that grant. A few of these respondents specifically agreed that the Committee is not in a position to conclude on whether the ECB meets the definition of government in IAS 20 or were of the view that the Committee should not address such complex individual transactions.

13. However, some other respondents said to reduce diversity in the application of IFRS 9 and IAS 20, it would be helpful for the Committee to provide more

clarity about the applicability of IAS 20 to TLTRO III transactions. In particular, they suggested further explanation of:

(a) how to determine whether a central bank or other similar body meets the definition of government in IAS 20; and

(b) whether the interest rates on TLTRO III loans represent a below-market rate.

14. Some respondents also questioned whether, and if so how, subsequent changes in cash flow estimates affect the identification and accounting for a government grant applying IAS 20. They were concerned about the application of paragraph 10A of IAS 20 when conditions have to be met for an entity to be eligible for the below-market rate of interest, ie if contingent rates indexed to specific performance targets result in a grant with a variable amount. This is because they disagree with a reading of IAS 20 that implies an entity can identify and recognise a government grant associated with a loan at a below-market rate only at initial recognition of the loan. These respondents are of the view that judgement is needed in determining the applicable paragraphs in IAS 20 to apply when accounting for loans for which there is conditionality associated with the interest rate. For example, a few respondents observed that such a loan might qualify as a forgivable loan to which paragraph 10 of IAS 20 applies.

Comments related to the effective interest method

15. With respect to the application of the effective interest method to TLTRO III transactions, most respondents agreed that in order to determine the effective interest rate of a TLTRO III transaction, an entity needs to assess whether the instrument has a floating or fixed rate. There was also agreement that the methodology applied at initial recognition is relevant for subsequent measurement.

16. Most respondents disagreed with treating the interest rate mechanism of TLTRO III transactions as comprising a floating rate and a fixed rate element. They were of the view that the whole TLTRO III interest rate is a floating market rate and that any change in the interest rate made by the ECB represents a reset to market rates to which paragraph B5.4.5 of IFRS 9 applies.

17. Only a few respondents commented on how to treat conditions attached to the interest rate when determining the effective interest rate at initial recognition of the financial liability. Those respondents agreed that an entity needs to assess whether it will meet the lending threshold over the life the loan. However, they asked for further clarity about how to make such an assessment when determining the effective interest rate.

Committee's conclusion

18. The Committee considered this feedback at its February 2022 meeting[1].

19. With respect to whether TLTRO III tranches contain a government grant in the scope of IAS 20, Committee members decided not to conclude on whether the ECB is government (as defined in IAS 20) or whether the interest rate is below-market.

20. On discussion, the Committee also decided to add wording to the agenda decision to state that determining whether a TLTRO III tranche contains a portion that is treated as a government grant—either because the interest rate is below-market or because the loan is a forgivable loan (as defined in IAS 20)—requires judgement based on the specific facts and circumstances.

21. Committee members generally acknowledged that the application of IAS 20 and IFRS 9 to the same transactions can give rise to practical difficulties, most notably after initial recognition.

22. With respect to the application of the effective interest method after initial recognition, the agenda decision refers to the requirements in paragraphs B5.4.5 and B5.4.6 of IFRS 9 but the Committee did not conclude specifically on their application to the TLTRO III interest rate. The Committee noted that the IASB is best placed to consider the questions relating to application of the effective interest rate method as part of the post-implementation review of the classification and measurement requirements in IFRS 9, together with similar matters already raised in the first phase of that review.

[1] Agenda Paper 3 to the Committee's February 2022 meeting analyses comments received.

23. Eight of 14 Committee members voted to finalise the agenda decision.

24. Appendix A to this paper includes the wording of the agenda decision, approved by the Committee.

Questions for the Board

25. The staff would like to ask the Board the following questions.

Questions for the Board
Do Board members object to the Committee's: (a) decision that a standard-setting project should not be added to the work plan; and (b) conclusion that the agenda decision does not add or change requirements in IFRS Accounting Standards?

Appendix A—The Agenda Decision

A1. The Agenda Decision below was approved by the Committee at its February 2022 meeting.

TLTRO III Transactions (IFRS 9 *Financial Instruments* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*)

The Committee received a request about how to account for the third programme of the targeted longer-term refinancing operations (TLTROs) of the European Central Bank (ECB). The TLTROs link the amount a participating bank can borrow and the interest rate the bank pays on each tranche of the operation to the volume and amount of loans it makes to non-financial corporations and households.

The request asks:

a. whether TLTRO III tranches represent loans with a below-market interest rate and, if so, whether the borrowing bank is required to apply IFRS 9 or IAS 20 to account for the benefit of the below-market interest rate;

b. if the bank applies IAS 20 to account for the benefit of the below-market interest rate:

    i. how it assesses in which period(s) it recognises that benefit; and

    ii. whether, for the purpose of presentation, the bank adds the benefit to the carrying amount of the TLTRO III liability;

c. how the bank calculates the applicable effective interest rate;

d. whether the bank applies paragraph B5.4.6 of IFRS 9 to account for changes in estimated cash flows resulting from the revised assessment of whether the conditions attached to the liability have been met; and

e. how the bank accounts for changes in cash flows related to the prior period that result from the bank's lending behaviour or from changes the ECB makes to the TLTRO III conditions.

Applying the requirements in IFRS Accounting Standards

The Committee observed that IFRS 9 is the starting point for the borrowing bank to decide how to account for TLTRO III transactions because each financial liability arising from the bank's participation in a TLTRO III tranche is within the scope of IFRS 9. The bank:

a. assesses whether it would separate any embedded derivatives from the host contract as required by paragraph 4.3.3 of IFRS 9;

b. initially recognises and measures the financial liability, which includes determining the fair value of the financial liability, accounting for any difference between the fair value and the transaction price and calculating the effective interest rate; and

c. subsequently measures the financial liability, which includes accounting for changes in the estimates of expected cash flows.

The Committee noted that the request did not ask about the existence of an embedded derivative and, therefore, this agenda decision does not discuss the requirements in IFRS 9 regarding the separation of embedded derivatives.

Initial recognition and measurement of the financial liability

Applying paragraph 5.1.1 of IFRS 9, at initial recognition a bank measures each TLTRO III tranche at fair value plus or minus transaction costs, if the financial liability is not measured at fair value through profit or loss. A bank therefore measures the fair value of the liability using the assumptions that market participants would use when pricing the financial liability as required by IFRS 13 *Fair Value Measurement*. The fair value of a financial liability at initial recognition is normally the transaction price—that is, the fair value of the consideration received (paragraphs B5.1.1 and B5.1.2A of IFRS 9). If the fair value at initial recognition differs from the transaction price, paragraph B5.1.1 requires a bank to determine whether a part of the consideration received is for something other than the financial liability.

The Committee observed that determining whether an interest rate is a below-market rate requires judgement based on the specific facts and circumstances of the relevant financial liability. A difference between the fair value of a financial liability at initial recognition and the transaction price might indicate that the interest rate on the financial liability is a below-market rate.

If a bank determines that the fair value of a TLTRO III tranche at initial recognition differs from the transaction price and that the consideration received is for only the financial liability, the bank applies paragraph B5.1.2A of IFRS 9 to account for that difference.

If a bank determines that the fair value of a TLTRO III tranche at initial recognition differs from the transaction price and that the consideration received is for more than just the financial liability, the bank assesses whether that difference represents the benefit of a government loan at a below-market rate of interest (treated as a government grant in IAS 20). An entity assesses this difference only at initial recognition of the TLTRO III tranche. The Committee noted that if the difference is treated as a government grant, paragraph 10A of IAS 20 applies only to that difference. The bank applies IFRS 9 to account for the financial liability, both on initial recognition and subsequently.

Should a portion of a TLTRO III tranche be treated as a government grant in IAS 20?

IAS 20 defines:

a. government as referring to ‘government, government agencies and similar bodies whether local, national or international’;

b. government grants as ‘assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity…’; and

c. forgivable loans as ‘loans which the lender undertakes to waive repayment of under certain prescribed conditions’.

Paragraph 10A of IAS 20 requires an entity to treat as a government grant the benefit of a government loan at a below-market rate of interest. The benefit of the below-market rate of interest is measured as the difference between the initial carrying amount of the loan determined by applying IFRS 9 and the proceeds received. Paragraphs 12 and 20 of IAS 20 specify requirements for an entity to recognise government grants in profit or loss.

The Committee observed that a TLTRO III tranche would contain a portion that is treated as a government grant in IAS 20 if the bank assesses that the ECB meets the definition of government in paragraph 3 of IAS 20 and:

a. the interest rate charged on the TLTRO III tranche is a below-market interest rate as referred to in paragraph 10A of IAS 20; or

b. the loan is a forgivable loan (as defined in paragraph 3 of IAS 20) to which paragraph 10 of IAS 20 applies.

The Committee observed that making these assessments require judgement based on the specific facts and circumstances. The Committee therefore noted that it is not in a position to conclude on whether the TLTRO III tranches contain a benefit of a government loan at a below-market rate of interest or a forgivable loan in the scope of IAS 20.

The Committee acknowledged that judgement may also be required to identify the related costs for which the portion of the TLTRO III tranche that is treated as a government grant is intended to compensate. The Committee nonetheless concluded that IAS 20 provides an adequate basis for the bank to assess whether the TLTRO III tranches contain a portion that is treated as a government grant in IAS 20 and, if so, how to account for that portion.

Calculating the effective interest rate at initial recognition of the financial liability

Appendix A to IFRS 9 defines both the amortised cost of a financial liability and the effective interest rate. Calculating the effective interest rate requires an entity to estimate the expected cash flows through the expected life of the financial liability by considering all the contractual terms of the financial instrument.

In calculating the effective interest rate for a TLTRO III tranche at initial recognition, the question arises as to what to consider in estimating the expected future cash flows and, specifically, how to reflect uncertainty that arises from conditionality related to the contractual interest rate. The Committee noted that the question of what to consider in estimating the expected future cash flows to calculate the effective interest rate is also relevant for fact patterns other than that described in the request. The Committee therefore concluded that considering how to reflect conditionality in the contractual interest rate when calculating the effective interest rate is a broader matter, which it should not analyse solely in the context of TLTRO III tranches. Such an analysis could have unintended consequences for other financial instruments, the measurement of which involves similar questions about applying IFRS Accounting Standards. The Committee is therefore of the view that the IASB should consider this matter as part of the post-implementation review of the classification and measurement requirements in IFRS 9, together with similar matters already identified in the first phase of that review.

Subsequent measurement of the financial liability at amortised cost

The original effective interest rate is calculated based on estimated future cash flows at initial recognition as required by IFRS 9. The Committee noted that whether a bank alters the effective interest rate over the life of a TLTRO III tranche depends on the contractual terms of the financial liability and the applicable requirements in IFRS 9.

The contractual terms of TLTRO III tranches require interest to be settled in arrears on maturity or on early repayment of each tranche. There is therefore only one cash outflow over the life of the tranche.

Paragraphs B5.4.5 and B5.4.6 of IFRS 9 specify requirements for how an entity accounts for changes in estimated contractual cash flows.

For floating-rate financial instruments, paragraph B5.4.5 of IFRS 9 specifies that the periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate. IFRS 9 does not define what a floating rate is.

Paragraph B5.4.6 of IFRS 9 applies to changes in estimated contractual cash flows of financial liabilities other than those addressed in paragraph B5.4.5, irrespective of whether the change arises from revisions of estimated contractual cash flows or from a modification of the contractual terms of the liability. However, when changes in contractual cash flows arise from a modification of the contractual terms, an entity assesses whether those changes result in the derecognition of the original financial liability and the recognition of a new financial liability by applying paragraphs 3.3.2 and B3.3.6 of IFRS 9.

The Committee also noted that the application of paragraph B5.4.6 of IFRS 9 depends on a bank’s estimates of expected future cash flows in calculating the effective interest rate at initial recognition of the financial liability because paragraph B5.4.6 requires the use of the original effective interest rate to discount the revised cash flows.

The Committee observed that the question of how conditionality related to the contractual interest rate is reflected in the estimates of expected future cash flows when applying the effective interest method affects both initial and subsequent measurement. As this question is part of a broader matter, the Committee considered that it should not be analysed solely in the context of TLTRO III tranches. The Committee is therefore of the view that the IASB should consider this matter as part of the post-implementation review of the classification and measurement requirements in IFRS 9, together with similar matters already identified in the first phase of that review.

Disclosure

If a bank assesses that the ECB meets the definition of government in IAS 20 and that it has received government assistance from the ECB, the bank needs to provide the information required by paragraph 39 of IAS 20 regarding government grants and government assistance.

Given the judgements required and the risks arising from the TLTRO III tranches, a bank also needs to consider the requirements in paragraphs 117, 122 and 125 of IAS 1 *Presentation of Financial Statements*, as well as paragraphs 7, 21 and 31 of IFRS 7 *Financial Instruments: Disclosures*. These paragraphs require a bank to disclose information that includes its significant accounting policies and management's assumptions and judgements in applying its accounting policies that have the most significant effect on the amounts recognised in the financial statements.

Conclusion

The Committee concluded that IAS 20 provides an adequate basis for the bank to assess whether TLTRO III tranches contain a portion that is treated as a government grant in IAS 20 and, if so, how to account for that portion.

Regarding the question of how conditionality related to the contractual interest rate is reflected in the estimates of expected future cash flows when calculating the effective interest rate at initial recognition or in the revisions of estimated future cash flows on subsequent measurement of the financial liability, the Committee concluded that the matters described in the request are part of a broader matter that, in isolation, are not possible to address in a cost-effective manner and should be reported to the IASB. The

IASB should consider this matter as part of the post-implementation review of the classification and measurement requirements in IFRS 9.

For these reasons, the Committee decided not to add a standard-setting project to the work plan.