STAFF PAPER

September 2022

IASB® meeting

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

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Introduction

1. This paper sets out the staff's recommendations for clarifying amendments to the contractual cash flow characteristics requirements in IFRS 9 *Financial Instruments*. The purpose of the additional application guidance and illustrative examples is to clarify some of the underlying principles of the solely payments of principal and interest ('SPPI') assessment to assist with the consistent application of these requirements.

2. These clarifying amendments are proposed as part of the standard-setting project started by the IASB in May 2022 in response to feedback received on the *Request for Information Post-implementation Review of IFRS 9—Classification and Measurement* (RFI).

3. In July 2022, the IASB discussed the staff's preliminary analysis of the underlying principles with regards to:

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

4. This paper further considers the potential clarifications that could be made, taking into consideration the views and questions from IASB members shared at that meeting and is structured as follows:

   (a) a summary of the staff's recommended clarifications to the SPPI requirements in IFRS 9 and a question for the IASB;

   (b) the staff's analysis of clarifying amendments regarding:

      (i) a basic lending arrangement

      (ii) contractual terms that could affect the timing or amount of contractual cash flows;

      (iii) illustrative examples; and

   (c) the staff's analysis of the usefulness of amortised cost measurement in the case of financial assets with particular ESG-linked features.

Summary of staff's recommendations

5. The staff recommend clarifying that for contractual cash flows to be SPPI, a basic lending arrangement does not give rise to variability in cash flows due to risks or factors that are unrelated to the borrower, even if such terms and conditions are common in the specific market in which the entity operates.

6. The staff further recommend clarifying 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 that could arise from any contingent events are SPPI in all circumstances (ie the probability of a contingent event occurring is not considered);

   (b) the contingent event is specific to the borrower;

   (c) the timing and amount of any variability in contractual cash flows are determinable and specified in the contract; and

(d) the contractual cash flows arising from the contingent event do not represent an investment in the borrower or exposure to the performance of the underlying assets.

7. The staff also recommend adding examples to illustrate the application of the SPPI requirements to specific fact patterns.

Question for IASB
Do you agree with the staff's recommendations in paragraphs 5 to 7 for clarifying amendments to IFRS 9?

Staff analysis of clarifying amendments

Basic lending arrangement

8. As discussed in Agenda Paper 16A for the July IASB meeting, the concepts of a 'basic lending arrangement' and 'basic lending-type return' have been discussed extensively as part of the IASB's deliberations when developing IFRS 9 and is the underlying rationale for the SPPI assessment (see Agenda Paper 6D for the September 2013 joint IASB-FASB meeting).

9. The IASB decided that amortised cost provides useful information to users of financial statements about the amount, timing and uncertainty of future cash flows of financial assets only if such cash flows are SPPI. Paragraph B4.1.7A of IFRS 9 establishes the link between SPPI and a basic lending arrangement by stating that contractual cash flows that are SPPI are consistent with a basic lending arrangement.

10. The IASB noted in paragraph BC4.182(b) of the Basis for Conclusions on IFRS 9 that the assessment of interest focusses on *what* the entity is being compensated for instead of how much the entity receives for a particular element. Amortised cost as a measurement basis only provides useful information about the amount, timing and uncertainty of future cash flows if the 'what' is consideration for basic lending risks, costs and a profit margin.

11. For the purpose of the SPPI assessment, paragraph 4.1.3(b) of IFRS 9 states that interest consists of consideration for the time value of money, 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.

12. To assist entities with carrying out the SPPI assessment, the IASB also included a discussion of the most common components of interest typically found in a basic lending arrangement. However, as discussed in paragraph 29 of Agenda Paper 16A for the July 2022 IASB meeting, it was not the IASB's intention to limit the components of interest to only those components mentioned or for those components to become a 'safe haven' from the SPPI requirements, ie as long as something is labelled 'credit risk' or 'profit margin' no further analysis is needed.

13. The staff acknowledge that the SPPI assessment may in some cases require judgement and that it could be useful to consider the different components, that constitute the interest rate on a financial asset, separately to determine whether there are any contractual terms that are unrelated to a basic lending arrangement. However, it was not the IASB's intention to require a detailed quantitative analysis of the components of interest to justify whether the contractual cash flows are SPPI or not.

14. Although the objective of the SPPI assessment is to determine whether contractual cash flows are consistent with a basic lending arrangement, the staff acknowledge that in some circumstances it might be difficult to determine whether that is the case, as demonstrated through the questions about financial assets with ESG-linked features. In those cases, it might also be helpful to consider the inverse, in other words, whether any contractual cash flows are *inconsistent* with a basic lending arrangement.

15. As noted in Agenda Paper 3B discussed at the July 2021 IASB meeting, in our view, 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' or common practice in a market, does not necessarily give rise to contractual cash flows that are SPPI.

16. In our view, the concept of a basic lending arrangement is more akin to a generally accepted concept of basic lending regardless of the particular market or jurisdiction the loan is made in. It is therefore considered from a market participant perspective taking into account all of the terms and conditions of the financial instrument. 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.

17. Furthermore, for contractual cash flows to be SPPI (and consistent with a basic lending arrangement), having no variability in the cash flows is not a requirement. There are several examples of instruments where there is variability in cash flows included in paragraph B4.1.13 of IFRS 9, that are still considered SPPI.

18. The key consideration however (as discussed in paragraph B4.1.7A of IFRS 9), is whether that variability results in contractual cash flows that are inconsistent with a basic lending arrangement. Variability in cash flows arising from changes in market factors or variables such as equity or commodity prices or indexes is unrelated to lending and is therefore inconsistent with a basic lending arrangement.

19. This is because IFRS 9 requires interest to compensate the lender for the risks and costs associated with lending the principal amount to a particular borrower for a specified period of time. Consideration paid to the lender is not consistent with a basic lending arrangement if it relates to risks or factors that are not generally considered to be basic lending risks or costs (ie if it relates to risks or factors that are not specific to the borrower or the instrument). Also see paragraphs 21-39 of this paper for further analysis of contractual terms that change the timing or amount of contractual cash flows.

20. The staff therefore recommend clarifying that for contractual cash flows to be SPPI, a basic lending arrangement does not give rise to variability in cash flows due to risks or factors that are unrelated to the borrower, even if such terms and conditions are common in the specific market in which the entity operates.

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

21. As explained in paragraphs 37–42 of Agenda Paper 16A for the July 2022 IASB meeting, some entities may have inferred from the example in paragraph B4.1.10 of IFRS 9 (a change in contractual cash flows triggered by a change in the credit risk of the borrower), that the nature of any contingent event must be associated with one of the components of interest listed in paragraph B4.1.7A of IFRS 9 for the cash flows to be SPPI.

22. However, the staff are of the view that IFRS 9 requires all variability in contractual cash flows over the life of the instrument to be assessed and that variability cannot be assumed to be consistent with a basic lending arrangement simply because it affects one of the components of interest mentioned in paragraph B4.1.7A of IFRS 9. Similarly, it is not necessary to link the variability in cash flows to one of the interest components explicitly mentioned in paragraph B4.1.7A of IFRS 9. IFRS 9 mentions liquidity risk as an *example* of 'other basic lending risks' because it is a common component of interest; it does not state that it is the only other basic lending risk.

23. Although paragraph B4.1.10 of IFRS 9 already requires an entity to determine whether the contractual cash flows that could arise over the life of the instrument due to a contingent event are SPPI, the staff think it would be helpful to identify and clarify the underlying principles for making this assessment.

Cash flows arising from a contingent event

24. When developing IFRS 9, the IASB considered stakeholder feedback that a contingent feature should not affect the classification of a financial asset if the likelihood that the future event will occur is remote.[1] However, the IASB rejected this view and confirmed that even if the probability of a contingent event is remote/low, the entity has to consider all contractual cash flows that could arise over the life of the instrument.[2]

25. The view is further confirmed when the IASB decided that reclassifications on the basis of the financial asset's contractual cash flows are not permitted. The IASB noted

[1] Paragraph BC4.186 of the Basis for Conclusions on IFRS 9
[2] Paragraph BC4.189 of the Basis for Conclusions on IFRS 9

that unlike a change in business model, the entity classifies the financial asset at initial recognition on the basis of the contractual cash terms over the life of the instrument.[3]

26. The SPPI assessment is therefore based on all contractual cash flows that could arise over the life of the financial instrument, it is not a probability-based assessment. In other words, for the purpose of the SPPI assessment, an entity must assume that the contingent event will occur.

27. This is why paragraph B4.1.10 of IFRS 9 requires an entity to assess the contractual flows before and after the contingent event to determine whether the cash flows are SPPI. If a contingent event would result in cash flows that are not SPPI (regardless of the likelihood), the financial asset must be measured at fair value through profit or loss. In other words, even though the contractual cash flows could be variable within a range of possible outcomes over the life of the instrument, if the cash flows from all possible outcomes are SPPI, the financial asset has contractual cash flows that are SPPI and is eligible to be measured at amortised cost or fair value through other comprehensive income (FVOCI). This principle is illustrated in the example of Instrument C (ie a variable rate instrument subject to an interest rate cap or floor) in paragraph B4.1.13 of IFRS 9.

Contingent event is specific to borrower

28. As discussed in paragraph 19 of this paper, IFRS 9 requires interest to compensate the lender for the risks and costs associated with lending the principal amount to a particular borrower for a specified period of time. Therefore, the consideration received should relate to the risks and costs associated with the specific borrower and financial instrument.

29. The staff therefore believe that, to be consistent with that principle, the contingent event that could lead to changes to the contractual cash flows, also needs to be specific to the borrower. We are of the view that a contingent event that relates to factors that are not specific to the borrower such as market variables (for example, an equity index), cannot result in contractual cash flows that are SPPI.

[3] Paragraph BC4.117 of the Basis for Conclusions on IFRS 9

30. The nature of the contingent event does not need to be unique to the borrower, but the occurrence (or non-occurrence) of the contingent event must be. For example, a lender could include ESG-linked features in the contractual terms of all borrowers. But to qualify for the reduction in the contractual interest rate, the entity itself has to meet pre-defined ESG targets (ie pre-defined reduction in greenhouse gas emissions). Although all borrowers have the same contingent event (reduction in the interest rate if pre-defined targets are met), the occurrence (or non-occurrence) of the event is specific to each borrower. This is because the borrower has to meet the pre-defined targets set out in its agreement with the lender, to receive a reduction in the interest rate on its lending arrangement. Contingent events that are not specific to the borrower or relate to targets or factors that depend on collective action, for example a reduction in the industry average of greenhouse gas emissions, does not result in cash flows that are SPPI.

31. The staff acknowledge that requiring the contingent event to be 'specific to the borrower', has similarities with the definition of a derivative in IFRS 9, which refers to 'a non-financial variable that is not specific to a party to the contract'. However, for the purpose of the SPPI assessment, the staff propose to require the condition to be specific to the borrower, rather than to either party to the contract. As discussed in paragraph 19 of this paper, in a basic lending arrangement, the lender is compensated for basic lending risks and cost associated with extending credit to the borrower. Therefore, a change in contractual cash flows due to a contingent event that is specific to the lender or another party would not be consistent with a basic lending arrangement.

32. The staff also do not propose making a distinction between financial or non-financial variables when making this assessment. As discussed in paragraph 18 of this paper, variability in contractual cash flows arising from market variables that are unrelated to a basic lending arrangement do not result in cash flows that are SPPI.

33. Similarly, the staff are of the view that not all non-financial variables that are specific to the borrower would be consistent with a basic lending arrangement. For example, adjustments to the contractual interest rate that depend on an entity's revenue or profits in a specific period, are not consistent with a basic lending arrangement even if revenue and profits could be non-financial variables specific to the borrower. Such

cash flows are more akin to an investment in the borrower. Similarly, contractual cash flows that entitle the lender to share in the profit on the sale of the underlying asset, represents an investment in the underlying asset, rather than a basic lending arrangement. Therefore, the staff are instead proposing that the contingent event should not expose the lender to the performance risk of the underlying assets or cash flows that are not SPPI. See paragraphs 37-39 of this paper.

Changes to cash flows are determinable and specified in the contractual terms

34. Amortised cost, as an allocation mechanism, works best for financial assets with contractual cash flows that are fixed both in timing and amount (ie those that are known at contract inception and that are not contingent). However, as noted in Agenda paper 6B for the September 2013 joint IASB-FASB meeting, 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.

35. Although there is no explicit requirement in IFRS 9 for contractual cash flows to be determinable, in the staff's view, this is fundamental to the SPPI assessment. This is because, as stated in paragraph 25 of this paper, a financial asset is classified at initial recognition on the basis of the contractual cash flows over the life of the instrument. If an entity is not able to determine that all contractual cash flows that could arise over the life of the instrument are SPPI, the financial asset is measured at fair value through profit loss.

36. We are therefore of the view that for changes to the amount or timing of contractual cash flows arising from a contingent event specified in the contract, to give rise to cash flows that are SPPI, those changes to the cash flows have to be determinable at initial recognition and specified in the contract. In other words, in addition to knowing what would give rise to a change to the cash flows, an entity (the lender) must also know what the adjustment to the contractual interest rate would be, to conclude that all contractual cash flows that could arise over the life of the instrument are SPPI.

Cash flows do not represent an investment in the borrower or underlying assets

37. As mentioned in paragraph 33 of this paper, the staff are proposing to add a requirement that the contractual cash flows arising from a contingent event do not represent an investment in the borrower or underlying assets. An example could be a contractual term that increases the interest rate on a loan if the borrower's profitability exceeds a certain threshold. Although this contingent event is specific to the borrower, it is akin to an investment in the borrower (ie sharing in the borrower's profitability) and not consistent with a basic lending arrangement.

38. We are of the view that this is consistent with the example in paragraph B4.1.16 of IFRS 9, which states that 'if the contractual terms stipulate that the financial asset's cash flows increase as more automobiles use a particular toll road, those contractual cash flows are inconsistent with a basic lending arrangement'.

39. In determining whether the contractual cash flows arising from a contingent event are consistent with a basic lending arrangement, the nature of the contingent event could be indicative (although not determinative) that the cash flows are not SPPI but rather an investment in the borrower or underlying assets.

Illustrative examples

40. As discussed in previous IASB meetings[4], the staff's view is that the issues raised with regards to financial assets with ESG-linked features in response to the RFI, would best be addressed by clarifying the underlying principles of the SPPI assessment and demonstrating how these principles can be applied in particular scenarios. We therefore think it would be helpful to include additional examples in paragraphs B4.1.13 and B4.1.14 of IFRS 9 to illustrate how the SPPI requirements are applied to financial assets with ESG-linked features.

41. The following example illustrates contractual cash flows that are SPPI:

[4] See paragraph 32 of Agenda Paper 3B for the April 2022 IASB meeting.

Instrument	Analysis
Instrument I Instrument I is a loan that pays a fixed interest rate over the life of the loan. The fixed interest rate is periodically adjusted by a set number of basis points to reflect the borrower's achievement of a pre-defined ESG target that is specific to the borrower. If the borrower achieves the target, the contractual interest rate for the next period is reduced by the set number of basis points.	The contractual cash flows of the instrument are solely payments of principal and interest. The contingent event (meeting a pre-defined ESG target) is specific to the borrower and the changes in the contractual cash flows arising from the contingent event are set out in the contractual terms. The contractual cash flows arising over the life of the instrument are solely payments of principal and interest and do not represent an investment in the borrower or the underlying assets.

42. The following example illustrates contractual cash flows that are not SPPI:

Instrument	Analysis
Instrument J Instrument J is a loan with a contractual interest rate that is adjusted in accordance with the carbon price index.	The contractual cash flows of the instrument are not solely payments of principal and interest. The contractual cash flows on the instrument vary in response to a market variable (the carbon price index). The contractual cash flows that arise over the life of the instrument do not compensate the

Instrument	Analysis
	lender for the risks and costs associated with lending the principal amount to a particular borrower for a specified period of time and therefore are not consistent with a basic lending arrangement.

Usefulness of amortised cost measurement in the case of financial assets with particular ESG-linked features

43. The staff believe that the clarifications proposed above are consistent with the objective of the SPPI assessment to determine whether amortised cost as a measurement model would provide the most useful information to users of financial statements given the characteristics of a financial asset.

44. Paragraph BC4.7 of the Basis for Conclusion on IFRS 9 notes:

> Almost all respondents to the 2009 Classification and Measurement Exposure Draft supported the mixed attribute approach, stating that amortised cost provides relevant and useful information about particular financial assets in particular circumstances because it provides information about the entity's likely actual cash flows. Some respondents said that fair value does not provide such information because it assumes that the financial asset is sold or transferred on the measurement date.

45. As discussed in Agenda Paper 16A for the July meeting of the IASB, amortised cost measurement typically provides useful information for financial assets whose contractual cash flows are either fixed or variable due to factors related to a basic lending arrangement. This includes financial assets whose contractual cash flows can change over the life of the financial asset, for example from a variable interest rate to a fixed rate.

46. The staff therefore believe it is important to ensure that the application of the proposed clarified requirements to financial assets with ESG-linked features would continue to provide useful information to users of financial statements about the amount, timing and uncertainty of future cash flows.

47. Paragraphs 15-16 of Agenda Paper 3B discussed in April 2022 set out the reasons respondents to the RFI gave for why they believe amortised cost provides more useful information about the future cash flows of these instruments than fair value, which included:

    (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;

    (b) amortised cost as a mechanism is capable of providing useful information about variabilities in the contractual cash flows arising from the ESG-linked feature; and

    (c) the issuers of financial instruments with ESG-linked features often measure the financial liability at amortised cost.

48. The view that fair value would not provide more useful information than amortised cost for such financial instruments was also shared during the joint meeting of the Capital Markets Advisory Committee (CMAC) and the Global Preparers Forum (GPF) in June 2022. CMAC members indicated that they were either indifferent to the measurement basis of ESG-linked loans or favoured amortised cost. Both CMAC and GPF members expressed concerns about measuring the fair value of these types of loans because limited market data is available. These members also expressed concerns about reliability and auditability if fair value measurement were to be required for ESG-linked loans.

49. Members of the Accounting Standards Advisory Forum (ASAF) also confirmed during their July 2022 meeting that many of their stakeholders believe that fair value through profit or loss would not provide more useful information about these financial assets. Their stakeholders did not believe that these common ESG-linked features impacted the economic substance of the loans. In their view, measuring financial

assets with such ESG-linked features at fair value while measuring similar financial assets without such features at amortised cost would not provide useful and comparable information to users of financial statements.

50. We continue to agree with the IASB's conclusion in paragraph BC4.23 of the Basis for Conclusions on IFRS 9, that if a financial asset contains cash flows that are not principal and interest, a valuation overlay to the contractual cash flows (ie fair value) is required to ensure that the reported financial information provides useful information to users of financial statements.

51. In considering whether there would be any information loss to users of the financial statements if financial assets are measured at amortised cost when there is variability in the contractual cash flows (as described in paragraphs 21–39 of this paper), we have considered what the most relevant information to users of financial statements is likely to be.

52. In our view and as confirmed by CMAC and ASAF members, the most useful information about financial assets with characteristics as described in paragraphs 21–39 of this paper, is the return on the instrument the lender receives and the cash flows the lender does not expect to receive. Amortised cost as a measurement basis captures both these elements through the effective interest method and the impairment requirements. Therefore, for these instruments, amortised cost is capable of providing useful information to users of the financial statements.

53. This is consistent with the IASB's rationale as set out in paragraph BC4.6 of the Basis for Conclusions on IFRS 9 that measuring financial assets at amortised cost is the most appropriate measurement approach for particular types of financial assets in particular circumstances.