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AUTORITÉ DES NORMES COMPTABLES

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PDC n°8

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Post-implementation Review of IFRS 9—Classification and Measurement

Dear Andreas,

I am writing to you on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above-mentioned Post Implementation Review (PIR).

We welcome the timely publication of the consultation document. IFRS 9 *Financial Instruments* is an IFRS Standard that generally applies to a significant number of items (ie all financial assets and financial liabilities) recognised in entities' financial statements. Thus, this Standard is essential for many entities, in particular financial institutions. We trust the International Accounting Standards Board (Board) to make the best use of the feedback received in this PIR, which, in our view should be substantial as many entities have been applying IFRS 9 for now 4 years.

- **The need to monitor the forthcoming developments, in particular the transition to a sustainable economy**

Many insurance entities are going to first apply IFRS 9 together with IFRS 17 *Insurance Contracts* from 2023 onwards. IFRS 9 is expected to be a 'pervasive' IFRS Standard for insurers. Accordingly, 2023 is set to witness a second 'wave' of major players first applying IFRS 9. We encourage the Board to monitor the issues that may arise in this context.

In addition, we think that major changes are currently ongoing in the economy, in particular the transition to a more sustainable economy (ESG matters). Those changes create a specific backdrop that did not exist when the Board developed IFRS 9. Consequently, we encourage the Board to monitor those developments and assess the need to 'upgrade', if need be, IFRS 9 in response to those changes. We identified below two main issues that should warrant further consideration of the Board.

  - ***The measurement basis applicable to sustainability-linked loans***

This is a nascent category of instruments that is set to play an instrumental role in the transition to a sustainable economy. Paragraphs 31–34 of this letter include a description of those instruments together with their increasing importance in entities' funding in France and in Europe. There are currently questions as to whether those instruments are solely for the payments of principal and interest on the amount outstanding (SPPI or basic lending arrangements). In our view and in principle, they are—this is because ESG risks (in particular the environmental risk) affect, and are expected to clearly affect, the credit risk and some other risks that are inherent to a basic

lending arrangement. We also think that amortised cost is the right measurement basis for most of those instruments. Paragraphs 35–40 of this letter further develop our view. That being said, we acknowledge that limited evidence currently exists to support our view and that differing views may exist in this respect. Accordingly, we recommend the Board undertake standard-setting to clarify that interest rate including consideration for the exposure to particular ESG risks specific to the borrower is consistent with a basic lending arrangement—and thus does not prevent those instruments from meeting the SPPI criterion. We also think any standard in this respect should come along with a 'filter test' that would ensure that the change in the interest rate of those loans is commensurate to the borrower's sustainability performance. We think that measuring those instruments at fair value through profit or loss would raise major implementation issues, introduce volatility in profit or loss and might ultimately 'nip their issuance in the bud'—thus depriving entities from an essential tool in the transition to a more sustainable economy.

- ***The interaction between (i) sales of assets arising from the rebalancing of portfolios linked to ESG investment strategies and (ii) the determination of the business model within which assets are held***

Paragraphs 14–19 of this letter explain that financial institutions and some other entities with significant investment activities have developed a roadmap that should lead them to have carbon neutral activities. Regulation in particular is strongly encouraging this green trajectory and, more broadly, 'ESG investment strategies'. These strategies will inevitably lead entities to rebalance their portfolios of financial assets. We recommend the Board specify that the fact that an entity may sell a financial asset when it no longer meets its investment policy due to its ESG strategy is not inconsistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows business model (HTC).

As a final note on this topic, our answer to Question 9 also includes a request for standard-setting in relation to contracts that, we think, could be partially eligible to the 'own use exemption' in paragraph 2.4 of IFRS 9—those contracts are becoming more widespread as the use of renewable energies increases.

- **The need to revisit the accounting for investments in equity and 'equity-type' instruments (Question 4)**

Paragraphs 59–65 of this letter reiterate our view that the prohibition in IFRS 9 to reclassify to profit or loss ('recycling prohibition') the changes in the fair value of investments in equity instruments that an entity elects to present in other comprehensive income (OCI) does not provide useful information for long-term investments in equity instruments. The holding of such instruments is also expected to play an important role in the transition to a more sustainable economy. Accordingly, we recommend the Board reconsider its position on this matter. Paragraph 63 of this letter describes possible ways forward on how to introduce recycling together with a robust impairment test for investments in equity instruments.

Paragraphs 66–70 of this letter describe the need to extend the existing classification and measurement for investments in equity instruments to investments in 'equity-type instruments'. The requirements in IFRS 9 have indeed created a strong bias towards the 'direct holding' of equity instruments—whose changes in fair value can be presented in OCI—, this being made at the expense of 'indirect holding' through investment funds for example––which are measured at fair value through profit or loss because such instruments do not meet the definition of equity instruments in IAS 32 *Financial Instruments: Presentation* (those instruments generally have the features of those described in paragraphs 16A–16B or 16C–16D of IAS 32). This accounting bias has translated into effective and unwanted changes to some entities' investment policies. Those changes have had significant implementation cost for those entities whilst impeding their risk diversification strategies. We expect the severity of this problem to increase with the application of IFRS 9 by insurance entities from 2023 onwards. Paragraphs 71–74 to this letter include a proposed approach for identifying investments in 'equity-type instruments' ('equity type test')—this approach is underpinned on the assumption, we deem reasonable, that investments in equity instruments should be treated alike irrespective of the way they are held (direct or indirect holding).

- **The need for limited refinements to some other central aspects of IFRS 9**

  - ***Possible enhancements to the determination and reassessment of the business model within which a financial asset is held (Question 2)***

We think that assessing the business model within which an entity holds a financial asset to derive the asset's measurement basis has been an improvement to financial reporting. Even though identifying the applicable business model requires the use of judgement and can be complex, this assessment is generally working well—

ie it provides useful information at a reasonable cost for all stakeholders.

Nonetheless, as explained in paragraphs 10–13 of this letter, we think the requirements for reclassifying financial assets are overly restrictive and may result in (limited) circumstances in which the business model in IFRS 9 no longer reflects the manner an entity manages those assets. We think there is headroom for easing the requirements without 'giving a free pass' to unfounded reclassifications. However, we acknowledge this should come along with enhanced application guidance to determine the business model within which an asset is held (paragraph 22 of this letter).

- **Improvements to the assessment of whether a financial asset is SPPI targeting contractually-linked instruments (Questions 1 and 3)**

Determining whether a financial asset is SPPI is an area in the application of the requirements in IFRS 9 garnering much of our stakeholders' attention and scrutiny. The Board's decision to waive bifurcation of financial assets—a decision we regretted when the Board developed IFRS 9—has led the SPPI test to play a pivotal role in the classification and measurement of financial assets because the existence of any variability in an asset's contractual cash flows can result in this asset failing the test and thus, being ineligible to amortised cost accounting. The risks for an asset not passing this test or, in some circumstances, the complexity of demonstrating that an asset passes the test, have led some entities to revisit the features of the instruments they issue.

That being said, with regard to assets currently being issued, we observe that the principle-based approach in IFRS 9 for determining whether they are SPPI is generally working well and does not create significant implementation difficulties.

Nonetheless, application challenges arise for contractually-linked instruments. In our view, those instruments should warrant further consideration from the Board. IFRS 9 includes application guidance to assess which tranches included in those instruments are SPPI. Our stakeholders think the SPPI test is onerous to apply for those instruments—in particular the requirement to 'look through' the instrument until the entity can identify the underlying pool of instruments that are creating the cash flows, which, in our stakeholders' view, is either complex to operationalise or not practically feasible. This may be here an area in IFRS 9 raising a real cost-benefit issue. In paragraph 51 of this letter, we recommend the Board undertake standard-setting to develop a simpler principle-based approach.

- **The long-standing practice of applying amortised cost accounting to financial assets (Question 7)**

Applying the effective interest method (EIM) to assets subsequently measured at amortised cost does not generally raise significant implementation difficulties. Paradoxically, IFRS 9 does not include much application guidance in relation to this method—this contrasts with the importance of items measured at amortised cost in entities' financial statements. However, we observe that most of the requirements in this respect are largely carried forward from IAS 39 *Financial Instruments: Recognition and Measurement*. Practice around the EIM has thus developed over time and has often led to consensus between entities, auditors and regulators. To the best of our knowledge, users are familiar with this practice and have not expressed significant concerns about how entities apply the EIM. These, in our view, explain why (i) few practical difficulties exist about the EIM and (ii) any possible standard-setting (for which we see no compelling argument) in this area—or any reading of the existing requirements by the IFRS Interpretations Committee—should be considered with utmost diligence to avoid unnecessary and undesired disruption to existing practices.

The consultation document sought specific feedback on this matter. We think helpful to the Board to understand the existing practices—this should bring useful input to the PIR and also bring further context to a request that the IFRS Interpretations Committee is currently considering.

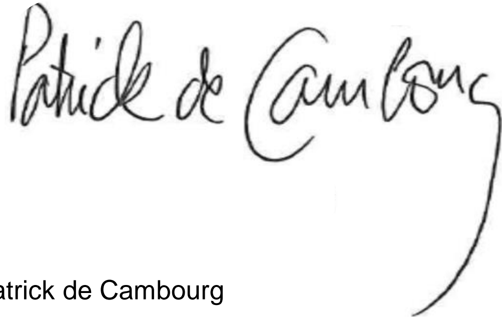
Paragraphs 101–107 of our letter provide feedback on how entities determine, absent any specific requirement in IFRS 9, the effective interest rate at initial recognition when a financial asset or financial liability's contractual cash flows are subject to uncertainty. We are not aware of significant diversity in practice in this respect.

Paragraphs 108–123 of our letter describe the circumstances in which entities apply paragraph B5.4.5 and paragraphs B5.4.6 respectively when accounting for changes in an asset's expected cash flows (further to a non-substantial modification, a change in market rates of interest, etc.). As the letter indicates, we agree that application of those paragraphs require the use of judgement but we are not aware of significant diversity in reporting practices in this respect. We think the long-standing practice that has been existing provides useful information. Paragraph 123 includes our recommendations for the Board if it were to undertake standard-setting for modifications to contractual cash flows.

Appendix A to this letter provides additional feedback on points mentioned above together with other matters.

Should you need any further clarification, please do not hesitate to contact me.

Yours sincerely,



Patrick de Cambourg

APPENDIX A

Question 1—Classification and measurement

Do the classification and measurement requirements in IFRS 9:

(a) enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?

(b) result in an entity providing useful information to the users of the financial statements about the amount, timing and uncertainty of future cash flows? Why or why not? Please provide information about the effects of the classification and measurement changes introduced by IFRS 9, including the ongoing costs and benefits in preparing, auditing, enforcing or using information about financial instruments.

This question aims to help the Board understand respondents' overall views and experiences relating to the IFRS 9 classification and measurement requirements. Sections 2–8 seek more detailed information on the specific requirements.

Question 1(a)—Do the requirements in IFRS 9 enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them?

1. We agree that the requirements in IFRS 9 generally enable an entity to align the measurement of financial assets with the cash flow characteristics of those assets and how the entity expects to manage them.
2. In particular, we welcome the introduction in IFRS 9 of the business model as a feature determining the measurement basis that applies to a financial asset—this is because the business purpose of holding assets determines the extent to which actual cash flows to an entity will align (or misalign) with the asset's contractual cash flows and thus, the measurement basis that will provide the most useful information.
3. That being said, we regret that IFRS 9 ignores the business model under which an investment in an equity instrument is held (long term holding versus trading purpose) and uses fair value through profit or loss as an anchor point (see paragraph 62 of this letter).

Question 1(b)—Do the requirements in IFRS 9 result in an entity providing useful information to the users of the financial statements about the amount, timing and uncertainty of future cash flows?

4. The users we consulted confirmed they are generally satisfied with the existing requirements in IFRS 9 and how entities currently apply those requirements. They indicated their preference for amortised cost accounting when assessing a financial institution's banking book—using fair value measurement ('the valuation overlay') limits the predictive value of the net interest margin. In their view, amortised cost accounting also provides useful information for financial assets that are subject to limited variability in their contractual cash flows.
5. The requirements in IFRS 9 for classification and measurement generally provide useful information at a reasonable cost.
6. Corporate entities generally welcomed the simplification to the classification and measurement of financial instruments brought by IFRS 9 even though they expressed disappointment about the changes introduced to the measurement of investments in equity instruments. The first time application of IFRS 9 has generally not materially affected those entities—except corporate entities holding significant portfolios of investments in (i) equity instruments or (ii) funds holding equity instruments or debt instruments (see paragraphs 54–57 and 67–70 of this letter), the financial performance of which is now exposed to significant volatility.
7. Financial institutions have a more nuanced view about the simplifications introduced by IFRS 9. In their view, IFRS 9 is not easier to apply than IAS 39 *Financial Instruments: Recognition and Measurement*—there has simply been a shift in matters creating complexity or practical difficulties. Auditors and regulators generally share this view. Specifically:
    a. assessing whether an asset has cash flows that are solely for the payments of principal and interest on the principal amount outstanding ('SPPI' or 'SPPI test') is subject to the utmost attention and requires 'bespoke' and thorough analyses. By removing the option to bifurcate

embedded derivatives in financial assets[1], the existence of variability in contractual cash flows can thwart the eligibility to amortised cost accounting, thus leading the SPPI test to play a pivotal role in determining an asset's measurement basis. The SPPI test has even led some entities to (i) limit or waive the origination of some instruments (loans with participation rights for example) or to (ii) modify the contractual features of the instruments they originate to pass the SPPI test, or avoid the 'benchmark test' in paragraphs B4.1.9B–B4.1.9.D of IFRS 9.

b. assessing the business model within which a financial asset is held can be complex and requires the use of judgement (see our answer to Question 2).

Question 2—Business model for managing financial assets

(a) Is the business model assessment working as the Board intended? Why or why not? Please explain whether requiring entities to classify and measure financial assets based on the business model assessment achieves the Board's objective of entities providing users of financial statements with useful information about how an entity manages its financial assets to generate cash flows

(b) Can the business model assessment be applied consistently? Why or why not? Please explain whether the distinction between the different business models in IFRS 9 is clear and whether the application guidance on the evidence an entity considers in determining the business model is sufficient. If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) Are there any unexpected effects arising from the business model assessment? How significant are these effects? Please explain the costs and benefits of the business model assessment, considering any financial reporting or operational effects for preparers of financial statements, users of financial statements, auditors or regulators. In responding to (a)–(c), please include information about reclassification of financial assets (see Spotlight 2).

Question 2(a)—Is the business model assessment working as the Board intended?

8. As mentioned in paragraph 2 of this letter, we think that assessing the business model within which a financial asset is held to derive its measurement basis has been an improvement to financial reporting.

9. In our view, the business model assessment is generally working as the Board expected. That being said, we identified two matters that the Board should consider to improve the requirements in IFRS 9 in this respect ie:

   a. reclassification of financial assets (see paragraphs 10–13) and

   b. rebalancing of portfolios linked to 'ESG investment strategies' (see paragraphs 14–19).

- **Reclassifications of financial assets**

10. We think the requirements in IFRS 9 about the reclassification of financial assets are highly restrictive and may ultimately result in circumstances in which the business model in IFRS 9 no longer reflects the manner an entity manages the assets—this results in information that may not faithfully reflect the amounts, timing and uncertainty of cash flows. Paragraph B4.4.1 of IFRS 9 indicates that changes in the business model for managing a financial asset are '*expected to be very infrequent'*. The requirements in paragraphs B4.4.1 of IFRS 9 effectively translate this expectation into reality—they effectively 'freeze' the business model at an asset's initial recognition date with almost no realistic possibility to make reclassifications. This explains why, to the best of our knowledge, reclassifications of financial assets in our jurisdiction have not been frequent.

11. The absence of reclassification arises even in circumstances in which the entity considers it has evidence that it has changed the business model for managing assets by reference to the pieces of relevant evidence set out in paragraph B4.1.2B of IFRS 9—including (i) the reporting to the entity's key management personnel, (ii) how risks are managed and (iii) the basis of management's compensation—but the change does not meet all the criteria set out in paragraph B4.4.1 of IFRS 9 to result in a reclassification. That may be, for example, because the change is not demonstrable to external parties, which can often be the case for changes relating to banks' treasury or liquidity

[1] In our letter dated March 2013, we regretted the Board's decision not to reintroduce bifurcation for financial assets. We hold the long-standing view that, despite its complexity, bifurcation could resolve the concerns about financial assets with limited leverage that do not exactly meet the SPPI criterion. Our letter is accessible here.

portfolios that are not ‘customer facing’, or because the change is not significant to the entity.

12. Another illustration of the ‘disconnection’ that may exist between the manner assets are managed and the business model that results from IFRS 9 is the case of loans syndications. Applying IFRS 9, an entity is required to assess the business model when a loan is originated. When the loan is subject to a syndication process, this is only at the end of that process an entity exactly knows the part of the loan it will retain—this part will usually be eligible to a business model whose objective is to hold financial assets in order to collect contractual cash flows (HTC)—and the part it will sell to other parties through the syndication process—this part is usually eligible neither to a HTC business model nor to a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (HTCS). The requirements in IFRS 9 oblige an entity to estimate at the origination date the part it expects to (i) retain and (ii) sell. The entity has little information to make this estimation. The syndication process—which usually lasts several weeks—may result in the entity retaining a proportion that is different from the one it estimated at inception. In those circumstances, the entity may ultimately hold a proportion of the loan in excess of the proportion it estimated at the outset of the process—the business model for this ‘in excess proportion’ (or unsold part) cannot be changed to a HTC business model at the end of the syndication process. This leads to a discrepancy between the business model specified in IFRS 9 and the manner the entity manages the related asset.

13. Stakeholders think there is headroom for easing the reclassification requirements without reducing the usefulness of information or paving the way for unfounded reclassifications. In particular, they think the requirements in IFRS 9 should reflect the specific features of a syndication process. Accordingly, we recommend the Board undertake standard-setting to consider permitting reclassifications in circumstances other than those specified in paragraph B4.4.1 of IFRS 9.

- **Rebalancing of portfolios linked to ‘ESG investment strategies’[2]**

14. Paragraph B4.1.3A of IFRS 9 specifies that ‘*the business model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the assets’ credit risk* […]. *Irrespective of their frequency and value, sales due to an increase in the assets’ credit risk are not inconsistent with a business model whose objective is to hold financial assets to collect contractual cash flows because the credit quality of financial assets is relevant to the entity’s ability to collect contractual cash flows. Credit risk management activities that are aimed at minimising potential credit losses due to credit deterioration are integral to such a business model*’ (the ‘credit risk exception’)

15. Paragraphs B4.1.2C, B4.1.3B and B4.1.4 specify other circumstances in which sales of assets may, or may not, be consistent with a HTC business model.

16. Sales of financial assets arising in the context of financial entities’ strategies towards a green economy did not exist when the Board developed IFRS 9. Such sales arise, or are expected to arise, because the regulatory framework, pressure from third parties or commitments taken by financial institutions lead those financial institutions[3] to (i) invest in assets fostering the transition to a green economy and (ii) disinvest assets that are not part of that transition (for example, reducing the funding to carbon intensive industries). Financial institutions have generally developed a roadmap that should lead them to have ‘carbon neutral’ activities on the mid or long terms. This roadmap will inevitably lead entities to sell assets that are not consistent with their green (or decarbonisation) strategy, or more broadly, with their ESG strategy.

17. For current originations of financial assets’ portfolios, there are questions about whether the expectation of such sales to arise might preclude from assessing that those assets are being held within a HTC business model[4]. For past originations, there are also questions as to whether the occurrence of significant sales may result in entities meeting, in some circumstances, the criteria set out in paragraph B4.4.1 of IFRS 9 and thus, in entities reclassifying their financial assets or precluding the classification of newly originated assets in a HTC business model.

18. As explained in paragraph 38 of this letter, ESG risks affect—and are expected to clearly affect—the credit risk and other risks that are inherent to a ‘basic lending arrangement’. When developing the credit risk exception, the Board may have retained the principle that sales arising as a response to the changes in the main features of a basic lending arrangement are not inconsistent with a HTC business model. In our view, building on this principle, sales arising from an ESG strategy should not

[2] The developments in this section also apply to assets held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (‘HTCS’) business model.
[3] This matter is not limited to financial institutions and may affect other corporate entities having significant investments in debt instruments.
[4] On originations that will occur in the mid or long terms, no such matter will arise as the newly-originated assets are expected to comply with the ESG strategy of financial institutions.

be inconsistent with a HTC business model.

19. Sales arising from ESG strategies may affect a significant number of assets' portfolios and thus significantly affect the measurement basis of those portfolios. Accordingly, we recommend the Board clarify the fact that an entity may sell financial assets when they no longer meet its investment policy due to its ESG strategy is not inconsistent with a HTC business model.

Question 2(b)—Can the business model assessment be applied consistently?

20. The existence of sales is the most challenging feature in assessing the business model within which an entity holds an asset.
21. We have been made aware of diversity in the manner entities consider sales in the business model assessment (HTC or HTCS business models). This diversity indicates that the requirements in IFRS 9 could be further enhanced.
22. Accordingly, we recommend the Board develop additional application guidance to improve the identification of the applicable business models. This would help entities make more consistent assessments.

Question 2(c)—Are there any unexpected effects arising from the business model assessment?

23. As indicated in paragraph 7 of this letter, the business model assessment is an area of stakeholders' scrutiny. Further application guidance in this respect could help reducing the costs entailed by this assessment.
24. Some corporates reported this assessment is burdensome for short-term receivables that are subject to factoring operations[5]—ie the entity holding a short-term receivable sales this asset to a bank before the asset's contractual cash flows expire. In those circumstances, the entity may conclude that it holds the receivable within a business that is not HTC. This is because the entity will recover the asset's cash flows through a sale rather than from collecting the cash flows at the asset's maturity. This implies the entity measures the receivable at fair value through profit or loss rather than amortised cost. The affected entities think that measuring those receivables at fair value result in costs that do not justify the benefits to users—amounts derived from fair value are similar to those that would result from amortised cost accounting.

Question 3— Contractual cash flow characteristics

(a) Is the cash flow characteristics assessment working as the Board intended? Why or why not? Please explain whether requiring entities to classify and measure a financial asset considering the asset's cash flow characteristics achieves the Board's objective of entities providing users of financial statements with useful information about the amount, timing and uncertainty of future cash flows. If, in your view, useful information could be provided about a financial asset with cash flows that are not SPPI applying IFRS 9 (that is, an asset that is required to be measured at fair value through profit or loss applying IFRS 9) by applying a different measurement approach (that is, using amortised cost or fair value through OCI) please explain:

(i) why the asset is required to be measured at fair value through profit or loss (that is, why, applying IFRS 9, the entity concludes that the asset has cash flows that are not SPPI).

(ii) which measurement approach you think could provide useful information about the asset and why, including an explanation of how that approach would apply. For example, please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk).

(b) Can the cash flow characteristics assessment be applied consistently? Why or why not? Please explain whether the requirements are clear and comprehensive enough to enable the assessment to be applied in a consistent manner to all financial assets within the scope of IFRS 9 (including financial assets with new product features such as sustainability-linked features).If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects? Please explain the costs and benefits of the contractual cash flow assessment, considering any

[5] Those operations result in the receivables being derecognised.

financial reporting effects or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about financial instruments with sustainability-linked features and contractually linked instruments.

Question 3(a)—Is the cash flow characteristics assessment working as the Board intended?

25. In our view, the existing requirements in IFRS 9 provide a sufficient basis to help entities determine whether a financial asset is SPPI (or 'meets the SPPI criterion'). Furthermore, we observe that (i) the IFRS Interpretations Committee (Committee) has received few requests seeking clarifications about how to determine whether a financial asset is SPPI and (ii) IFRS 9 has been amended only once in this respect[6]—these observations indicate the requirements are overall well-understood and provide information that is generally useful.
26. We have not identified significant categories of instruments that, we think, would fail the SPPI test while being, in substance, 'basic loan arrangements' to which amortised cost accounting would provide more useful information.
27. Accordingly, in our view, the requirements in IFRS 9 are working as expected. This being said, we nuanced below our conclusion when discussing the case of sustainability-linked loans (see paragraphs 30–46) and contractually linked instruments (see paragraphs 47–52).

Question 3(b)—Can the cash flow characteristics assessment be applied consistently?

28. Our answer below distinguishes the case of sustainability-linked loans and contractually-linked financial instruments from other financial assets.

- **Financial assets that are neither sustainability-linked loans nor contractually-linked financial instruments[7]**

29. Determining whether a financial asset is SPPI may require the use of judgement. However, we observe that entities generally reach the same conclusions for instruments having identical or similar features. Accordingly, we have not been made aware of significant diversity in reporting practices.

- **Sustainability-linked loans**

30. This is an area where practical challenges exist. We welcome the analysis framework set out in Agenda Paper 3B for the July 2021 Board meeting which indicates how to read the requirements in IFRS 9. However, we think the expected importance of such instruments in the banking landscape should warrant further consideration from the Board.

    - ***What are sustainability-linked loans and what is their importance?***

31. The Loan Syndications and Trading Association (LSTA) defines such instruments as '*any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives. The borrower's sustainability performance is measured using predefined sustainability performance targets (SPTs), as measured by predefined key performance indicators (KPIs), which may comprise or include external ratings and/or equivalent metrics, and which measure improvements in the borrower's sustainability profile'*[8]. The incentive is often achieved through margin ratchets—if the borrower meets the predetermined SPTs, there is generally a step down in the instrument's interest rate (margin premium); conversely there is generally a step up in the instrument's interest rate.
32. The LSTA's guidance also explains that:
    a. the KPIs should be *material* to the borrower's core sustainability and business strategy, and address relevant environmental, social and governances (ESG) challenges. The guidance also specifies that such KPIs should be (i) relevant to the borrower, (ii) measurable and quantifiable and (iii) able to be benchmarked.
    b. the SPTs should be *ambitious*. Applying the LTSA guidance, this means the STPs should

[6] *Prepayment Features with Negative Compensation*—Amendments to IFRS 9 published in October 2017.
[7] Question 3(c) includes our comments on contractually-linked instruments.
[8] Loan Syndications and Trading Association, *Guidance on Sustainability Linked Loan Principles* and *Sustainability Linked Loans Principles*, May 2021—accessible here and here.

(i) represent a material improvement in the respective KPIs and be beyond a 'business as usual' trajectory, (ii) where possible be compared to a benchmark or an external reference, (iii) be consistent with the borrower's overall sustainability ESG strategy and (iv) be determined on a predefined timeline, set before or concurrently with the origination of the instrument.

c. the borrower should periodically report its performance against each STP. This performance should be subject to verification.

33. The sustainability-linked loans (SLL) market is still nascent but has grown quickly over the recent years. According to data from Dealogic and Credit Agricole CIB[9], this market was worth USD 269 billion over the first half of 2021[10]—Europe and America accounted for 58% and 30% of this market respectively. Europe has been at the forefront of sustainability-linked loan issuances since 2017. More than a quarter of European loans now have a pricing mechanism with ESG features[11]. France, Italy, Spain and Germany account for more than a half of SLLs in Europe—with 19%, 15%, 12% and 8% respectively.

34. These data indicate SLLs are expected to become material as a broadening range of entities (in particular corporates) are using them. In the light of those trends, we think SLLs will be instrumental in implementing the transition to a 'green economy' in the European Union.

- ***Are those instruments SPPI?***

35. Those instruments did not exist when the Board developed IFRS 9. Accordingly, there is a question as to how to assess the features of those instruments[12] in the light of the existing principles in IFRS 9 on the SPPI criterion.

36. This question, of an accounting nature, has far-reaching implications for financial institutions in our jurisdiction. Should those instruments fail to meet the SPPI criterion, this would imply such instruments should be measured at fair value through profit or loss—despite being held in a HTC or HTCS business model. This could create a significant shift in the measurement of the 'banking book' of financial institutions, which, we think, is unwanted. This would also result in most of the loans recently issued by entities failing to meet this criterion, thus potentially 'nipping in the bud' the issuance of instruments that should play a pivotal role in the transition to a more sustainable economy.

37. Paragraph B4.1.7A of IFRS 9 states*: 'contractual cash flows that are SPPI are consistent with a basic loan arrangement*'. This paragraph goes on and says: '*in a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time*'.

38. In our view, and as explained further in Appendices B and C to this letter, ESG risks (in particular the environmental risk) affect—or are expected to *clearly* affect—the credit risk and other risks (liquidity risk for example) that are inherent to a 'basic lending arrangement'. In other words, there is an emerging link between ESG risks and the pricing of the most relevant features of a basic lending arrangement. This is notably because the current changes to the regulatory framework in which financial institutions operate and driven by ESG risks are of such an extent that they affect the financial institutions' cost of capital and, ultimately, the interest charged on the originated loans. Because of that emerging link, we think the interest charged on a SLL is consistent with the interest asked for a basic lending arrangement. Accordingly, we think SLLs meet, in principle, the SPPI criterion.

39. Having said that, we acknowledge that assessing whether SLLs are SPPI is currently somewhat challenging because:

a. the market for those instruments is still nascent—general trends will stabilise in the mid or long terms. Accordingly, there is still limited *quantitative* evidence clearly demonstrating, for example, a link between ESG risks and the credit risk. Some stakeholders may expect more than a *qualitative* assessment to conclude that SLLs meet the SPPI criterion and thus, may not entirely share the analysis summarised in paragraphs 37–38 above.

b. there are structural changes, mostly regulatory by nature, currently unfolding and that are expected to materially affect how financial institutions do business and price the funding and

[9] Quoted by *Option Finance* n°1629, 8 November 2021, pages 16-19.
[10] Bloomberg estimated this market at around $300 billion in the first three quarters of 2021.
[11] S&P Global, *Sustainability-linked loan supply outpaces green bonds and loans amid US surge*, July 2021—accessible here.
[12] The developments in this section only relate to SLLs solely including KPIs that are specific to the borrower.

cost of risk component of such financial instruments. However, all those changes are not effective yet.

c. establishing a link between ESG risks and the credit risk of the borrower is not, itself, sufficient—IFRS 9 requires that the credit risk of a financial asset is for the credit risk associated with the principal amount of that particular financial asset. This means an entity has to demonstrate that the SPTs specified in a SLL affect the probability of defaulting on that particular loan—this demonstration can be complex to make in practice.

40. However, we are confident that the existing momentum around the transition to a green economy will materialise in a manner that most of SLLs will unquestionably meet the SPPI criterion once those regulations are effective. We also note that rating agencies are currently developing principles on how to include ESG risks in their credit risk analyses—this should help buttress the link between ESG risks and SLLs' credit risk.

- ***How to account for revisions of estimates of SLLs' contractual cash flows***

41. A SLL that (i) meets the SPPI criterion and (i) is held in a HTC business model, is subsequently measured at amortised cost[13]. The interest rate on a SLL usually varies after its initial recognition, depending on whether an entity meets the predefined SPTs. This may lead the entity to revise its estimates of payments on the SLL.

42. In paragraphs 108–123 of this letter, we described the circumstances in which entities apply paragraphs B5.4.5 and B5.4.6 when there is a change in an instrument's expected contractual cash flows.

43. The SLL market is still nascent. Accordingly, there is limited visibility as to the accounting entities apply when they revise their estimates of cash flows. That being said, consistent with the approach retained for other instruments, we expect an entity to apply:

a. paragraph B5.4.5 whenever a change results in repricing the instrument's interest rate or a component of such rate to, or approximatively to, the market interest rate of that component––ie the revised interest rate reflects the instrument's relevant SPPI components (time value of money, credit risk, liquidity risk and other risks). This analysis is similar to the one currently retained for step-up on ratchet loans.

b. paragraph B5.4.6 in other circumstances. In our view, the catch-up adjustment recognised in profit or loss applying this paragraph may be less significant if an entity determines the effective interest rate at initial recognition using a probability-weighted average approach when it has a well diversified portfolios of SLLs due to the application of law of large number (see paragraph 106 of this letter) than if an entity determines the effective interest rate using a single best estimate.

- ***Our recommendation in relation to the accounting for SLL***

44. We are convinced that SLLs meet, in principle, the SPPI criterion as ESG risks start to affect the relevant features of a 'basic loan arrangement'. However, as explained in paragraph 39, our conviction is essentially based on a qualitative analysis. Quantitative information will surface over time as the SLL market develops and reaches maturity—in other words, robust quantitative evidence will be made know in the mid or long terms.

45. We acknowledge that some stakeholders may not share our views given the limited pieces of evidence available to date. To avoid diversity in practice, we recommend the Board undertake standard-setting in this area and clarify that interest rate including consideration for the exposure to particular ESG risks specific to the borrower is consistent with a basic lending arrangement and thus, does not prevent SLLs from meeting the SPPI criterion. In our view, any standard-setting in this respect should also include a 'filter test' that would exclude loans including leverage related to ESG risks—ie a test ensuring that the change in the interest rate of SLLs is commensurate to the borrower's sustainability performance.

46. We are convinced that amortised cost[14] is the right measurement basis to report the financial performance of those instruments. We think measuring such instruments at fair value would not provide useful information:

a. we do not see any merits here in having a 'valuation overlay' to amortised cost. In our view,

[13] The developments in this section also apply to assets held within a HTCS business model—ie to assets subsequently measured at fair value through other comprehensive income (FVOCI). Applying paragraph 5.7.11 of IFRS 9, the amounts related to those assets that are recognised in profit or loss are the same as the amounts that would have been recognised in profit or loss if those assets had been measured at amortised cost. More generally, our references to amortised cost accounting throughout this letter also include assets measured at FVOCI.

[14] Including assets measured at FVOCI.

the ESG step-up or premium introduce limited variability to the contractual cash flows that an entity estimates at initial recognition. We think that amortised cost has more predictive value for those instruments than fair value measurement—the users we consulted confirmed this view.

b. it would be questionable to 'fair value' all risks embedded in the instrument just because of the ESG risk—this is one risk among other risks inherent to a basic loan arrangement and this risk is not expected to outsize other risks. In addition, most of such risks (benchmark interest rate risk, credit risk not related to ESG-risk, liquidity, capital, etc.) are priced with a fixed component whereas as explained in paragraph 43a, the ESG component may be repriced at market. Therefore, measuring such loans at their fair value in their entirety would mostly consist in 'fair valuing' the fixed components of such loans whereas amortised is deemed to be the measurement basis that better reflects the estimation of future cash flows when those assets are held into a HTC or HTCS than fair value.

c. those instruments are, in principle, funded and are not structured to introduce 'leverage'. We think that the guidance set out by the LTSA may help identify and scope-out instruments that are structured to reflect risks other than ESG risks or ESG risks that are leveraged—in other words, this guidance could be helpful to develop the above-mentioned 'filter test'. We also note that the ongoing developments in relation to sustainability reporting may also help in bringing consistency in KPIs used to assess the entity's performance on ESG matters.

d. the borrower is expected to subsequently measure those loans at amortised cost[15]. We think desirable, notably for users, to have the same measurement basis on the asset and liability sides.

e. measuring those instruments at fair value would be complex to operationalise and would introduce significant volatility in the reporting of financial institutions' performance.

Question 3(c)—Are there any unexpected effects arising from the cash flow characteristics assessment?

- **Contractually-linked instruments**

47. The requirements to assess whether each tranche of contractually-linked instruments is SPPI are onerous to apply. In particular, the requirement in paragraph B4.1.22 to 'look through' the instrument until the entity can identify the underlying pool of instruments that are creating the cash flows is either complex to operationalise or not practically feasible in some cases (in which case entities conclude, by default, that the tranches are not SPPI).

48. This could be the case when the vehicle to which the financing is provided includes revolving periods (instruments in the underlying pool can change) and the only documentation available regarding future underlying assets is the prospectus.

49. Operational difficulties may also arise when the entity holding the issued note has only an 'investment relationship' with the vehicle (ie the entity is not involved in the vehicle's management or governance) and thus, does not have access to the contractual documentation of each single asset in the pool.

50. In addition, when an entity is providing senior financing, it is sometimes unclear whether the asset is within the scope of the contractually-linked instrument application guidance (or alternatively if the asset should be assessed in accordance with the requirements in paragraph B4.1.17 of IFRS 9 applying to non-recourse financial assets). This is because it is unclear from the definition of contractually-linked instruments whether all or only some of the instruments issued by the vehicle must be contractually linked for the application guidance to apply.

51. We recommend the Board develop a more principle-based approach to assess whether tranches are SPPI. Such an approach could align with the requirements in paragraph B4.1.17 of IFRS 9 applying to non-recourse financial assets. Alternatively, many of the application difficulties related to the scope and the look through could be simply addressed if the Board were to narrow the scope of the contractually-linked instrument requirements to subordinated tranches—applying this approach, the most senior tranche would be assessed in the same way as other similar non-recourse senior financial assets.

52. Applying that approach, an entity may reach better conclusions than to those reached applying the 'look through' approach but with significantly reduced implementation costs. In particular, the current emphasis on whether an asset is within scope of the contractually-linked instrument requirements would be significantly reduced and economically similar senior non-recourse financial assets would

[15] Applying the requirements in IFRS 9 in relation to embedded derivatives and those in IAS 32, we expect the sustainability-linked features not to be embedded derivatives that must be separated from the host contract.

be analysed in a similar way with similar conclusions.

- **IFRS 9 creates a bias in favour of the 'direct holding' of SPPI assets**

53. In the context of their investment strategies, some entities prefer investing in funds acquiring assets that are SPPI as underlying items (such as bonds) ('indirect holding') rather than holding them directly (or controlling them) ('direct holding'). Those entities usually prefer the 'indirect holding' because it dilutes risks and it results in reduced management costs compared to a 'direct holding'.

54. An entity that directly holds assets that are SPPI (for example by acquiring directly the assets or consolidating the fund holding them) subsequently measures those assets at amortised cost (subject to the business model assessment). In contrast, an entity that 'indirectly holds' such assets (through investments in a fund that the entity does not control) recognises:

    a. an investment in equity instruments if the fund issues instruments meeting the definition of equity instrument in IAS 32 *Financial Instruments: Presentation*. In this case, an entity measures its investment at fair value and can elect to present the subsequent changes in fair value in other comprehensive income (OCI) without recycling (see paragraph 59 below). Because of the recycling prohibition, the entity is incentivised to present the subsequent changes in fair value in profit or loss. In practice almost all funds fail such definition either because they are 'puttable' or have a finite life.

    b. a financial asset ('debt instrument') if the fund issues instruments that do not meet the definition of equity instruments in IAS 32. The debt instrument does not meet the SPPI criterion even though the fund only invests in assets that are SPPI. In this case, an entity measures the debt instrument at fair value through profit or loss. In practice, almost all funds fall into such category.

55. In the circumstances described in paragraph 54.b, the entity's investments typically used to meet the definition of available-for-sale financial assets applying IAS 39. The entity used to present the subsequent changes in the fair value of those instruments in OCI with recycling in profit or loss when the entity disposed of those instruments.

56. The classification and measurement approach retained in IFRS 9—which does not permit a 'look-through approach'—results in entities with significant indirect holdings of SPPI assets facing significant volatility in profit or loss compared to the approach that existed in IAS 39. Unsurprisingly, IFRS 9 has created a bias in favour of the 'direct holding' of SPPI assets. This has resulted in a shift towards direct holding for some entities with significant investing activities. This shift has:

    a. increased holding costs for those affected and created operational complexity,

    b. discouraged the investment in funds and thus, diversification of risks.

57. The simplifications brought by IFRS 9 to the classification and measurement approach applicable to financial assets have had detrimental effects on the indirect holding of debt instruments.

Question 4— Equity instruments and other comprehensive income

(a) Is the option to present fair value changes on investments in equity instruments in OCI working as the Board intended? Why or why not? Please explain whether the information about investments in equity instruments prepared applying IFRS 9 is useful to users of financial statements (considering both (i) equity instruments measured at fair value through profit and loss; and (ii) equity instruments to which the OCI presentation option has been applied). For equity instruments to which the OCI presentation option has been applied, please explain whether information about those investments is useful considering the types of investments for which the Board intended the option to apply, the prohibition from recycling gains and losses on disposal and the disclosures required by IFRS 7.

(b) For what equity instruments do entities elect to present fair value changes in OCI? Please explain the characteristics of these equity instruments, an entity's reason for choosing to use the option for those instruments, and what proportion of the entity's equity investment portfolio comprises those instruments.

(c) Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in OCI? How significant are these effects? Please explain whether the requirements introduced by IFRS 9 had any effects on entities' investment decisions. If yes, why, how and to what extent? Please provide any available evidence supporting your response which will enable the Board to understand the context and significance of the effects. In responding to (a)–(c), please include information about recycling of gains and losses (see Spotlight 4).

Question 4(a)—Is the option to present fair value changes on investments in equity instruments in OCI working as the Board intended?

58. Our answer to this question includes our view and proposed ways forward in relation to:

    a. the recycling issue (see paragraphs 59–65), and

    b. the measurement that should apply to investments in 'equity-type instruments' (see paragraphs 66–74).

- **The recycling prohibition does not provide useful information for long-term investments in equity instruments—it should be be reconsidered**

59. Applying IFRS 9, an entity measures investments in equity instruments at fair value. Paragraphs 4.1.4 and 5.7.5 of IFRS 9 specify that at initial recognition of an investment in an equity instrument that is neither held for trading nor contingent consideration recognised by an acquirer in a business combination, an entity may make an irrevocable election to present in OCI subsequent changes in the fair value of that investment ('presentation election'). Paragraph B.5.7.9 of IFRS 9 states that amounts presented in OCI shall not be subsequently transferred to profit or loss ('recycling prohibition').

60. We have a long-standing view that the amounts presented in OCI shall subsequently be transferred to profit or loss when they relate to instruments that are held in a long-term perspective. We found the Board's rationales supporting the recycling prohibition in IFRS 9 unconvincing when this Standard was developed. Four years after the initial application of IFRS 9, we still think the approach retained in IFRS 9 does not provide useful information as it does not appropriately portray the performance of long-term investments.

61. As a response to an EFRAG Discussion Paper[16] published in 2018, we set out our views and recommendations for a way forward in this respect. Our letter dated June 2018 includes those views. We agree that an entity should measure investments in equity instruments at fair value. However, for those instruments that are held in a long-term perspective ('long term investments' in our 2018 letter), we think (i) subsequent changes in fair value (ie unrealised gains or losses) should be presented in OCI and (ii) those changes should be transferred to profit or loss to reflect the ultimate gains or losses realised on the instrument's disposal—and by doing so, to reflect the entity's effective performance[17]. We think this approach would better serve users who generally use the statement of profit or loss as

[16] EFRAG Discussion Paper *Equity Instruments—Impairment and Recycling*, March 2018

[17] The Final Report of the High Level Forum on the Capital Markets Union published in June 2020 noted that *'without [recycling], given that capital gains typically represent 60% of overall equity returns, IFRS profits will not reflect the true financial performance and can create disincentives for insurers to invest in equities. The final recommendation calls on the EU to continue to attempt to resolve this issue through engagement with the IASB. However, if the IASB does not adequately and expeditiously address this issue, then the EU must pursue its own solution to them'.* The report is accessible here.

the basis to understand an entity's performance.

62. In contrast, we think the existing requirements in IFRS 9 are not helpful for both users and entities:
    a. they are conceptually questionable:
        i. the Board designed the presentation election for a specific population of investments in equity investments––ie those held for strategic reasons or non-contractual benefits. However, IFRS 9 does not restrict this election to 'strategic investments'. The discrepancy between the 'Board's intention' and how the requirements were ultimately specified illustrates a weakness in the standard-setting process.
        ii. the accounting for instruments to which the presentation election is applied is difficult to understand: dividends earned on the instruments are presented in profit or loss whereas the realised gain (or loss) is 'trapped' in OCI. This asymmetry obfuscates the understanding of an entity's performance.
    b. they create an incentive to present the subsequent changes in fair value in profit or loss for an entity to give a full picture of its performance. They disregard how such instruments are held––IFRS 9 considers the business model within which financial assets are held but does not do so for equity instruments, thus putting equity instruments held for trading and those held on a long-term basis on an equal footing.

63. We think that the introduction of recycling should come along with the introduction of a robust impairment test. We acknowledge that developing a new impairment model for investments in equity investments is not an easy task. However, we think this way forward is worth being further investigated. In our 2018 letter, we identified two possible approaches:
    a. developing further the requirements in IAS 39 for the impairment of investments in equity instruments specified in paragraphs 59 and 61 of this Standard, together with the introduction of an impairment reversal mechanism.
    b. developing an impairment model requiring impairment when there is a 'prolonged decline' in the fair value of an investment in an equity instrument below its cost. This approach would also come along with the introduction of an impairment reversal mechanism. The 'prolonged decline' feature could be assessed as follows:
        i. any decline in the fair value below cost over a period longer than a predefined threshold would trigger the recognition of an impairment loss; and
        ii. an entity would recognise an impairment loss without waiting for the end of the predefined period if the equity instrument' fair value is lower than its cost and a recovery in value above cost before the end of the threshold period is not probable.

64. We also think that the necessary transparency around the 'recycling' in profit or loss could be considered in the context of the *Primary Financial Statements* standard-setting project––we understand the Board contemplates the introduction of an 'investing category' in the statement of profit or loss which could 'host' any recycled gains or losses.

65. For the reasons set out above, we recommend the Board reconsider the requirement in paragraph B.5.7.9 prohibiting the recycling of changes in fair value of investments in equity instruments that an entity elects to present in OCI. We think entities making this election should be required to apply recycling, together with a dedicated impairment test, when instruments are held in a long-term perspective[18].

- **The need to revisit the measurement requirements applicable to investments in 'equity-type instruments'[19]**

    - ***Aligning the measurement requirements of investments in equity-type instruments on those applicable to investments in equity instruments***

66. An entity can either 'directly hold' equity instruments (ie controlling those instruments through a controlled fund) or 'indirectly hold' them (for example through a non-controlled fund).

67. The indirect holding of equity instruments is often made through investments in funds whose shares are (i) 'puttable financial instruments' or (ii) financial instruments that impose on the entity that issued those instruments an obligation[20] to deliver to the holder a pro rata share of the net assets of the

[18] That is in circumstances other than for trading purpose.
[19] The developments in this section are based on our letter dated 5 July 2019 commenting on EFRAG's request for advice in relation to alternative measurement for investments in equity instruments. This letter is accessible here.
[20] The obligation arises, in particular, because liquidation is certain to occur and outside the entity's control (case of limited life entities).

entity only on liquidation (for example, UCITS, ETF or AIF). Those instruments are financial liabilities but are classified as equity instruments *by the issuer* (ie the fund) if they have all the features and meet the conditions specified in paragraphs 16A–16B or 16C–16D of IAS 32.

68. Such instruments do not meet the definition of an equity instrument in IAS 32 (they are no investment in equity instruments from the holder's perspective) and thus, are not eligible for the presentation election in paragraphs 4.1.4 and 5.7.5 of IFRS 9. Accordingly, those instruments are financial assets for the holder and are subject to the classification and measurement requirements applicable to such items. Because the contractual terms of those financial assets do not give rise on specified dates to cash flows that are SPPI, such assets are measured at fair value through profit or loss.

69. From an economic perspective, entities may decide to hold equity instruments indirectly for the following reasons:

    a. risk spreading and diversification,

    b. accessing to a higher level of liquidity,

    c. relying on dedicated experts monitoring the positions,

    d. isolating the assets backing some specific underlying liabilities,

    e. simplifying the operational burden of accounting for each single asset,

    f. reducing costs.

70. Investment in funds are integral to most long term investment business models. They are also 'equity-type' in nature. Accordingly, we think the classification and measurements requirements in IFRS 9 applicable to equity instruments, together with recycling, should also apply to equity-type instruments (see a proposed approach below).

- ***What are investments in equity-type instruments?***

71. We consider that the driving principle for accounting for equity-type investments is both simple and straightforward: we see no conceptual reason to account differently for equity investments depending on whether an entity holds them directly or indirectly.

72. To determine whether the investment in a fund is as equity-type instrument, we recommend the Board introduce an 'equity-type test' (ETT) similar to the SPPI test applicable to contractually linked instruments. This test would aim to ensure that an equity fund is not leveraged and does not provide a 'structured' performance.

73. The ETT could, for example, rely on the following principles:

    a. the contractual terms of the units are instruments as described in paragraphs 16A-16B or 16C-16D of IAS 32; and

    b. the underlying pool of assets solely includes:

        i. equity instruments or ETT equity-type instruments (in which case the entity must 'look through' until it can identify the underlying pool of instruments that are creating the cash flows);

        ii. cash or cash equivalents to meet the liquidity constraints of the funds; and potentially

        iii. instruments that reduce the cash-flow variability (for example hedge of foreign exchange risk exposure) and or manage operational issues related to the fund management—this concept is similar to the one developed in paragraph B4.1.24 of IFRS 9 except that the aim is to provide an 'equity performance' instead of a 'SPPI performance' profile.

74. If the investment in the fund satisfies the ETT, then the fund is qualified as equity-type and can be treated as an equity instrument. If the investment fails the test or the entity cannot perform the test, then the investment in the fund shall be measured at fair value through profit or loss.

Question 4(b)—For what equity instruments do entities elect to present fair value changes in OCI?

75. Entities do not necessarily restrict the use of presentation election to 'strategic investments'. Diversity in practice exists. We have not received sufficient information to identify any 'general trend' in this respect.

Question 4(c)—Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in OCI?

76. We extended the scope of this question to include the unexpected effects of measuring investments in equity-type instruments at fair value through profit or loss.

- **The effects of the recycling prohibition**

77. Entities that have significant portfolios of investments in equity instruments—held with a long-term perspective—which chose to apply the presentation election to those portfolios say they had to rethink their internal and external communication. This is because the recycling prohibition results in the profit or loss statement not entirely reflecting entities' performance. This results in additional reporting costs.
78. Investing in equity instruments is a very substantial component of the insurance activity. Insurers in our jurisdiction will first apply IFRS 9 together with IFRS 17 *Insurance Contracts* from 1 January 2023 onwards. The recycling prohibition creates several challenges for those stakeholders:
    a. insurers are in a 'long cash position'. Thus, they invest in equity instruments with a long-term horizon. Presenting the changes in the fair value of insurers' investments in equity instruments in profit or loss, on a period-by-period basis, would not reflect the economic reality of their business because any gain or loss on investments is only realised at the expiry of their investment horizon.
    b. insurers usually expect to apply the OCI election to investments in equity instruments related to insurance liabilities that are *not* accounted for applying the variable fee approach (VFA)––this to avoid accounting mismatches and thus, undesirable volatility in profit or loss. The recycling prohibition will result in entities never presenting in profit or loss the realised gains (or losses) on those equity instruments. A significant part of insurance entities' financial performance will not be reflected in profit or loss.
79. The transition to IFRS 9 is ongoing in the insurance industries and decisions are to be made about investments in equity instruments. We understand those decisions may ultimately result in reducing the investments in such instruments.

- **The effects of measuring investments in equity-type instruments at fair value through profit or loss**

80. In paragraphs 53–57 of this letter, we indicated that IFRS 9 created a bias in favour of the direct holding of debt instruments. IFRS 9 creates a similar bias in favour of the direct holding of equity instruments—this is because, as explained in paragraphs 67–69, indirect holdings of equity instruments are measured at fair value through profit or loss if those holdings are made through a puttable fund.
81. For some entities with significant investment activities, this bias has resulted in significant arbitrages towards the direct holding of equity instruments. It has also resulted in deterring the investment in puttable funds.

Question 5—Financial liabilities and own credit

(a) Are the requirements for presenting the effects of own credit in OCI working as the Board intended? Why or why not? Please explain whether the requirements, including the related disclosure requirements, achieved the Board's objective, in particular, whether the requirements capture the appropriate population of financial liabilities.

(b) Are there any other matters relating to financial liabilities that you think the Board should consider as part of this post-implementation review (apart from modifications, which are discussed in Section 6)?Please explain the matter and why it relates to the assessments the Board makes in a post-implementation review.

Question 5 (a)—Are the requirements for presenting the effects of own credit in OCI working as the Board intended?

82. In our view, the requirements are working as intended. They capture the appropriate population of financial liabilities and result in useful information.

Question 5(b) Are there any other matters relating to financial liabilities that you think the Board should consider as part of this post-implementation review

83. We observe that IFRS 9 did not significantly change the classification and measurement requirements applicable to financial liabilities compared to those in IAS 39. Accordingly, our stakeholders have a long-standing experience of those requirements. They have not reported to us significant matters that should warrant further consideration from the Board.

Question 6—Modifications to contractual cash flows

(a) Are the requirements for modifications to contractual cash flows working as the Board intended? Why or why not? Please explain what changes you consider to be modifications of a financial asset for the purpose of applying paragraph 5.4.3 of IFRS 9 and as a modification of a financial liability for the purpose of applying paragraph 3.3.2 of IFRS 9. Does the application of those paragraphs, and the disclosure requirements related to modifications, result in useful information for users of financial statements?

(b) Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not? Please explain whether the requirements enable entities to assess in a consistent manner whether a financial asset or a financial liability is modified and whether a modification results in derecognition. Have the requirements been applied differently to financial assets and financial liabilities? If diversity in practice exists, please explain how pervasive the diversity is and its effects on entities' financial statements.

Question 6(a)—Are the requirements for modifications to contractual cash flows working as the Board intended?

- **Modifications to the contractual cash flows of financial *liabilities***

84. Entities apply the requirements in paragraph 3.3.2 of IFRS 9 and assess whether modifications to the contractual cash flows of financial liabilities are 'substantial'.
85. To make such a determination, entities apply the requirements in paragraph B.3.3.6 of IFRS 9 (the 'quantitative test' or '10 per cent test'):
    a. if entities determine that the discounted present value of the cash flows under the modified terms is equal to, or more than, 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability, they conclude the modification is substantial and thus, account for the modification as an extinguishment of the original liability.
    b. otherwise, entities usually make an additional assessment to confirm that the modification is not substantial. The purpose of this test, 'qualitative' in nature, is to assess whether the modification has introduced features that could significantly alter the future economic risk exposure of the instrument—if so, the modification is also deemed being substantial. This test requires the use of judgement based on an entity's facts and circumstances. We agree that IFRS 9 does not explicitly require an entity to perform this qualitative test. However, we observe that entities generally use similar indicators for this test (for example, a change in currency).
86. We think the manner entities apply the requirements in IFRS 9 in this respect provides useful

information. Furthermore, we have not made been aware of significant application difficulties. Accordingly, we think those requirements overall work as intended.

- **Modifications to the contractual cash flow of financial *assets***

87. In contrast, we acknowledge that the requirements in IFRS 9 with regard to the modifications to the contractual cash flows of financial assets are significantly less detailed than those applicable to financial liabilities––the requirements in paragraph 5.4.3 of IFRS 9 are rather incomplete.
88. Consistent with the Committee's conclusions set out in an agenda decision published in September 2012, entities generally apply the requirements in paragraphs 10–11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and have developed an analogy to the notion of 'substantial modification' that paragraph 3.3.2 of IFRS 9 uses for financial liabilities. Those entities have then applied their judgement to develop an accounting policy to determine when a modification to the contractual cash flows of a financial asset is substantial. Some entities:
    a. apply the '10 per cent test' described above together with a qualitative test, or
    b. apply a qualitative test; if not conclusive, that test is supplemented with a quantitative test, or
    c. only perform a qualitative test.
89. Despite the headroom given to entities' judgement, we have not been made aware of users having difficulties in understanding how entities account for modifications.

Question 6(b)—Can the requirements for modifications to contractual cash flows be applied consistently?

- **Modifications to the contractual cash flows of financial *liabilities***

90. The assessment of whether a modification of a financial liability is substantial may materially affect entities—this is usually a single 'one-off event' that may materially affect the entity's performance for a given reporting period.
91. As explained in paragraph 85 above, entities perform the 10 per cent test required by IFRS 9, together with a qualitative test. Entities generally use similar indicators for the qualitative test. Despite the headroom given to judgement regarding the qualitative test, we have not been made aware of significant diversity in reporting practices. Accordingly, we think the requirements can be applied consistently.
92. Accordingly, in our view, the requirements in IFRS 9 provide an adequate basis for an entity to determine how to account for modifications to the contractual cash flows of financial liabilities.

- **Modifications to the contractual cash flows of financial *assets***

93. This is an area where entities apply their judgement and thus, where diversity in reporting practices may exist. Modifications to the contractual cash flows may arise frequently for financial institutions.
94. That being said, we observe that when such modifications occur, they do not, individually, materially affect an entity's performance for a given reporting period. We also observe that undertaking standard-setting in this respect may prove to be challenging. In particular, we note that after having extensively discussed this matter, the Committee considered in May 2016 whether to undertake a potential narrow-scope project to clarify the requirements in IFRS 9 and IAS 39 about when a modification or exchange of financial assets results in derecognition of the original asset. Some Committee members observed that, in their experience, the circumstances in which an entity should derecognise financial assets that have been modified or exchanged is an issue that arises in practice. However, because of the broad nature of the issue, the Committee noted that it could not resolve it in an efficient manner.
95. We are also unaware of users signalling this matter as being important to their understanding of entities' performance[21]. Practice has unfolded and entities have generally documented their accounting policy. We are also unaware of difficulties in relation to how the practice has evolved.
96. Accordingly, we see no compelling case for undertaking standard-setting in this area. We have identified other areas throughout of this letter which, in our view, would warrant standard-setting of much higher priority.

[21] Users said however they are interested in information about the amount of assets subject to modifications to their contractual cash flows.

Question 7—Amortised cost and the effective interest method

(a) Is the effective interest method working as the Board intended? Why or why not? Please explain whether applying the requirements results in useful information for users of financial statements about the amount, timing and uncertainty of future cash flows of the financial instruments that are measured applying the effective interest method.

(b)Can the effective interest method be applied consistently? Why or why not? Please explain the types of changes in contractual cash flows for which entities apply paragraph B5.4.5 of IFRS 9 or paragraph B5.4.6 of IFRS 9 (the 'catch-up adjustment') and whether there is diversity in practice in determining when those paragraphs apply. Please also explain the line item in profit or loss in which the catch-up adjustments are presented and how significant these adjustments typically are. If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

In responding to questions (a)–(b), please include information about interest rates subject to conditions and estimating future cash flows (see Spotlight 7).

Question 7(a)—Is the effective interest method working as the Board intended?

97. The existing requirements in IFRS 9 in relation to the effective interest method (EIM), *as currently applied*, work as the Board intended and provide useful information. The users with whom we sought feedback confirmed this view.

98. Applying the EIM happens to be complex when part of the contractual cash flows of the financial instruments are either (i) not certain to occur and/or (ii) their timing of occurrence is uncertain. Those circumstances in which uncertainty arises are typically linked to the existence of prepayment options or interest step-up clauses or participation rights. That being said, we observe that entities are used to this complexity and think the requirements in IFRS 9 are generally sufficient to address those circumstances.

99. However, we draw the Board's attention to the implementation difficulties that the requirements in paragraph B5.4.6 may entail when applicable. Applying this paragraph, an entity adjusts the gross carrying amount of a financial asset or amortised cost of a financial liability to reflect actual and revised estimated contractual cash flows. An entity presents the adjustment ('catch-up adjustment') in profit or loss as income or expense. We have been made aware that no IT system currently exists to automatically (i) determine the revised amount of the modified asset or liability and (ii) recognise the catch-up adjustment arising thereof. This is a manual process which, if applied to large population of contractual modifications, would be highly costly to implement[22]. In our view, only significant information benefits would justify such implementation costs.

Question 7(b)—Can the effective interest method be applied consistently?

100. Our answer below discussed three aspects of the EIM:

  a. determination of the effective interest rate at initial recognition (see paragraphs 101–107),

  b. accounting for subsequent changes in contractual cash flows (see paragraphs 108–123), and

  c. presentation of the catch-up adjustments (see paragraphs 124–125).

- **Determination of the effective interest rate at initial recognition**

101. As explained in paragraph 98 above, there are circumstances in which a financial instrument's contractual cash flows are subject to uncertainty. This raises the matter of how an entity determines the effective interest rate (EIR) of a financial instrument at its initial recognition.

102. Appendix A to IFRS 9 includes a definition for the EIR explaining that *'an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example prepayments, extension, call and similar option)*'. However, IFRS 9 does not further develop how an entity selects a single amount from within the range of possible cash flows after having considered the contractual features creating uncertainty—in other words, IFRS 9 does not specify, for example,

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[22] The 'catch-up' accounting—that is, conceptually, a possible variation of amortised cost accounting—seems to have originated in US GAAP. Paragraphs 89–100 of *Statement of Financial Accounting Concepts No. 7 – Using Cash Flow Information and Present Value in Accounting Measurements* published in 2000 discussed '*interest methods of allocation*'. We would not entirely share the FASB's view in paragraph 97 that explains that '*the catch-up approach to be preferable to other techniques for reporting changes in estimated cash flows because it is consistent with the present value relationships portrayed by the interest method* and can be implemented at a reasonable cost' (emphasis added).

whether the entity retains the probability-weighted average (or expected value), the most likely outcome or the statistical median[23]. This is a significant matter left to entities' judgement.

103. The matter arises for example for financial liabilities that are measured at amortised cost and include an embedded derivative which is not accounted for separately.

104. In June 2021, the Committee published a tentative agenda decision (TAD) dealing with several aspects of the accounting for European Central Bank's Targeted Longer-Term Refinancing Operations ('TLTRO III'). A question arose of how an entity calculates the EIR for a TLTRO III tranche on initial recognition—ie 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. The Committee tentatively '*noted that the question of what to consider in estimating the expected future cash flows for the purpose of calculating the effective interest rate is also relevant to fact patterns other than that described in the request. The Committee therefore concluded that considering how to reflect uncertain conditions in calculating the effective interest rate is a broader matter, which it should not analyse solely in the context of TLTRO III tranches. This is because such an analysis could have unintended consequences for other financial instruments, the measurement of which involves similar questions about the application of IFRS Standards*'.

105. We agree with the Committee's observation.

106. Having said that, we observe limited diversity in practice in this respect in our jurisdiction. Entities usually retain:

    a. the probability-weighted average when the uncertainty relates to a portfolio of financial instruments, and

    b. the most likely outcome when the uncertainty relates to a single financial instrument.

107. Our observations above do not apply for floating rate financial instruments—ie those instruments for which the interest rate periodically resets to reflect the movements in the market rates of interest (ie typically loans whose remuneration is based on EURIBOR benchmark rates). In this case, at initial recognition, entities retain the market rate of interest observed at that date and subsequently adjust that rate applying paragraph B5.4.5 of IFRS 9. In other words, at initial recognition, the EIR is not based on the projected levels of the market rate of interest at each subsequent resetting date over the instrument' entire expected life—this approach would be highly complex to implement and would require applying paragraph B5.4.6 of IFRS 9, which, in our view, clearly does not apply to such instruments[24].

- **Accounting for subsequent changes in contractual cash flows**

108. We have set out below our observations and possible recommendations (if any) in relation to changes that are the most frequent in our jurisdiction.

109. An entity computes an instrument's original EIR based on estimated future cash flows at initial recognition applying the definition of the EIR in Appendix A to IFRS 9.

110. Paragraphs B5.4.5 and B5.4.6 of IFRS 9 specify requirements for how an entity accounts for subsequent changes in an instrument's estimated future cash flows:

    a. paragraph B5.4.5 applies to floating-rate financial instruments. Applying this paragraph, the EIR is adjusted prospectively.

    b. paragraph B5.4.6 applies to changes in estimated future cash flows of financial instruments other than those dealt with in paragraph B5.4.5, irrespective of whether the change arises from a non-substantial modification or another change in expectations. In this case, an entity recognises a catch-up adjustment in profit or loss whilst maintaining the instrument at the initial EIR.

111. We observe that recent debates in the context of the request on TLTRO III transactions received by the Committee (see paragraph 104 above) have shed light on differing views existing about when an entity applies the above-mentioned paragraphs. This is quite a surprise for us because:

    a. paragraphs B5.4.5 and B5.4.6 were carried forward unchanged from IAS 39 (paragraphs 'AG7' and 'AG8'). The requirements in those paragraphs have thus been subject

[23] Paragraph 6.92 of the *Conceptual Framework for Financial Reporting* includes a definition for those types of estimates.

[24] The Board discussed how to determine the EIR for floating rate instruments in October 2008. It tentatively decided that expectations (and changes in expectations) of future cash flows should *not* be considered. The Board never finalised this decision through amendments to IAS 39 and IFRS 9.

to a long-standing practice. Had this practice been inappropriate, the Board should have signalled this at an earlier stage—for example when the Board developed IFRS 9.

b. we have not identified any substantial diversity in reporting practice in this respect.

112. There is no definition of 'market rate of interest' in IFRS 9. This requires the use of judgement. In our view, this lack of definition is the crux of the debate about the applicability scope of each of those two paragraphs. We note this is no new matter—as stated in an Agenda Decision published in July 2008, '*judgement is required to determine whether an instrument is a floating rate instrument within the scope of paragraph AG7 or an instrument within the scope of paragraph AG8'*[25].

113. We think helpful to describe the prevalent reporting practices in France which, we understand, largely reconcile with the practices observed in other jurisdictions. Accordingly, we encourage the Board (and the Committee) to carefully assess the merits (and the drawbacks) of creating unsolicited disruptions in this area.

- ***Circumstances in which entities apply paragraph B5.4.5 of IFRS 9***

114. Entities apply this paragraph to changes to, what they view as, a 'market rate of interest'. This includes rates that:

    a. are floating by nature (for instance an EURIBOR benchmark rate[26]), or

    b. have (i) a floating component and (ii) a fixed component (typically a credit spread) if this component also periodically resets to a market rate—in other words entities apply paragraph B5.4.5 when the interest rate rests *in its entirety* to a market rate (or *approximatively to* a market rate). This typically includes the interest rate applying to ratchet loans[27]. This also includes in our view, the interest rate applied to some TLTRO III tranches further to the fixed 50 basis points discount given by the ECB for a fixed period[28].

115. In our view, a Committee's agenda decision published in January 2016 supports the practice described in paragraph 114(b) above.

116. This agenda decision relating the separation of an embedded floor from a floating rate host contract states that '…*the term 'market rate of interest' is linked to the concept of fair value as defined in IFRS 13* Fair Value Measurement *and is described in paragraph AG64 of IAS 39 as the rate of interest 'for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating'.*

117. If the term 'market rate of interest' is linked to the concept of fair value, this means, in our view, that a market rate of interest is equivalent to the interest rate that a market participant would charge for lending on similar terms and to a similar party. Accordingly, an adjustment to the interest rate that results in that rate (or the credit spread within that rate) being equivalent to (or approximatively equivalent to) the rate that would be charged by a market participant shall be accounted for applying paragraph B5.4.5 of IFRS 9.

118. Accordingly, we disagree with the view set out in paragraphs 81–83 the IASB staff agenda paper prepared for the November 2021 Committee meeting explaining that paragraph B5.4.5 only applies to general movements in the market interest rates (such as benchmark interest rates) not specific to a particular entity. We think this is only one possible reading of the requirements in IFRS 9.

119. Consistent with the approach retained for identifying a 'market rate of interest', entities also apply paragraph B5.4.5 of IFRS 9 to the changes:

    a. to the interest rate of instruments including a prepayment option with no, or no significant, penalty if those changes result in the instrument's interest repricing to the market rate. Entities consider that they have, in substance, an option to reprice the instrument to market interest rate. For example, banks in our jurisdictions offer long-term fixed-rate mortgages to customers. Customers can prepay the loan with no significant penalty. Customers are incentivised to renegotiate the loan's interest rate when the market interest rates for mortgages decrease (or they can refinance the loan with another lender at a market rate of interest). The renegotiated rate usually equals the interest rate that would be offered, at the renegotiation date, by any bank to the customers. If the renegotiation does not result in a

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[25] The Board discussed further this matter in October 2008. The Board tentatively decided that '*a floating rate financial instrument is an instrument with contractual variable cash flow amounts arising from changes in market variables [and that it would] not define the term market variable but may provide examples'*. The Board asked the staff to prepare a draft of the proposed amendments. As far as we now, the Board did not publish any proposed amendments to IAS 39 and IFRS 9 in this respect.

[26] We understand there is currently no debate as to whether such benchmark rates are 'market rates of interest'.

[27] Those are loans whereby the credit spread is increased in accordance with a scale of predetermined rates, on the occurrence of one or more predetermined events that are linked to the borrower's financial situation.

[28] Our letter dated 20 July 2021 commenting on the Committee's TAD sets our analysis in this respect.

substantial modification of the loan, entities usually apply paragraph B5.4.5 of IFRS 9 to the changes in contractual cash flows arising thereof.

b. modifying the nature of the interest rate and the revised interest rate equals the market rate of interest. This is the case when the contractual terms are modified to change the interest rate from a floating rate to a fixed interest rate—if the fixed rate is at market conditions at the modification date.

- ***Circumstances in which entities apply paragraph B5.4.6 of IFRS 9***

120. Entities generally apply paragraph B5.4.6 of IFRS 9 to changes other than those (i) described in paragraphs 114–119 above and (ii) resulting in the derecognition of the initial instrument. This is because those changes, they think, are not a result of movements in market interest rates.

121. Those circumstances notably include:

a. the restructuring of financial assets ('debt restructuration') ie when the terms and conditions of the initial instrument are modified because of the borrower's financial difficulties. This was notably the case at the height of the Covid-19 crisis when banks granted moratoria to some of their clients—those moratoria mostly consisted in payment suspension of a few months, with interests that may or not continue to accrue during the suspension period. Those forbearance measures resulted in catch-up adjustments in profit or loss.

b. modifications[29] to the instrument's contractual maturity (extensions for example)[30].

c. changes in the contractual cash flows of a debt instrument issued with participation rights[31].

- ***Overall assessment of how entities apply the requirements in paragraphs B5.4.5 and B5.4.6 of IFRS 9***

122. In our view, as currently applied, the requirements in the above-mentioned paragraphs generally provide useful information. In particular, we think the catch-up accounting may provide useful information when reflecting forbearance measures (ie when the change in the interest rate reflects a concession granted to the issuer rather than an adjustment to market conditions).The users we consulted confirmed our view. We do not see any merits in restricting the scope of paragraph B.5.4.5 as described in paragraph 118 of this paper.

123. That being said, we have the following recommendations for the Board *if it were to undertake standard-setting for modifications to contractual cash-flows*[32]:

a. we think any clarifications to the requirements in IFRS 9 should make clear that the term 'market rate of interest' is linked to the concept of fair value in IFRS 13, and thus that any modification to a financial instrument resulting in repricing its interest rate to the market interest rate conditions does not result in any catch-up accounting. We think users would be better served by a prospective adjustment to the EIR—the entity recognising interest revenue or expense at a rate portraying market conditions—than maintaining the original EIR.

b. we agree there could be questions about whether the accounting applied to changes to credit spreads of ratchet loans entirely aligns with the principle set out in paragraph a. above. The credit spread reset of such loans is indeed predetermined at the loans' inception—ie the credit spread reflects the market conditions at inception and thus, not necessarily those that will exist when the credit spread is increased (ie at the reset date) because future credit spreads are most often not observable at inception. Accordingly, we recommend the Board clarify that the requirements in paragraphs B5.4.5 also apply when the market credit is not observable and the predetermined credit spread reflects at inception the market credit spread that would apply had one or more predetermined events occurred at that date.

c. we think applying the requirements in paragraph B5.4.6 of IFRS 9 to the circumstances in which the (i) instrument's maturity is extended and (ii) the revised interest rate is the weighted average of the initial interest rate and the market rate of interest at the renegotiation date results in information that is not useful. The entity would indeed (i) recognise a catch-up adjustment being the difference between the original interest rate and the market rate of

[29] Modifications that are not substantial.

[30] That being said, entities usually consider there is an accounting policy election when a financial *liability* includes an extension option. At the initial recognition of the instrument, the entity may well consider the option is:

- an embedded derivative. In this case, the entity applies paragraph B5.4.6 when it exercises the option, or
- an off-balance sheet commitment. In this case, when the entity exercises the option, it derecognises the original instrument and recognises a new liability.

[31] This only applies to financial liabilities with such clauses because the financial assets are not, from the holder's side, SPPI—the holder thus measures them at FVPL.

[32] We think there is no compelling argument at this stage to undertake standard-setting in this area.

interest over the revised remaining period and (ii) subsequently recognise interest revenue (or expense) applying the original EIR. In our view, this outcome is not economically meaningful. Accordingly, we think paragraph B5.4.5 should instead apply in those circumstances.

- **Presentation of the catch-up adjustments**

124. Entities usually present the catch-up adjustments to financial assets in the line item whose presentation is required by paragraph 82(a)(i) of IAS 1 *Presentation of Financial Statements*—ie the line item called '*interest revenue calculated using the EIM*'. Some entities present the catch-up adjustments outside the net interest margin in a line item called 'cost of credit risk' when the catch-up relates to forbearance measures related to debt restructurations.

125. We have not received sufficient feedback to report how entities present the catch-up adjustments to financial liabilities.

Question 8—Transition

(a) Did the transition requirements work as the Board intended? Why or why not? Please explain whether the combination of the relief from restating comparative information and the requirement for transition disclosures achieved an appropriate balance between reducing costs for preparers of financial statements and providing useful information to users of financial statements. Please also explain whether, and for what requirements, the Board could have provided additional transition reliefs without significantly reducing the usefulness of information for users of financial statements.

(b) Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not? Please explain any unexpected effects or challenges preparers of financial statements faced applying the classification and measurement requirements retrospectively. How were those challenges overcome?

Question 8 (a)—Did the transition requirements work as the Board intended?

126. We have not been made aware of significant difficulties in relation to the transition to IFRS 9. The users we consulted said the information they received at the transition was generally useful. Overall, the transition requirements in IFRS 9 strike a proper cost-benefit balance.

127. Financial institutions said the transition requirements have overall proved being helpful.

128. One corporate indicated that, with hindsight, they wished they had restated comparative periods. Presenting comparative information applying the requirements in IAS 39 and information applying IFRS 9 from the date of initial application onwards required educational efforts in terms of internal and external communication—this is notably because the measurement requirements applicable to investments in equity instruments are dissimilar between the two Standards.

Question 8 (b)—Were there any unexpected effects of, or challenges with, applying the transition requirements?

129. The prohibition in paragraph 7.2.1 of IFRS 9 of applying this Standard to items that have been already been derecognised at the date of initial application has often been a relevant factor in the entities' decision *not* to restate comparative periods—restating comparative information applying this prohibition would have created operational difficulties, in particular for investments in equity instruments. This is the most significant unexpected effect.

130. This prohibition has been a matter of concern for insurers that will first apply IFRS 9 together with IFRS 17 in 2023[33]. We note and welcome the fact that the Board published in December 2021 an amendment to IFRS 17 that helps address the practical difficulties arising from that prohibition and will encourage insurers to restate comparative information for the effects of IFRS 9.

[33] See our comment letter dated 21 September 2021 on the Exposure Draft *Initial Application of IFRS 17 and IFRS 9—Comparative information*

Question 9—Other matters

(a) Are there any further matters that you think the Board should examine as part of the post-implementation review of the classification and measurement requirements in IFRS 9? If yes, what are those matters and why should they be examined? Please explain why those matters should be considered in the context of the purpose of the post-implementation review, and the pervasiveness of any matter raised. Please provide examples and supporting evidence when relevant.

(b)Considering the Board's approach to developing IFRS 9 in general, do you have any views on lessons learned that could provide helpful input to the Board's future standard-setting projects?

Question 9(a)—Are there any further matters that the Board should examine as part of this PIR?

131. We identified two areas which, in our view, should warrant the Board's consideration ie:

   a. the interaction between IFRS 9 and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* (see paragraphs 132–138), and

   b. contracts eligible to the 'own use exemption' (see paragraphs 139–145).

- **The interaction between IFRS 9 and IAS 20**

132. As mentioned in paragraph 104 above, the Committee published in June 2021 a TAD dealing with several aspects of the accounting for European Central Bank's Targeted Longer-Term Refinancing Operations ('TLTRO III'). In the TAD, the Committee discussed whether the TLTRO III tranches represent loans with a below-market interest rate and if the requirements of IAS 20 were to apply, how an entity would account for the benefit of the below-market interest rate.

133. The TAD specified that if the difference between (i) the fair value of a TLTRO III tranche at initial recognition and (ii) the transaction price, and if the consideration received is for more than just the financial liability, paragraph 10A of IAS 20 applies to that difference. The TAD did not specify, for example, whether paragraph 10A of IAS 20 would be applicable after the initial recognition of a TLTRO III tranche, in particular when the initial recognition of a grant in paragraph 7 of IAS 20 are ultimately met (ie when the entity obtains reasonable assurance that it will meet the conditions attached to the grant and that the grant will be received.

134. Further to the comments received on the TAD, the staff proposed to amend the TAD to specify that paragraph 10A of IAS 20 only applies at initial recognition of a TLRO III tranche. In other words, the entity would not recognise a grant if the criteria in paragraph 7 of IAS 20 were to be met after that date—the entity would instead apply the requirements in paragraph B.5.4.6 of IFRS 9 if meeting the criteria in paragraph 7 of IAS 20 would not result in the extinguishment of the financial liability (ie if they do *not* account for a 'substantial modification' of the contractual cash flows of the financial liability)[34].

135. We do not disagree with the staff's reading of the requirements in IFRS Standards. However, we think that valid alternative readings exist and would lead to a different conclusion—several comment letters received included alternative views which, we think, are also convincing. In particular, we agree with those supporting the view there is no reason to restrict the application of paragraph 10A of IAS 20 only for the liability's initial recognition. The existence of several readings indicates the interaction between IAS 20 and IFRS 9 is not entirely clear and should be addressed through standard-setting.

136. The staff's view is, in fact, predicated upon the (strong) assumption there is only unit of account for TLTRO III tranches and that IFRS 9 is the applicable IFRS Standard to that unit of account—the TAD reflects this view by mentioning that '*IFRS 9 is the starting point for the borrowing bank to determine its accounting for TLTRO III transactions'*. Referring to the words in paragraph 10A of IAS 20, the benefit of a government loan at a below-market rate of interest is treated as a government grant but is not, itself, a government grant. In other words, the fact that paragraph 10A of IAS 20 applies to government loan at a below-market rate of interest does not mean, in the staff's view, that the requirements in IAS 20 overall apply to that loan.

137. We question whether the staff's view results in the most useful information. Consistent with this approach, the fair value of a TLTRO III liability at initial recognition would include the probability of whether the entity will meet the conditions specified in the TLTRO III programme. If the entity assesses at initial recognition it will not meet the criteria in paragraph 7 of IAS 20, it will not recognise

[34] We understand that, applying the staff view, an entity would apply paragraph 10A of IAS 20 only if there were a derecognition of the initial financial liability followed by the recognition of a 'new' financial asset—ie when meeting the criteria in paragraph 7 of IAS 20 would account for a 'substantial modification'.

any grant at this date (or any component '*treated as a grant*'). However, the liability's fair value will reflect the corresponding uncertainty—in other words, the liability's fair value will generally be lower than the consideration received. The staff's paper does not outline that the requirements in paragraph B5.1.2A on 'Day 1 differences' would apply in those circumstances and would indirectly result in recognising something similar to a grant (though the conditions in paragraph 7 of IAS 20 are not met). We question whether such accounting provides useful information. In contrast, we think paragraph 9 of IAS 20 suggests considering there are two units of accounts for such loans could be more useful:

a. the first unit of account would be a financial liability in the scope of IFRS 9 whose cash-flows correspond to MRO interest cash-flows + redemption amount and its initial fair value would be unaffected by the conditions attached to the TLTRO III programme. Accordingly, the fair value of that liability would generally equate the proceeds received and thus, no initial 'Day 1' difference would exist.

b. the second unit of account would consist of the benefit the bank is getting when it fulfils the criteria to get the difference between MRO and Facility Deposit rate which is a grant in the scope of IAS 20 that would be recognised, initially measured and subsequently remeasured applying IAS 20.

138. Overall, we think there is further thoughts to give on this matter. We think the Committee should not interpret further the requirements in IFRS 9 and IAS 20 and recommend the Board undertake standard-setting in this respect.

- **Contracts eligible to the 'own use exemption'**

139. Paragraph 2.4 of IFRS 9 specifies that the requirements in IFRS 9 are applicable to '*contracts to buy or sell a non-financial item that can be settled net in cash or another financial instruments, or by exchanging instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements*' ('own use exemption').

140. IFRS 9 includes little application guidance to determine whether a contract related to non-financial items qualifies for the own use exception—paragraph 2.6 of IFRS 9 provides examples of various facts and circumstances that determine whether the contracts are entered into for the purpose of 'own use'. For example, IFRS 9 does not specify the percentage of the underlying contract's volumes which can be settled net in cash or another financial instruments (or degree of net settlement) that is compatible with the exemption.

141. The assessment of whether a contract is scoped out of derivative accounting applying the above-mentioned exemption arises frequently for entities managing commodity contracts. There is a widespread perception among entities managing such contracts that the existing application guidance could be substantially enhanced, in particular in comparison to the application guidance existing in ASC 815 *Derivatives and Hedging*. Consequently, we encourage the Board to consider whether the requirements in IFRS 9 could be further developed.

142. There are also questions about the relevance of the requirements in IFRS 9 about derivatives embedded in contracts eligible to the 'own use exemption' (cap or floor on the price or characteristics other than volumes for example). If the embedded derivative is not closely related to the economic characteristics and risks of the host contract, an entity shall account for that derivative separately and measure it at fair value through profit or loss. Some stakeholders note that ASC 815 permits, in some circumstances, an entity to apply the US own use exemption to contracts that include embedded derivatives. We recommend the Board develop application guidance in relation to embedded derivatives and assess the need to replicate parts of the requirements applicable in US GAAP.

143. Additionally, we have been made aware of an increasing number of transactions for which the existing requirements in IFRS 9 may be inadequate. Those refer to contracts for which the volumes of the underlying items (typically commodities) are higher than the entity's expected usage ('oversized contracts'). Applying the existing requirements in IFRS 9, such contracts are not eligible, *in their entirety*, to the 'own use exemption'. Such contracts become more frequent, in particular when the underlying item is a 'renewable energy'. This is because the supply of such energy type can be erratic (because the supply of energy depends on climate conditions for example). In those circumstances, entities will enter into contracts whose volumes are wittingly agreed to exceed the expected usage––this ultimately ensures that entities will be supplied with the volumes they need to carry out their normal operations.

144. Applying the existing requirements in IFRS 9, oversized contracts are considered as a unique unit of

account. Such contracts are not eligible to the own use exemption and consequently, are accounted for as derivatives measured at fair value through profit or loss. In our view, the Board should consider permitting an entity to treat those contracts as two units of accounts:

a. the first unit of account would capture the volumes that are equivalent to the entity's expected usage—this unit of account would be eligible to the own use exemption ie the entity would not recognise any derivative.

b. the second unit of account would capture the volumes that are in excess of the entity's expected usage—this unit of account would give rise to a derivative measured at FVPL.

145. In our view, distinguishing two units of account for those contracts—ie clarifying that part of the notional amount of a derivative may be qualified as own-use contracts—would provide more useful information.

Question 9(b)—Views on lessons learned that could provide helpful input to the Board's future standard-setting projects

146. We do not have any comment on this point.

APPENDIX B[35]

Financial assets with contractual cash flows linked to ESG targets. How and why do they respond to the assessment of cash flow characteristics?

Sustainability-linked loans or environmental, social and governance (ESG)-linked loans are loans with clauses where the interest rate varies depending on predetermined environmental, social and governance metrics and borrower's achievement of ESG targets. The ESG clauses are established at the inception of the contract.

From an accounting perspective, the question is whether the contractual cash flows of the ESG-linked loans, meet the Solely Payment of Principal and Interest (SPPI) criterion in IFRS 9.

To meet the SPPI criterion, IFRS 9 states that "*interest consists of the consideration for the time value of money, for credit risk … for other basic lending risks (for example liquidity risk) and costs (for example, servicing or administrative costs) associated with holding the financial asset for a period of time, as well as a profit margi*n". (IFRS 9. 4.1.3b) – IFRS 9 B4.1.7.A). Moreover, paragraph B4.1.10 gives an example of a relationship between default of payment and an increase in credit risk. A financial instrument with an interest rate risk that is reset at a higher rate if the borrower misses a particular number of payments could meet the SPPI criterion. Besides, the new interest rate should be established at the inception of the contract to compensate the lender for the increased credit risk (B4.1.11 a).

Therefore, to assess whether loans with ESG-linked features meet the SPPI criterion, it should be assessed whether **the ESG targets** defined at inception of the contract **should be considered as a component of the credit risk affecting the probability of the borrower defaulting on the ESG-linked loan or of other basic lending risks as prescribed by IFRS 9.**

An ESG clause will index the interest rate to the company's sustainability performance. The more virtuous and committed the company is to sustainable development, the more attractive its financing rate will be. On the contrary, would the company fail to meet the sustainable performance targets, this will undermine its capacity to repay its loans which may consequently, trigger the default of the company.

The extent to which ESG risks can be linked to credit risk, but also liquidity, market and operational risks has been considered by the supervisory authorities and regulators through an extensive and developing set of literature and regulation that demonstrates this link.

As detailed in Appendix C, international supervisors share a consensus to include climate-linked risks and more broadly ESG-linked risks under traditional prudential risk categories that are covered by capital requirements.

- Indeed, the BCBS clearly indicates in its April 2021 report that climate risk drivers should be addressed through the existing conventional prudential risk categories as no evidence has been found *'that would suggest an additional risk category needs to be developed to address banks' climate risks*'.
- The *Guide* for supervisors published in May 2020 by the Central Banks and Supervisors Network for Greening the Financial System (NGFS) integrates climate-related and environmental risks into prudential supervision. It stated that '*several supervisors' reports have shown that these climate-related risks are in fact drivers of conventional prudential risk types for both the banking and insurance sectors*'.
- As the NGFS rightly put it in its May 2021 progress report on the *Guide for Supervisors*, '*this work [from the BCBS] contributes to the consensus that traditional risk categories (e.g. credit risk, market risk, liquidity risk, operational risk, or, regarding the insurance sector, underwriting risk) suitably capture the eventual impact of climate related risks factors'.*
- The same logic applies to other ESG risk drivers, as shown in the implementation in the EU, which is the most advanced jurisdiction on this topic.

Thus, the ECB *Guide on climate-related and environmental risks* (November 2020) and the EBA *Management and supervision of ESG risks for credit institutions and investment firms* report (June 2021) state that '*ESG risks materialise through the traditional categories of financial risks (credit risk, market risk, operational and reputational risks, liquidity and funding risks)*'.

Besides, supervisory expectations to reflect ESG risks in traditional prudential risk categories have already been implemented.

- BCBS explicitly requires for banks to manage the impact of climate-related risk drivers on credit, market and operational risk (Draft Guidance issued in November 2021).

[35] Appendices B and C were prepared with the help of the French Banking Association.

- The ECB Guide (2020), developed jointly with National Competent Authorities, includes supervisory expectations of Eurozone banks and is applicable from Jan 1, 2022 for the management of climate-related and environmental risks to Significant Institutions. NCAs also issue guidance documents applicable to Less Significant Institutions they directly supervise.
- The forthcoming EBA Guidelines on the management of ESG risks by institutions applicable by Jun. 2023 (CRD6 mandate) and SREP Guidelines in 2022 will include ESG risks in the supervision of credit institutions.
- The European Commission in its CRD6 proposal states (recital 33 & 34): '…*ESG factors represent the main three pillars of sustainability. To maintain adequate resilience to the negative impacts of ESG factors, institutions established in the Union need to be able to systematically identify, measure and manage ESG risks, and their supervisors need to assess the risks at the level of the individual institution as well as at the systemic level, giving priority to environmental factors and progressing to the other sustainability factors as the methodologies and tools for the assessment evolve*'.
  Especially, Article 73 of the CRD is amended as such: '*Institutions shall have in place sound, effective and comprehensive strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed in the short, medium and long term time horizon, including environmental, social and governance risks.*'

Also, these risks will be subject to a specific attention by the supervisors, in the EU under the SREP process and through supervisory stress testing with, ultimately the power for the competent supervisor to require supervised banks to cover risks not covered or insufficiently covered under Pillar 1 by additional capital.

Finally, beyond the sole environmental risk, the experience of failed companies shows that the societal and governance factors can affect the ability of companies to repay their debts and consequently increase the credit risk that credit institutions have on those companies. In this context, it is worth mentioning, for example, violations of social factors that can lead to legal and reputational risks for companies or poor governance (e.g. in terms of malpractice and accounting irregularities (i.e. Wirecard, Enron), Money Laundering / terrorist Financing risk or Environmental/Social risks management) that can affect a company's ability to generate profit or even its ability to conduct business, thereby also leading to increased risk on banks' exposure to this counterparty.

It is and will be essential that banks, through their loans to companies (and tomorrow to individuals) that include such ESG/sustainability clauses, are able to price through the interest rate not only this additional credit risk but also these other basic lending risks. Eventually, in a mature market, this pricing will also become a market price based on quantified evidence and historical data.

If ESG-linked loans could not be classified at amortised cost because there are excluded in principle from the SPPI criterion, their measurement at FVTPL would generate volatility in profit or loss and could therefore make these instruments less attractive to distribute on banks 'side which could undermine the objectives of the European Green Deal.

A final point concerns ESG (Environmental, Social, and Governance) bonds comprised of debt instruments with principal and interest cash flows and linked to certain sustainable objectives of the issuer. From a bank perspective, these bonds may be part of the securities holdings required by banking regulations for the liquidity portfolio and may be eligible for an HTC or HTCS model. The same issues as described above can arise when assessing the terms of these bonds as regards to the SPPI criterion.

Appendix C: ESG risks inclusion in traditional prudential risk categories

APPENDIX C

ESG risks: inclusion in 'traditional' prudential categories of risks.

ESG risk drivers are feeding into 'traditional categories of risk' and it will thus be covered by additional capital under Pillar 1, but also eventually Pillar 2 requirement.
Indeed, those risks start to be subject to specific regulation and increased attention from the supervisors, especially in the EU, under the SREP process and through supervisory stress testing with, here again, ultimately the power for the competent supervisor to require supervised banks to cover risks not covered or insufficiently covered under Pillar 1 by additional capital.
Finally, the macroprudential risks derived from ESG risk drivers will also be covered by capital requirements in a near future.

All in all, if exhaustive quantification of the direct translation of ESG risks into credit risk may not be feasible yet, the prudential framework is gradually but rapidly requiring the incorporation of all ESG risks into the existing risks (mainly credit but also liquidity, market and operational risks) which will have to be covered by the profitability of the operations but also by the capital which will ultimately cover expected losses (provisioning) and unexpected ones (via Risk Weighted Assets).

Consensus of international supervisors to include of climate-related risks and more broadly ESG risks under traditional prudential risk categories covered by capital requirements

In its April 2020 stocktake of existing initiatives[36], the Basel Committee for Banking Supervision (BCBS) looked at the way in which climate-related financial risks are integrated by its members and noted that the members 'consider it appropriate to address climate-related financial risks within their existing regulatory and supervisory frameworks' and that research has been conducted to determine how this can be achieved. BCBS then looked at possible gaps in the current Basel Framework, where climate-related financial risks may not be sufficiently addressed.

One year later, in its report *Climate-related risk drivers and their transmission channels* published in April 2021[37], the BCBS clearly indicates the general preference of member supervisory authorities to address climate risk drivers through the existing conventional prudential risk categories: '*reports from a range of supervisory authorities further suggest that the existing Basel risk categories could also be used to reflect climate-related risks*'. The Committee then adds: '*based on a review of a broad set of examples of how climate risk drivers can impact banks, this report has not found any evidence that would suggest an additional risk category needs to be developed to address banks' climate risks*.'

BCBS April 2021 report refers in particular to:

- ACPR report published in October 2019, *Climate change: which risks for banks and insurers*?[38], which states that '*the risks associated with climate change to be an aggravating factor for types of existing*'.
- Bank of England Prudential Regulation Authority (PRA) report *Transition in thinking: the impact of climate change on the UK banking sector*, published in September 2018[39] which states that '*for banks, these climate-related risk factors manifest as increasing credit, market and operational risks'*.
- the central bank of the Netherlands' (DNB) study *An energy transition risk stress test for the financial system* published in October 2018[40]
- NGFS[41] *Guide for supervisors: integrating climate-related and environmental risks into prudential supervision* published in May 2020[42] where it is stated that '*several supervisors' reports have shown that these climate-related risks are in fact drivers of conventional prudential risk types for both the banking and insurance sectors*', with the example of Dutch Supervisor DNB's guidance *Good Practice Integration of*

[36] https://www.bis.org/bcbs/publ/d502.pdf
[37] https://www.bis.org/bcbs/publ/d517.pdf
[38] https://acpr.banque-france.fr/node/162192
[39] https://www.bankofengland.co.uk/prudential-regulation/publication/2018/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector
[40] www.dnb.nl/media/naiiupcg/persberos_transition-risk-stress-test-versie_web_tcm46-379397.pdf
[41] The Central Banks and Supervisors Network for Greening the Financial System (NGFS), established in December 2017, is a group of Central Banks and Supervisors willing, on a voluntary basis, to exchange experiences, share best practices, contribute to the development of environment and climate risk management in the financial sector, and to mobilise mainstream finance to support the transition toward a sustainable economy. Its purpose is to define and promote best practices to be implemented within and outside of the Membership of the NGFS and to conduct or commission analytical work on green finance. As of Nov. 30, 2021, the NGFS consists of 102 members and 16 observers.
[42] www.ngfs.net/en/guide-supervisors-integrating-climate-related-and-environmental-risks-prudential-supervision

climate-related risk considerations into banks' risk management, published in April 2020[43] where '*Chapter 1 demonstrates how climate change can be a driver of conventional risk types, such as credit, market and operational risk*'.

As the NGFS rightly put it in its May 2021 progress report on the *Guide for Supervisors*[44], '*this work* [from the BCBS*] contributes to the consensus that traditional risk categories (e.g. credit risk, market risk, liquidity risk, operational risk, or, regarding the insurance sector, underwriting risk) suitably capture the eventual impact of climate-related risks factors*'.

Considering the level of advancement of the various international jurisdictions and the urgency to act on climate, the work of the BCBS at international level is currently focused on banks' management of climate-related risk. However, as detailed further, the same logic applies to other ESG risk drivers, as shown in the implementation in the EU, which is the most advanced jurisdiction on this topic.

Thus, ECB analyses in the same way the characteristics of climate-related and environmental risks in the section 3.2 of its *Guide on climate-related and environmental risks* published in November 2020 which sets out SSM supervisory expectations on the matter[45] (apart from the breakdown between transition and physical risks). ECB Guide states indeed the following: '*physical and transition risks are drivers of existing risk, in particular credit risk, operational risk, market risk and liquidity risk, as well as non-Pillar 1 risks* (…) *Climate-related and environmental risks may, in fact, be drivers of several different risk categories and sub-categories of existing risk categories simultaneously*'.

EBA published in June 2021 its *report Management and supervision of ESG risks for credit institutions and investment firms*[46], under a CRD5 and an IFD mandate, which notably provides common definitions of ESG risks and their transmission channels. EBA states in this report that '*ESG risks materialise through the traditional categories of financial risks (credit risk, market risk, operational and reputational risks, liquidity and funding risks)*' as soon as in the first paragraph of the executive summary of the report and is developed further.

We could also mention here German supervisor BaFin's earlier conclusions that are also aligned in its *Guidance Notice on Dealing with Sustainability Risks* published in January 2020[47] and thus quotes: '*BaFin considers sustainability risks as factors of the existing risk types listed below[48]. We are not advocating a separate risk type of "sustainability risks", as segregation would be extremely difficult. Sustainability risks may have a significant impact on all of these existing risk types and be a factor that contributes to their materiality*.'

Implementation of supervisory expectations in the EU to reflect ESG risks in traditional prudential risk categories

In its draft Guidance issued in November 2021[49], BCBS, which takes into account the developments and best practices in its members' jurisdictions, has translated its conclusions from its April 2021 report into explicit requirements for banks to manage the impact of climate-related risk drivers on credit, market and operational risk.

The conclusions of ECB risk and supervisory analyses are already integrated in supervisory expectations of Eurozone banks, in the above-mentioned ECB Guide (2020) with supervisory expectations applicable from 1 January 2022 for the management of climate-related and environmental risks. Note also that the ECB required Significant Institutions to perform a self-assessment early 2021 which has been followed by the delivery of a bank action to comply with the expectations of the Guide and this serve as a basis for the supervisory dialogue with the ECB on ESG risk management.

ECB Guide has been developed jointly with National Competent Authorities, but it pertains only to Significant Institutions (subject to direct ECB supervision). However, NCAs also issue guidance documents applicable to Less Significant Institutions (which they directly supervise). We can mention here the above-mentioned examples of ACPR Good practices document published in May 2020, DNB Good Practices document published in April 2020 or BaFin Guidance published in January 2020.

EBA June 2021 report on ESG risk management and supervision and its recommendations will feed into forthcoming EBA Guidelines on the management of ESG risks by institutions by June 2023 (CRD6 mandate) and

[43] https://www.dnb.nl/media/jwtjyvfn/definitieve-versie-gp-en-qa-klimaatrisico-s-banken.pdf
[44] https://www.ngfs.net/sites/default/files/media/2021/11/08/progress_report_on_the_guide_for_supervisors.pdf
[45] https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr201127~5642b6e68d.en.html
[46] https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1015656/EBA%20Report%20on%20ESG%20risks%20management%20and%20supervision.pdf
[47] https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2019/meldung_191220_MB_Nachhaltigkeitsrisiken_en.html
[48] Credit risk/counterparty default risk, market risk, liquidity risk, operational risk, strategic risk, reputational risk (for those applicable to banks)
[49] https://www.bis.org/bcbs/publ/d530.pdf

into SREP[50] Guidelines in 2022 to include ESG risks in the supervision of credit institutions. After reporting in section 5 on the integration of ESG factors and ESG risks in the supervision of banks, including in the various blocks of the supervisory assessment, EBA's conclusion not only recalls that '*the impact of ESG risks materialises in the form of existing financial risks (e.g. credit risk, market risk and operational risk)*' but also clarifies that '*supervisory review should proportionately incorporate ESG risks as drivers of financial risks, in particular risks to capital and risks to liquidity and funding*'. EBA further indicates that *'the assessment of ESG risks should [already] progressively and proportionally be incorporated into the supervisory capital assessment*', while future developments in methodologies and data could allow a '*more quantitative consideration*' of these risks.

Climate-related risk coverage by capital requirements

Basically, the transmission mechanisms for climate/environmental risks can be summarised as follows for the main categories of risk under Pillar 1 which are directly subject to capital requirements.

- to credit risk first through the effect on '*a borrower's ability to repay and to service debt (the income effect) or on a bank's ability to fully recover the value of a loan in the event of default because the value of any pledged collateral or recoverable value has been reduced*', as ultimately reflected in exposures' PD and LGD.
- to market risk through the impact on financial assets valuation (potential downward price shocks, increase in market volatility, lower effectiveness of hedges).
- to liquidity risk (ability to raise funds or liquidate assets, or indirectly through customers' demands for liquidity – such as drawdown of deposits or credit lines).
- to operational risk, notably through liability risk and regulatory compliance risk associated with climate-sensitive investments and businesses and also through risk on bank's business continuity.

Counterparty violations of social factors can lead to legal and reputational risks for themselves can also affect the ability to repay financial claims to credit institutions thus affecting mostly the credit risk of the latter. Similarly, a poor governance (e.g. in terms of code of conduct, Money Laundering / terrorist Financing risk or Environmental/Social risks management) can affect a company's ability to generate profit or even its ability to conduct business and it can subject it to legal costs, thereby also leading to increased credit risk on banks' exposure to this counterparty while also possibly generating operational risk.

Going further and in line with EBA recommendations in its Jun. 2021 report, ESG Risks which would be not covered under Pillar 1, such as migration risk, credit spread risk in the banking book, real estate risk, strategic/business model risk or reputational risk, or insufficiently covered under Pillar 1, would be covered under Pillar 2. In the EU, this is done under the SREP process (including notably the ICAAP process on banks' side) which gives rise to a Pillar 2 Requirement (P2R) capital charge and also via the supervisory stress tests which may lead to additional capital needs under the Pillar 2 Guidance (P2G).

- Credit institutions are expected to quantify climate-related and environmental financial risk and include the material ones in their internal assessment of their risk-to-capital and risk-to-liquidity and funding adequation (ICAAP and ILAAP). The requirement already exists under the SREP guidelines, but it is also clarified in ECB Guide in the specific context of ESG risks; it is also clearly stated in BCBS draft guidance issued in November 2021. Based on those assessments and simulations—that includes stressed conditions, banks can adjust the internal capital they need to cover all their risks (i.e. in addition to Pillar 1 coverage). Note that EBA guidelines on the internal stress testing of ESG risks is foreseen by the EU Commission in its renewed sustainable finance strategy published in July 2021[51].
- The SREP assessment is comprehensive on banks' strategies, processes and risks, and it takes a forward-looking view to determine how much capital each bank needs to cover its risks. The ICAAP and the ILAAP reports are the main bank deliverables based on which the supervisory dialogue takes place, the quality of the underlying processes and the reliability of these assessments is reviewed and challenged by the supervisor who performs its assessment of risk levels and mitigants using also other supervisory tools such as on-site inspections, benchmarks and thematic reviews. Ultimately, any supervisory concern on risks coverage may be addressed by supervisory measures, including additional own funds requirements (P2R) to account for the risks to capital not covered or deemed insufficiently covered under Pillar 1 and institution-specific quantitative liquidity requirements if Pillar 1 coverage of risks to liquidity and funding is insufficient.
- Regarding own funds, on top of the P2R, supervisors would additionally be able to request banks to hold additional capital in the form of a P2G, based on the quantitative or qualitative results of a supervisory stress testing exercise. In this area, things are also moving very fast: ACPR organised a pilot bottom-up exercise already in 2020[52], EBA also conducted a pilot top-down exercise in 2020[53], ECB performed a

[50] Supervisory Review and Evaluation Process, cf. *infra*
[51] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021DC0390&from=EN
[52] https://acpr.banque-france.fr/sites/default/files/medias/documents/20210602_as_exercice_pilote_english.pdf
[53] https://www.eba.europa.eu/risk-analysis-and-data/eu-wide-pilot-exercise-climate-risk

top-down economy-wide climate stress test in 2021[54]. Next year, ECB is conducting its first bottom-up climate risk scenario analysis and stress testing exercise and this exercise, whether on stand-alone basis or combined with the usual supervisory stress test ('EU-wide stress test'), is expected to be repeated periodically in the future, whether led by ECB or EBA with potential impact on P2G that would be maintained on an ongoing basis.

Finally, beyond the impact on bank's counterparties, asset valuation, liquidity and operations, ESG risks can impact the financial system and the economy as a whole with potential systemic consequences. This is one objective of the current consultation of the EU Commission published Nov 30, 2011[55] to take this risk into account in the targeted review of the macroprudential framework and to assess whether a legislative change on the matter would be warranted (CRR 2 mandate). The topic is also at the legislative agenda since it has been included by the EU Commission in article 133 of its CRD 6 with a proposed coverage of climate-related macroprudential risks through the Systemic Risk Buffer[56] and ultimately an extra capital requirement to be passed on to clients, while recalling the above review of the general EU framework in 2022.

[54] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op281~05a7735b1c.en.pdf
[55] https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/2021-banking-macroprudential-framework-consultation-document_en.pdf
[56] http://ec.europa.eu/finance/docs/law/211027-proposal-crd-5_en.pdf