Amundi
ASSET MANAGEMENT

# EFRAG consultation on the IFRS 9 review

IFRS 9

The International Accounting Standards Board (IASB) has begun a post-implementation review of IFRS 9. The first phase concerns the classification and evaluation of financial instruments. At the end of September, the IASB sent out a survey requesting information from companies, investors, auditors, and regulators on these fundamental aspects of the standard.

EFRAG[1] prepared a draft response and has just requested comments by 14 January 2022; the deadline for contributions to the IASB consultation is 28 January 2022.

EFRAG considers that the classification and measurement principles set out in the IFRS 9 generally provide useful information, but some points need to be improved, in particular the application of the SPPI (solely payments of principal and interest) test to new financial instruments with sustainability-linked features.

Regarding equity investments, EFRAG would like the standard be revised so that changes recorded as OCI[2] are recycled to profit or loss at the time of sale. It would also like financial instruments whose price movements replicate those of equity markets to receive the same accounting treatment as equities.

## Debt instruments

### SPPI test of Sustainable finance products

EFRAG considers the revision of the SPPI test as applied to sustainable finance products to be quite urgent, and would like the IASB to deal with this as a priority, without waiting for the finalisation of the post-implementation review.

The IASB is aware of difficulties induced by instruments whose cash flow is determined based on the issuing entity's achievement of ESG targets. Its survey therefore included questions regarding the approach used by investors to assess whether such assets are SPPI.

In practice, some entities consider that these instruments can be classified as SPPI by considering the adjustment of interest payments to be justified by credit risk, while others regarded it as a margin. Still other investors consider that its effect on cash flow is de minimis and that it therefore does not affect the asset's classification[3].

Bonds with coupons indexed to the achievement of ESG indicators (Sustainability-linked bonds or SLB) have recently appeared on the markets and currently represent only a fairly small fraction of "sustainable" bond issues, which are still dominated by "green bonds". But **the stock of SLBs is set for strong growth in the coming years, and it is important to make sure uncertainties around their eligibility for recognition as amortised costs or FVOCI[4] don't restrict the appetite of European investors for this type of bond.**

Over the first 9 months of 2021, "GSSS" bond issues, comprised of "green", "social", "sustainability", and "sustainability-linked" bonds, reached $775 billion, with $62 billion in SLB issues, whereas in 2020, SLB issues were under $10 billion. It should also be emphasised that over half of this amount, for SLBs, was issued by European entities[5].

The urgent need to revise the SPPI criteria for these instruments is justified by the need for the insurance and the banking sectors to be able to fully support the Green Pact for Europe, especially the achievement of the intermediate target of reducing net Greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels.

### Distinction between "contractually linked instruments" and "'non-recourse' financial assets"

EFRAG considers this subject to be of a lower priority, but would nevertheless like the provisions relating to the classification of an instrument as either a "contractually linked instrument" (CLI) or a "'non-recourse' financial asset" to be revised.

CLIs are defined in the IFRS 9 Application Guidance as instruments issued by an entity that structures credit risk into different tranches.

1. European Financial Reporting Advisory Group
2. Other comprehensive income
3. IFRS 9 Application Guidance, Paragraph B4.1.18
4. Fair value through other comprehensive income
5. Source: MOODY'S – 27 October 2021: Sustainable Bonds on course to top £1 trillion annual issuance in 2021

The cash flows generated by the entity are thus allocated according to the level of subordination of each tranche.

In some cases, categorisation as a CLI or a "'non-recourse' financial asset" is due to a difference in form but not in substance. However since the criteria for determining the SPPI nature of these two types of product are not the same, the analysis of basically comparable financial instruments can lead to contradictory results.

EFRAG shows two economically similar arrangements for financing an entity holding a portfolio of assets, which itself is wholly owned by the originator. In one case, the financing is provided by debt and equities, and in the other, by two tranches of debt. The originator subscribes to all the equities or junior debt securities, depending on the case. Both arrangements result in a similar commitment for the originator, and both senior debts have identical guarantees and cash flow. However, in one case, the existence of two tranches of debt leads to considering the securities of the senior tranche as CLIs, whereas in the other case, these securities constitute a 'non-recourse' financial asset.

Currently, the SPPI nature of a CLI depends on compliance with three conditions: :

- The instrument's cash flow must meet the SPPI criterion,
- The instrument's exposure to credit risk must be less than or equal to that of the entire underlying portfolio,
- The instruments in the underlying portfolio must themselves meet the SPPI criterion.

These criteria are more stringent than those for 'non-recourse' financial assets, particularly if the portfolio to be financed is made up of real assets such as property.

### Changes to contractual cash flows

The IASB considers that it could be useful to clarify the rules to be applied when a change is made to a financial instrument.

In the absence of a definition of "substantial change" and without a quantitative threshold for changes in receivable cash flow that would trigger derecognition, various approaches have been put in place by entities applying the IFRS 9 standard.

Three types of accounting treatment are used:

- Derecognition of assets: an approach rarely used by banks,
- Recalculation of the gross book value such that it is equal to the present value of the renegotiated or modified contractual cash flow, established by means of the original effective interest rate,
- Change in the effective interest rate: an approach corresponding to the treatment of variable-rate assets.

In view of the practices already established, EFRAG is not convinced that additional normative work is necessary, and would like to verify this need by asking the stakeholders.

### Amortised cost and effective interest method

EFRAG considers that the effective interest method generally provides useful information. It notes, however, that the use of this method can prove complex for financial instruments with optional cash flow clauses, either at the initial valuation or at subsequent valuations.

However, loans with optional clauses represent a growing proportion of transactions in Europe. In this context, EFRAG wishes to better understand the various accounting approaches and obtain quantitative information on the adjustments of accounting value that were carried out over the past 5 years following revisions of expected cash flow.

## Equities and equity-type instruments

### Recycling of equity instruments to FVOCI

**The other provision of the standard whose revision EFRAG considers high priority is the impossibility of "recycling" accumulated changes in OCI to profits or losses at the time equity instruments are sold.**

EFRAG relies in particular on the responses to its 2019 public consultation concerning the appropriateness of an alternative accounting treatment to those proposed by IFRS 9 to better reflect the financial performance of long-term investments[6].

Of the 63 responding entities, nearly 70% said that an alternative accounting treatment is desirable, and 78% of these (52% of all respondents) felt that the most appropriate mechanism would be FVOCIs with realised gains or losses "recycled" to profit or loss. Of the 15 responses submitted by insurers and the associations representing insurance companies, 11 favoured the addition of this accounting treatment to IFRS 9.

If recycling to profit or loss becomes applicable, EFRAG is in favour of establishing a robust impairment model and introducing reversibility, so that improvement of the value of an instrument after an impairment loss has been recorded, can be recognised as net profit.

EFRAG would like to collect information on the implementation of the "equities classified as FVOCI" accounting treatment: reasons for choosing this option and the percentage of these securities in investment portfolios.

6. In its action plan on sustainable finance, in June 2018, the European Commission asked EFRAG to explore potential alternative accounting treatments to fair value measurement for long-term investment portfolios of equity instruments. To prepare its response, submitted to the Commission at the end of January 2020, EFRAG launched a public consultation in May 2019.

### Similar treatment for certain funds

In 2019, EFRAG had also consulted on the appropriateness of extending the alternative accounting treatment to instruments not considered as equity instruments under IAS 32, in particular investment funds (UCITS, ETFs, AIFs). Of the 41 entities responding to the question, 36 were favourable

IFRS 9 defines equity instruments from the issuer's point of view, based on the criteria set in IAS 32 Financial instruments - Presentation.

Since units in UCITS do not meet certain criteria of this standard, investments in fund units are not eligible for measurement at FVOCI (not recyclable to income), which is authorised for equities. As fund units do not qualify as SPPI instruments, changes in their fair value are recognised in income.

EFRAG considers that financial products that react in the same way as equities to market changes should be able to benefit from a similar accounting treatment. But it emphasises that the conditions that will determine the scope of instruments eligible for the accounting treatments reserved for equities ("equity-type" instruments) must be carefully defined.

At the beginning, EFRAG believed that the definition of an "equity-type" instrument should be limited to funds and other puttable instruments that invest in equities, their associated derivatives, and the necessary cash, but some entities would like to expand this class to funds containing both equities and receivables.

EFRAG is thus again inquiring into the scope of financial instruments whose accounting treatment could be aligned with that of equities and the criteria that could be established to define this "equity-type" category, in particular taking into account the characteristics of the underlying instruments.

## In short: there are several suitable concepts for the standard

### Business model for asset management

EFRAG observes that the business model can generally be assessed consistently and that this subject does not require additional guidelines for implementation.

### Financial liabilities and credit quality

As regards the accounting treatment of financial instruments as liabilities, EFRAG considers that the principles set out in IFRS 9 meet expectations and it has no other information that could contradict this point of view.

It should be recalled that the major change made by IFRS 9 for the treatment of debt instruments by issuing entities is the recognition of changes in fair value linked to changes in the issuer's credit risk as OCI. IAS 39, previously applied, allowed changes in credit risk to be recognised as profit or loss, leading to paradoxical communication.


Sources :

EFRAG – November 2021: EFRAG's draft comment letter in response to the IASB Request for Information on the Post Implementation Review - IFRS 9 Financial Instruments – Classification and Measurement

IASB – September 2021: Request for Information Post Implementation Review - IFRS 9 Financial Instruments – Classification and Measurement

MOODY'S – 27 october 2021: Sustainable Bonds on course to top £1 trillion annual issuance in 2021

EFRAG – January 2020: Answer to EC request for technical advice on alternative accounting treatments for Long-term Equity Investments

EFRAG – January 2020: FEEDBACK STATEMENT – Survey on alternative accounting treatments for Long-term Equity Investments

COMMISSION REGULATION (EU) 2016/2067 of 22 November 2016 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standard 9

Amundi - Normes IFRS - July 2019: Will the European Commission instigate new accounting rules for financial assets?

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