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Comments on Exposure Draft “Amendments to the Classification and Measurement of Financial Instruments”

Dear Madam, dear Sir,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, we appreciate the opportunity to comment on the Exposure Draft “Amendments to the Classification and Measurement of Financial Instruments". Principal authors of this comment letter were Peter Bitzyk, Florian Botschen, Michael Hammer, Stephan Kinsele, Philip Kudrna, Anna Ledermüller, Gerhard Margetich, Roland Nessmann, Ernst Schönhuber und Ingrid Schwarzäugl. In order to ensure a balanced Austrian view on the consultation, the professional background of these authors is diverse.

Best regards,
Romuald Bertl
Chairman

Comments on Exposure Draft "Amendments to the Classification and Measurement of Financial Instruments"

General comments

AFRAC welcomes the IASB's efforts to address the concerns of stakeholders raised in the context of the post-implementation review of IFRS 9 Classification and Measurement (the 'PIR') and of a request to the IFRS Interpretations Committee (the 'IFRS IC'). This ED mainly responds to a request from stakeholders to clarify some aspects of the application guidance for assessing contractual cash flows characteristics of financial assets and accounting for the settlement of a financial liability using an electronic payment system.

In general, AFRAC welcomes the IASB's ED and agrees with the proposed amendments to the classification and measurement of financial instruments. In particular, we consider that the proposed clarification on the general SPPI requirements would provide a good basis for evaluating whether contractual cash flows of financial assets with ESG-linked or similar features meet SPPI requirements. Considering the rapid increase in financial assets with ESG-linked features in the European environment, AFRAC would like to remind that this solution is expeditiously needed. Therefore, we encourage the IASB to prioritise the publication of the proposed clarifications on the general SPPI requirements before the other IFRS 9 amendments.

With respect to the proposed amendments to IFRS 7 we ask the IASB to first finalize the amendments to IFRS 9 including the aforementioned clarifications and to issue the disclosure requirements in IFRS 7 subsequently after that review.

Specific comments

Question 1 – Derecognition of a financial liability settled through electronic transfer

Paragraph B3.3.8 of the draft amendments to IFRS 9 proposes that, when specified criteria are met, an entity would be permitted to derecognise a financial liability that is settled using an electronic payment system although cash has yet to be delivered by the entity.

Paragraphs BC5–BC38 of the Basis for Conclusions explain the IASB's rationale for this proposal.

Do you agree with this proposal? If you disagree, please explain what aspect of the proposal you disagree with. What would you suggest instead and why?

> Yes, we agree. We appreciate the board's approach which further clarifies the requirements for the derecognition of liabilities.
>
> However, as according to B3.3.10 an entity that elects to apply paragraph B3.3.8 to the settlement of a financial liability using an electronic payment system shall apply the requirements in that paragraph to ALL settlements made through the same electronic payment system, there

may be issues concerning the transactions within a group of companies or if a payment system offers different types of transactions. The following examples may illustrate this matter:

Company A is part of a group of companies that basically has chosen to apply the settlement date accounting for all intragroup transactions in its local accounts as well as for its reporting. Therefore, Company A accounts for the derecognition of those intragroup liabilities using the settlement date approach. Due to technical reasons or due to the usance of the local market, Company A has chosen to apply the approach to derecognise their liabilities when the payment order is carried out for other transactions (e.g. term deposits, current accounts). It uses one single electronic payment system for all transactions. We understand that the current proposal would not allow Company A to apply different accounting methods for the different types of transactions. As B3.3.8 applies for financial liabilities but not for financial assets, this could also cause practical issues, if trade date accounting and settlement date accounting for intragroup assets and intragroup liabilities cannot be applied consistently.

In practice, one payment system may offer different types of payment transactions. E.g., the user may choose to make instant payment transactions, to have a standard transaction or to give a payment order to be settled at a later date. Will a company be allowed to apply B3.3.8 in this case?

We suggest that the choice to apply B3.3.9 shall be available for classes of financial instruments rather than being based on the use of a specific electronic payment system. B3.3.8 (c) also refers to the settlement risk associated with the “electronic payment system”, together with B3.3.10 that would mean that the settlement risk is only to be assessed in connection with the electronic payment system and is then carried out for all types of transactions running over this system. Apart from the described case of different types of transactions, the board might also give consideration to the fact that entities are increasingly working in an environment where creditors could be attached to certain sanction risks and electronic payment systems might block or stop the transaction to such creditors for a certain time with a certain possibility that the transaction will be reversed. Therefore, also in such cases it might be advisable to delete the provisions in B3.3.10 or to mitigate them in the sense that an entity might not derecognise financial liabilities before the settlement date, even if it uses the same payment system, only if it has reasonable expectations that the individual transaction might not be treated in the usual way by the electronic payment system.

Furthermore, we suggest, that the requirement, that the time between payment instruction and cash delivery has to be “short”, should be based on existing market standards and on usance. This is particularly relevant, as payments to different clients in different countries may take different time periods, even if effected by the same payment system. Therefore, the term “short” can have a different meaning in a different context.

Finally, additional guidance should be provided how the conditions under B3.3.8 and 9 shall be applied. E.g., whether it is necessary that B3.3.8 (a) to (c) are legally enforceable?

Question 2 - Classification of financial assets—contractual terms that are consistent with a basic lending arrangement

Paragraphs B4.1.8A and B4.1.10A of the draft amendments to IFRS 9 propose how an entity would be required to assess:

(a) interest for the purposes of applying paragraph B4.1.7A;
(b) contractual terms that change the timing or amount of contractual cash flows for the purposes of applying paragraph B4.1.10.

The draft amendments to paragraphs B4.1.13 and B4.1.14 of IFRS 9 propose additional examples of financial assets that have, or do not have, contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs BC39–BC72 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree, please explain what aspect of the proposals you disagree with. What would you suggest instead and why?

Yes, we agree. We understand that the proposed changes better reflect the economic reality and address current market developments. We believe that these amendments give helpful guidance on how to determine which changes to the interest are in line with a basic lending agreement and which are not and how to assess contingent events.

However, there is still a number of open issues to address (e.g. modifications, definition of interest), which have already been identified in the course of the PIR to IFRS 9 and do need further treatment. Furthermore, the definition of what really constitutes a basic lending risk still remains rather vague, and the limited additional guidance provided in BC55 is not seen as a significant improvement in this context.

Having stated this, we generally appreciate the clarification achieved due to the changes to B4.1.10A. However, we believe that the criterion "specific to the debtor" may require further clarification in future as markets continue to develop. Please consider the following aspects: Is the borrower only the entity directly issuing the instrument – or is a wider interpretation acceptable? An instrument may be issued by a subsidiary, but the ESG-KPIs/criteria might be that of the whole group. Depending on the interpretation, it could be argued that the criteria are not strictly that of the (direct) borrower. The problem becomes more relevant, as certain ESG-KPIs (e.g. Greenhouse Gas Emissions) have different scopes that also comprise the whole supply chain, which exceeds the scope of consolidation under IFRS 10. It could be argued that an entity can influence, who are its suppliers and customers and that, therefore, any KPI referring to the entity's supply-chain is still "specific to the borrower", but more guidance seems necessary in this context.

Furthermore, we propose to supplement the example for "Instrument EA" under B4.1.13 by the condition, that the periodical adjustments of the interest rate are aligned with the direction and

magnitude of the change in basic lending risks or costs due to the contractually specified reduction in greenhouse gas emissions (see B4.1.8A).

Question 3 - Classification of financial assets—financial assets with non-recourse features

The draft amendments to paragraph B4.1.16 of IFRS 9 and the proposed addition of paragraph B4.1.16A enhance the description of the term ‘non-recourse’.

Paragraph B4.1.17A of the draft amendments to IFRS 9 provides examples of the factors that an entity may need to consider when assessing the contractual cash flow characteristics of financial assets with non-recourse features.

Paragraphs BC73–BC79 of the Basis for Conclusions explain the IASB’s rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree, please explain what aspect of the proposals you disagree with. What would you suggest instead and why?

Yes, we agree. We think, that the proposal helps to better understand under which circumstances a financial asset, that includes non-recourse features, may meet the SPPI-criteria.

Editorial remark: BC73 should start with “Paragraph B4.1.16” instead of “Paragraph B.4.1.6”.

Question 4 - Classification of financial assets—contractually linked instruments

The draft amendments to paragraphs B4.1.20–B4.1.21 of IFRS 9, and the proposed addition of paragraph B4.1.20A, clarify the description of transactions containing multiple contractually linked instruments that are in the scope of paragraphs B4.1.21– B4.1.26 of IFRS 9.

The draft amendments to paragraph B4.1.23 clarify that the reference to instruments in the underlying pool can include financial instruments that are not within the scope of the classification requirements of IFRS 9.

Paragraphs BC80–BC93 of the Basis for Conclusions explain the IASB’s rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree, please explain what aspect of the proposals you disagree with. What would you suggest instead and why?

We agree. The clarifications are positive and helpful.

However, although the changes to the standard are reasonable, we struggle to understand how they shall be applied in specific circumstances. Especially the question has emerged, whether there may only be one single senior tranche meeting the SPPI criterion or whether this may also apply to other less senior tranches.

We find, that the last sentence in B4.1.20 may be misleading:
It currently reads:
"In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches, which means the tranches have non-recourse features."

We believe it should read:
"In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches, which means *these* tranches have non-recourse features."
[Not all tranches have non-recourse features!]

The addition in B4.1.23 is highly appreciated.

Question 5 – Disclosures—investments in equity instruments designated at fair value through other comprehensive income

For investments in equity instruments for which subsequent changes in fair value are presented in other comprehensive income, the Exposure Draft proposes amendments to:

(a) paragraph 11A(c) of IFRS 7 to require disclosure of an aggregate fair value of equity instruments rather than the fair value of each instrument at the end of the reporting period;
(b) paragraph 11A(f) of IFRS 7 to require an entity to disclose the changes in fair value presented in other comprehensive income during the period.

Paragraphs BC94–BC97 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree, please explain what aspect of the proposals you disagree with. What would you suggest instead and why?

We agree. The changes to 11A are helpful.

Question 6 – Disclosures—contractual terms that could change the timing or amount of contractual cash flows

Paragraph 20B of the draft amendments to IFRS 7 proposes disclosure requirements for contractual terms that could change the timing or amount of contractual cash flows on the occurrence (or non-occurrence) of a contingent event. The proposed requirements would apply to each class of financial asset measured at amortised cost or fair value through other

comprehensive income and each class of financial liability measured at amortised cost (paragraph 20C).

Paragraphs BC98–BC104 of the Basis for Conclusions explain the IASB's rationale for this proposal.

Do you agree with this proposal? Why or why not? If you disagree, please explain what aspect of the proposal you disagree with. What would you suggest instead and why?

We do not fully agree to this proposal.

The changes to 20B require to include qualitative and quantitative information which shall give a better understanding of the sensitivity of changes to cash flows to the user. Especially for financial institutions the requirements are overshooting and burdensome. In fact, the quantitative information required by 20B (b) may result in a sensitivity analysis of changes to interest income or expense from non-fixed interest financial assets and the effects on the fair value resulting from such changes. This is contradictory to BC103, which states, that a sensitivity is not required. 20C may be read differently and is likely to lead to unintended results.

The proposed disclosures would relate not only to financial assets with ESG features. Cash flow variability, which is based on the occurrence (or non-occurrence) of a contingent event that is specific to the debtor, also relates to features such as margin ratchets whereby the margin is adjusted by reference to certain financial ratios of the debtor. Other examples may be cross-selling clauses or penalty interest. Such margin adjustments are considered to be SPPI-based on the existing requirements. We think that, if features are SPPI-based, they relate to simple basic lending and there is sufficient accounting mechanism in IFRS 9 for capturing their variability.

We want to point out, that systems for identifying these features and for tracking the range of the potential changes were not necessary for financial institutions during IFRS 9 implementation and, therefore, the proposed disclosure requirements may have significant operational challenges and implementation costs. Financial institutions would have to analyze their whole loan portfolio. Additionally, the current wording would be applicable to a wide range of contingent events specific to the entity which potentially could be relevant (e.g. margin-grid or ratchet loans). We think that the effort is not in relation with the requirements of an intended short-term solution. As long as it is not clear how changes to cash flows shall be considered in the context of basic lending arrangements, effective interest method, etc., we do not expect that such information would give the reader the appropriate and useful information which should be provided. We suggest to first finalize the PIR for IFRS 9 Classification and Measurement and Expected Credit Loss and to review IFRS 7 as a whole afterwards.

If the board keeps the proposal, additional guidance will be definitely required. In our view quantitative information should only be required for the most relevant or material types of contingent events and not for all potential events (that may have a very low probability of ever occurring).

We understand that the transitional requirements are fine for the application of IFRS 7.11A. If the board keeps the proposal for 20B, preparers will need more time to prepare meaningful and relevant information as especially financial institutions would have to analyse their whole existing loan portfolio concerning the relevant data. It might be practically impossible to implement the respective proposed timeline in IFRS 7.44JJ.

Finally, we would suggest that the board clarifies whether or how, respectively, the requirements of 20A to 20C shall apply to financial liabilities.

Question 7 - Transition

Paragraphs 7.2.47–7.2.49 of the draft amendments to IFRS 9 would require an entity to apply the amendments retrospectively, but not to restate comparative information. The amendments also propose that an entity be required to disclose information about financial assets that changed measurement category as a result of applying these amendments.

Paragraphs BC105–BC107 of the Basis for Conclusions explain the IASB's rationale for these proposals.
Do you agree with these proposals? Why or why not? If you disagree, please explain what aspect of the proposals you disagree with. What would you suggest instead and why?

We agree.