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July 19th, 2023

International Accounting Standards Board (IASB)
IFRS Foundation
Columbus Building, 7 Westferry Circus
Canary Wharf, London E14 4HD
Submitted electronically

Re: IIF's Public Comment Letter on the IASB Exposure Draft on amendments to the Classification and Measurement of Financial Instruments

Dear Sir or Madam,

The Institute of International Finance (IIF)[1] and its members, which broadly represent the global financial services industry, are pleased to submit industry perspectives in response to the International Accounting Standards Board (IASB or the "Board") consultation on its "Exposure Draft (ED) on the Amendments to the Classification and Measurement of Financial Instruments – Proposed amendments to IFRS 9 and IFRS 7."[2]

The IIF welcomes the IASB's objective to respond to feedback on the Post-Implementation Review (PIR) of the classification and measurement requirements in IFRS 9 *Financial Instruments* by improving the understandability of some of these requirements and the usefulness of related information disclosed by an entity applying the requirements in IFRS 7 *Financial Instruments: Disclosures*. In particular, the IASB's efforts to address features linked to Environmental, Social and Governance (ESG) concerns to meet Solely Payments of Principal and Interest (SPPI) requirements in IFRS 9 is an important aspect for institutions who urgently need guidance on the classification of financial assets and whether their contractual cash flows are consistent with a basic lending arrangement.

The remainder of this letter provides comments along the three main themes (1) Derecognition of financial liabilities, (2) Classification of financial assets, and (3) Disclosures. If applicable, it refers to the questions outlined in the ED.

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[1] The Institute of International Finance (IIF) is the global association of the financial industry, with about 400 members from more than 60 countries. The IIF provides its members with innovative research, unparalleled global advocacy, and access to leading industry events that leverage its influential network. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial, and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, professional services firms, exchanges, sovereign wealth funds, hedge funds, central banks, and development banks.

[2] IASB 2023. "Exposure Draft Amendments to the Classification and Measurement of Financial Instruments Proposed amendments to IFRS 9 and IFRS 7." March 2023

1. *Derecognition of financial liabilities*

Despite the acknowledgeable IASB's efforts in clarifying the recognition and derecognition principles of financial assets and financial liabilities, the IIF expresses its concern that they might result in unintended consequences. This results particularly from adding "shall apply settlement date accounting" to the drafted paragraph B3.1.2A. Setting the default accounting treatment to settlement date accounting could lead to recognizing a derivative between the pricing (trade) date and settlement date for issuances of financial liabilities leading to extra burden for entities to account for these derivatives (i.e., as the financial liability would not qualify for regular way treatment, which is reserved for purchase/sales of financial assets and not issuances of financial liabilities). An example where these characteristics can be found is the market for Swiss Franc (CHF) covered bonds. As in other markets for covered bonds, the pricing for CHF covered bonds is to be done first, followed by the finalization of legal documents, which is largely procedural in nature and does not impose a true risk of non-issuance but may take longer to finalize compared to other markets. A Swiss prospectus, for example, needs to be prepared for listing purposes on top of the usual drawdown package. Consequently, a longer period is required for the documents to be finalized prior to the settlement date. Per market convention, it may take up to 22 business days for CHF covered bonds to be settled. At the very least, the underwriter would purchase all the issued amounts at the agreed pricing that is determined based on the pricing date. If the settlement date accounting principles are applied, the issuer would have to hedge themselves against any potential price differences between pricing and settlement date putting an avoidable extra burden on the issuer.

Furthermore, the proposal may cause disruption to longstanding accounting practices, such as entities that adjust their cash for items in transit (e.g., cheques), and could lead to mismatches in inter-company transfers, since the liability side potentially changes when a financial instrument is derecognized using settlement date accounting. It could also implicitly create a new requirement for entities to confirm with a counterparty whether they have received the cash of a transaction.

We recommend that instead of explicitly having proposed paragraph B3.1.2A to specify that settlement date accounting should be applied when recognizing or derecognizing a financial asset or financial liability, the Board may consider cross-referencing the new electronic payment option in proposed paragraph B3.3.8 into the existing paragraph B3.3.1(a) of IFRS 9 that covers extinguishment. We propose the following wording change in paragraph B3.3.1 (a):

"B3.3.1 A financial liability (or part of it) is extinguished when the debtor either:

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services**, unless an entity elects to apply paragraph B3.3.8**."

Related to <u>Question 1</u> of the ED, the IIF generally welcomes the possibility to optionally derecognize a financial liability that is settled using an electronic payment system although cash has yet to be delivered but an entity is firmly committed to paying the liability. However, we express concern as to whether all factors have been considered in the cost-benefit discussion of the conditions under which the proposed exception in B3.3.8 could be applied. Entities would need to assess each payment system they use to identify whether all criteria of the amendment are met. In the context of global financial institutions, which commonly use different payments systems in various jurisdictions with different legal frameworks,

evaluating whether all criteria are met across these systems is complex and the costs of applying this exception would be high. In addition, given the fact that this option is only available for non-cancellable payments (even if the intention is to only cancel payments in rare circumstances), the application to payment systems in general could be very narrow and rarely used in practice.

As a result, the proposed amendment may not be ultimately used in practice given the high cost to assess and potential narrow scope of application. To resolve our concern, we think the ability to withdraw, stop or cancel the payment instruction should be considered in the context of what caused the entity to perform such an action and the entity's past practices. If the entity only withdraws, stops, or cancels the payment instruction in rare or emergency situations and doing so requires a significant amount of effort, we believe paragraph B3.3.8 (a) should be satisfied. We therefore propose the following wording change to paragraph B3.3.8 (a):

"the entity ~~**has no ability to**~~ **will not** withdraw, stop or cancel the payment instruction**, except in rare circumstances (such as correcting a payment error)**;"

Finally, we note that there is an inconsistency between B3.3.8(a) and (b) where the word "practical" is missing in the former, and we therefore suggest it to be inserted into B3.3.8(a). A definition of an "electronic payment system" could also be provided so that it is clear which payment systems would be eligible for the election available in paragraph.

2. *Classification of financial assets*

The IIF welcomes and appreciates the IASB's efforts to address ESG-linked features in the context of the SPPI requirements in IFRS 9 and supports the IASB's objective of taking a holistic and principles-based approach. We also welcome the clarification in BC47(a) that "the elements of interest specified in paragraph B4.1.7A of IFRS 9 do not constitute an exhaustive list of the elements that are consistent with a basic lending arrangement." However, with reference to Question 2, we consider this an important clarification that should instead be incorporated into the application guidance.

Another concern relates to the last sentence of B4.1.8A in relation to the requirement on "magnitude" and the IIF suggests removing this "magnitude" requirement in the final version of the standard for the following reasons:

a. It conflicts with the second statement in B4.1.8A where the assessment should not be based on "how much." Moreover, coupled with the Board's view that the change must be "proportionate" in BC52, we think this requirement could be onerous to assess for features other than credit risk such as ESG.
b. It is not clear what concern the IASB is trying to address with the proposed "magnitude" requirement. If it is leverage, it would already be covered in B4.1.9.

Furthermore, we suggest that the definition in B4.1.10A of "specific to the debtor" be expanded to "specific to debtor / debtor's Group (including actions that affect 3rd parties)" and still be able to pass the SPPI test to account for special circumstances that are important in the context of ESG-linked targets. As stated in B4.1.10A, a contingent event must be "specific to the debtor" for the instrument to pass SPPI. However, the following two real-life examples demonstrate that it will be more appropriate to also include the group level: (1) Where the borrower in a lending arrangement is a holding company or a funding entity and channels the

borrowed amount to other companies within the group, potential adjustments to interest can and should be based on ESG targets to be met by the entire group, rather than by a single entity. (2) Adjustment to interest is based on ESG targets tagged to Scope 3 emissions. Scope 3 encompasses emissions that are not produced by the borrower / borrower group itself but by other companies along the broader value chain. The borrower / borrower group can have a direct impact on Scope 3 emissions through its business policies and procedures and is therefore specific to the debtor / debtor group.

In addition to that, the IIF notes that the principles outlined in B4.1.10A are potentially broader in scope than just ESG-linked features and therefore may have unintended consequences, including for example credit-related contingencies. In practice, many loans have terms that would be considered credit related contingencies (e.g., when a loan's interest rate changes as certain entity specific metrics or ratios change). It will be onerous, especially for global banks, to identify and continuously monitor the entire population of contingent features.

Moreover, some contingent features may not be as straightforward to assess under the new criteria (e.g., linking governance-related diversity triggers to "lending risks or costs"). Significant judgment could be involved in the decision as to whether a loan is fulfilling the criteria of the principle. Furthermore, the examples in B4.1.13 and B4.1.14 are stating two extreme cases. However, in practice, the triggers could be less obvious. For example, if there's an ESG related feature within a loan such as the quota of women on the board, a company would get a certain discount on the interest rate. Linking this to lending risks or costs is tenuous. It's not altogether clear that those are related.

Finally, we see a potential conflict between the requirements of B4.1.10A / BC 67 of the ED against paragraph 4.1.3 of the existing IFRS 9 when applied to loans where increased costs of the lender are passed to borrowers. These common terms include, for example, tax and regulatory costs. Based on the current IFRS 9, these loans would pass the SPPI test as paragraph 4.1.3 acknowledges that the basic lending arrangement includes consideration for "other basic lending risks and costs, as well as a profit margin". In contrast, B4.1.10A of the ED requires the contingent event that drives the changes in contractual cash flows to be specific to the debtor for the financial instrument to pass the SPPI test. BC67 specifically states that where the contingent event is specific to the creditor the loan would be inconsistent with a basic lending arrangement. Application of the ED's guidance would thus result in loans that passes increased costs to fail the SPPI test.

A literal interpretation of the ED's requirements could even result in loans whose interest rates are linked to the bank's cost of funds, to fail the SPPI test since a Bank's cost of fund is specific to the creditor and because the term "contingent event" is currently not defined in IFRS 9/ ED.

We recommend addressing this conflict by amending the ED. For instance, the ED can clarify that the passing of increased costs to the borrower remains consistent with a basic lending arrangement.

Referring to <u>Question 3</u>, we suggest that the look through test should be considered in tandem with the new criteria relating to overcollateralization and amounts of equity in the structure. B4.1.17A requires the degree of overcollateralization and the amounts of equity to be considered in applying the SPPI test. We believe that B4.1.17A should be read in tandem with the requirements of the "look through test" required by B4.1.17. The example in BC76 concluded that a loan to a Special Purpose Vehicle (SPV) with limited overcollateralization and little equity

"might not have" cash flows that pass SPPI without performing a look through test. However, based on the literal application of BC76, both of the following scenarios could fail SPPI, leading to a counter intuitive outcome: (1) The underlying assets are highly rated "vanilla" corporate bonds and thus it is very likely for the lender to receive back the full amount of principal and interest (for simplicity assume a fixed rate). (2) The underlying assets have high volatility cash flows and thus, it is not certain whether the lender will recover its full principal and interest.

We therefore recommend the following:

a. It should be stated explicitly in B4.1.17A that the overcollateralization and equity test be considered in tandem with the look through test.
b. The example in BC76 should include the look through test. For instance, the example can specify that the structure has little overcollateralization, little equity and has assets with volatile cash flows.
c. The amended example in BC76 should be included in the main text of the standard.

Referring to Question 4 on Contractually Linked Instruments (CLIs), the IIF is pleased and appreciative that these have been covered as part of the PIR process and we are generally supportive of the clarifications provided during the IASB discussions on the topic and in the ED. **To improve this standard, the IIF has the following suggestion: the staff paper 16B presented in September 2022 contains a lot of useful application guidance on the definition of CLI and only a small element of that is expressed in the ED. We recommend that more of this guidance should be included in the final standard which in our view will contribute to consistency in application and comparability across preparers.** The standard would benefit from including this high-quality detailed work that has already been undertaken by the IASB. We would suggest that the staff incorporate this guidance into the application guidance or as a basis for the conclusions of the final standard. We recommend that the following extract from paragraph 38 of the September 2022 staff paper is included since this provides clear guidance on how to distinguish between Non-Recourse Financing (NRF) and CLI structures where there are multiple tranches of debt (without this clarification the standard would remain unclear on these structures):

> *In a scenario that the underlying pool performs poorly, insufficient cash flows from the underlying pool of financial assets to make payments of interest and principal on the tranches according to their place in the waterfall payment structure do not trigger a default of the issuer, but rather reduce the contractual rights of the holders of the affected tranches to receive cash flows. This feature distinguishes a CLI structure from other forms of subordination such as the creditor ranking, whereby the contractual rights to receive cash flows; would generally remain unaffected.*

In terms of the additional paragraph B4.1.20A we are supportive of the concept that a junior instrument held by a sponsor should not be counted when assessing whether there are multiple CLIs. We would suggest that the wording be amended slightly, particularly the sentence:

> *Such transactions do not contain multiple contractually linked instruments because the structured entity is created to facilitate the lending transaction from a single creditor.*

In some cases, a bank may originate a single tranche of senior debt with the junior instruments held by the sponsor. The bank may syndicate part of the senior debt to reduce concentration risk. We do not think that a subsequent syndication of a pro rata share of a single external debt tranche

should impact the analysis of whether the instrument is a CLI or not. We think the focus for this paragraph should be the number of debt tranches with different credit concentrations. If there are only two debt tranches with the junior instrument held by the sponsor and the external creditors hold between them a single *pari passu* tranche – then this should not be a CLI. We would suggest this sentence is amended to:

> *Such transactions do not contain multiple contractually linked instruments because the structured entity is created to facilitate the lending transaction from a single* ***debt instrument from creditor(s).***

Beyond this amendment, members of the IIF appreciate the clarification provided in the draft amendments for certain fact patterns (i.e., B4.1.20A), the amendments provide more clarity, and we welcome the clarification in paragraph B4.1.23 that would allow some investments in lease receivable structures to potentially qualify for amortized cost measurement. However, we think the CLI guidance continues to be stricter than NRF guidance, which can result in different SPPI conclusions for instruments with the same or similar risk profiles and cash flow characteristics. We have identified one such example below:

- **Scenario 1: Non-recourse loan.** A lender originates a non-recourse loan (Loan A) that is collateralized by a pool of auto or aircraft leases with a single tranche and has exposure to residual value risk of the vehicles or aircrafts (i.e., assets that would not pass SPPI). The non-recourse guidance requires that the look-through cash flows are not inconsistent with SPPI, which does not necessarily require the underlying pool of collateralized assets to also pass SPPI (B4.1.17), unlike the CLI guidance. When considering other factors (e.g., there is sufficient loan-to-value, sufficient cash flows generated by the borrower to repay the principal and interest, and adequate credit enhancements), this non-recourse loan will likely pass the SPPI test despite having a potential exposure to residual value risk from the underlying collateral.
- **Scenario 2: Senior tranche loan.** In contrast, under the CLI requirements, a senior tranche loan (Loan B) that is collateralized by the same auto or aircraft leases, with the same risk exposure as Loan A (including exposure to residual value risk), will fail the SPPI test. This is due to the strict look-through CLI requirement that each financial asset within the underlying pool (aside from certain instruments permitted by B4.1.24) must pass the SPPI test. This would be the case even if Loan B has more junior tranches in structure providing further credit enhancements than Loan A has.

We believe that the failed SPPI conclusion reached for the CLI senior tranche instrument (Loan B) resulting in the FVTPL classification does not provide more relevant and useful information to users of the financial statements when the asset is significantly over-collateralized with potentially lower credit risk than other lending products (e.g., Loan A) that are eligible to be held at amortized cost.

We recommend removing the CLI criterion that each financial asset must pass SPPI within the underlying pool (i.e., B4.1.23), to better align the CLI look-through test with the non-recourse look-through test, thus achieving similar SPPI outcomes for instruments with similar risk profiles. If the Board wishes to keep this requirement, we recommend that additional clarification is provided for paragraph B4.1.23 for situations where the residual value risk of the underlying lease receivables is removed by a guarantee issued by the debtor.

Furthermore, it would be helpful to expand the example in paragraph BC77 to include a variation to the situation described (i.e., where the creditor has the contractual right to require a debtor to pledge additional assets if specified assets do not generate sufficient cash flows or when their value decreases below a specified threshold). One situation we have seen in practice is a CLI where only holders of certain tranche(s) (e.g., senior note holder) have this right while other tranches (e.g., mezzanine and junior note holders) do not. Under current requirements, the senior note will often be considered as part of the CLI assessment. However, if the contractual terms provide the senior note holder with the contractual right to require the sponsor to transfer additional assets into the structured entity if the existing underlying assets do not generate sufficient cash flows, we believe the senior note does not have a non-recourse feature and therefore should not be considered a CLI.

3. *Disclosure*

The IIF acknowledges the IASB´s efforts to increase transparency and benefits that users will get from disclosing contractual terms that could change the timing or amount of contractual cash flows. **However, the IIF expresses its concern that the scope of the proposed disclosures in the ED is very broad and will not provide meaningful information to financial statement users. It remains uncertain what information need of users the disclosure is intended to address.** BC99 notes that financial statement users provided feedback that they would like a better understanding of the effect of ESG-linked and similar features that could change the timing or the amount of contractual cash flows. Therefore, it is unclear whether the users are equally concerned with other contingent events to warrant such extensive disclosures and the excessive information gathered for every type of contingency will distract financial statement users from assessing contingencies that are important and relevant to their needs.

Moreover, the entire population of contingencies includes terms that are common in the market and are already well understood by users. For example, credit-related contingencies, such as loans where the borrower's interest rate is linked to their credit rating, are standard in many loan agreements. Including this information with contingent features users are concerned about will not be decision-useful, and users will need to isolate the relevant information for their needs from the aggregated disclosure. Moreover, disclosing the quantitative range of possible increases or decreases for different contingent features could be misleading (e.g., upon aggregation when the ends of the range may not be applicable to the majority of the population).

Furthermore, referring to Question 6, these disclosure requirements would entail enormous operational efforts and changes to systems within each institution. Many global financial institutions operate with a broad range of products which will fall within the scope of the proposed disclosures, most notably credit-related contingencies. Considering the volume and variety of contingent features, there will be significant operational effort and cost to collect information on every type of contingency within an institution and the effort to maintain this process will be extensive and burdensome. This requires enormous effort that cannot be handled by many institutions' current information systems and entities will need to upgrade their IT systems to meet the disclosure requirements.

In addition to that, contingent features are one element of the overall SPPI analysis. Specifically calling out contingent features to have specific IFRS 7 disclosure requirements would arguably give rise to an inconsistent approach. We also note that existing disclosure requirements would require identification and disclosure of any material significant judgment applied in assessing whether instruments pass SPPI.

Consequently, we recommend that the IASB develop more targeted disclosure requirements to align with user feedback as noted in BC99 of the Exposure Draft. We believe that a qualitative approach (i.e., removing the requirement for quantitative disclosures) on the contingent events that could change the timing or amount of contractual cash flows of financial assets would still provide meaningful information without creating undue complexity or burden to users.

Another concern raised by the members of the IIF is related to the interaction of this disclosure requirement with other projects such as the IFRS 9 impairment PIR, FICE, and amortized cost pipeline project. Including the discussion around additional disclosures into these projects could reduce duplicative work effort.

We thank the IASB for its consideration of our comments and welcome any additional stakeholder engagement around this topic to help the IASB in its efforts around IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures*. If you have any questions, please do not hesitate to contact Martin Boer at mboer@iif.com or Tim Steinhoff at tsteinhoff@iif.com.

Sincerely,

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