European Securities and Markets Authority

The Chair
24 January 2022
ESMA32-339-197

Mr Andreas Barckow
Chairman
International Accounting Standards Board (IASB)
Columbus Building
7 Westferry Circus, Canary Wharf
London
E14 4HD
United Kingdom

Ref: IASB's Request for Information on the Post Implementation Review of IFRS 9 – Classification and Measurement

Dear Mr Barckow,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the IASB's Post Implementation Review (PIR) of IFRS 9 *Financial Instruments* Classfication and Measurement. ESMA supports the IASB's objective to bring transparency, accountability and efficiency to financial markets by providing high-quality accounting standards.

ESMA strongly supports PIRs as an opportunity to assess how issuers apply in their financial statements the IFRS requirements and how these can be further improved to address any issues that may challenge consistent application, enforceability and usefulness to users of financial statements.

Our answers to the IASB's Request for Information (RFI) included in Appendix to this letter are based on the evidence from supervision and enforcement activities undertaken by European enforcers on financial statements as discussed within the European Enforcers Coordination Sessions (EECS) and the Financial Institutions Task Force (FITF).

When discussing the financial reporting issues related to the IFRS 9 Classification and Measurement requirements, ESMA identified selected areas for which it believes the IASB could intervene to improve clarity of the IFRS 9 requirements and provide further guidance to issuers.

In particular, ESMA calls on the IASB to provide more guidance on the assessment of whether sales of financial assets are compatible with the business model "held to collect" and the change in the objective of the entity's business model. Moreover, ESMA recommends that the

IASB provide additional guidance and/or examples on the assessment of whether the cash flows of certain assets with sustainability related features are cash flows that are solely payments of principal and interest. Due to the increasing importance of this issue, ESMA believes that it should be addressed by the IASB in a timely manner outside the PIR.

Furthermore, ESMA recommends that the IASB provide further explanations on assessing when modified financial instruments shall be derecognised, including criteria for derecognition and practical examples illustrating the application of those criteria. In addition, ESMA would welcome further guidance on the question of whether conditions attached to the interest rate should be reflected in the estimates and revisions of expected future cash flows when determining the effective interest rate.

Finally, ESMA believes that some fact patterns related to the classification of non-derivative financial instruments as held for trading may warrant further guidance from the IASB.

In case you have any questions or comments please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department.

Yours sincerely,

signed

Verena Ross

Appendix

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?

1. We refer to our comments on Question 3.

Question 2 – Business model for managing financial assets

a) Is the business model assessment working as the Board intended? Why or why not?

b) Can the business model assessment be applied consistently? Why or why not?

c) Are there any unexpected effects arising from the business model assessment? How significant are these effects?

2. Over the last years, European enforcers have discussed several cases related to the assessment of changes in business models for managing financial assets and consequences of these changes for the measurement of the financial assets. ESMA finds that the provisions of IFRS 9 regarding the determination of a business model are mostly adequate. However, ESMA notes that it is not always easy to assess (i) whether sales of financial assets are compatible with the business model whose objective is to hold financial assets in order to collect contractual cash flows ("held to collect"), (ii) whether the sales meet the reclassification requirements in paragraphs 4.4.1 and B4.4.1-B4.4.3 of IFRS 9 and (iii) how to determine the reclassification date.

Compatibility of sales with the 'held to collect' business model.

3. According to the application guidance in IFRS 9 (paragraph B4.1.2C), the frequency, value and timing of sales in prior periods, the reasons for those sales and expectations about future sales activity should be considered when determining whether cash flows are realised by collecting the financial assets' contractual cash flows (business model 'held to collect'). The business model can be "held to collect" even when sales of financial assets occur or are expected to occur in the future (paragraph B4.1.3.). This applies in particular when the sales are due to an increase in the assets' credit risk (paragraph B4.1.3A). Sales for other reasons may also be consistent with the business model "held to collect" if those sales are infrequent or insignificant in value both individually and in aggregate. However, significant and frequent sales in a particular period can also be consistent with the held to collect business model if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's business model (paragraph B4.1.3B). An example for such explanation provided in the standard is the sale of financial assets during an unexpected stress case in order to meet the entity's liquidity needs (paragraph B4.1.4 Example 4). In addition, selling assets close to their maturity with proceeds

approximately equal to remaining contractual cash flows does not prevent classification as held to collect either (paragraph B4.1.3B).

4. In a case discussed by European enforcers, an issuer did not consider sales of financial assets up to an annual amount of 5% of the held to collect portfolio value at the end of the previous annual reporting period as significant or frequent. Sales due to an increase in credit risk were not included in this threshold. In this connection, enforcers observed that IFRS 9 does not explain how “infrequent” and “insignificant in value” should be determined in practice. More specifically, it is not clear what the relevant reference point (e.g. portfolio size, portfolio total return) and reference period (e.g. entire life of the portfolio or comparison on the period-by-period basis) are. ESMA acknowledges that judgement is an inherent aspect of principle-based standards. However, given the need to exercise a very high degree of judgement in this case and the risk of potential overlap between the business models “held to collect” and “held to collect and sell”, ESMA believes that the standard could provide further guidance or illustrative examples which would help to assess the frequency and significance of sales. Moreover, ESMA would welcome further guidance or examples of how an entity can demonstrate that certain frequent and significant sales that occur in a particular period (B4.1.3B) do not reflect a change in the entity’s business model.

Meeting the reclassification requirements in paragraphs 4.4.1 and B4.4.1-B4.4.3 of IFRS 9.

5. Paragraph 4.4.1 requires an entity to reclassify financial assets when there is a change in the objective of the entity’s business model for managing those financial assets. Paragraph B4.4.1 states that such changes (a) are expected to be very infrequent, (b) must be determined by the entity’s senior management as a result of external or internal changes, (c) must be significant to the entity’s operations, and (d) must be demonstrable to external parties. Examples of a change in business model provided in the same paragraph include a change in portfolio management following an acquisition of a company and due to the shutting down of the retail mortgage business. Furthermore, according to paragraph B4.4.3, a change in intention related to particular financial assets, the temporary disappearance of a market, or a transfer of financial assets between parts of the entity with different business models do not constitute a change in business model.

6. European enforcers discussed several cases related to the assessment of compliance with the criteria for reclassification of the financial assets as a result of internal changes in response to adverse changes in market conditions or increased capital pressure and observed reclassifications fo financial assets (e.g. reclassifications from the fair value through other comprehensive income (FVOCI) measurement category to the amortised cost (AC) category in accordance with paragraph 5.6.5). Such changes were assessed by the entities’ senior management as changes in business model.

7. Based on the case discussions, ESMA believes that the IASB should provide more guidance or examples regarding the demonstrability of a change in the objective of the entity’s business model to external parties and significance for the entity’s operations, also when internal changes mentioned in paragraph B4.4.1 are triggered by changes in market conditions.

Determination of the reclassification date.

8. Paragraph B4.4.2 of IFRS 9 requires that a change in the business model must occur before the reclassification date which is defined in Appendix A of IFRS 9 as 'the first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets'. In ESMA's view, it is not clear whether the term 'reporting period' also includes interim reporting periods for which the entity prepares interim financial statements. ESMA considers therefore that the notion of reclassification date/reporting period should be clarified.

Question 3 – Contractual cash flow characteristics

a) Is the cash flow characteristics assessment working as the Board intended? Why or why not?

b) Can the cash flow characteristics assessment be applied consistently? Why or why not?

c) Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?

9. European enforcers discussed the question of whether the cash flows of certain assets with sustainability related features, which are also referred to as assets with environmental, social or governance (ESG) features, are cash flows that are solely payments of principal and interest (SPPI). This relates in particular to assets with interest rates linked to ESG indicators or other environmental metrics related to the borrower (e.g. compliance with CO_2 emissions standards). The interest rate of these instruments is periodically adjusted to reflect changes in meeting the performance metrics.

10. Based on these discussions, ESMA believes that the IASB should provide additional guidance and/or examples on the assessment whether or not the ESG-features are part of the basic lending agreement and, in particular, whether ESG-linked interest rate adjustments represent compensation for the entity's exposure to the ESG risk of the borrower or the compensation for credit risk.

11. ESMA notes that this issue is of great importance for many European issuers and notes that there are substantial concerns that, with the increasing volume of issuances of debt instruments with ESG-linked features, significant diversity in practice might arise as regards compliance of those instruments with the SPPI criterion. Therefore, ESMA considers that the application of the SPPI requirements to assets with sustainability-linked features should be addressed by the IASB in a timely manner outside the PIR. ESMA notes, however, that this specific issue cannot be assessed in isolation and requires a closer look at the broader question of when the application of the effective interest method provides information about the uncertainty, timing and amount of the contractual cash flows that is useful to users of financial statements.

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?

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

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?

12. ESMA believes that the current option to present fair value changes on investments in equity instruments in OCI is working as the Board intended. ESMA reiterates its view, expressed in the past,[1] that there is no evidence that provides appropriate basis to conclude that recycling needs to be reintroduced to support long-term investments. We also remain concerned that “recycling may introduce in some cases, and especially for financial institutions, short-term accounting incentives to put in place opportunistic profit-taking disposal policies, thus sustaining earnings management practices, which would be contrary to the objective of encouraging long-term investments.”

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?

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)?

13. ESMA does not have any comments on this question.

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?

b) Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?

14. ESMA notes that IFRS 9 does not provide substantive guidance on when a modification of a financial asset results in its derecognition. ESMA notes that this issue has significant practical relevance, especially in the context of COVID-19 where a variety of economic support and relief measures have been taken by governments. Relief measures have also been provided by issuers to borrowers on a voluntary basis. These measures often

[1] We refer to ESMA response to the EFRAG consultation on Equity Instruments – Research On Measurement Project (https://www.esma.europa.eu/sites/default/files/library/esma32-61-353_response_to_efrag_questionnaire_fair_value.pdf) and ESMA response to EFRAG’s Discussion Paper Equity Instruments – Impairment and Recycling (https://www.esma.europa.eu/sites/default/files/library/esma32-61-259_esma_response_to_efrag_dp_equity_instruments_-_impairment_and_recycling.pdf).

required an assessment of whether the modifications of the financial assets result in derecognition of these assets.

15. For example, in some cases discussed by European enforcers, restructuring measures with regard to some loan contracts accounted for at amortised cost resulted in a situation where the contractual cash flows of the modified loan could no longer be considered as SPPI. This raised the question of whether such changes are so fundamental as to require derecognition of the original instrument, considering that failing the SPPI test is not a trigger for a reclassification out of amortised cost under IFRS 9 (IFRS 9 limits such reclassification to changes of business model).

16. Taking into account the limited guidance in IFRS 9, ESMA suggests that, to avoid diversity in accounting, the standard should provide further explanations on assessing when a modified financial asset shall be derecognised, including criteria for derecognition and practical examples illustrating the application of those criteria.

17. Moreover, ESMA observes diversity in practice in the application of the guidance in paragraphs 3.3.2 and B3.3.6 regarding the determination of whether the modification of a financial liability is substantial. In particular, ESMA notes that, in addition to the quantitative criterion in paragraph B3.3.6, qualitative criteria are applied by issuers. The application of these qualitative criteria occasionally results in (a) derecognition of a liability although the 10%-threshold is not exceeded or (b) omission of derecognition despite breaching the 10%-threshold. ESMA recommends that the IASB provide additional guidance on the application of the qualitative criteria.

18. In addition, ESMA noted that the requirements in paragraphs 5.4.3 and B3.3.6 regarding the accounting treatment of the costs or fees incurred in connection with the modification of a financial asset or a financial liability that does not result in the derecognition of that asset or liability are not sufficiently clear. Paragraph 5.4.3 requires that the gross carrying amount of the modified financial asset shall be recalculated using the financial asset's original effective interest rate (EIR). On the other hand, according to the same paragraph, any cost or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of this asset. However, amortisation of the fees/costs over the remaining term seems to imply an adjustment to the EIR. The same applies to similar requirements in paragraph B3.3.6 with regard to modified financial liabilities. ESMA recommends that the IASB clarifies the accounting treatments of costs and fees.

Question 7 - Amortised cost and the effective interest method

a) Is the effective interest method working as the Board intended? Why or why not?

b) Can the effective interest method be applied consistently? Why or why not?

19. European enforcers observed that the application of the guidance in paragraph B5.4.6 of IFRS 9 regarding the accounting treatment of changes in estimates of payments or receipts resulting from the financial assets and financial liabilities measured at amortised cost (excluding modifications in accordance with paragraph 5.4.3 or changes in estimates of expected credit losses) is not always clear. For example, in one case discussed by European enforcers, the borrowing rate applicable to some loans was linked to the

achievement of predefined lending performance thresholds in the specified periods. Interest was settled in arrears on the maturity of the loan. In this case, it was not clear how the changes in the assessment of reaching the thresholds shall be treated by the lender.

20. ESMA believes that further guidance should be provided by the IASB on the question of whether conditions attached to the interest rate should be reflected in the estimates and revisions of expected future cash flows when determining the effective interest rate.

21. Moreover, based on the discussions around the above mentioned case, ESMA would find it helpful if the IASB could provide additional guidance on when an interest rate (or a component of an interest rate) should be considered floating for the purpose of determining whether the effective interest rate of a financial instrument needs to be adjusted in accordance with the requirements in paragraph B5.4.5.

Question 8 – Transition

a) Did the transition requirements work as the Board intended? Why or why not?

b) Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not?

22. ESMA does not have any comments on this question.

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?

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?

23. ESMA observes that some fact patterns related to the classification of non-derivative financial instruments as held for trading may warrant further guidance from the IASB.

24. As defined in Appendix A of IFRS 9, non-derivative financial assets or financial liabilities are considered as held for trading if they (a) are acquired or incurred principally for the purpose of selling or repurchasing it in the near term, or (b) on initial recognition are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking. Moreover, paragraph BA.6 states that trading generally reflects active and frequent buying and selling, and financial instruments held for trading are generally used with the objective of generating a profit from short-term fluctuations in price or dealer's margin. Further guidance regarding financial liabilities which also refers to short-term profit-taking can be found in paragraph BA 7.

25. ESMA notes that in practice it is not always clear when short-term profit taking is present. For example, in a case discussed by European enforcers, a bank issued structured liabilities (certificates) that met the definition of hybrid contracts in paragraph 4.3.1 of IFRS

9. The instruments were issued to satisfy clients' investment needs and contributed to the bank's profitability through structuring fees implied in the pricing of the host instrument and of the derivative components and by means of imperfect hedging of the risks associated with the instruments (holding an open residual position). The instruments were usually held by lenders until maturity and could also be exchanged in the secondary market. The only reason for the bank to repurchase the certificates was to provide liquidity to the market as market maker, which did not include earning profits on the bid ask-spread. All risk positions embedded in the certificates and related hedges were managed by trading desks belonging to the trading business unit of the bank. Even if the frequency of these buybacks was rather limited and in line with the volumes of securities that were classified at amortised cost, the bank classified the securities issued as financial liabilities held for trading.

26. In another case discussed, following the decision to divest its ownership in Company A (100% subsidiary of the issuer), the issuer gradually reduced its stake in the issued share capital of Company A to 12% (initially it had control and subsequently a significant influence over Company A). The objective of the issuer was to sell all the shares in Company A within 12 months. As it was expected that the remaining stake would be sold within a year from the balance sheet date, the investment in Company A was presented as a current financial asset under IFRS 9 and measured at fair value through OCI. Based on the definition in appendix A it could be argued that the remaining stake should be classified as held for trading because the asset is acquired for the purpose of selling in the near term.

27. When discussing these cases, European enforcers noted that clarification in IFRS 9 would be helpful as to whether active and frequent buying and selling is a necessary prerequisite for classification as held for trading or whether there are exceptions to this principle. If there are situations where classification as held for trading is required despite the absence of active and frequent buying and selling, ESMA would welcome examples of such patterns. It might also be helpful to provide additional clarity on when assets acquired for the purpose of selling in the short term do not meet the definition of assets held for trading.