The Chair
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Dr Wolf Klinz
EFRAG FRB Chair
European Financial Reporting Advisory Group (EFRAG)
35 Square de Meeûs
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Ref: EFRAG's due process on the IASB's Exposure Draft Amendments to the Classification and Measurement of Financial Instruments

Dear Dr Klinz,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to EFRAG's due process with regards to Exposure Draft ED/2023/2 *Exposure Draft Amendments to the Classification and Measurement of Financial Instruments.* We are pleased to provide you with the following comments with the aim of improving the consistent application and enforceability of IFRS in the European Union.

ESMA, like EFRAG, supports the IASB's proposal to permit an entity to deem a financial liability that is settled using an electronic payment system to be discharged before the settlement date if specified criteria are met. To improve consistency in the application, ESMA considers that better clarity should be provided on when the liability is derecognised when an entity elects to apply the proposed requirements.

ESMA welcomes the IASB's intention to clarify the notion of a basic lending arrangement which is key for the assessment of the SPPI criterion. However, ESMA has concerns that the proposed changes could have unintended consequences. Moreover, unclarity may arise as to when specific features of a financial instrument (e.g. certain ESG-related futures) will represent cost of lending. Therefore, ESMA considers that further clarifications on the application of requirements in paragraphs B4.1.8A and B4.1.10A as well as additional examples should be provided by the IASB.

ESMA supports the proposed clarifications regarding the assessment of contractual cash flow characteristics of financial assets with non-recourse features and contractually linked instruments.

Finally, while ESMA generally agrees with the proposed disclosure requirements, it is not clear to ESMA why an entity is no longer required to disclose the fair value of each instrument at the end of the reporting period and only should disclose the aggregate fair value of FV OCI equity instruments.

More detailed comments on the ED are set out in Appendix to this letter. In case you have any questions or comments please do not hesitate to contact me or Isabelle Grauer-Gaynor, Head of the Corporate Finance and Reporting Unit.

Yours sincerely,

[signed]

Verena Ross

Appendix

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?

1. ESMA supports the IASB's proposal to permit an entity to deem a financial liability that is settled using an electronic payment system to be discharged before the settlement date if specified criteria are met. ESMA considers that limiting the circumstances in which an earlier derecognition is allowed through the use of specified criteria will allow enhanced comparability of the financial statements adequately taking into account the concerns expressed by some stakeholders regarding the tentative agenda decision of the IFRS Interpretation Committee in September 2021 on electronic cash transfers.

2. ESMA notes that paragraph B3.1.2A of the ED that requires application of the settlement date accounting to financial assets and financial liabilities[1] does not include a definition of the settlement date and refers for further explanation to currently existing paragraph B3.1.6. The latter paragraph defines the settlement date as the date on which an asset is delivered to or by an entity and provides further explanations on how settlement date accounting is applied to assets. However, this paragraph does not include any guidance on the application of the settlement date accounting to liabilities. ESMA, like EFRAG, recommends that the IASB add such explanations. However, ESMA does not agree with the clarification proposed in paragraph 27 of EFRAG's draft letter. In particular, ESMA does not support that the settlement date is considered as the date on which cash is transferred from an entity's bank account as, in this case, the application of the settlement date accounting may, depending on the contractual terms, result in derecognition of a financial liability before this liability is discharged.

3. To avoid any ambiguity, ESMA also recommends that the IASB specifically explains how the settlement date concept applies to transactions that are not regular way purchases or sales, in particular OTC derivatives. ESMA has concerns that the requirement in paragraph B3.1.2A may otherwise be seen by some as conflicting with paragraph 3.1.1 of IFRS 9, which states that financial assets and financial liabilities are recognised when the entity becomes party to the contractual provisions of the instrument. Paragraph B3.1.2(c), which provides an example of the application of this principle to forward contracts within the scope

[1] In this context, paragraph BC10 of the ED IFRS 9 Basis for Conclusions explains that IFRS 9 currently already requires application of settlement day accounting to financial assets and financial liabilities, except for a regular way purchase or sale of financial assets.

of IFRS 9, explains that the contract 'is recognised as an asset or a liability on the commitment date, instead of on the date on which settlement takes place'.

4. Moreover, ESMA considers that the IASB should provide better clarity on when the liability is derecognised when an entity elects to apply paragraph B3.3.8. This paragraph states that the liability is to be discharged before the settlement date if, and only if, the entity has initiated the payment instruction and three conditions listed in this paragraph are met. Although paragraph B3.3.9 requires that the time between initiating a payment instruction and the cash being delivered is short, ESMA understands that the length of this time period could exceed one day. In this case, applying paragraph B3.3.8 in a situation where the payment instruction is initiated before the end of the reporting period and the settlement date is after the end of the reporting period may lead to inconsistent results (i.e. in some cases the liability will be derecognised in the financial statements prepared for the reporting period and in other cases not).

5. Finally, in the interest of better comparability, ESMA recommends that the IASB explore the possibility to require the application not only to all settlements made through the same electronic payment system, but to all settlements through all payment systems used by the entity.

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; and

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?

6. In its response to the IASB's Request for Information on the Post Implementation Review of IFRS 9 – Classification and Measurement[2] ESMA expressed the need to provide additional guidance on when the cash flows of a financial asset can be considered cash flows that are solely payments of principal and interest (SPPI) with reference to certain assets with environmental, social or governance (ESG) features. At the same time ESMA

[2] ESMA32-339-197 Letter to the IASB *IASB's Request for Information on the Post Implementation Review of IFRS 9 – Classification and Measurement*, 24 January 2022.

noted 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.

7. Against this background, ESMA welcomes the IASB's intention to clarify the notion of a basic lending arrangement which is key for the assessment of the SPPI criterion. In particular, ESMA supports the inclusion of the clarification that "the assessment of interest focuses on what an entity is being compensated for, rather than how much compensation an entity receives", which is currently in the Basis for Conclusion, in the standard (paragraph B4.17A of the ED). However, ESMA recommends clarification in this context that "de minimis" principle of paragraph B4.1.18 still applies. ESMA also agrees that the term 'basic lending arrangement' should refer to the nature of a lending arrangement, rather than to an arrangement that is common or widespread in a particular market or jurisdiction (paragraph BC51 of the ED Basis for Conclusions).

8. Moreover, ESMA strongly supports the IASB's conclusion that creating an exception from the requirements on contractual cash flow characteristics in IFRS 9 for financial assets with ESG linked features would not be appropriate.

9. However, ESMA has concerns that, with the proposed changes, unclarity may arise on when specific features of a financial instrument (e.g. certain ESG-related futures) will represent cost of lending rather than an exposure to factors unrelated to a basic lending arrangement. In addition, the application of the amended requirements could result in unintended consequences in the coming years given the pace of financial innovation and introduction of new features by market participants.

10. In relation to the requirements in paragraph B4.1.8A, ESMA specifically notes that, to be consistent with a basic lending agreement, a change in contractual cash flows has to be aligned with the direction and magnitude of the change in basic lending risks or costs. The ED does not provide further explanations on how this consistency can be assessed. Given that, as indicated in paragraph 47 of the Basis for Conclusions, in the IASB's view a quantitative analysis is not necessarily required to demonstrate the consistency, ESMA considers it would be very useful to provide guidance on how the assessment of consistency can be conducted. In particular, the comparison of the magnitude of changes could be subject to significant judgement and highly subjective in practice. In this context, ESMA recommends that the IASB explains how so-called "punitive rates", where increase in the interest rate upon a missed payment is not commensurate with the increase in the expected credit losses of the instrument, should be treated.

11. ESMA understands that, for instruments whose cash flows may change following the occurrence (or non-occurrence) of a contingent event, the compliance with the conditions in paragraph B4.1.10A of the ED does not automatically imply that the instrument only gives rise to cash flows that are solely payments of principal and interest. Against this background, the analysis of the instrument EA included as an example in paragraph B4.1.13 seems to be incomplete as it does not explain, for example, the alignment of changes in an instrument's cash flows with the direction and magnitude of the change in basic lending risks and costs. ESMA also encourages the IASB to provide more (and

possibly more complex) examples, in addition to the example with instrument EA, of how the requirements of paragraphs B4.1.8A and B4.1.10A should be applied in practice.

12. With regard to requirements in paragraph B4.1.10A, ESMA notes that they are rule-based in nature and the ED provides very little explanations on why certain contractual terms are consistent with a basic lending agreement. While ESMA understands the practical difficulties in finding a comprehensive principle-based definition of a basic lending arrangement, it encourages the IASB to further elaborate on the reasons of why certain features (e.g. ESG-linked features) represent cost of lending. This should, however, not be understood as a request for an exhaustive list of features representative of the cost of lending.

13. Moreover, ESMA considers that the concept of the contingent events specific to the debtor should be further clarified. For instance, it would be useful to clarify whether scope 3 emissions of entities are specific to the debtor.

14. Paragraph B4.1.10A explains that in order to be consistent with a basic lending agreement the contractual cashflows cannot represent an investment in the debtor. In order to avoid structuring opportunities ESMA proposes to clarify that an investment in the debtor exists even if there is only an indirect link between the instrument's cash flows and the revenues or profits, e.g. the instrument's cash flows are linked to an increase in the market share of the debtor or in the number of new opening stores.

15. Finally, ESMA, similarly to EFRAG, considers it helpful to include in IFRS 9 a definition of a contingent event.

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?

16. ESMA welcomes the provision of additional guidance on the assessment of the contractual cash flows characteristics of financial assets with non-recourse features.

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?

17. ESMA agrees with the proposed clarifications related to contractually linked instruments. However, ESMA considers it would be useful to provide additional clarity on which specific characteristics of the secured lending assessment described in new paragraph B4.1.20A are key for the conclusion that this arrangement does not contain multiple contractually linked instruments. In particular, the IASB could clarify the assessment in the following alternative scenarios:

    a) the senior tranche was held by more than one creditor, or

    b) the junior tranche is held by another creditor (i.e., an entity different from the debtor).

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; and

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?

18. ESMA agrees with the proposed amendments to paragraph 11A(f) that require entities to disclose the changes in fair value of the equity instruments designated at fair value through other comprehensive income (FVOCI equity instruments) during the period, separately disclosing (a) the amount related to investments derecognised during the reporting period and (b) the amount related to investments held at the end of the reporting period. However, ESMA encourages the IASB to consider whether a disclosure of the full amount of fair value changes accumulated in other comprehensive income for investments derecognised during the reporting period would also be useful information about the performance of the FVOCI equity instruments.

19. With regard to the proposed amendment to paragraph 11A(c), it is not clear to ESMA why an entity is no longer required to disclose the fair value of each instrument at the end of the reporting period and only should disclose the aggregate fair value of FV OCI equity instruments. ESMA considers that separate disclosure of the fair value of material investments in FVOCI equity instruments at the end of the reporting period is useful information to help users to evaluate the performance of those equity investments.

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?

20. ESMA agrees with the proposed disclosure requirements, as these disclosures will enable users of financial statements to understand the effect of contractual terms that could change the timing or amount of contractual cash flows as well as the extent of an entity's exposure to such contingent events.

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?

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