European Securities and Markets Authority

ESMA REGULAR USE

The Chair

9 February 2021
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Sue Lloyd
Chair
IFRS Interpretation Committee
Columbus Building
7 Westferry Circus
Canary Wharf, London E14 4HD
United Kingdom

Agenda Item Request: Accounting for the TLTRO III transactions (IFRS 9, IAS 20)

Dear Ms Lloyd,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that enhances the protection of investors and promotes stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. In the context of ESMA's supervisory convergence work in the area of financial reporting, I would like to raise with you an issue related to the application of IFRS 9 *Financial Instruments* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance.* ESMA has identified diversity in the application of the requirements of IFRS 9 and IAS 20 in relation to the accounting treatment of the European Central Bank's Targeted Longer-Term Refinancing Operations (TLTRO III) by banks.

Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee (IFRS IC) considers clarifying the relevant accounting requirements. A detailed description of the case is set out in the appendix to this letter. We would be happy to further discuss this matter with you.

In case you have any questions or comments regarding this letter, I suggest you contact Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Steven Maijoor

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1 Description of fact pattern

1. The targeted longer-term refinancing operations (TLTROs) are operations of the European Central Bank (ECB) that provide financing to credit institutions. The TLTROs are targeted operations, as the amount that banks can borrow is linked to their loans to non-financial corporations and households. By offering banks long-term funding at attractive conditions they stimulate bank lending to the real economy.
2. The third TLTRO programme (TLTRO III) consists of ten refinancing operations, each with a maturity of three years, starting in September 2019 with a quarterly frequency. During 2020, some of the transaction parameters were modified to support the continued access of businesses and households to bank credit in the face of disruptions and temporary funding shortages associated with the COVID-19 pandemic.
3. The borrowing rate applicable to the TLTRO III loans is linked to the lending patterns of the participating banks. The reduced interest rates are subject to the achievement of predefined lending performance thresholds based on the eligible net lending of the bank in the specified periods.
4. The borrowing rate in these operations for banks which do not achieve lending performance thresholds is the average ECB interest rate on the main refinancing operations (MRO rate) over the life of the respective refinancing operation. However, during the periods from 24 June 2020 to 23 June 2021 and from 24 June 2021 to 23 June 2022, the borrowing rate is 50 basis points below the average MRO rate over the respective period.
5. For banks that reach the lending performance threshold during the predefined reference periods the borrowing rates can be as low as 50 basis points below the average interest rate on the deposit facility (DFR) during the periods from 24 June 2020 to 23 June 2021 and from 24 June 2021 to 23 June 2022, and as low as the average interest rate on the deposit facility during the rest of the life of the respective TLTRO III transaction.[1]
6. Interest will be settled in arrears on the maturity of each TLTRO III operation or on early repayment.
7. The modifications of the TLTRO III transaction parameters related to the introduction of a lower borrowing rate during the special interest rate periods from 24 June 2020 to 23 June 2021 and from 24 June 2021 to 23 June 2022 were made on 30 April 2020 and on 10 December 2020[2] respectively.

[1] For details on the terms of the TLTRO III operations see information published on the ECB's website: https://www.ecb.europa.eu/mopo/implement/omo/tltro/html/index.en.html.

[2] The decision of the ECB's Governing Council to extend the period of favourable interest rates to June 2022 took effect on 3 February 2021, when the corresponding amendments to the TLTRO III conditions were published in the Official Journal of the European Union.

2 Rationale for submission

a) Accounting for the transactions according to requirements of IFRS 9 or IAS 20.

8. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified diversity as to whether IAS 20 requirements are applied to the TLTRO III transactions.

9. Generally, financial instruments are accounted for according to the requirements of IFRS 9. However, the benefit of a loan at a below-market rate of interest is accounted for in accordance with IAS 20 provided that the loan is received from a party qualified as "government, government agencies and similar bodies" as defined by the standard. More specifically, according to IAS 20, the benefit of the below-market rate of interest (measured as the difference between the initial carrying value of the loan determined in accordance with IFRS 9 and the proceeds received) shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

b) Use of discrete or "blended" effective interest rates to calculate the interest expense

10. As the borrowing rate for banks which do not achieve lending performance thresholds during the special interest rate periods is 50 basis points lower than the borrowing rate applicable for the remaining term of the loan, there are different views on how to calculate the applicable effective interest rate. In particular, it is questionable whether it is necessary to use discrete interest rates for the calculation of the interest expense on the loans in each individual accounting period or whether an average ("blended") effective interest rate should be applied for the entire term of the loan. Another view is that there is an accounting policy choice with regard to these two methods. This question arises regardless of whether IAS 20 is eligible.

c) Accounting treatment of the changes in estimates of payments due to revised assessment of meeting the eligibility criteria upon application of IFRS 9

11. There are different approaches to the accounting treatment of changes in estimates of payments due to a change in the assessment of whether the lending performance thresholds will be reached. The change in the assessment may also result from the ECB's modifications of the TLTRO III transaction parameters (see paragraph 7) with a retrospective effect on the interest rate applied. The issue in question is whether recalculation of the amortised cost of the financial liability in accordance with the paragraph B5.4.6 of IFRS 9 is required as result of those changes.

3 Current practice

a) Accounting for the transactions according to requirements of IFRS 9 or IAS 20.

View 1: TLTRO III transactions are loans at a below-market interest rate and include benefits which are treated as government grants according to IAS 20

12. Proponents of view 1 note that TLTRO III transactions allow banks to refinance at potentially very favourable conditions. In particular, depending on the time period and achievement of the lending performance thresholds the borrowing rate might be significantly under MRO rate. Moreover, during the special interest rate periods which were introduced later on in the context of the COVID-19 pandemic, the borrowing rate can even be as low as the average DFR minus 50 basis points. Bank refinancing at these interest rates is quite low compared to the current refinancing costs of many banks. Therefore, proponents of view 1 believe that TLTRO III transactions are loans at a below-market interest rate. In their view, the favourable rate is compensation for the banks' financing cost over the related period.
13. IFRS 9 provides for the basis of accounting for financial instruments, whether at market rate or at below-market interest rate. However, IAS 20 deals with the accounting for any benefit of a government loan at below-market rate of interest. Proponents of view 1 note that the TLTRO III are provided by the ECB, which is the central bank of the 19 European Union countries and, as such, not a government. However, paragraph 3 of IAS 20 defines government as governments, government agencies and similar bodies whether local, national or international. There is no specific guidance in IAS 20 on which institutions can be considered similar bodies. Since the ECB is a supra-national public institution, one of the institutions of the European Union, proponents of view 1 believe that the ECB shall be considered a similar body under this definition. Moreover, considering the explanations on the TLTRO III transactions and changes to its conditions by the ECB[3] ("preserve the very attractive funding conditions", "support banks' efforts to keep credit flowing to the real economy in a time of high stress", "provides for further incentives for banks", "ensure that counterparties can flexibly benefit from the prolonged support"), proponents of view 1 consider that the benefit of a below-market rate of interest from ECB corresponds to a government grant, as defined in paragraph 3 of IAS 20 ("assistance by government in the form of transfers of resources to an entity in return for past of future compliance with certain conditions relating to the operating activities of the entity").
14. In result, under view 1, the TLTRO III transactions are loans at a below-market interest rate which benefits shall be treated as government grants according to IAS 20.
15. IAS 20 provides guidance on the recognition of government grants in profit or loss. According to paragraph 8, a government grant is recognised only when there is reasonable assurance that the conditions attached to it are met. Paragraph 10A explains the measurement of the benefit of the below-market rate of interest and paragraph 12 requires the recognition of that benefit in profit or loss on a systematic basis over the periods in

[3] https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr201210_1~e8e95af01c.en.html

which the entity recognises as expense the related costs that the grant is intended to compensate.

16. However, with regards to TLTRO III transactions, it is not clear which costs are intended to be compensated by the benefit of these transactions and in which period the corresponding expenses are recognised by the banks. According to one view, once the relevant conditions are met, the benefit will be spread over the remaining time of the transaction. Proponents of another view argue that the period is determined by timing of bank's lending to non-financial corporations and households, to which the TLTRO III interest rate is linked.

17. In addition, it is not clear whether the requirements of IAS 20 regarding the presentation of grants related to assets can be applied to the TLTRO III transactions. According to paragraph 24, two methods of presentation of grants are regarded as acceptable, recognising grant as deferred income or deducting grant when calculating the carrying amount of the asset. According to one view, the second method could be applied to the TLTRO III transactions by analogy. Proponents of this view consider it permissible to add the amount of the benefit of the TLRTO III loan when calculating the carrying amount of the TLTRO III liability. According to another view, this analogy is unacceptable.

View 2: TLTRO III transactions are accounted for as loans at a market interest rate according to IFRS 9

18. The fair value of the loan is determined in accordance with IFRS 13 *Fair Value Measurement* as an "exit price". A fair value measurement of a liability assumes thereby that the liability is transferred to a market participant at the measurement date. The relevant market is the principal market or, in absence of a principal market, the most advantageous market which the borrower has access to. Even when there is no observable market to provide pricing information about the transfer of a liability at the measurement date, a fair value measurement shall assume that a transaction takes place at that date using the assumptions that market participants would use when pricing the liability. Since there is no secondary market for the TLTRO III loans, the borrowers need to develop those assumptions considering factors specific to the liability, the relevant market and the market participants as required by paragraph 23 of IFRS 13.

19. Proponents of view 2 argue that, when developing the measurement assumptions, it should be taken into account that the TLTRO III transactions, where the borrowing rate is linked to the lending behaviour of banks, have unique conditions. Different interest rates may apply to banks participating in TLTRO III transactions, and even for a given bank, different interest rates will apply over the life of the loan. These conditions make them hardly comparable to other bank refinancing instruments, so that there are no suitable benchmarks for TLTRO III loans. Taking into account these observations, proponents of view 2 consider that it is reasonable to assume that TLTRO III transactions are not at below-market interest rates but rather at market.

20. Moreover, proponents of view 2 argue that even if the TLTRO III transactions were at a below-market interest rate, they still would not meet the definition of government grants under IAS 20. First of all, the definition of government or similar bodies is not consistent with the status of central banks given their independence. Moreover, the ECB's very

specific tasks and responsibilities, which focus on defining and implementing the monetary policy in the Euro area, make this institution substantially different from governments or governmental agencies which typically provide economic benefits to businesses as part of their fiscally oriented measures. The character of the ECB's targeted longer-term refinancing operations, which declared objective is to support the accommodative stance of monetary policy, confirms this view.

21. Apart from that, proponents of view 2 point out that the purpose of the TLTRO-operations is to free up resources in the banking system for non-financial corporations and households, so that the main beneficiaries of the TLTRO III-loans are not the specific banks but rather those entities to which banks might now lend, or even the banking system.

22. Furthermore, proponents of this view note that the accounting treatment of a grant according to IAS 20 assumes that there is an expense which the grant compensates for. It is not clear how this would apply to a lending facility from a central bank to a financial institute which does not bind banks to any specific limitations on the interest rate applied to their customers.

23. For loans at below-market interest rate which do not meet the definition of a government grant in IAS 20, the difference between the transaction price and the lower fair value shall be treated according to paragraph B.5.1.2A(b) of IFRS 9. Assuming that unobservable inputs will be used in calculating the fair value of loans, this would result in recognition of that difference in profit or loss over the remaining life of the loan.

b) Use of discrete or "blended" effective interest rates to calculate the interest expense (regardless of whether IAS 20 is eligible)

View 1: Discrete interest rates shall be used

24. According to paragraphs 5.3.1 and 4.2.1 of IFRS 9, the TLTRO III loans are subsequently measured at amortised cost.[4] Interest expense on these loans shall be calculated by using the effective interest method, applying the effective interest rate (EIR) (paragraph 5.4.1 and Appendix A of IFRS 9). As the interest paid on the loans is linked to the DFR and/or MRO rate, the interest payments will vary with changes in those rates. However, even with an unchanged MRO rate, banks which do not achieve lending performance thresholds will apply different borrowing rates in different time periods to calculate the interest payments on the loans. The borrowing rate applied by those banks during the special interest rate periods is 50 basis points below the borrowing rate applied for the rest of the loan term.[5] Proponents of view 1 note that the borrowing rate applicable during the special interest rate periods was reduced by the ECB after the launch of the first TLTRO transactions in light of disruptions and temporary funding shortages associated with the COVID-19 pandemic. Therefore, according to view 1, it is reasonable to apply a lower EIR for the

[4] The fact that the interest rate is linked to the bank's lending activity does not imply the existence of an embedded derivate as defined in paragraph 4.3.1 of IFRS 9 because the non-financial variable is specific to the party to the contract.
[5] For example, the borrowing rate applied during the special interest rate period is -1,0% if the borrowing rate applied for the rest of the loan term is -0,5%.

calculation of the interest expense on the loans during the period when banks' lending behaviour was affected by the COVID-19, i.e. during the special interest rate periods.

View 2: A "blended" interest rate shall be used

25. Proponents of view 2 believe that a constant "blended" interest rate should be used over the entire life of the loan to calculate the interest expense on the loans for the TLTRO III refinancing operations launched after the loan terms were amended to introduce a lower borrowing rate during the special interest rate period (subject to the changes in the MRO rate[6] and potential EIR adjustments related to the achievement of the lending performance thresholds). In their argumentation, proponents of view 2 refer to Example B.27 in the Guidance on Implementing IFRS 9, which explains the calculation of the EIR for instruments with a predetermined rate of interest that increases or decreases progressively.

View 3: The use of a discrete or "blended" interest rate is an accounting policy choice

26. Proponents of view 3 point out that in contrast to the loans in Example B.27 the rate of interest of the TLTRO III is not predetermined. They consider TLTRO III instruments to be variable rate loans, as their interest rate is linked to the DFR and/or MRO rate and to the lending patterns of the participating banks. Proponents of view 3 acknowledge that entities normally account for periodic floating-rate payments on an accrual basis in the period they are earned. However, they believe that for reasons of practicability a constant "blended" interest rate may also be used as an accounting policy choice.

c) Accounting treatment of the changes in estimates of payments due to revised assessment of meeting the eligibility criteria upon application of IFRS 9

View 1: Immediate recognition of amortised cost adjustment in profit or loss

27. Proponents of view 1 believe that any changes in the estimates of payments resulting from the revised assessment of reaching the lending performance thresholds should be accounted for according to paragraph B5.4.6 of IFRS 9 as this paragraph is applied when an entity revises its estimates of payments or receipts (excluding modifications in accordance with paragraph 5.4.3 and changes in estimates of expected credit losses). Under this view, the bank shall recalculate the amortised cost of the financial liability, discounting the re-estimated future cash flows with the original EIR, and recognise the adjustment to amortised cost in profit or loss. It is, however, not clear how the changes in cash flows that relate to the period before the change in the assessment of reaching the thresholds should be treated when calculating the new amortised cost under this view. To answer this question, it might be necessary to distinguish between the changes resulting from the bank's lending behaviour and those due to modifications of TLTRO III conditions by the ECB.

[6] Current MOR rate of 0 % was set by the ECB on 16 March 2016.

View 2: Adjustment of the EIR due to the changes in estimates of payments

28. Proponents of view 2 note that the TLTRO III loans are floating-rate financial liabilities because the interest payed on the loans is linked to the DFR and/or MOR rate. In accordance with the specific requirements for floating-rate instruments under paragraph B5.4.5 of IFRS 9, no catch-up adjustment to profit or loss is recognised when the re-estimation of cash flows reflects movements in the market interest rates. Proponents of view 2 consider the application of the requirements of paragraph B5.4.5 to the TLTRO III loans to be appropriate. However, since the changes in the estimates might result bank's behaviour and from the modifications of loans conditions by the ECB, it is questionable, whether the changes in the estimates of payments can be considered the result of changes of market interest rates.

4 Request

29. ESMA seeks clarification on
    - How to assess whether the TLTRO III transactions involve loans at a below-market interest rate and, if so, whether the advantage of the below-market rate of interest needs to be accounted for according to the requirements of IFRS 9 or IAS 20 (see details under (a) in section 3 of this Appendix);
    - how to assess in which period the benefit of the TLTRO III transactions needs to be recognised, if the advantage of the below-market interest rate needs to be accounted for according to IAS 20 (see details under (a) in section 3 of this Appendix);
    - whether it is acceptable, in terms of presentation, to add the amount of the benefit of the TLRTO III loan when calculating the carrying amount of the TLTRO III liability (see details under (a) in section 3 of this Appendix);
    - how to calculate the applicable effective interest rate (see details under (b) in section 3);
    - whether the changes in estimates of payments due to revised assessment of meeting the eligibility criteria (i.e. achievement of predefined lending performance thresholds) should be accounted for in accordance with paragraph B5.4.6 of IFRS 9 requiring recalculation of the amortised cost of the financial liability or not (see details under (c) in section 3); and
    - how to account for changes in cash flows related to the prior period resulting from the bank's lending behaviour or from changes in TLTRO III conditions by the ECB (see details under (c) in section 3).
30. ESMA is of the view that the lack of clarity of the wording of IFRS 9 and IAS 20 leads to divergent practices of the European banks. Given the overall volume of the TLTRO III

operations, ESMA considers that this matter is relevant across the EU with a material effect on the financial statements of the affected banks.[7]

31. Consequently, ESMA invites the IFRS IC to clarify the applicable requirements.

[7] Please refer to ESMA Public Statement on the accounting for TLTRO III.