KPMG

Do green bonds contain embedded derivatives?

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If a company issues green bonds, then considering whether they are hybrid contracts with embedded derivatives is key when determining how to account for and present them in the financial statements.

What's the issue?

Green or sustainability-linked bonds are becoming increasingly popular with companies as a means of raising finance. These are debt instruments that are usually linked to funding or promoting corporate social responsibility by meeting either environmental, social or governance (ESG) targets. But do these bonds contain an embedded derivative that will require separation under IFRS 9 *Financial Instruments*?

Getting into more detail

What is a green or a sustainability-linked bond?

Generally, a green bond has strict terms that require the issuance proceeds to be allocated specifically for environmentally friendly or sustainability purposes (e.g. to upgrade a ventilation system in a factory to reduce harmful emissions).

However, a sustainability-linked bond's terms are more flexible in that its proceeds can be used for general corporate expenditure. An issuer of a sustainability-linked bond can commit explicitly to future improvements in sustainability metrics within a specific time period. If the target is met, then the issuer is rewarded financially via the bond's terms; if it is missed, then the issuer is penalised. For example, tyre-maker Z issues a five-year sustainability-linked bond with a 2.5% coupon and will use the proceeds to upgrade its production system to incorporate recycled rubber into its tyres. As part of the terms of the bond, Z commits to ensuring that each tyre it produces will contain at least 25% recycled rubber in three years' time. If the target is met, then the annual coupon payment on Z's bond will reduce by 0.5% to maturity, but if it is missed it will rise by 0.5%. Are these features an embedded derivative that requires separation?

Do these bonds contain an embedded derivative?

When making this assessment, an issuer considers first whether the green or sustainability-linked bond is a hybrid contract – i.e. one that includes both a non-derivative host instrument and one or more embedded derivatives. It then assesses whether an embedded derivative requires separation from the host contract (bifurcation) under IFRS 9. *[IFRS 9.4.3.1, B4.3.1]*

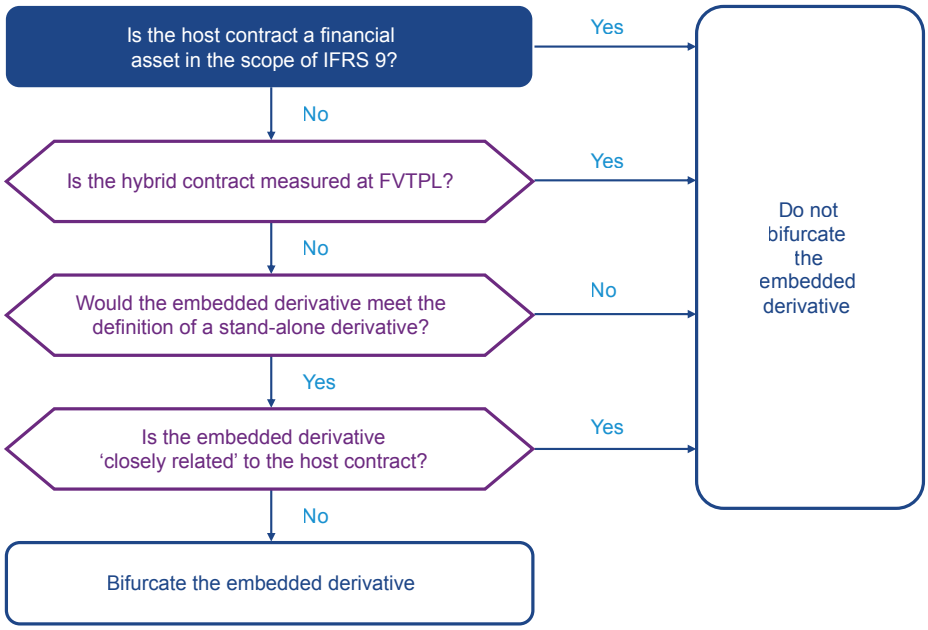
In our tyre-maker example, Z will need to assess whether the interest step feature is a separable embedded derivative. If it is, then Z has two financial instruments – a host instrument (the bond) measured at amortised cost and a derivative (the interest step-up feature) measured at fair value through profit or loss (FVTPL). If the fair value of the embedded derivative cannot be measured reliably, then Z measures the whole hybrid contract at FVTPL. *[IFRS 9.4.3.6]*

How does an issuer know when to separate an embedded derivative?

Under IFRS 9, an issuer separates an embedded derivative in a hybrid contract containing a financial liability host if:

- the economic characteristics and risks of the embedded derivative are not closely related to those of the host;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the hybrid contract is not measured at FVTPL. *[IFRS 9.4.3.3, B4.3.1]*

The following flowchart illustrates how an issuer applies these requirements.



In our tyre-maker example, the interest step feature might not meet the definition of a derivative if it were a separate instrument. The definition of a derivative excludes those instruments with a non-financial underlying variable that is specific to a party to the contract. Although IFRS® Standards provide no guidance on how to determine whether a non-financial variable is specific to a party to the contract, in our view, the analysis comprises two questions. *[Insights 7.2.30.60]*

- ***Is the variable non-financial or financial?*** In our example, it is a non-financial underlying variable because it is linked to the successful upgrading of the tyre manufacturing process.
- ***Is it specific to a party to the contract?*** In our example, it is specific to the tyre-manufacturer and its ability to incorporate recycled materials into its new tyres.

Therefore, the interest step-up feature in our tyre-maker example does not meet the definition of a derivative because the underlying variable that drives the value of the feature is non-financial and specific to the issuer. Tyre-maker Z accounts for the sustainability-linked bond as a financial liability measured at amortised cost, including the features of the non-separable embedded derivative as part of the contractual terms of the instrument. *[Insights 7.7.290.10]*

However, in other facts and circumstances this analysis might differ and issuers need to understand the details of the contractual terms and features when making their assessment.

Disclosures

IFRS 9 does not require separate presentation of separable embedded derivatives in the balance sheet. In our view, under certain circumstances, embedded derivatives that are separated from a host financial liability should be presented

together with the host contract – e.g. instruments with different measurement bases. For example, a host financial liability that is carried at amortised cost and a separated embedded derivative may be included in the same line item. *[Insights 7.10.310.40]*

A company is not required to present separable embedded derivatives as a separate line item in the balance sheet. However, it is required to disclose separately those financial instruments carried at amortised cost and those carried at fair value. Therefore, embedded derivatives that are separated from financial liabilities but not presented separately in the balance sheet are disclosed in the notes to the financial statements. *[Insights 7.2.380.10, 7.10.30.20]*

Actions for management to take now

Management need to consider the following.

- Could any of the contractual terms in issued green or sustainability-linked bonds be considered an embedded derivative?
- Is any embedded derivative in the hybrid contract required to be separated from the host contract (bifurcated) under IFRS 9?
- Are any embedded derivatives appropriately presented and disclosed in the issuer's financial statements?

References to 'Insights' mean our publication **Insights into IFRS**

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