Do green loans meet the SPPI criterion?

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Mahesh Narayanasami
Partner
KPMG US, DPP New York

What's the issue?

Generally, green loans have a feature(s) that adjusts their contractual cash flows (interest) when a borrower meets certain contractually specified environmental, social and governance (ESG) targets. For example, the contractual interest rate is reduced if the borrower meets specific targets for reducing carbon emissions or increased if the borrower does not meet those targets. These sustainability-linked adjustments to contractual cash flows generally give a borrower incentives to contribute to the development of green projects and minimise their negative impact on the environment. However, when a lender assesses the classification of green loans, a question arises over whether such sustainability-linked adjustments to contractual cash flows are consistent with the SPPI criterion – i.e. whether the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding. *[IFRS 9.4.1.2]*

Getting into more detail

An example of a green loan

Borrower X is a global commodity (crude oil) trading company. X enters into a borrowing agreement with a lender in which its base interest rate is USD LIBOR +1%. The spread is adjusted every year following the results of the sustainability assessment as follows.

Sustainability assessment – Total score*	Annual interest adjustment
200+	Sustainability discount (–0.03%)
100–199	No adjustment
0–99	Sustainability premium (+0.03%)

* Total score is calculated based on a predetermined formula using sustainability key performance indicators, which include air emissions programmes, oil spill disclosures and performance and complaints on emissions of effluents.

In this case, the lender needs to consider the interest adjustment feature in the context of the SPPI assessment under IFRS 9 *Financial instruments*.

SPPI assessment on green loans

If the sustainability-linked feature could only have a de minimis effect on the contractual cash flows of the loan, then it does not affect the classification of the loan. *[Insights 7.4.300]*

"Lenders will need to assess whether green loans with sustainability-linked features that adjust the contractual interest rates meet the SPPI criterion under the financial instruments standard, IFRS 9."

Mahesh Narayanasami
Partner
KPMG US, DPP New York

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In making this assessment, the lender considers the possible effect of the sustainability-linked feature in each reporting period and cumulatively over the life of the loan. However, if the effect of the sustainability-linked feature could be more than de minimis, then a lender needs to apply judgement to assess whether the feature would be consistent with a basic lending arrangement and meet the SPPI criterion.

It appears that a feature that makes a sustainability-linked adjustment to the contractual interest rate would not prevent the loan from meeting the SPPI criterion if it reflects compensation for a change in the credit risk of the financial asset. This would be the case if the adjustment is a reasonable proxy for a change in the credit risk of the financial asset. *[Insights 7.4.200.10–20]*

To reach this conclusion, it appears that the lender would need evidence that there is appropriate linkage between:

- the sustainability condition;
- the amount and direction of the adjustment to the cash flows; and
- the expected related change in credit risk, considering both the impact on probability of default and loss given default (e.g. on the value of collateral).

This assessment may require the exercise of judgement and the lender needs to consider the specific facts and circumstances, including the nature of the borrower's business, any collateral and any relevant market data.

If the effect of the sustainability-linked feature on the contractual cash flows of the loan could be more than de minimis and the SPPI criterion is not met, then the lender classifies the green loan as at fair value through profit or loss (FVTPL).

Disclosures

If a lender's judgements about the SPPI assessment have a significant effect on the amounts recognised in its financial statements, then it discloses those judgements. *[IAS 1.122]*

In addition, carrying amounts of financial assets measured at amortised cost and those measured at FVTPL are disclosed separately in the balance sheet or in the notes to the financial statements. *[IFRS 7.8]*

Further, a lender needs to consider disclosures:

- under IFRS 7 *Financial Instruments: Disclosures* on risks arising from these loans and how it manages those risks; and
- on fair value under IFRS 13 *Fair Value Measurement*. The extent of these disclosures will depend on whether the green loans are measured at fair value on a recurring basis, or at amortised cost.

Actions for management to take now

Management needs to consider the following.

- What type of green loans does the lender hold – i.e. what types of features are included that adjust the contractual cash flows of the loans?
- Do the features that adjust the contractual cash flows meet the SPPI criterion?
- If judgements about the SPPI assessment have a significant effect on the amounts recognised in the financial statements, then are these judgements appropriately disclosed?

The International Accounting Standards Board is undertaking a post-implementation review of the classification and measurement requirements in IFRS 9. Based on the results of the review, we may update our guidance in this article in the future.

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

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