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Our ref RD/288

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Dear Dr. Barckow

Comment letter on Exposure Draft ED/2023/2 *Amendments to the Classification and Measurement of Financial Instruments – Proposed amendments to IFRS 9 and IFRS 7*

We appreciate the opportunity to comment on the International Accounting Standards Board's (IASB) Draft ED/2023/2 *Amendments to the Classification and Measurement of Financial Instruments – Proposed amendments to IFRS 9 and IFRS 7* (ED), published on 21 March 2023. We have consulted with, and this letter represents the views of, the KPMG network.

We appreciate the IASB's efforts to address stakeholder concerns identified in the Post-implementation Review of IFRS 9 *Financial Instruments – Classification and Measurement* and matters arising from the IFRS Interpretations Committee's tentative agenda decision "Cash received via electronic transfer as settlement for a financial asset (IFRS 9 *Financial Instruments*)".

We broadly agree with the proposals, however we have varying concerns relating to specific sections of the ED. Our key concerns regarding the ED are as follows:

Electronic payments

- Whilst we agree with providing an exception to allow derecognition of a financial liability at an earlier date than settlement date, we have concerns about the potential operability of the exception, as the criteria appear to be a high hurdle.
- We do not agree with an accounting policy choice on a system-by-system basis, as we believe this would create additional diversity to current practice and we also question the usefulness of the information provided in this case. We believe it would be more appropriate if the exception is applied to all electronic payments regardless of the specific system used.
- We believe additional guidance is required to explain how the general requirement applies to the recognition or derecognition of financial liabilities, given the existing requirements in IFRS 9 are only in the context of financial assets.

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Contractual terms that are consistent with a basic lending arrangement

- Given the approach taken by the IASB in addressing stakeholder concerns for financial assets with Environmental, Social and Governance (ESG) linked features, we have significant concerns about unintended consequences based on the proposals as currently drafted. We believe the proposals should be revised to address these concerns, including making updates to existing examples in IFRS 9 in contemplation of the proposals. Given the urgency for standard setting on this topic, we also believe these specific proposals (and the related proposals on disclosure) should be separated from the rest of the ED.

Contractually linked instruments

- Whilst the characteristics of contractually linked instruments included in the proposals are helpful, we do not agree the proposals have adequately addressed stakeholder concerns and it remains unclear what constitutes a tranche and how to determine the correct application between the requirements for non-recourse features and contractually linked instruments.

Transition

- We generally support the proposals about transition, but we recommend the IASB provide separate transition requirements related to the recognition and derecognition of financial assets and financial liabilities including the exception.
- As implementation of the proposals related to electronic payments may involve significant time, cost and effort, we suggest the IASB consider this when setting an effective date for these proposals.

The appendix to this letter contains our detailed responses to the questions raised in the Exposure Draft.

Please contact Reinhard Dotzlaw at reinhard.dotzlaw@kpmgifrg.com or Colin Martin at colin.martin@kpmgifrg.com if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix

KPMG's responses to the specific questions raised in the Exposure Draft

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 of Conclusions explain the IASB's rationale for this proposal. Do you agree with this proposal? If you disagree with the proposal, please explain what you would suggest instead and why?

Proposed derecognition exception for financial liabilities (paragraphs B3.3.8 – B3.3.10 of the draft amendments to IFRS 9)

We agree with the direction of the proposal that allows derecognition of a financial liability settled using an electronic payment system earlier than the date that cash has been delivered by the entity in certain circumstances. However, we have a number of observations and concerns as set out below.

Definition of an electronic payment system and scope

The scope of the proposals is not clear, as an 'electronic payment system' is not defined and there is no guidance to explain how 'settled with cash' should be interpreted. For example, it is not clear whether card transactions would fall into the scope of the proposals. Where the debtor settles its payables using a debit card, given the funds used to settle a transaction is the debtors' own funds, it may be viewed that the payable is settled with the debtor's own cash and therefore the transaction would be in scope of the proposals.

However, where the debtor settles its payables using a credit card, it is unclear whether that payable is *settled with cash*. One view is that from the debtor's perspective, they are replacing one liability with another and no cash is involved in settlement. Alternatively, it may be viewed that the debtor has effectively received a cash advance from its credit card issuer via the use of its credit card and uses that cash to settle its payable.

Therefore, we recommend the IASB provide further guidance on the scope of electronic payment systems including how to interpret 'settled with cash' and whether the payment processor could also be the debtor.

As the proposals refer to an electronic payment system in the singular, it is also not clear which system would be subject to analysis under paragraph B3.3.8 where there is more than one system involved in an electronic payment transaction. Further, as the proposals allow the exception to be applied on a system-by-system basis, it is not clear what would be considered a different or separate electronic payment system and whether local laws and regulations are relevant to this determination.

Take for example, System B is implemented in Location X and Y. The contractual terms and conditions of System B state that subject to local laws and regulations, payment instructions cannot be cancelled. In Location X, there is regulation in place to protect individuals and entities from any unauthorised payments being initiated and as a result, unauthorised payments which have been initiated through System B in Location X can be cancelled. In Location Y, there is no such regulation in place and therefore any payments initiated through System B from Location Y cannot be cancelled. Based on the proposals, it is not clear whether there is one electronic payment system comprising System B because the contractual rights and obligations of System B are the same in both jurisdictions, or two electronic payment systems comprising localised Systems BX and BY because the operative terms and conditions should take into account both contractual and statutory rights and obligations.

Therefore, we also recommend that the IASB provide a definition of an electronic payment system, a description of their key characteristics and whether the terms and conditions of an electronic payment system should only consider the contractual rights and obligations, or if statutory rights and obligations should also be considered in determining the electronic payment system(s) that are within the scope of the proposals.

Application of the exception

We have concerns over the potential limited applicability of the exception. Specifically in relation to paragraph B3.3.8(a), the criterion refers to the debtor having "*no* ability to withdraw, stop or cancel the payment instruction". Whilst we agree with the technical rationale for this criterion as set out in BC28 – BC29, for entities to have a reasonable chance of applying the proposed exception, we believe that the conditions may need to be more permissive for the proposed exception to be effective. A literal interpretation of *no ability* would mean that *any* ability to withdraw, even one with a severe penalty that would deter the debtor from exercising the right in all but the most extreme of cases, would limit the application of the exception.

For example, we understand that payments made through the Single Euro Payments Area (SEPA) system under the Standard SEPA transfer scheme and Society for Worldwide Interbank Financial Telecommunications (SWIFT) transfers can be cancelled by the debtor until T1 (i.e. one day after the payment instruction was initiated) but are subject to a penalty. Based on the proposals, it is not clear whether the existence of a cancellation penalty impacts paragraph B3.3.8(a) from being met. We therefore recommend the IASB explain further how an entity's 'ability' should be considered and the circumstances in which paragraph B3.3.8(a) would be met.

It is also not clear, based on paragraphs B3.3.8(c) and B3.3.9, whether settlement risk refers only to the electronic payment system, the debtor, or both. We recommend the IASB provide further guidance in respect of the assessment of settlement risk, as well as the inclusion of the discussion included in BC33 – BC34 to provide further clarity around this assessment.

We have also observed there are different ways in which the exception criteria can be interpreted. One interpretation is that paragraph B3.3.8 criteria must be demonstrated on the date the payment instruction was initiated (T0) in order for the exception to apply and if it cannot be met, then the liability must be derecognised on settlement date under paragraph B3.1.2A. Alternatively, it could be interpreted that the entity makes a continual assessment to ascertain when all the criteria under paragraph B3.3.8 are met to determine when the financial liability can be derecognised under the exception. For example, if all criteria are met on T1, then the financial liability can be derecognised on T1 under the exception. We recommend the IASB clarify how the exception should be applied – i.e. whether an assessment is required to be performed at payment initiation or a continual assessment is required to determine when the liability could be derecognised.

We do not agree with the notion of an accounting policy choice as implied under paragraph B3.3.10, more specifically the ability to apply such a choice on a system-by-system basis. We believe such a choice would create additional diversity to current practice and may result in similar transactions being treated differently by an entity that uses similar (but different) payment systems. For example, an entity uses electronic payment system X for its suppliers based in Country B and uses electronic payment system Y for its suppliers based in Country C. If electronic payment systems X and Y have substantially the same terms and conditions, the entity could apply the derecognition exception to liabilities it owes to Country C suppliers and derecognise its liabilities owed to Country B suppliers at settlement date.

Based on our outreach, we also understand that there are electronic payment systems (for example SEPA) that offer a variety of transaction types (or schemes) where the timing and terms and conditions between payment initiation and settlement date could vary[1]. Consequently, whether the criteria under paragraph B3.3.8 is met will differ for *each* type of payment, even if those payments are initiated from the same electronic payment system. As a result, we do not believe that a policy choice on a *system*-by-*system* basis would be appropriate.

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[1] There are a number of other factors that impact the timing and terms and conditions of an electronic payment, such as (but not limited to) the type of payment (e.g. international vs domestic, spot vs future payment), the number of parties involved in effecting the electronic funds transfer and settlement, the progress of the payment instruction within the transaction process, the electronic payment system's infrastructure, framework and protocols, as well as the legal and regulatory environment.

Given the nature of each payment could differ, despite being initiated from the same electronic system, we also believe that the financial information provided to the users of financial statements resulting from a policy choice on a system-by-system basis may not be useful. We therefore recommend that where an entity chooses to apply the derecognition exception, it must be applied to all electronic payments settled through an electronic payment system(s), regardless of the specific system used. In the current wording of the proposals, the expression used in paragraph B3.3.10 is "made through the same electronic payment system". We believe the phrase should be replaced with "made through ~~the same~~ any electronic payment system meeting the criteria specified in B3.3.8 of IFRS 9".

If the IASB were to retain the choice on a system-by-system basis, we recommend the IASB consider, in finalising the amendments, the fact that some electronic payment systems include more than one type of payment mechanism, only some of which would meet the criteria specified in paragraph B3.3.8.

General clarification (paragraph B3.1.2A of the draft amendments to IFRS 9)

We generally support the proposed clarification of the general requirement under paragraph B3.1.2A as it relates to financial assets. However, the existing requirements in IFRS 9 with respect to settlement date accounting is only written in the context of regular way purchases or sales of financial assets. Paragraph B3.1.2A also includes a cross reference to paragraph B3.1.6 of IFRS 9, which states that "the settlement date is the date an asset is delivered to or by an entity", but it is not clear how this applies to financial liabilities. For example, with written or posted cheques, the debtor may not be able to obtain the necessary information to determine the settlement date.

In addition, as financial instruments (including derivatives) are recognised on the date "the entity becomes party to the contractual provisions of the instrument" (paragraph 3.1.1 of IFRS 9), the requirement to recognise financial instruments on settlement date could appear inconsistent with the general recognition requirement.

We recommend the IASB provide additional guidance to explain how settlement date accounting applies to financial liabilities, as well as the interaction with the existing recognition and derecognition requirements. The IASB may also want to consider whether updates should be made to section B.32 of the Guidance on implementing IFRS 9 *Financial Instruments* (carried forward from the implementation guidance accompanying IAS 39 *Financial Instruments: Recognition and Measurement*), as it currently states that the "special rules about recognition and derecognition of financial assets using trade date or settlement date accounting" does not apply to financial liabilities.

Other related concerns: cash and presentation of cash-in-transit

When an entity applies the proposed exception to derecognise a liability before settlement date, it is not clear whether cash should be derecognised at the same time. Cash is a financial asset and as such, the general clarification of paragraph B3.1.2A could be seen to apply. That would mean cash would not be derecognised at the same time the liability is derecognised. Even if 'cash', at the time the payment instruction has been initiated, can no longer be presented as cash (see comment below), it is not clear what the corresponding entry should be at the time the liability is derecognised. We recommend the IASB clearly state that if the exception is applied, the other side of the liability derecognition entry is cash, or provide further guidance on this, as this will be a significant issue in practice.

Similarly, if the proposed exception is not applied, there remains the issue around how the debtor should present 'cash-in-transit' (CIT) between payment initiation date and derecognition of the financial asset on settlement date. Although under IAS 7 *Statement of Cash Flows,* the CIT balance would no longer meet the definition of 'cash' or a 'demand deposit' whilst in transit, it is not clear whether the CIT balance would meet the definition of a cash equivalent, other financial asset, or something else. It is equally unclear where the CIT balance should be presented in the cash flow statement. Although the scope of the proposals do not include IAS 7 considerations, the presentation of the CIT balance is an equally significant question in practice, given the importance of cash and cash equivalents as a metric for users of financial statements. We note the population of CIT is likely to substantially increase as a result of the proposals under paragraph B3.1.2A. Therefore, we recommend that the issue is added to this project, or another broader project that considers issues in relation to IAS 7 (e.g. Statement of Cash Flows and Related Matters project).

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 purpose 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?

Overall

We agree with the observations made in paragraph BC43 about the usefulness of amortised cost measurement for financial assets with ESG linked features and the *notion* that the amendments to IFRS 9 should apply to *all* financial assets within its scope. However as explained below, this approach has resulted in many challenges.

Based on the proposals, we have significant concerns about the practical application, unintended consequences and structuring risks as detailed below. We strongly recommend the IASB revise these proposals to address the concerns identified and consider updates to the existing examples in IFRS 9 that may be impacted by the proposals (see below). We also recommend the IASB separate these specific proposals (including the related disclosure proposals) from the remaining proposals, as it may allow the IASB to move more quickly to address the urgency for standard setting on this topic.

Assessment of 'interest' in SPPI (paragraph B4.1.8A of the draft amendments to IFRS 9)

We believe 'how much' compensation is a relevant consideration, as it often helps to inform 'what for'. BC47(c) states that a quantitative analysis is "not necessarily required" to be performed over the elements of interest in determining whether the contractual cash flows are consistent with a basic lending arrangement. Though it may not have been the IASB's intention to imply that the amount of compensation is not relevant to the assessment of interest, based on paragraph B4.1.8A, it is possible that

the standard may be misinterpreted given the clarification in BC47(c). Therefore, we recommend the IASB reconsider the proposals to better reflect the interaction between the standard and the basis for conclusions.

Practical application issues

We also have concerns with paragraph B4.1.8A requiring that a change in contractual cash flows must be aligned with both the *direction* and *magnitude* of the changes in basic lending risks or costs. Such a requirement would go beyond the current requirements and would be especially difficult to demonstrate and audit for ESG features – in particular for 'S' and 'G' features, given the ESG market is still evolving.

For example, consider a lender that issues a loan and includes a Board diversity target of at least 50% of the debtor's Board of Directors to comprise of women. The interest rate on the loan issued will decrease by up to 10bps on a sliding scale, the closer the actual Board diversity percentage approaches the target. In assessing whether the change in contractual cash flows is directionally consistent with basic lending risks or costs, it is not clear how an entity would appropriately demonstrate that there is a relationship between a Board diversity target and basic lending risks and costs and how they correlate. If the intention is for financial assets with such features to fail SPPI where the magnitude and direction requirements cannot be demonstrated, this would be inconsistent with the observations made in BC43 and would not address stakeholder concerns.

It is also not clear how an entity would assess that the magnitude of such a change is appropriate and what level of precision is required to determine that the amount of change in the contractual cash flows is aligned to changes in basic lending risks and costs. On this point, we note that BC52 states that a change in contractual cash flows should be 'proportionate to' a change in lending risks or costs and thus implies it is a relative assessment (for example a 2% change in lending risks or costs should approximately equate to a 2% change in contractual cash flows). However, even in such an assessment, *how* that proportionality should be assessed is not clear.

Interaction between the proposals and existing IFRS 9 requirements

Moreover, the requirement to assess the magnitude of compensation in an instrument appears, more generally, to be inconsistent with IFRS 9. Apart from leverage considerations as required under paragraph B4.1.9 of IFRS 9, there is no existing requirement to evaluate the appropriateness of pricing (i.e. for an instrument to be at market at the time of issuance) for the purposes of assessing whether the contractual cash flows of an instrument are SPPI and it is not clear why direction and magnitude are then necessary to the evaluation of *changes* to contractual cash flows.

In addition, we note that this represents an internal inconsistency within the proposals, as it requires an assessment of the magnitude of changes to contractual cash flows for alignment with changes in basic lending risks and costs for the cash flows to be considered SPPI. However, this also implies that the amount of compensation is not

relevant to the assessment of interest for the SPPI assessment. This implication appears to conflict with existing guidance on leverage.

We further note that the requirement to assess the direction and magnitude of changes in contractual cash flows for alignment with changes in basic lending risks or costs [2] is included in paragraph B4.1.8A, which predominantly focuses on the assessment of interest. We question the location of this requirement, given the remaining guidance on assessing changes to contractual cash flows are located from paragraphs B4.1.10 – B4.1.12 of IFRS 9.

Considering all the above, we recommend the proposal requiring the direction and magnitude of changes in contractual cash flows be aligned with changes in basic lending risks or costs be removed from paragraph B4.1.8A. Instead, recognising the risk of unintended consequences, we believe this should only be required for financial assets which have contractual features that change the timing and amount of contractual cash flows based on a contingent event that is specific to a debtor, as we believe that the direction and magnitude of changes is most relevant for this population.

We also recommend the IASB provide additional guidance and illustrative examples to explain how this assessment would be performed and the level of precision that would be appropriate, as well as revising the language so there is more flexibility to accommodate the challenges that preparers and auditors will face in the context of an evolving market.

Contingent cash flows (paragraph B4.1.10A of the draft amendments to IFRS 9)

We have concerns over the unintended consequences and the potential structuring risks that the proposals pose if they are finalised as written. Though BC69 concludes that not all contingent events that are specific to a debtor would be consistent with a basic lending arrangement, the proposals do not make this clear. Paragraph B4.1.10A could be interpreted that so long as changes in contractual cash flows are specific to the debtor and do not represent an investment in the debtor nor an exposure to the performance of specified assets, SPPI is met. As such, the proposals could give rise to structuring risks where entities could avoid fair value measurement.

In addition, whilst we agree that amortised cost would provide useful information about financial assets with ESG linked features, based on the proposals as they are written, it is not clear why contingent events that are specific to a debtor are consistent with a basic lending arrangement. For example, consider a loan where the interest rate decreases as the debtor achieves specific renewable energy key performance

[2] We note the phrase “basic lending costs and risks” in paragraph B4.1.8A is used to explain how or when something would be considered a “basic lending arrangement”. However, given ‘basic lending’ has not been defined, the use of these similar phrases to explain one another only adds to the lack of clarity in the proposals. Much of the discussion around what is considered a “basic lending arrangement” is included in the BCs of the proposals and perhaps including at least some of those discussions, such as BC51 and BC52, into the body of the proposals would be more helpful.

indicators (KPIs) each quarter. In this example, although the renewable energy KPI will be specific to the debtor and does not represent either an investment in the debtor or an exposure to the performance of specified assets, it is not clear why the changes in contractual cash flows would be consistent with a basic lending arrangement.

Interaction between the proposals and existing IFRS 9 requirements

It is also not clear how paragraph B4.1.10A interacts with paragraph B4.1.8A, as well as the existing requirements of IFRS 9. As a result, there may also be unintended consequences such that instruments that currently meet SPPI would fail SPPI under the proposals and vice versa. For example, instruments that have non-viability clauses that form part of their contractual terms that provides the national resolving authority the power to write down the par amount (as explained in paragraph B4.1.13 for Instrument E). Prior to the proposals, such instruments would not meet SPPI. However, given the trigger for the non-viability clause is usually specific to the debtor, one may interpret paragraph B4.1.10A to mean that they would meet SPPI.

Likewise, if the contingency must be specific to a debtor for a change in contractual cash flows to be consistent with a basic lending arrangement, it is not clear why, for example, Instrument C in paragraph B4.1.13 remains SPPI. In that instrument, there is a cap feature which is triggered by market interest rates reaching a specified level. Arguably, the changes in contractual cash flows in this instrument could be viewed as having a contingent feature that is not specific to a debtor. Instead, it is contingent on market interest rates. Therefore, under the proposals, it appears as though the instrument no longer meets SPPI. However, the proposals do not make any further edits to the rationale and conclusion for Instrument C in paragraph B4.1.13 of IFRS 9 and it remains SPPI compliant.

Another example would be a loan with a fixed interest rate plus a variable margin that compensates the lender for its funding costs. Such a loan would currently meet SPPI, however it is not clear under the proposals whether they will continue to do so. BC67 states that a change in contractual cash flows due to a contingent event that is specific to the creditor or another party would be inconsistent with a basic lending arrangement. However, BC67 also states that in a basic lending arrangement, the creditor is compensated only for basic lending risks and costs associated with extending credit to the debtor. We do not think that simply because a contingency is specific to the creditor it would mean that the contractual cash flows are inconsistent with a basic lending arrangement.

It is also not clear whether the requirement that changes in contractual cash flows align with the direction and magnitude with changes in basic lending risks or costs under paragraph B4.1.8A must be considered if the instrument also has contingent cash flows that are specific to the debtor.

In addition, it is not clear how the leverage guidance under paragraph B4.1.9 should be considered where leverage is applied to contingent cash flows that are specific to the debtor.

Clarification of key concepts in the proposals

We believe further guidance on when a contingency is specific to a debtor would be useful. For example, where there are changes to contractual cash flows based on group-level ESG targets, but the instrument has been issued by a subsidiary. Given all the components of the group as a whole are not in the control of the subsidiary, the implication is that group level targets are not specific to an individual debtor within the group. This may be exacerbated in cases where there may be ESG targets that are also dependent or partially dependent on entities outside the scope of consolidation under IFRS 10 *Consolidated Financial Statements*.

We strongly recommend the IASB consider revising the proposals to make it clear how they should interact with each other and with other existing IFRS 9 requirements, as well as to remove any unintended contradictions. In addition, we note that stakeholders have raised questions on the clarity of certain concepts and many important clarifications and explanations of those concepts currently reside in the basis for conclusions. As part of the finalisation process, we recommend that consideration is given to incorporating this information into the body of the standard so there can be no doubt as to the IASB's intentions, including:

- the discussion in BC51 – BC52 around what is considered a 'basic lending arrangement';
- the considerations in BC70 to explain more clearly what could represent an investment in the debtor;
- the considerations in BC64 – BC65 regarding whether a contingent feature is specific to a debtor;
- the IASB's view noted in BC55 that the key principle is whether the changes in timing or amount of contractual cash flows are consistent with a basic lending arrangement and variability cannot be assumed to be consistent with a basic lending arrangement simply because it arises from one of the elements of interest mentioned in paragraph B4.1.7A of IFRS 9; and
- the IASB's conclusion in BC69 that not all contingent events that are specific to a debtor would be consistent with a basic lending arrangement.

Examples (paragraphs B4.1.13 – B4.1.14 of the draft amendments to IFRS 9)

We support the proposal to provide examples, however the current analysis does not fully explain how the conclusions were reached. In particular, for "Instrument EA" under B4.1.13, it is not clear how the contractual cash flows arising from the occurrence or non-occurrence of the contingent event are in all circumstances SPPI, for example:

- the assessment of interest and what it compensates for;
- how the magnitude and the direction of changes in contractual cash flows are aligned with a change in basic lending risks or costs;

- how/why the nature of the contingency is consistent with a basic lending arrangement (other than it is specific to the debtor); and
- how/why the resulting contractual cash flows do not represent either an investment in the debtor or an exposure to the performance of specified assets.

We recommend the IASB incorporate these missing elements into the rationale of the examples provided.

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?

We generally support the proposed description of non-recourse features and the example factors to consider for the look through test, but we have some specific observations.

Description of non-recourse features (paragraph B4.1.16A of the draft amendments to IFRS 9)

It was our understanding (based on BC47) the IASB meant to *clarify* the meaning of a non-recourse feature, while the description under paragraph B4.1.16A will *change* the meaning such that the proposals would narrow the scope of what is considered a non-recourse feature. Based on our outreach, we understand this could impact some US mortgages. In the event of a default in such a mortgage, the lender only has recourse to the value of the collateral and not to any other assets of the borrower. To many, these loans are considered to be non-recourse. However, paragraph B4.1.16A refers to cash flows being limited to those generated from specified assets "both over the life of the financial asset and in the case of default". As such, certain US mortgages will no longer be considered non-recourse, as over the life of the instrument the cash flows are not limited to the cash flows generated from the property, but from the borrower's salary/sources of funds. As a result, the SPPI assessment may change for those US

mortgages, as prior to the proposals, the 'look-through' test would be a relevant consideration.

Example factors to consider when assessing SPPI of non-recourse features (paragraph B4.1.17A of the draft amendments to IFRS 9)

It may be helpful to make clear in example factors under paragraph B4.1.17A, what the implications would be if, for example, the cash flows are expected to exceed the contractual cash flows and if there are any loss absorbing instruments issued by the debtor.

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?

Characteristics of contractually linked instruments (paragraphs B4.1.20 – B4.1.21 of the draft amendments to IFRS 9)

We acknowledge the proposals under paragraph B4.1.20 are helpful to an extent, as it provides a description of the key characteristics of contractually linked instruments (CLI). However, we do not agree that the proposals have adequately addressed stakeholder concerns. It is still not clear what constitutes a 'tranche' and it is still difficult to determine whether the requirements for non-recourse features or contractually linked instruments should be applied.

What constitutes a 'tranche'

It is important to understand what constitutes a 'tranche', as it impacts whether the classification assessment of an instrument is in the scope of the CLI requirements under paragraph B4.1.21 or the non-recourse requirements under paragraph B4.1.17. However, based on the proposals, it is still not clear what is considered a 'tranche', as no explicit definition has been provided. Based on the proposed edits made to paragraph B4.1.20 in the proposals, it could be interpreted that a 'tranche' refers to

CLIs, but the word 'tranche' is then used to describe the characteristics of a CLI. The circular use of the term in the proposals only adds to the existing lack of clarity.

For example, an entity (sponsoring entity) establishes a structured entity (SE) to hold certain assets it has transferred and the SE issues one type of note to third parties. The sponsoring entity also provides credit enhancement to the third party noteholders in one of the following forms:

- Excess spread: The excess spread is the difference between the interest received on the underlying assets transferred to the SE by the sponsoring entity and the interest paid to the noteholders. This excess spread is initially deposited into a reserve account held by the SE and serves as a first line of protection for the noteholders against losses. Accumulated excess spread that is not paid to noteholders is ultimately retained by the sponsoring entity.
- Overcollateralisation: This arises when the principal of the underlying assets is greater than the principal amount of the issued notes. The cash flows related to this excess collateral are paid by the SE to the sponsoring entity using a schedule predefined in the waterfall.

In this example, consideration of whether the credit enhancement(s) are a tranche will impact whether the notes issued to third parties are assessed for classification as CLI or non-recourse. Given both the proposals and existing requirements in IFRS 9 do not prohibit the forms of an instrument to be considered a 'tranche' and a 'tranche' could be interpreted as something that meets the definition of CLI, we believe that the credit enhancement in the form of excess spread or excess collateral constitutes a tranche. This is because the credit enhancement could be seen as an asset held by the sponsoring entity and:

- the SE has issued multiple instruments, being the credit enhancement and the notes to the third party noteholders;
- the prioritisation of payments uses a waterfall payment structure to the noteholders and to the credit enhancement holders, which results in a disproportionate allocation of losses between the holders of different instruments; and
- the tranches have non-recourse features because a holders' right to the contractual cash flows are limited to the cash flows of specific assets that are within the SE.

Similarly, it is not clear whether other instruments such as ordinary shares, other equity instruments issued, or liquidity facilities would constitute a tranche. For ordinary shares, it could be argued that as these represent a residual interest of the SE, whilst there is no waterfall payment structure per se, ordinary shareholders would rank last and would provide a level of credit protection to other noteholders. Therefore, in a structure that issues a senior note, junior note and equity, there will still be a disproportionate allocation of losses across holders of these instruments. However, the assessment as to whether ordinary shares would have non-recourse features may be driven by the issuer's structure. For example, if the issuer is a SE that only holds mortgages, the cash flows associated with the ordinary shares will effectively be limited to the cash

flows generated by those assets. On the contrary, where the issuer is an entity with a range of normal operations, then the equity cannot be non-recourse because the residual interest that ordinary shareholders could be entitled to would be generated from all the entity's operations and assets. In the absence of clear guidance, it could be argued that in certain circumstances, where the CLI characteristics are present, ordinary shares could constitute a tranche. An alternative interpretation may be that ordinary shares are not part of a CLI structure in either case because they are not 'contractually-linked' to other instruments.

Liquidity facilities are typically intended to cover a mismatch between interest payment dates rather than to provide protection against credit losses. However, if a vehicle is about to default, it would be unusual if the vehicle did not fully draw its liquidity facility before that default occurs (and therefore result in a credit risk absorbing layer in the waterfall). This practice was observed in the financial crisis. Therefore, it is not clear what analysis should be undertaken in determining if this could constitute a tranche. Applying the concepts under paragraph B4.1.20, a liquidity facility, prima facie may not have a payment structure that creates a disproportionate allocation of losses across holders. In addition, if the concepts under paragraph B4.1.20A apply, it is not clear whether the liquidity facility is a tranche, as they are typically issued by the vehicle's sponsor (see next two paragraphs).

Underlying principle of paragraph B4.1.20A

It is not clear why the instruments issued under paragraph B4.1.20A do not contain all the characteristics of multiple contractually linked instruments as described in paragraph B4.1.20. Based on our reading of the transaction described in paragraph B4.1.20A, it appears that the instruments contain all the characteristics of CLI:

- more than one instrument is issued by the SE – a junior and a senior note;
- inherent in such types of notes there is a prioritisation of payments resulting in a disproportionate allocation of losses between the holders of different tranches; and
- the tranches have non-recourse features because a holders' right to the contractual cash flows are limited to the cash flows of specific assets that are within the SE.

However, paragraph B4.1.20A concludes that the structure is not CLI because the SE is created to facilitate the lending transaction from a single creditor. Though it is not clear, it appears that the underlying principle being applied is that the junior note cannot be regarded as a tranche as it is not held by a third party and therefore, there are no 'multiple' CLIs being issued by the SE.

As it stands, classification of CLI under the proposals appears to be based on an entity's capital structure at the time when the investor acquires the instrument. We have concerns about this, as it exposes the guidance to structuring risks where an entity could avoid fair value measurement. This is especially the case where an entity's capital structure could change subsequent to initial recognition. Using paragraph B4.1.20A as an example, the entity holding the junior tranche could sell the tranche to a

third party shortly after initial recognition. Likewise, the junior tranche could be bought back from a third party shortly after initial recognition.

Considering the above, we recommend the IASB provide a further clarification as to what constitutes a 'tranche', including whether the form of an instrument impacts whether it can be regarded as a 'tranche'. We believe that a key characteristic of tranches in a CLI structure is that the contractual right of the tranche holder reduces in the event that the underlying pool does not generate sufficient cash flows such that the failure to pay interest or principal does not constitute a default event. We also do not agree with what appears to be the underlying principle in paragraph B4.1.20A. Instead, we would recommend that paragraph B4.1.20A is revised so that the conclusion applies only when the sponsor is contractually required to hold the junior note (for the purposes of providing credit protection) at all times.

Practical application issues

From a practical perspective, it may be difficult for a purchaser of a senior note in the secondary market to determine whether the vehicle sponsor holds the most junior note for the purposes of providing credit protection. We recommend the IASB make it clear in the proposals the impact on classification where an entity is unable to obtain the necessary information to assess whether paragraph B4.1.20A would apply.

We have also observed that when describing the characteristics of CLI, paragraph B4.1.20 states that "…the tranches have non-recourse features (see paragraph B4.1.16A)". This could cause confusion and could be misinterpreted to mean that both the non-recourse and CLI requirements must be applied. The IASB may want to consider including an additional clarifying statement to confirm whether this is the case.

Instruments in the underlying pool (paragraph B4.1.23 of the draft amendments to IFRS 9)

We agree with the notion that instruments in the underlying pool could include financial instruments not in the scope of the classification requirements of IFRS 9.

We acknowledge that the proposal under paragraph B4.1.23 states that the underlying pool can include *financial instruments* that are not within the scope of the IFRS 9 classification requirements. We take this to mean that such an instrument should, first and foremost, meet the definition of a financial instrument; however, the example refers to a portfolio of 'lease receivables'. A 'lease receivable' is not a defined term in the Standards and as such may be interpreted in different ways. Further, assuming 'lease receivables' refers to a lessor's net investment in a lease, as defined in IFRS 16 *Leases*, it includes eligible residual value guarantees provided to the lessor. Although paragraph AG9 of IAS 32 *Financial Instruments: Presentation* specifies that a lessor regards a finance lease as a financial instrument, the contractual cash flows in a finance lease are not necessarily solely payments of principal and interest on the principal amount outstanding because of the residual value guarantees. We therefore recommend the IASB either reconsiders the phrase 'lease receivables' and use a defined term to avoid any unintended consequences or provide further guidance to

make clear the elements of a 'lease receivable' that could not form part of the underlying pool.

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?

We support the proposals related to the disclosure of investments in equity instruments designated at fair value through other comprehensive income and do not have any comments.

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?

We generally support the proposed disclosures for contingent events specific to a debtor. However, the scope appears to be broad, which may result in a significant amount of disclosure being provided by entities and we have concerns about the usefulness of this information. We also have some concerns about the practical application of the proposals as detailed below.

Scope (paragraph 20C of the draft amendments to IFRS 7)

It is not clear if the intended scope was to require *all* financial instruments with contingent cash flows that are specific to a debtor. There are potentially a large number of instruments issued that would have contractual cash flows that could change based on the debtor meeting financial covenants, as well as other typical contingent terms and conditions such as early prepayment clauses or increases in interest rates where the entity defaults on the loan or is in arrears. It is not clear if such contingencies were intended to be captured by the scope. We would also question whether the disclosure requirements for these typical and standard types of debtor-specific contingencies would provide users with additional information that is useful for decision making and whether they would even obscure the information that is useful, such as the effects of ESG linked features or those of less standard contingencies.

We also question the usefulness of the quantitative information required for financial assets subsequently measured at fair value through other comprehensive income (FVOCI), given these assets are measured at fair value and the expectations of future cash flows would already form part of that fair value measurement. Similarly, we question whether such disclosures for credit-impaired financial assets would provide useful information.

Further, the proposals are not clear whether the probability of a contingency occurring may be considered in determining if disclosure is required. For example, paragraph 86 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* does not require the disclosure where the possibility of an outflow in settlement is remote. In the absence of any probability considerations and given the broad scope as implied by the proposals, the amount of the disclosure required as a result of the proposals will be onerous and present an operational challenge for preparers. Also, the resulting information could be less meaningful to the users of financial statements. We recommend the IASB consider the inclusion of a probability consideration in paragraph 20C when determining the appropriate detail to disclose.

Practical application issues (paragraph 20B of the draft amendments to IFRS 7)

It is not clear whether and how these disclosure requirements would apply to partnerships (including carried interest) or funds with issued units that are liability classified. For example, what is the contingency specific to the debtor where the fund is considered the debtor and the contractual cash flows change based on the performance of the fund's assets? We recommend the IASB provide further guidance to make clear whether these types of transactions would be in scope of the disclosure and if so, provide illustrative examples and guidance to explain how they would apply.

There are also other practical issues to be addressed in meeting the disclosures under paragraph 20B. For example, an instrument where changes to the interest rate triggered by a debtor-specific contingency determined by a contractually specified formula. Where the formula incorporates future variables that are unknown at the reporting date, it is not clear whether the entity is required to estimate those future variables to determine the potential change in contractual cash flows and whether it would be appropriate to apply probability considerations.

Notwithstanding paragraph 20C, which requires that an entity consider the appropriate level of detail and level of aggregation or disaggregation in disclosing the information required under paragraph 20B, it would help encourage more consistent application if this consideration was accompanied by an illustration. For example, if Instrument A has debtor-specific contingencies X, Y and Z – is the requirement under paragraph 20B(b) to disclose:

- in aggregate, the range of changes in contractual cash flows for X, Y and Z, or
- separately, the range for X, the range for Y and the range for Z?

We therefore also recommend the IASB provide illustrative disclosures of the proposals to explain how the disclosure objective can be met.

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?

Transition (paragraphs 7.2.47 – 7.2.49 of the draft amendments to IFRS 9)

We generally support the proposals, though in the context of restating prior periods, it is not clear what would be considered the "use of hindsight" as referred to under paragraph 7.2.48.

We also recommend separate transition requirements for the proposals related to the recognition and derecognition of financial assets and financial liabilities, including the exception (i.e. paragraphs B3.1.2A and B3.3.8 – B3.3.10) settled through electronic transfer, as it would allow entities to:

- Separately apply the proposals relating to electronic transfers at a different date to the other proposals. For example, an entity may want to (early) apply the amendments related to SPPI assessment while it prepares itself for implementation of electronic transfer amendments.
- Choose to restate comparative information for the effects of electronic transfers whilst not doing so for other amendments. For example, for entities that operate in industries where trade debtor/creditor days are a KPI, restating comparatives would result in information that is more comparable over time.

We also observe the proposals related to the derecognition of a financial liability settled through electronic transfer may require widespread change and involve significant effort and cost in implementation for both entities and auditors alike, such as:

- Changes to systems – we understand that many systems currently do not have a feedback mechanism in place to notify the debtor when the other party has received the cash and implementing such a change could be costly and involve significant effort for entities to implement.
- Bank reconciliation processes – given the long standing practice in many jurisdictions where cash is recognised in the financial statements at the amount per the bank statement balance adjusted for any unpresented cheques, the proposals may require changes to existing bank reconciliation processes to align for IFRS® Accounting Standards requirements. Additional bank reconciliation processes may also need to be implemented by entities who report under both US GAAP and IFRS, given the amount of cash and cash equivalents could differ.
- Additional consolidation adjustments – as a result of the proposals, when accounting for cash settlement of intercompany balances effected through an electronic payment system, this could result in no cash being recognised by entities within the same group at the standalone level over a period of time. However, at the consolidated level, as cash has not been transferred outside the group, this would require additional elimination entries to reflect this. Depending on the size of the group and the number of transactions where no cash is recognised at the standalone level, this could require a significant amount of effort by preparers to identify and process the relevant elimination entries for the consolidated accounts.

Therefore, we recommend the IASB consider the above when setting an effective date for the proposals related to electronic payments, as entities may need significant time to appropriately implement the necessary change.

Other matters

Clarifying amendments:

Throughout the ED, both in the body and basis of conclusions, we note that the phrases ‘clarifications’ or ‘clarifying aspects’ have been used to describe the proposed amendments. Several questions have been raised about how this should be interpreted and therefore whether entities should or could apply such amendments before the ED is finalised. That is, do the amendments only clarify existing requirements, or do they introduce new or different requirements.

Similarly, questions have also been raised as to how the proposals would be applied when they are adopted by an entity – i.e. whether the effect of any change from adoption of the amendment is accounted for as a correction of an error under IAS 8. We have seen this question arise even when specific transition requirements are included in the ED.

As such, we believe the use of such phrases is not helpful, as they create ambiguity over the nature of the proposals and how they should be applied. We therefore recommend the IASB avoid the use of these phrases.

Business model assessment:

The proposals include amendments to assist entities in their assessment of whether financial assets, including those with ESG linked or similar features, have contractual cash flows that are SPPI.

However, the business model assessment as required under paragraphs 4.1.1, 4.1.2(a) and 4.1.2.A(a) of IFRS 9, is equally important in the classification of financial assets as subsequently measured at amortised cost or at FVOCI.

As ESG initiatives become more prevalent and regulation for entities are gradually agreed, there may be instances where business models include investment guidelines such that loans to borrowers who breach a specified ESG score must be sold. Entities with such investment guidelines may not meet the held to collect business model, which could undermine the efforts the IASB has put into this ED.