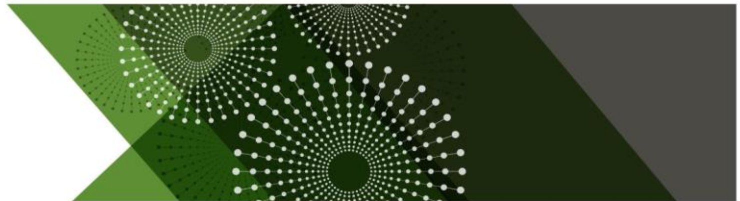

XRB | Te Kāwai Ārahi Pūrongo Mōwaho
EXTERNAL REPORTING BOARD

Mr Andreas Barckow 19 July 2023

Chairman of the International Accounting Standards Board
IFRS Foundation
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Submitted to: www.ifrs.org

Dear Andreas

IASB/ED/2023/2 *Amendments to the Classification and Measurement of Financial Instruments* (Proposed amendments to IFRS 9 and IFRS 7) *('the ED')*

Thank you for the opportunity to comment the ED, which has been exposed in New Zealand. In developing our responses to the ED, we have focused on those questions that we considered would be of most relevance to New Zealand stakeholders.

While we are generally supportive of the ED proposals, we have the following **recommendations**:

Derecognition of financial liabilities settled via electronic transfer:

- To explain the principle for determining whether an 'electronic payment system' is within the scope of the proposed accounting policy choice for derecognition; and
- To refine the requirements on determining when the entity is unable to withdraw or cancel an electronic payment, to make these requirements easier to understand and apply consistently.

Classification of financial assets – clarifications relating to 'basic lending arrangements':

- To explain in the amendments how and why contractual cash flows that vary based on the achievement of ESG-related targets are consistent with a 'basic lending arrangement'; and
- To refine the requirements relating to contingent events that are specific to the debtor so that the principle is clear, to ensure that these requirements do not result in unintended consequences and to assist entities in applying these requirements.

Our recommendations and responses to the specific questions for respondents are provided in the Appendix to this letter. If you have any queries or require clarification of any matters in this letter, please contact Gali Slyuzberg (gali.slyuzberg@xrb.govt.nz) or me.

Yours sincerely

Carolyn Cordery
Chair – New Zealand Accounting Standards Board

Appendix

Question 1 – Derecognition of a financial liability settled through electronic transfer
Paragraph B3.3.8 of the draft amendments to IFRS 9 proposes that, when specified criteria are met, an entity would be permitted to derecognise a financial liability that is settled using an electronic payment system although cash has yet to be delivered by the entity. Paragraphs BC5–BC38 of the Basis for Conclusions explain the IASB's rationale for this proposal. Do you agree with this proposal? If you disagree, please explain what aspect of the proposal you disagree with. What would you suggest instead and why?

Response to Question 1

1. We agree with the proposals to allow a financial liability that is settled via an electronic payment system to be derecognised on the date of initiating the payment instruction (provided that the 'settlement risk' is low) – as opposed to requiring entities to wait until the settlement date before the liability can be derecognised.

2. However, we recommend stating the principle for determining whether a type of electronic payment is within the scope of the accounting policy choice, to help preparers determine whether and when the accounting policy choice applies, and in order to 'future proof' these requirements for new types of electronic payments.

3. Furthermore, it may be challenging and time-consuming for entities to ascertain the point at which the criterion in paragraph B3.3.8(a) would be met, i.e. whether and for how long the entity has the ability to cancel or withdraw an electronic payment instruction – particularly when an entity uses the services of various banks in different countries, whose electronic payment systems might operate differently in this regard. We recommend addressing this matter by making one or more of the following changes.

   (a) Updating paragraph B3.3.8(a) to refer to the *practical* ability to withdraw or cancel the payment instruction – rather than the ability to do so in general. This would make the principle of this requirement consistent with paragraph B3.3.8(b) – which refers to the entity having no *practical ability* to access the cash to be used for settlement of the liability).

   (b) Reducing the de-recognition criteria in paragraphs B3.3.8(a) and B3.3.8(b) into a single criterion that refers to *practical ability*. We understand that it is very unlikely for an entity to meet one criterion and not the other. That is, the criterion of not being able to stop, cancel or withdraw the payment instruction and the criterion of not being able to access the cash to be used for settling the liability are generally met at the same time. Reducing these two criteria into a single criterion that refers to *practical* ability would streamline the requirements and make it easier for entities to determine when they can de-recognise a financial liability before the settlement date.

   (c) Providing additional guidance to help entities assess when practical ability to cancel or withdraw the payment and/or access the related cash exists.

Question 2 – Classification of financial assets—contractual terms that are consistent with a basic lending arrangement Paragraphs B4.1.8A and B4.1.10A of the draft amendments to IFRS 9 propose how an entity would be required to assess: (a) interest for the purposes of applying paragraph B4.1.7A; and (b) contractual terms that change the timing or amount of contractual cash flows for the purposes of applying paragraph B4.1.10. The draft amendments to paragraphs B4.1.13 and B4.1.14 of IFRS 9 propose additional examples of financial assets that have, or do not have, contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Paragraphs BC39–BC72 of the Basis for Conclusions explain the IASB's rationale for these proposals. Do you agree with these proposals? Why or why not? If you disagree, please explain what aspect of the proposals you disagree with. What would you suggest instead and why?

Response to Question 2

4. We have specific recommendations on the proposals that relate to the assessment of whether cash flows are consistent with a 'basic lending arrangement' for the purpose of applying the 'solely payments of principal and interest test' ('SPPI test') – including the proposals relating to financial assets with ESG-linked features. However, we support the IASB's initiative to assist entities in the application of the abovementioned assessment.

Support for the initiative to provide further guidance on 'basic lending arrangement' and the classification of financial assets with ESG-linked features

5. We agree that it is important to ensure that entities have sufficient guidance for the classification of financial assets with ESG-linked features, and to ensure that the requirements result in appropriate outcomes. The following are comments that stakeholders raised during the PIR of IFRS 9 and/or the current consultation on the ED.

   (a) During the first stage of the PIR of IFRS 9, stakeholders noted that under the current requirements of IFRS 9, it can be unclear whether a loan with ESG-linked features is consistent with a 'basic lending arrangement' and therefore whether it passes or fails the 'SPPI test' (when the ESG-linked features are not 'de minimis' – see below). Stakeholders noted that generally, classification of such loans at amortised cost seems the appropriate outcome and would provide useful information – but without further clarification of the existing requirements in IFRS 9, there is a risk that such loans would fail the SPPI test and would need to be measured at fair value. This could have the unintended consequence of discouraging banks and other financial institutions from offering such loans, which are proving useful for encouraging responsible corporate behaviour.

   (b) Stakeholders noted that it is timely to address this matter. They acknowledged that loans with ESG-linked features are currently not highly prevalent in New Zealand, and that contractually-specified changes in interest rates resulting from ESG-linked features are mostly 'de-minimis' at this stage (and therefore do not materially impact the

classification and measurement of such loans). However, they noted that loans with ESG-linked features are likely to become more common in the future. Also, it is expected that when financial assets with ESG-linked feature become more prevalent and as the market gains more experience with such instruments, the impact of ESG-linked features on interest would become more substantial – as it will become more and more challenging to prove that a loan is 'green' if the ESG-linked features have a 'de-minimis' impact on the interest.

Recommendation to explain how financial assets with ESG-linked features are consistent with a 'basic lending arrangement

6. We note that the ED proposes to include the following example underneath paragraph B4.1.13, in relation to financial assets with ESG-linked features:

   "Instrument EA is a loan with an interest rate that is periodically adjusted by a specified number of basis points if the debtor achieves a contractually specified reduction in greenhouse gas emissions during the preceding reporting period."

7. The ED says that this instrument meets the SPPI test, noting that "the occurrence of the contingent event (achieving a contractually specified reduction in greenhouse gas emissions) is specific to the debtor", and the contractual cash flows are "in all circumstances solely payments of principal and interest on the principal amount outstanding".

8. It is not clear from the wording of this example (or from the other proposed amendments in the ED) how and why the cash flows of Instrument EA are consistent with a 'basic lending arrangement' and therefore meet the SPPI test.

   (a) The proposed additional requirements about cash flows that are subject to change based on contingent events do not change the fact that such cash flows still need to be consistent with a 'basic lending arrangement', as described in existing paragraph B4.1.7A, in order for the financial asset to pass the SPPI test.

   (b) Existing paragraph B4.1.7A states that in a basic lending arrangement, interest typically reflects the debtor's credit risk and the time value of money, as well as other basic lending risks and costs associated with holding the asset, such as liquidity risk, and a profit margin.

   (c) While it is clear from the 'Instrument EA' example that the changes in the cash flows are specific to the debtor, which is consistent with the new guidance in paragraph B4.1.10A, this fact alone is not sufficient for meeting the description of 'basic lending arrangement' in paragraph B4.1.7A.

9. We have the following recommendations to address the abovementioned lack of clarity.

   (a) Regarding the changes in the cash flows of 'Instrument EA' that are based on the achievement of greenhouse gas emissions targets, we recommend explaining *which of the basic lending risks or costs described in paragraph B4.1.7A do these changes in cash flows relate to*. For example, if the achievement of greenhouse gas emission targets is considered to be related to the debtor's credit risk, then it is important to explain this.

(b) It is important that the *principles* driving the decision that 'Instrument EA' is consistent with a basic lending arrangement and meets the SPPI test are clearly articulated. Preparers can then use this when applying these principles to other types of financial assets with ESG-linked features, and to other types of financial assets with variable contractual cash flows that depend on a contingent event.

Recommendation relating to the proposed requirement for a contingent event to be specific to the debtor

10. Proposed paragraph B4.1.10A states: "For a change in contractual cash flows to be consistent with a basic lending arrangement, the occurrence (or non-occurrence) of the contingent event must be specific to the debtor." There is a risk that this proposal could cause financial assets that are not consistent with a 'basic lending arrangement' to meet the 'SPPI test', and to be reclassified from fair value through surplus or deficit to amortised cost, which would not be appropriate. It is important to ensure that the proposed requirement does not unintentionally bring financial assets that are more usefully measured at fair value into the amortised cost category.

11. We recommend explaining in paragraph B4.1.10A that when the occurrence or non-occurrence of the contingent event is specific to the debtor, this fact on its own does not mean that the change in contractual cash flows is consistent with a basic lending arrangement – and that it is necessary to consider the description of 'basic lending arrangement' in paragraph B4.1.7A when assessing whether a change in contractual cash flow that is subject to a debtor-specific contingent event is consistent with a basic lending arrangement for the purpose of the SPPI test.

12. We are also aware of certain loans with ESG-linked features where, under the ED proposals, it could be challenging to determine whether an ESG-linked target represents a contingent event that is specific to the debtor. This is the case for the following types of loans.

    (a) *Loans where achievement of the ESG-linked target is partially dependent on the debtor*: For a loan contract where interest is adjusted based on whether the debtor is in the top X% of sustainability leaders for a particular industry or group, it is not clear from the ED whether the condition of meeting the 'top X%' target qualifies as a contingent event that is specific to the debtor. Meeting this target is partially dependent on the debtor's actions, but it is also dependent on the actions of other entities.

    (b) *Loans where the ESG-linked target relates to the group that the debtor is part of*: In some loans with ESG-linked features, the ESG-based target relates to the *group* that the debtor is part of, rather than debtor entity itself. For example, the interest on a loan may be adjusted based on whether the debtor's parent entity achieves certain ESG-based targets. It is not clear whether such a target constitutes a contingent event that is specific to the debtor.

13. Therefore, we recommend further amendments to help reporting entities determine how the assessment of whether a contingent event is specific to the debtor should be applied to the types of situations above. This could be done by way of examples, similarly to the examples

added for 'Instrument EA' and 'Instrument I', taking into account our recommendations above to clearly articulate the principles driving the decisions in the examples. Alternatively, this could be done by adding paragraphs with guidance on contingent events that are dependent partially on the debtor and partially on external factors, and contingent events that are specific to the group that the debtor is part of, but not the debtor itself.

Questions 3–7

14. We have not commented on these questions.