Comments

Exposure Draft: Amendments to the Classification and Measurement of Financial Instruments

Proposed amendments to IFRS 9 and IFRS 7

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Summary

The German Banking Industry Committee (Die Deutsche Kreditwirtschaft - DK) welcomes the IASB's approach to address the concerns expressed by stakeholders in the context of the Post-Implementation Review (PIR).

The proposals for derecognition of a financial liability by electronic transfer require very deep analyses from the companies. Against this background and also the fact that this is not a PIR topic, the derecognition provisions of IFRS 9 should be left unchanged for the time being and the topic should be examined more comprehensively in a separate project.

With regard to the ESG issue, we welcome the fact that IFRS 9 remains principle-based and that no case-by-case rules have been included. We interpret the changes in connection with the newly introduced examples in such a way that ESG-linked financial instruments can in principle be accounted for at amortised cost. Nevertheless, we consider some paragraphs to be difficult to understand. In particular, the term "magnitude" raises so many questions that we advocate deleting the term without replacement.

We welcome the proposed amendments on financial instruments with non-recourse features and on credit-linked instruments (CLI). Regarding CLI, we would like to see some explanations from the September 2022 staff papers added to the explanations.

The proposed disclosure requirements are clearly too extensive. They lead to a massive overloading of the notes and thus to an information overload. The resulting (very limited) information benefit would be disproportionate to the necessary costs. We therefore advocate that the IASB significantly reduce the scope of the planned disclosure requirements.

With regard to the transition, the intended transitional provisions are basically comprehensible to us. It is essential to ensure appropriate implementation deadlines.

1. 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?

In principle, we have no objections to the introduction of an option. However, the criteria for exercising this option are clearly too extensive. In order to apply the exception proposed in B3.3.8, entities would need to conduct in-depth analyses for each of the payment systems used to determine whether all the criteria of the amendment are met.

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For global credit institutions, which typically use a variety of payment systems in different jurisdictions with different legal frameworks, assessing whether all criteria are met in these systems is too complex and the cost of applying this exception is thus too high.

We therefore propose to leave the derecognition requirements of IFRS 9 unchanged for the time being and to address the issue more comprehensively in a separate project.

2. 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?

We welcome the fact that IFRS 9 remains principle-based and that no case-by-case rules have been included for the ESG issue.

In this context, we also consider the statements of BC47a that the interest elements mentioned in the draft are not conclusive to be positive. Due to the high relevance of this statement, we advocate integrating this passage into the mandatory part of the standard.

We read the newly inserted paragraphs B4.1.8A and B4.1.10A in connection with examples B4.1.13 and B4.1.14, so that we come to the conclusion that ESG-linked financial instruments can in principle be accounted for at amortised cost.

Nevertheless, paragraphs B4.1.8A and B4.1.10A are perceived as difficult to understand, also how they relate to each other and how the paragraphs fit to the two examples. In particular, the formulations used in B4.1.8A "basic lending risks", "aligned with the direction and magnitude of" or "contingent event must be specific to the debtor" raise questions. Especially the term "magnitude" is problematic, as it implies a proof of correlation for ESG-related financial instruments, which will often not be feasible in practice. In this respect, we advocate deleting the term "magnitude" without replacement.

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We welcome that the IASB defines the meaning of "specific to the debtor" in paragraph B4.1.10A of the draft as "the occurrence of a contingent event ... if it depends on the debtor achieving a contractually specified target, even if the same target is included in other contracts for other debtors". However, we question the IASB's reasoning in paragraph BC67, which concludes 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". Loans that currently meet SPPI requirements may contain lender-specific clauses that relate to "non-financial variables". BC67 could therefore have unintended consequences for some loans with lender-specific clauses (e.g. additional cost clauses due to capital requirements or interest rate increases when a lender's fiscal circumstances change).

Finally, we assume that the current "de minimis" regulations will continue to apply unchanged within the framework of the examination of the cash flow criteria. In our view, this should be made even clearer.

3. 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 welcome the proposed amendment. This clarification reflects common accounting practice in Germany, as also set out, for example, in IDW RS HFA 48 (margin no. 204ff.).

4. 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?

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We generally support the clarifications provided during the IASB discussions on this topic. As we are clearly in favour of principle-based accounting standards, we understand that not all individual cases discussed can be included in IFRS 9. However, we give consideration to the inclusion of the following extract from paragraph 38 of the September 2022 paper, which provides clear guidance on how to distinguish Non Recourse Financing (NRF) and CL structures:

In a scenario that the underlying pool performs poorly, insufficient cash flows from the underlying pool of financial assets to make payments of interest and principal on the tranches according to their place in the waterfall payment structure do not trigger a default of the issuer, but rather reduce the contractual rights of the holders of the affected tranches to receive cash flows. This feature distinguishes a CLI structure from other forms of subordination such as the creditor ranking, whereby the contractual rights to receive cash flows would generally remain unaffected.

The intended clarification in IFRS 9.B4.1.20A clarifies the scope of the requirements for contractually linked instruments and rightly denies certain transactions the status of contractually linked instruments. However, we would propose to amend the wording of the following sentence as follows:

Such transactions do not contain multiple contractually linked instruments because the structured entity is created to facilitate the lending transaction from a single ***debt instrument from*** *creditor****(s)****.*

In some cases, a bank may issue a single tranche of senior debt with the subordinated instruments held by the sponsor. The bank may syndicate a portion of the senior debt to reduce concentration risk. We do not believe that subsequent syndication of a pro-rata portion of a single external debt tranche should impact the analysis of whether or not the instrument is a CLI. In our view, the focus of this paragraph should be on the number of debt tranches with different credit concentrations. If there are only two debt tranches with the subordinated instrument held by the sponsor and the external creditors hold a single pari passu tranche between them, then it should not be a CLI.

The reference in B4.1.20 that tranches can also have non-recourse characteristics is understandable, but this half-sentence also raises the question of whether the SPPI characteristic of a tranche with non-recourse characteristics is to be assessed solely on the basis of the requirements for contractually linked instruments or additionally also according to the requirements for non-recourse transactions. A clarification would be desirable.

<u>5. Question 5 – Disclosures – Investments in equity instruments designated at fair value through other comprehensive income</u>

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 agree.

6. 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?

The proposed extension of the disclosure requirements is clearly too extensive. The number of contracts expected to have such features may be substantial. Even for a medium-sized universal bank, the number of such financial instruments is likely to be in the six- to seven-digit range. Gathering information about the above features would be excessively burdensome.

The information required for the notes is not available in a form that would permit automated evaluation. This is particularly due to the fact that there are no limits to the imagination when it comes to the design of e.g. ESG-linked financial instruments. The concept of contingent modification of cash flows on a loan would concern many common features in a given contract. The question arises about contracts that were subject to changes (reduction) of profit margin as the contingent event occurred (EBIDTA / payments / transactions threshold / ratio) is met but it is possible that after some time the contingent event is reversed. So, the margin goes up and so do the cash flows. Will the given gross carrying value disclosed generate more or less cash flows within provided range potentially? This is not possible to predict. Accordingly, we do not believe that users will be able to make proper use of such information.

In addition, almost every financial instrument is unique, so clustering is not possible. The creation and maintenance of a new, all-encompassing contract database solely for the purposes of a note disclosure or the group-wide collection of this data is, in our view, impracticable.

Furthermore, the planned disclosure requirements would lead to a massive overloading of the notes and thus to an information overload. The resulting (very limited) information benefit would be disproportionate to the necessary costs (cost benefit principle). We also doubt that there is much interest in this information on the part of investors.

We advocate that the IASB significantly reduces the scope of the planned disclosure requirements; the focus here should be limited to the qualitative disclosures. The proposed quantitative disclosures urgently need to be reviewed, which we believe could be done in the planned project on "Amortised Cost and Effective Interest Rate and Modifications". In particular, liabilities and "classic" contingent features that relate to credit risk should definitely be excluded from the disclosure requirements.

Against the background of the very high complexity of the topic, we would like to point out the need for preparers to be given a sufficiently long period of time to implement the disclosure requirements.

7. 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?

The intended transitional provisions are basically comprehensible to us. It is clear from our answers to Q1 and Q6 that sufficiently long implementation periods are necessary.