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Dear Mr.Barckow

Exposure Draft: Amendments to the Classification and Measurement of Financial Instruments (Proposed amendments to IFRS 9 and IFRS 7)

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the Exposure Draft: Amendments to the Classification and Measurement of Financial Instruments (Proposed amendments to IFRS 9 and IFRS 7), published by the IASB on 21 March 2023 for public consultation.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors, and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We respond to each of the questions set out in the Exposure Draft. Our comments are focused on the following three topics:

- Derecognition of a financial liability settled through electronic transfer
- Contractually linked instruments
- ESG-linked financial instruments

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?

Our members acknowledge the objective of the proposed amendments and accounting policy choice provided in the Exposure Draft.

However, our members noted that understanding the rights and obligations underlying the different transfer schemes across the multiple jurisdictions they operate in may result in a complex, time consuming and costly project which includes but is not limited to:

- understanding the legal framework governing the contractual relationship between the ordering party and the beneficiary,
- other laws and regulations of the relevant jurisdiction,
- the underlying terms and conditions of the transfer scheme and the rights and obligations of the intermediary financial institution processing the transfer.

In addition, there is a clear read across between the expiration of cash flows in the context of financial asset derecognition and the discharge (extinguishment) of obligations in a financial liability. This needs to be carefully considered when understanding practices across different schemes, jurisdictions, and products if our members were to justify their accounting policy choices in this regard.

We also note that there is an internal inconsistency between B3.3.8 (a) and (b). We suggest inserting the word "practical" in (a) to be consistent with (b).

We would recommend that electronic payment systems are defined so that the scope is clear as these provisions may apply to a multitude of products and services which are not electronic transfers.

As a way to address the issues associated with the complexity of the proposed amendments, our members consider that the transitional provisions of the ED could be amended such that these proposed amendments are decoupled from the wider provisions of the ED or subject to further consideration on their relevance and benefit. This will allow our members to early adopt the more pressing amendments related to Contractually Linked Instruments (CLI), Non-Recourse Finance (NRF) and ESG Lending (see further comments below) while the provisions relating to the derecognition of financial liabilities can become effective at a **later**

date (if applicable) which in turn allows for the necessary legal, technical, systems and process review to be conducted. This will also achieve a better balance between the costs and benefits of the proposals and will provide better information to users.

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?

Our members welcome the proposed amendments to the requirements in paragraphs B.4.1.8A and B4.1.10A which provide additional guidance when assessing whether certain contractual terms are consistent with a basic lending arrangement and thus with the contractual cash flow characteristics test (SPPI). However, it would be useful to get additional insight from the Board (for example by supplementing the Basis for Conclusions) on the intended scope of the proposed changes. For example, there are certain instruments where the profit margin changes depending on the duration of the instrument (i.e. it increases as the lender's holding period increases.) which may be within the scope of these proposals. Our members consider that this was not the intention of the IASB however given the way the ED is drafted there is a risk that this interpretation might be plausible.

Our members also noted that there are certain areas that would benefit from additional application guidance as follows:

- The definition of the **borrower boundary** and whether a transaction that references for example group wide KPIs rather than the KPIs of the specific borrower would still be consistent with a basic lending arrangement. It seems counterintuitive that this would not be consistent with a basic lending arrangement given the prevalence of group-wide funding structures (e.g., funding vehicles) or group-wide KPIs which apply consistently across subsidiaries.

- Paragraph B4.1.8A states that 'Furthermore, a change in contractual cash flows is inconsistent with a basic lending arrangement if it is not aligned with the direction and magnitude of the change in basic lending risks or costs.' Our members expressed concerns with the lack of clarity of this statement and how it relates to the requirements on changes to the timing and amount of the contractual cash flows. This paragraph seems to operate as a backstop re-iterating the basic principle in IFRS that in a basic lending arrangement, compensation for time value of money and credit risk should be consistent with the change in basic lending risks (i.e., holding period and changes in credit worthiness of the borrower). We believe the clear reference to magnitude creates unnecessary complexity and uncertainty particularly when assessing features other than credit risk. This seems to refer to a requirement for a specific assessment which links to ESG and other contingent features to the changes in credit risk, disregarding that pricing operates within a range and is driven by directional consistency and commercial drivers. Our members would therefore recommend the removal of the references to magnitude.

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?

Our members welcome and agree with the proposed amendments (see note on further guidance on question 4 below).

It would be helpful to expand paragraph BC77 to include a scenario where the creditor has received a guarantee from an entity within the debtor's group and whether this is consistent with non-recourse finance and hence with a basic lending arrangement. In substance, our members view these types of rights as the same as the creditor having the right to require the debtor to add assets into the structure. This would be in line with the definition of a basic lending arrangement Furthermore, our members consider that it would be helpful to provide additional guidance in the context of multi-tranche scenarios which include similar guarantee rights to the lender. For example, a structured entity holding the underlying assets may issue three-tranche notes, i.e., senior, mezzanine and a junior tranche. Under current requirements, senior notes will often be considered as part of the assessment for contractually linked instruments. However, if the contractual terms of the arrangement provide the senior note holder the contractual right to require the sponsor to transfer additional assets into the structured entity if the existing underlying assets do not generate sufficient cash flows to maintain agreed borrowing base, our members consider that the senior notes do not have non-recourse feature and therefore will not be considered contractually linked instruments. An additional question arises in these instances more specifically whether the existence of the guarantee effectively means that the mezzanine tranche becomes non-recourse finance provided that the junior notes are held by the sponsor.

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?

Our members welcome and agree with the proposals however they consider that the guidance could be further strengthened. The staff paper 16 B presented at the September 2022 contains useful application guidance which in our view will contribute to consistency in application and comparability across preparers. Given that the high-quality detailed work and thought has already been performed by the IASB there is no reason why it should not be included in the final standard. Having this additional guidance will in our view contribute to provide better information to users. We consider that the staff can incorporate this guidance into the application guidance or basis for conclusions of the final standard. In particular, we recommend that the following extract from paragraph 38 of the September 2022 staff paper is included since this provides clear guidance on how to distinguish between NRF and CLI structures where there are multiple tranches of debt:

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.*

In terms of the additional paragraph B4.1.20A we are supportive of the concept that a junior instrument held by a sponsor should not be counted when assessing whether there are multiple contractually linked instruments. However, our members consider that the wording needs to be amended, particularly the sentence:

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

This is because, in some cases, a bank may originate a single tranche of senior debt with the junior instruments held by the sponsor. The bank may syndicate part of the senior debt to reduce concentration risk. We do not think that a subsequent syndication of a pro rata share of a single external debt tranche should affect the analysis of whether the instrument is a CLI or not. We think the focus for this paragraph should be on the number of debt tranches with different credit concentrations. If there are only two debt tranches with the junior instrument held by the sponsor and the external creditors hold between them a single Pari-passu tranche– then this should affect CLI assessment. We therefore suggest this sentence is amended to:

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).

We also suggest that 'tranche' is clearly defined.

We welcome the clarification in B4.1.23 that would allow some investments in lease receivable structures to potentially qualify for amortised cost measurement. However, its effect might be limited as the interaction between B4.1.23 and B4.1.24 appears to unintentionally disallow structures where the residual value risk in the underlying lease receivables is commonly removed by a guarantee issued by the debtor (sponsoring entity) to the underlying pool of lease receivables. We would suggest this sentence is amended to:

For the purpose of this assessment, the underlying pool can include financial instruments that are not within the scope of the classification requirements (see Section 4.1 of this Standard), for example, lease receivables and residual value guarantees that combined have contractual cash flows that are equivalent to payments of principal and interest on the principal amount outstanding.

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?

Our members agree with the proposals.

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?

Our members acknowledge the efforts of the IASB in bringing increased transparency to the disclosures of contractual terms that could change the timing or amount of contractual cash flows. Notwithstanding, our members are concerned that the scope of the proposed disclosures may be too wide, will not provide useful information and seems to disregard the undue cost / effort versus the additional benefits provided to the users. In addition, they are also uncertain what information need for users the disclosure is intended to address.

Our members note that changes to the timing and amount of contractual cash flows encompasses a wide variety of items which may already be captured by existing disclosures. For example: changes to the contractual cash flows attributable to asset recoverability are dealt with by the ECL disclosures, or changes to the contractual cash flows attributable to changes in the effective interest rate are dealt with by the specific EIR disclosures. This effectively means that the scope of the proposed disclosures should be clearly defined meaning that they should not apply equally to all classes of assets and liabilities. It is important to note that users already have a formed view on specific items (examples above) and creating an overarching disclosure which overlaps existing requirements without a specific anchor point (i.e., total change in carrying amount) may compromise the overall goal and impair intended benefits significantly,

This issue is exacerbated because our members operate with a broad range of products which will fall within the scope of the proposed disclosures, most notably financial assets whose cash flows may increase or decrease depending to the borrower achieving or not achieving set credit rating. For example, many vanilla corporate lending instruments have margin changes linked to borrower credit rating or have clauses where the spread increases at specific points in the life of the loan to reflect the increased credit risk attributable to the holding period or have clauses where coupon increases if there is a failure to pay a contractual amount. As such the notional amounts captured by this disclosure could be very high and disclosing the range of the maximum possible increase or decrease in coupon to a large notional figure could be misleading when the end of the ranges does not apply to the majority of the exposures, or the contingencies required to reach the end of the ranges are remote.

From an operational standpoint, the proposed disclosures require extensive data gathering which aims to capture unrelated changes. This will be very difficult to present in a meaningful way. Also, the data would be difficult to capture and reconcile to other financial records because it has not previously been subject to external reporting controls and associated governance (see below), giving rise to a significant incremental reporting burden.

In addition, a significant level of data aggregation will be required given the extent of the product offering our members make available to their customers. This will adversely impact the usefulness of the information, create unnecessary complexity, and create additional concerns (unintended consequences) such as:

- some information required by the disclosure is close to budgetary nature and thus commercially sensitive.
- data will be difficult to capture and will require extensive processes and systems development.
- data will need to be reconciled to financial records and be included in a robust control framework (e.g., SOX).
- data will be collected solely for accounting purposes with no other useful meaning from a management perspective.
- providing ranges of changes in timing and amount of the cash flows even in an aggregated form might not address the concerns of users as the number of products offered by our members will not allow a detailed view of the effects attributable to these contingent features.

- the proposal is likely to generate significant costs.

Our members consider that the staff could re-visit the scope of the disclosure to make it more targeted to the needs of users while addressing the cost / benefit considerations faced by preparers. Potential solutions could be as follows:

- Limit the scope of the disclosures to financial assets – The disclosure requirements for financial liabilities in IFRS 7 are stable and well understood. There are no changes in the ED relating to the classification of liabilities and so no driver for increased disclosure. Creating new disclosure requirements for changes in timing and amount of contractual cash flows of financial liabilities, if necessary, at all, should form part of a long-term project e.g., Effective Interest Rate (EIR)
- Exclude changes attributable to credit risk from the scope of the disclosure – this is partially dealt with by the Expected Credit Loss Requirements in IFRS 9 and should also form part of a long-term project e.g., Effective Interest Rate (EIR)
- Focus the disclosure on the financial instruments that have changes in the contractual cash flows that are attributable to other contingent features which are consistent with a basic lending arrangement (e.g., ESG lending).
- Be clear on which contingent features are in scope. For example, are credit -related ratchet clauses out of scope?
- Finally, we strongly recommend that the staff should conduct further outreach with end users prior to the finalisation of the ED to understand their specific needs and amend the proposed disclosures in line with their needs while considering challenges and concerns raised by preparers.

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?

As stated above, we suggest that IASB staff revisit the transition provisions of the ED to decouple the provisions of derecognition of financial liability as a result of an electronic transfer from the wider provisions of the ED. The former should have a later effective date than the latter.

This will allow our members to early adopt the more pressing and beneficial amendments regarding Contractually Linked Instruments (CLI), Non-Recourse Finance (NRF) and ESG

Lending while more lead time is given to assess the requirements on derecognition of financial liabilities. This caters for the necessary legal, technical, systems and processes reviews and will achieve a better balance between costs and benefits of the proposals. This will also allow for better information to be provided to users given the inherent complexity of the amendments.

In addition, our members consider that given the complexity of the proposed disclosure requirements, transition relief should be provided for interim reporting periods. This will allow our members to conduct the necessary changes to their processes, systems, and controls to ensure that these disclosures will become an integral part of their financial reporting framework.

Conclusion

We trust that the above comments are helpful, and we look forward to engaging further with the IASB on the Exposure Draft.

Yours sincerely,

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