Dr Andreas Barckow
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Dear Dr Barckow

Invitation to Comment: Request for Information - Post-implementation Review: IFRS 9 *Financial Instruments* Classification and Measurement

The UK Endorsement Board (UKEB) is responsible for endorsement and adoption of IFRS for use in the UK and therefore is the UK's National Standard Setter for IFRS. The UKEB also leads the UK's engagement with the IFRS Foundation (Foundation) on the development of new standards, amendments and interpretations. This letter is intended to contribute to the Foundation's due process. The views expressed by the UKEB in this letter are separate from, and will not necessarily affect the conclusions in, any endorsement and adoption assessment on new or amended International Accounting Standards undertaken by the UKEB.

There are currently approximately 1,500 entities with equity listed on London Stock Exchange that prepare their financial statements in accordance with IFRS Standards[1]. In addition, UK law allows unlisted companies the option to use IFRS and approximately 14,000 such companies currently take up this option[2].

We welcome the opportunity to provide comment on the IASB's Request for Information – Post-implementation Review: IFRS 9 *Financial Instruments* Classification and Measurement (RFI). To develop our response our work has included in-house research, a stakeholder survey, and feedback received during stakeholder roundtables and interviews. We summarise below our main findings from this work.

Our stakeholder outreach has highlighted that the IFRS 9 classification and measurement requirements generally work as intended and represent an improvement to the previous rule-based requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. Our response to the RFI will therefore focus on the three significant areas where we consider that improvement, and potentially standard setting activity, is required. Two areas of concern relate to the application of the contractual cash flow characteristics assessment for financial assets, while the third relates to the effective interest rate methodology.

[1] UKEB calculation based on LSEG and Eikon data. This calculation includes companies listed on the Main market as well as the Alternative Investment Market (AIM).
[2] UKEB estimation based on FAME, Companies Watch and other proprietary data.

Financial instruments with sustainability-linked features

1. The IFRS 9 classification and measurement requirements are designed to deal with all types of financial instruments. In recent years, instruments for which interest rates vary on the occurrence of one or more pre-determined events have become increasingly prevalent. Of these, financial instruments with ESG[3] features ("FIEF") are the most common and are expected to grow significantly in future. FIEF come in a variety of forms, including sophisticated instruments which clearly qualify for fair value treatment under IFRS 9. Our concern lies with financial instruments that, but for the ESG feature, would be considered basic lending and qualify for amortised cost accounting.

2. There is a general concern that IFRS 9 currently does not adequately cater for such instruments. In the absence of clear guidance, there is a risk that inconsistent accounting practices will develop for such instruments. Furthermore, UK stakeholders have expressed concern that FIEF that are in substance basic lending may be required to be accounted for at fair value based on the current drafting of IFRS 9. In this respect, it is worth noting that the purpose of ESG features in such instruments is generally to change behaviour and it is not intended that they will lead to an increase in the cash flows of the loan. Where the product in substance represents basic lending, IFRS 9 is based on the premise that amortised cost provides users with more decision useful information: (i) the effective interest rate (EIR) interest flows are reported as interest income, often monitored as a key metric for such instruments; and (ii) the expected credit loss requirements of IFRS 9 are considered to provide comprehensive and transparent information on the performance of the product. Measuring such basic lending instruments at fair value would lose that decision useful information.

3. In Appendix 1 paragraph A7, we make a number of suggestions to clarify the IFRS 9 requirements in this regard. These include adding relevant examples to IFRS 9 and providing further guidance as to what can be considered covered by credit risk, profit margin, and "other basic lending risks". Guidance included previously for the treatment of items related to liquidity risk and administrative costs provides precedent for such an approach.

4. We believe resolution of this issue is needed as a matter of urgency. This product set is expected to experience significant and sustained growth in the near future. We concur with stakeholders that attempting to resolve this issue via the Post Implementation Review (PIR) process is unlikely to lead to a timely outcome. We urge the IASB to address it via a more urgent mechanism than the PIR process, such as a targeted project addressing both the application of the contractual cash flow characteristics assessment to ESG features and the application of the amortised cost calculation for changes in contingent cash flows.

[3] These are sustainability-linked features including the Environmental, Social or Governance practices of the entity.

Amortised cost and the effective interest method

5. Stakeholder feedback indicates that the application guidance in IFRS 9 in relation to amortised cost and use of the effective interest method is not sufficiently clear. In particular, stakeholders raise the application of B5.4.5 and B5.4.6 and whether a revision of estimates should be reflected as a change in the effective interest rate or recognised as a 'catch-up adjustment'. We have therefore included recommendations on this issue in Appendix 1 paragraphs A12-A13. If, as expected, FIEF become more prevalent and the potential change in cash flows due to the ESG feature becomes greater, then this issue will become more significant. We consider that this issue should be addressed alongside those described above relating to FIEF and with the same urgency.

Contractually linked instruments and non-recourse finance

6. Currently there is limited guidance on the contractual cash flow characteristics assessment in IFRS 9 in relation to the boundary between contractually linked instruments (CLI) and non-recourse finance (NRF) transactions. The boundary is not clear and, with the existing guidance, distinguishing between the two is challenging. As CLI requires the underlying portfolio to meet the cash flow characteristics test to achieve amortised cost accounting and NRF does not, outcomes can be very different. Outcomes can also be counterintuitive: instruments with relatively little asset risk may be treated as CLI and measured at fair value while other instruments with significantly more asset risk may be treated as NRF and measured at amortised cost.

7. In Appendix 1 A10-A11 we make a number of suggestions to provide greater clarity and reduce current diversity of practice in this area. These include providing background information to clarify IASB's intent with regard to the CLI requirements, providing definitions of key terms, clarifying that lending provided by a single lender is not within scope of CLI, and considering a proposal whereby the most senior tranche of lending is treated as NRF, leaving only tranches which provide credit protection to the structure to be subject to the CLI requirements.

In addition to the above, we have considered the recent IFRS Interpretations Committee (IFRIC) tentative agenda decision (TAD) *Cash Received via Electronic Transfer as Settlement for a Financial Asset*. This is an important issue for UK stakeholders and, given the widespread implications of the TAD including the requirement for significant analysis, consideration of legal rights and potential creation of a new class of assets/liabilities (as discussed in paragraphs A14-A18 of Appendix 1), we agree with the stakeholder feedback provided to IFRIC that this matter should be addressed as part of the PIR of IFRS 9. We recommend that the IASB consider whether there is evidence of diversity in practice for which the benefits of standard setting are likely to exceed the costs. If the IASB considers that standard setting is needed, we recommend that it performs further research to assess potential solutions, including considering whether applying a practical expedient, such as that already taken for "regular way transactions"[4], might meet the concerns with the TAD without creating unintended consequences.

If you have any questions about this response, please contact the project team at UKEndorsementBoard@endorsement-board.uk

Yours sincerely

Pauline Wallace
Chair
UK Endorsement Board

c.c. Ms. Sue Lloyd, Chair, IFRS Interpretations Committee

[4] Accounting for 'regular way transactions' (IFRS 9 3.1.2), that is, permitting a policy choice to determine the extinguishment of a financial payable (as per IFRS 9 3.3.1) or receivable (as per IFRS 9 3.2.3(a)) at either the commencement or conclusion of a market standard settlement mechanism.

Appendix 1: Questions on Request for Information: *Post Implementation Review IFRS 9, Classification and Measurement* .

A1 Subject to the issues associated with the cash flow characteristics assessment and effective interest method noted below, we have found that the IFRS 9 classification and measurement requirements generally work as intended and are an improvement to the previous rule-based requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. Our response to the IASB's Request For Information (RFI) therefore focuses primarily on *Question 3: Contractual Cash flow Characteristics* and *Question 7: Amortised Cost and the Effective Interest Method*, where improvement, and potentially standard setting activity, are required. Individual responses to RFI questions for areas that, materially, work as intended are not provided. We also provide comment on the IFRS Interpretations Committee (IFRIC) tentative agenda decision (TAD) *Cash Received via Electronic Transfer as Settlement for a Financial Asset* at Question 9: Other Matters.

Question 3: Contractual cash flow characteristics
a) Is the cash flow characteristics assessment working as the Board intended? Why or why not? Please explain whether requiring entities to classify and measure a financial asset considering the asset's cash flow characteristics achieves the Board's objective of entities providing users of financial statements with useful information about the amount, timing and uncertainty of future cash flows. If, in your view, useful information could be provided about a financial asset with cash flows that are not SPPI applying IFRS 9 (that is, an asset that is required to be measured at fair value through profit or loss applying IFRS 9) by applying a different measurement approach (that is, using amortised cost or fair value through OCI) please explain: *(i)* why the asset is required to be measured at fair value through profit or loss (that is, why, applying IFRS 9, the entity concludes that the asset has cash flows that are not SPPI). *(ii)* which measurement approach you think could provide useful information about the asset and why, including an explanation of how that approach would apply. For example, please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk). (See Section 7 for more questions about applying the effective interest method.)
b) Can the cash flow characteristics assessment be applied consistently? Why or why not? Please explain whether the requirements are clear and comprehensive enough to enable the assessment to be applied in a consistent manner to all financial assets within the scope of IFRS 9 (including financial assets with new product features such as sustainability-linked features). If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.
c) Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects? Please explain the costs and benefits of the contractual cash flow assessment, considering any financial reporting effects or operational effects for preparers of financial statements, users of financial statements, auditors or regulators. In responding to (a)–(c), please include information about financial instruments with sustainability-linked features (see Spotlight 3.1) and contractually linked instruments (see Spotlight 3.2).

Contractual cash flow characteristics of financial assets

A2 To develop our response our work has included in-house research, a stakeholder survey and feedback received during stakeholder roundtables and interviews. This has identified two significant areas where the cash flow characteristics test is not working as intended, leading to inconsistent application and counterintuitive results, and a third area of concern relating to the effective interest rate methodology. We believe improvement, and potentially standard setting activity, is required in these areas. These issues are described below.

Financial instruments with sustainability-linked features

A3 The IFRS 9 classification and measurement requirements are principles-based and therefore intended to deal with all types of financial instruments, including new financial instruments as they emerge.

A4 Subsequent to IFRS 9 being issued, financial instruments for which interest rates vary on the occurrence of one or more pre-determined events have become more prevalent. Of these, financial instruments with ESG[5] features ("FIEF") are the most common and are expected to grow significantly in future. FIEF come in variety of forms, including sophisticated instruments which clearly qualify for fair value treatment under IFRS 9. The scope of this response and the discussion below relates to financial instruments that, but for the ESG[6] feature, would be considered basic lending and qualify for amortised cost accounting

A5 We understand that the IFRS 9 requirements do not provide adequate guidance to enable accounting for FIEF that is consistent with the substance of the transactions. Current practice varies, with some considering the ESG feature as part of credit risk, and others considering it a part of the profit margin. Many consider such features to meet the de-minimis criteria of IFRS 9 B4.1.18 but acknowledge this may not be a sustainable argument should these features become more prominent as this asset class continues to evolve and grow.

A6 UK stakeholders expressed overwhelming concern that, once ESG features are material, FIEF that in substance represent basic lending may be required to be accounted for at fair value based on current IFRS 9 requirements. In this respect it is important to note that the purpose of ESG features in such instruments is generally to change behaviour and it is not intended that they will lead to an increase in the cash flows of the loan. Where the product in substance represents basic lending, IFRS 9 is based on the premise that amortised cost provides users with more decision useful information. The EIR interest flows are reported as interest income, which in various forms is monitored as a key metric. The expected credit loss requirements of IFRS 9 are considered to provide comprehensive and transparent information on the

[5] These are sustainability-linked features including the Environmental, Social or Governance practices of the entity.

[6] Where the ESG feature is also considered "basic" such as pre-determined targets specific to the borrower, and not referencing indices or third parties who are not a specific to a party to the contract.

performance of the product. Discussion with a banking analyst highlighted that the transparency of amortised cost accounting produces more relevant information, facilitates comparison within and between organisations, and allows critical information such as lending growth and provision coverage to be clearly identified. By contrast lending at fair value was considered opaque and difficult to disaggregate to obtain the desired information. Accounting for basic lending instruments at fair value would lose decision useful information.

A7 The nature of basic lending products will evolve over time to meet the changing needs of society. A principles-based accounting standard should accommodate such changes in a way that provides decision useful information. To enable such products to pass the cash flow characteristics test, and hence achieve amortised cost accounting (to reflect the substance of the transaction), we recommend that IASB:

a) Provide additional examples illustrating the application of the cash flow characteristics assessment to FIEF products;

b) Provide further guidance as to permitted elements of credit risk and profit margin relevant to this debate. In doing so we recommend the IASB expands on Paragraph B4.1.7A of IFRS 9 which states that '*interest can also include consideration for other basic lending risks*' and '*interest can include a profit margin that is consistent with a basic lending arrangement*' to clarify the nature of "other basic lending risks" and how ESG features may fit within this. B4.1.7A already specifies liquidity risk and administrative costs as examples of activities which meet these definitions, and this creates precedent to include other helpful examples such as those relevant to FIEF assessments.

c) Be mindful when developing further guidance or interpretation that it does not cumulatively move the standard from a principles to a rules based approach or inadvertently create bright lines. This is considered particularly important when dealing with examples where there are likely to be further developments or ongoing changes, such as new product sets.

A8 In addition, we believe resolution of this issue is needed as a matter of urgency. This product set is expected to experience significant and sustained growth in the near future. Attempting to resolve this issue via the PIR process is considered unlikely to lead to a timely outcome and may exacerbate the inconsistent accounting practices. We urge IASB to address it via a more urgent mechanism than the PIR process, such as a targeted project addressing both the application of the contractual cash flow characteristics assessment to ESG features and the application of the amortised cost calculation for changes in contingent cash flows.

Contractually linked instruments and non-recourse finance

A9 Currently there is limited guidance on the contractual cash flow characteristics assessment in IFRS 9 in relation to the boundary between contractually linked instruments (CLI) and non-recourse finance (NRF) transactions. The boundary is not clear and, with the existing guidance, distinguishing between the two is challenging. As

CLI requires the underlying portfolio to meet the cash flow characteristics test to achieve amortised cost accounting and NRF does not, outcomes can be very different. Outcomes can also be counterintuitive: instruments with relatively little asset risk may be treated as CLI and measured at fair value while other instruments with significantly more asset risk may be treated as NRF and measured at amortised cost. Preparers tell us that the volume of analysis is onerous and costly, and the asset classes impacted diverse and widespread. Examples provided by stakeholders have, with permission, been shared with IASB staff.

A10 We strongly recommend that the IASB clarifies the objective for contractually linked instruments in IFRS 9, to help enhance stakeholder understanding of the transactions intended to be in scope as well as improving the framework for assessment.

A11 Further work would be required to determine the most effective way to improve clarity, but aspects to consider could include:

a) Providing definitions of key terms in B4.1.20 including "multiple" (we suggest this must be more than two), "tranche" and "issuer", and clarify whether these must be contractual or can be implied (for example, a legal vs implicit tranche).

b) Assessing the most senior tranche as non-recourse finance, leaving the CLI guidance to apply only to tranches which apply credit protection to the structure. This would provide clarity and reduce the number of instruments that need to be assessed under the more onerous/costly CLI guidance.

c) Clarifying that where lending is provided by a single lender this is not within the scope of CLI.

d) Clarifying what is meant by concentrations of credit risk, particularly in structures with only two parties – a borrower and a single lender.

Amortised cost and the effective interest method

Question 7: Amortised cost and the effective interest method	
a)	**Is the effective interest method working as the Board intended? Why or why not?** Please explain whether applying the requirements results in useful information for users of financial statements about the amount, timing and uncertainty of future cash flows of the financial instruments that are measured applying the effective interest method.
b)	**Can the effective interest method be applied consistently? Why or why not?** Please explain the types of changes in contractual cash flows for which entities apply paragraph B5.4.5 of IFRS 9 or paragraph B5.4.6 of IFRS 9 (the 'catch-up adjustment') and whether there is diversity in practice in determining when those paragraphs apply. Please also explain the line item in profit or loss in which the catch-up adjustments are presented and how significant these adjustments typically are. If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

A12 It is not always clear how uncertain cash flows should best be reflected in the EIR calculation, and specifically in which circumstances paragraphs B5.4.5 or B5.4.6 should be applied. This was illustrated in the recent IFRS Interpretations Committee (IFRIC) tentative decision on the accounting for the European Central Bank's Targeted Longer-Term Refinancing Operations (TLTRO)[7], which considered an instrument where the interest rate may vary on a pre-determined basis, on the occurrence of one or more pre-determined events. This is not an isolated example as such ratchet structures feature in other financial instruments, including many FIEF.

A13 We recommend the IASB provides further guidance on key terms such as "floating rate" and "market rate" to assist in understanding better the boundary between instruments to be accounted for under paragraph B5.4.5 and those to which B5.4.6 applies. Further examples, particularly those involving FIEF, would be helpful. In paragraph A8 we recommend removing the issue related to ESG instruments from the PIR and addressing it via a more urgent mechanism. We make the same recommendation in relation to this matter. If, as expected, FIEF become more prevalent and the potential change in cash flows due to the ESG feature becomes greater, a clear understanding of the application of the EIR requirements to such instruments will be required.

Question 9: Other matters	
a)	Are there any further matters that you think the Board should examine as part of the post-implementation review of the classification and measurement requirements in IFRS 9? If yes, what are those matters and why should they be examined? Please explain why those matters should be considered in the context of the purpose of the post-implementation review, and the pervasiveness of any matter raised. Please provide examples and supporting evidence when relevant.

A14 In its September 2021 update IFRIC published a tentative agenda decision (TAD) *Cash Received via Electronic Transfer as Settlement for a Financial Asset.* The IFRIC was asked whether an entity can derecognise a trade receivable and recognise cash on the date the cash transfer is initiated (its reporting date), rather than on the date the cash transfer is settled (after its reporting date). The IFRIC concluded that an entity derecognises the trade receivable on the date on which its contractual rights to the cash flows from the trade receivable expire and recognises the cash (or another financial asset) received as settlement for that trade receivable on the same date.

A15 Though we agree this approach complies with a literal reading of the IFRS 9 requirements, it appears to run counter to well established practice. While the TAD addresses only the specific transaction submitted to the Committee, it would appear to have far reaching implications. It is probable that, as a direct result of this TAD, entities will have to reconsider their approaches for a wide range of payment systems that were not considered by the IFRIC when it issued its TAD. These include: payment settlement, including cheque payments in lieu of trade payables/ trade receivables; credit card receipts that can be cancelled before they are settled; payments made for a financial liability by electronic transfer; and intragroup cash transfers straddling a reporting

[7] TLTRO III Transactions (IFRS 9 Financial Instruments and IAS 20 Accounting for Government Grants and Disclosure of Government Assistance), IFRIC, Tentative Agenda Decision, June 2021

period end. It would also appear that creditors paying accounts payable would have to review the approach they take to accounting for those transactions.

A16 The TAD would potentially require significant analysis by preparers to determine the exact point at which cash is legally transferred. This would require detailed analysis of each transaction type as the timing of extinguishment may not be known without additional information and analysis (e.g. for international transfers legal extinguishment may arise sometime in the middle of the settlement cycle, rather than only at the end). As noted by one respondent to the TAD, both entities involved in a transaction would need to be able to answer questions such as “if the receiver’s bank failed after the cash was received by the bank but before the receiver’s bank account was credited with the funds, would the receiver have a claim on the payer, or would the payer’s obligation be extinguished at this point and the receiver’s claim be solely on its own bank?”. Obtaining legal advice to establish when routine trade receivables (and trade payables) are extinguished for the different jurisdictions and settlement systems involved will be time consuming, costly and an unnecessary diversion from already established and understood norms in the market.

A17 Even if the legal rights can be established to the level required, new accounting will need to be established that addresses the potential mismatch between the timing of the settlement/payment of a receivable and the transfer of cash into/out of accounts. This may now happen earlier or later, which could be impacted by whether the counterparties are using the same paying /receiving bank or different institutions. Entities will be required to create a new class of financial asset/liability to “fill the gap” between, for example, a liability being extinguished and cash arriving in the bank account. This will require the creation of new subledgers and control systems.

A18 A significant number of respondents to the IFRIC noted similar concerns and recommended that, instead of an IFRIC Agenda Decision being published, the matter should instead be considered as part of the IFRS 9 PIR. The UKEB agrees with this view. We recommend that the IASB consider (as part of the PIR) whether there is evidence of diversity in practice for which the benefits of standard setting are likely to exceed the costs. If the IASB considers that standard setting is needed, we recommend that it performs further research to assess potential solutions, including considering whether applying a similar approach to that already taken for “regular way transactions”[8] might meet the concerns with the TAD without creating unintended consequences.

[8] Accounting for ‘regular way transactions’ (IFRS 9 3.1.2), that is, permitting a policy choice to determine the extinguishment of a financial payable (as per IFRS 9 3.3.1) or receivable (as per IFRS 9 3.2.3(a)) at either the commencement or conclusion of a market standard settlement mechanism.