Basel Committee on Banking Supervision | BIS

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Chair

Via email: commentletters@ifrs.org

18 July 2023

Mr Andreas Barckow
Chair
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

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

Dear Mr Barckow

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the International Accounting Standards Board's (IASB's) Exposure Draft *Amendments to the Classification and Measurement of Financial Instruments*.

The Committee has a strong interest in promoting high-quality financial reporting by banks and supports the IASB's efforts to further develop high-quality accounting standards that help to promote the safety and soundness of the financial system.

The Committee welcomes the improvements proposed by the IASB, in particular, the amendments to ensure that there is a sound basis to determine whether new products with environmental, social and governance (ESG)-linked or similar contingent features meet the conditions to be measured at amortised cost or fair value through other comprehensive income. These amendments are important to ensure that banks' financial reporting provides useful information about the amount, timing and uncertainty of future cash flows for new banking products being developed to help manage climate risks effectively and support an orderly transition.

In addition, the IASB should consider including further guidance on how it expects such ESG-linked or similar contingent features to be incorporated into the measurement of amortised cost. As these features become increasingly common, it is important to establish a clear and consistent approach to their measurement. This will not only enhance the consistency of application and comparability of financial reporting but also ensure that meaningful information is provided to users of financial statements. Further details are provided in the Annex.

This letter has been prepared by the Committee's Accounting and Audit Expert Group, chaired by Katherine Tilghman Hill, Vice President, Federal Reserve Bank of New York.

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If you have any questions regarding these comments, please contact Lushendren Pather at the Basel Committee Secretariat (Lushendren.pather@bis.org / +41 61 280 8268).

Yours sincerely

Pablo Hernández de Cos

Enclosures

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Annex: Comments on the IASB's Exposure Draft Amendments to the Classification and Measurement of Financial Instruments

Question 2 – Classification of financial assets – contractual terms that are consistent with a basic lending arrangement

Elements of interest that are consistent with a basic lending arrangement

1. Paragraph BC52 – The Committee supports the proposal to focus on whether elements of interest represent compensation for "risks or costs associated with holding the financial asset".

However, the Committee believes that "basic lending risks or costs" are not sufficiently defined in the exposure draft. In particular, B4.1.7A and B4.1.8A include typical elements of interest that would be consistent with a basic lending arrangement, and some that would not.

The IASB should consider providing more guidance on the underlying principles for assessing those elements of interest that are not explicitly covered by either B4.1.7A or B4.1.8A where there are amounts that are linked to contingent events.

2. The IASB should consider introducing a principle that helps preparers understand how to assess whether the objective of features linked to contingent events is to compensate the lender for a basic lending risk or cost. In developing such a principle, the IASB should consider explicitly stating that the intention is to continue to restrict the use of amortised cost accounting in relation to contingent features that introduce new risks which are not consistent with a basic lending arrangement.

To support such a principle, the IASB could require analysis of the main components of basic lending risks and costs associated with a financial asset to determine whether the contingent event will have more than a *de minimis* effect on the main components. For example, this would be the case if a lender can show that changes in contractual cash flows arising from a contingent feature linked to emissions levels represent compensation for basic lending risks or costs. However, a lender could not assume they are being compensated for a basic lending risk if they are unable to identify the specific risks for which they are being compensated. The IASB is also encouraged to support the principle by adding detail to the illustrative example.

3. In addition, the IASB could reiterate in B4.1.10A that changes in contractual cash flows that compensate changes in credit risk are consistent with a basic lending arrangement only if they represent consideration for the credit risk associated with the principal amount outstanding that is specific to the debtor (eg the change in contractual cash flows for an amortising loan should not be a fixed total amount but rather be defined as a proportion of the principal amount outstanding that is specific to the debtor).[1]

Assessing if compensation is aligned with the magnitude of change in risk

4. The Committee supports the proposals in B4.1.8A that a change in contractual cash flows is inconsistent with a basic lending arrangement if it "is not aligned with the direction and magnitude of

[1] Also refer to paragraph 10 of the submission below that seeks clarification on what "specific to the debtor means".

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the change in basic lending risks or costs". The Committee also supports the helpful explanations in BC52, which state that in a basic lending arrangement there is "a relationship between the perceived risk the lender is taking on and the compensation it receives for that risk", and which state that a change in contractual cash flows "has to be directionally consistent with, as well as proportionate to, a change in lending risks or costs".

5. The Committee believes the terms "aligned with" and "proportionate to" could be applied inconsistently. The IASB should consider providing additional guidance on how to assess if a change in cash flows reflects a change in lending risk, including criteria to assess whether there is a clear economic relationship between the contingent event and a specific lending risk or cost for which the entity is being compensated. This could be evidenced at a high level and based on qualitative analysis and need not be documented at a "loan-by-loan" level.

In other words, the entity should be able to evidence that linking contractual cash flows to a contingent event will generally be effective at reducing a specific lending risk or cost. One possible piece of such objective evidence might be provided by the entity having a formal risk management objective and strategy for, and systems to monitor, the occurrence of contingent events.

6. The IASB should consider if the wording in B4.1.8A that "the assessment of interest focuses on what an entity is being compensated for, rather than how much compensation an entity receives" is sufficiently clear.

For example, wording could be added to B4.1.10A to clarify that it is always necessary to assess if a change in cash flows is consistent with (ie aligned with the direction and magnitude of) the change in lending risk. For additional clarity, wording could be added to specify that, in circumstances where cash flows are increasing and risk is decreasing, accounting at amortised cost would be disallowed.

Use of illustrative examples

7. The Committee supports the IASB using illustrative examples to clarify how to apply the requirement. However, the Committee believes the current examples in B4.1.13 and B4.1.14 could benefit from further detail.

8. The IASB should consider providing more detailed and specific examples to illustrate when a product with ESG-linked features would or would not meet the conditions to be measured at amortised cost with reference to specific paragraphs of the standard.

Such examples could explain the analysis used to identify the specific risk or cost the entity is being compensated for, and the analysis used to demonstrate that the change in cash flows is consistent with the change in risk. In particular, the IASB could consider including an example of a contingent feature linked to a borrower's expenses for emission allowances and explaining whether such a feature could meet the conditions of not introducing exposure to a commodity price (B4.1.7A) and being specific to the debtor (B4.1.10A).

Contingent events specific to the debtor

9. B4.1.10A specifies that 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.

10. This could cause application challenges for loans where the contractually specified targets are linked to (a) a parent, a consolidated group or another entity within the same group; (b) changes in laws

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or regulations that apply to the lender and impact the costs associated with extending credit to a debtor; or (c) certain levels or ratios of expenses or revenues (eg from "green business activities") where changes in expenses or revenues depend on both the specific activities of the borrower and changes in market prices.

The IASB should consider providing guidance on how to interpret "specific to the debtor" and apply the proposed criteria in such cases.

11. The IASB should consider the potential for unintended consequences of existing loans measured at amortised cost that have contingent cash flow changes based on events not specific to the debtor, to avoid large numbers of contracts no longer meeting the criteria to be measured at amortised cost.

For example, additional cost clauses are a common feature in loans in some markets. They are not specific to the debtor but ensure the lender is protected from the impact of changes to laws or regulations, or changes in how they are interpreted or applied.

The Committee believes that such protective clauses are consistent with basic lending and relate to costs associated with extending credit. The IASB may wish to amend paragraphs B4.1.10A and BC67 to accommodate such protective clauses.

Disclosure of the effect of contractual terms that could change the timing or amount of contractual cash flows based on the occurrence of a contingent event

12. The Committee agrees that amortised cost could provide useful information to users about the amount, timing and uncertainty of future cash flows for some products with ESG-linked features. There is a need to consider the manner in which non-ESG linked features are treated.

13. The Committee welcomes the amendments to IFRS 7.20B to help users of financial statements understand the nature of contingent events that could affect the timing or amount of contractual cash flows, as well as quantitative information on the potential magnitude of such changes.