IFRS 9: Issuer's Accounting for Green Bonds

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Green bonds are debt instruments where the interest rate is linked to certain environmental, social and governance (ESG) metrics. Green bonds include contractual terms that cause cash flows to vary depending on whether certain ESG metrics are met (ESG features).

Some examples of ESG features include:

- A global crude oil trading company issues a loan where its base interest rate is the Canadian dollar offered rate (CDOR) plus 1 per cent, but the margin is adjusted every year based on the status of its total sustainability score. The total score is calculated based on a predetermined formula using sustainability key performance indicators (KPIs), including air emissions, oil spills and employee safety measures. The margin adjustment is based on the following table:

Sustainability program status	Total score	Adjustment to margin
Successful completion	180-230	Sustainability discount (-0.05%)
Regular completion	100-179	Zero (no change)
Non-successful completion	0-99	Sustainability premium (+0.025%)

- A telecommunications company issues a loan for general corporate purposes. The interest rate on the loan is 4 per cent but will increase by up to 0.05 per cent if certain social and governance metrics are not maintained. These metrics are based on:

  (a) the percentage of women on the board of directors and in the company's total workforce;

  (a) the number of training hours for employees; and

  (b) the number and severity of data breaches.

The Group discussed the following three issues on how ESG features affect the issuer's accounting for green bonds measured at amortized cost.

Issue 1: Are ESG features required to be separated and accounted for as derivatives by the issuer?

Analysis

Paragraph 4.3.3 of IFRS 9 *Financial Instruments* states: "[An] embedded derivative shall be separated from the host contract and accounted for as a derivative… if and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).*"*

Assuming conditions (a) and (c) are met, the focus of the analysis is condition (b) and determining whether the ESG feature would meet the definition of a derivative.

Appendix A of IFRS 9 defines a derivative as *"*[a] financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

(c) it is settled at a future date."

The key factor to determining if an ESG feature meets the definition of a derivative will be whether the underlying feature is a non-financial variable that is specific to a party to the contract.

The issuer will need to apply judgement and consider the nature of each ESG feature. ESG features are specific to the issuer if they relate to the issuer's operations and are intended to drive the issuer to meet predetermined sustainability performance objectives. In addition, ESG features related to "physical" variables or measures and do not have financial elements to them would be considered to have non-financial variable underlying (e.g., the amount of greenhouse gas the issuer emits). ESG features that do not meet the definition of a derivative would not be separately accounted for as a derivative.

The Group's Discussion

Group members agreed with the analysis and highlighted that determining whether the ESG features meet the definition of a derivative will depend on whether the features are non-financial variables that are specific to the issuer.

Some Group members thought that the examples of the ESG features included in the analysis appear to be non-financial and specific to the issuer. Therefore, these ESG features do not meet the definition of a derivative. However, they emphasized the need to carefully analyze the specific ESG features in the agreement when assessing whether the feature meets the definition of a derivative.

Issue 2: If no embedded derivative is required to be separated for ESG features, does the guidance on floating rate financial instruments apply to changes in cash flows resulting from ESG features?

View 2A– The guidance on floating rate financial instruments is not applicable

Proponents of this view note that paragraph B5.4.5 of IFRS 9 states: "For floating-rate financial assets and floating-rate financial liabilities, periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate." They think the changes in the interest payments due to ESG features do not reflect changes in market rates of interest.

Consequently, paragraph B5.4.5 of IFRS 9 is not applicable and the issuer should follow the guidance in paragraph B5.4.6 of IFRS 9. Changes in estimated interest payments would result in the issuer recording adjustments to the amortized cost of the loan with the corresponding income or expense being recognized in profit or loss.

View 2B– The guidance on floating rate financial instruments is applicable

Proponents of this view note that IFRS 9 does not define of "floating rate" and does not have guidance on how the term "market rates of interest" should be interpreted.

At its October 2008 meeting, the IASB discussed a floating rate financial instrument as "an instrument with contractual variable cash flow amounts arising from changes in market variables" and tentatively agreed to provide clarification as part of its Annual Improvements project. However, at its June 2009 meeting, the IASB decided to defer any amendments and subsequently this topic was not pursued.

In the absence of specific guidance, proponents of this view think changes in estimated interest payments due to ESG features reflect changes in market interest rates for such loans. Consequently, changes in estimated interest payments due to ESG features would adjust the effective interest rate (EIR).

There are two approaches to applying the floating rate guidance. Under the first approach the current period EIR and the interest accrual would be based on the current level of interest (based on current ESG metrics). The second approach would be to calculate and update the EIR based on projected interest payments taking into account expectations and changes in these expectations (based on current and projected ESG metrics).

Proponents also note that compared to View 2A, View 2B would result in a less volatile profit or loss.

The Group's Discussion

Group members thought either View 2A or 2B may be appropriate depending on the issuer's specific facts and circumstances.

Most Group members noted that View 2B applies if the interest rate movement from the ESG feature is expected to reflect changes in the issuer's credit risk. They observed that making this determination requires judgment and the issuer should consider its specific facts and circumstances when analyzing the terms in the loan agreement. One Group member commented that one assessment is to compare two recently issued loans where the only difference between them is the ESG features present in one. The issuer should analyze whether the difference in the interest rate reflects the issuer's credit risk. Another Group member observed that in cases where the ESG features have a small impact on the cash flows of the loan, the difference between View 2A or 2B may not be material to the issuer's financial statements. As a result, if not material, the issuer might apply View 2B to avoid the complexity of calculating the catch-up adjustments required by View 2A.

Issue 3: If a loan with ESG features is convertible into shares of the issuer, would the conversion feature meet the equity classification criteria?

Fact Pattern

- On July 1, 20X1 an industrial company, Company A, issues convertible bonds that matures on June 30, 20X6. The bondholders can convert the bonds at any time into common shares of Company A with a fixed conversion ratio (one common share for one bond).
- The contractual terms of the bond include a provision whereby if Company A does not meet certain ESG criteria by December 31, 20X5, Company A must pay bondholders an amount equal to 10 per cent of the bond's nominal value ("penalty amount").
- If the bonds have not been converted by that date, the penalty amount is due in cash and does not impact the conversion ratio. The bonds remain convertible until the maturity date.
- If the bonds have been converted before that date, the ESG criteria are not assessed and no penalty amount is due.
- The ESG criteria are for air emissions by the issuer and are based on limits set by statutory regulations. Company A has assessed that the ESG feature has a direct influence on its credit risk.

View 3A– The conversion option fails the fixed-for-fixed criteria and represents a separable embedded derivative

Proponents of this view note that bondholders will consider the likelihood of Company A paying a penalty when deciding whether to exercise their conversion options. Therefore, the penalty amount impacts the investor's economic decisions and is not distinct from the conversion option. Therefore, the cash penalty that is due if Company A fails the ESG criteria cannot be ignored when assessing whether the fixed-for-fixed criteria in IAS 32 *Financial Instrument: Presentation* is met.

Since the penalty payment is only triggered when Company A fails to meet the ESG criteria and the bonds have not been converted by December 31, 20X5, proponents of this view think the settlement amount for the converted common shares varies over the term of the bonds. As a result, the conversion option fails the fixed-for-fixed criteria.

The conversion option would be separated and accounted for as an embedded derivative (unless the instrument is designated at fair value through profit or loss). Company A would also need to determine whether the ESG feature and the conversion feature have to be treated as a single compound embedded derivative (this may depend on the conclusions in Issue 1).

View 3B– Because the penalty is unrelated to the conversion, the conversion option does not fail the fixed-for-fixed criteria and should be classified as an equity component

Proponents of this view think the cash penalty that is due if Company A fails the ESG criteria by December 31, 20X5 does not relate to the conversion option. The penalty amount is always paid in cash and does not affect the conversion ratio that remains fixed.

Paragraph 22 of IAS 32 gives an example of an equity instrument as "an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond." The principal amount of the bonds subject to the conversion option remains "fixed and stated" and is not affected by the ESG feature. The variation of the debt's carrying amount due to the ESG feature does not prevent the fixed-for-fixed criteria from being met because the amount that is converted remains the fixed principal amount.

Accordingly, the ESG feature should be assessed as a characteristic of the debt component and should be ignored when assessing whether the conversion option meets the fixed-for-fixed criteria.

View 3C– the conversion option does not fail the fixed-for-fixed criteria because the ESG feature has a direct influence on Company A's credit risk

Proponents of this view note that because it as a direct influence on Company A's credit risk, the ESG feature represents a component of credit risk. Therefore, the changes in the contractual cash flows resulting from the penalty reflect movements in market rates of interest specific to Company A.

Paragraph 22 of IAS 32 states: "Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument." Since the variability the ESG feature creates reflects a partial reset to market rates of interest specific to Company A, it is considered a floating rate and the "fixed cash" criteria are not breached.

The Group's Discussion

Group members thought both View 3B and 3C have merit.

Some Group members supported View 3B. They noted that the principal amount of the bonds subject to the conversion option remains "fixed and stated" and is not impacted by the ESG feature. The penalty paid in cash is viewed as an additional interest charge.

Other Group members supported View 3C in the fact pattern presented which stated the ESG feature has a direct influence on the issuer's credit risk. As such, the changes in the contractual

cash flows resulting from the penalty reflect movements in market rates of interest specific to the issuer.

Group members also noted that the accounting outcome is the same for the issuer when applying these two views.

In addition to the issuer's accounting discussed at the meeting, one Group member commented that at its July 2021 meeting, the IASB discussed the accounting for green bonds from the investor's perspective. The discussion focused on key factors an investor needs to consider in its analysis to determine how to apply the requirements in IFRS 9.

Overall, the Group's discussion raises awareness of the issuer's accounting for green bonds that are measured at amortized cost. No further action was recommended to the AcSB.