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Ms Sue Lloyd  
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Ourref RD/288

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Dear Ms Lloyd

**Tentative Agenda Decision: *TLTRO III Transactions (IFRS 9 and IAS 20)***

We appreciate the opportunity to comment on the IFRS Interpretations Committee's ('the Committee') tentative agenda decision "TLTRO III Transactions (IFRS 9 and IAS 20)" ('TAD'). We have consulted with, and this letter represents the views of, the KPMG network.

Overall, we support the Committee's tentative decision not to add a standard setting project to the work plan. We support the reasons for not doing so, and we agree that certain matters are best addressed through the post-implementation review ('PIR') of the classification and measurement requirements in IFRS 9 *Financial Instruments*.

In particular, we note that aspects of the questions raised such as what constitutes a market interest rate, what are the defining characteristics of a floating interest rate instrument and how to account for the modification of floating interest rate financial liabilities are well known and complex areas of practice. For this reason, we therefore recommend that the sections of the TAD addressing IFRS 9 are reviewed to ensure that they do not inadvertently introduce changes to current interpretations of the standards in advance of the conclusion of those projects and to avoid the introduction of potentially new practice issues that could impact a wide variety of fact patterns. At the same time, we believe that the section of the TAD addressing IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* could be enhanced to promote greater consistency in application.

In that context, we have set out below areas where we believe that the TAD could be made clearer without affecting the Committee's overall recommendation not to add a standard setting project to the workplan.

### **What constitutes a floating rate instrument?**

It is acknowledged in the TAD that IFRS 9 does not define what is meant by a floating rate instrument. We agree and it has been an area of practice interpretation for many years. Consistent with this conclusion, we believe that the Committee does not need to further elaborate on the issue by characterising the ECB's Deposit Facility Rate (and subsequent 50bp reduction) available to TLTRO III borrowers as (i) a variable interest rate element which is reset to reflect movements in the market rates of interest and (ii) another element which is fixed and therefore not reset to reflect movements in the market rates of interest. By providing this detailed analysis, the TAD inadvertently provides guidance on what constitutes a floating rate. We believe that defining a floating rate (and as a result the appropriate treatment following the modification of such a rate) is a subject that should be debated in full during the PIR of IFRS 9.

We also note that the ECB is capable of adjusting the borrowing rate in TLTRO III operations unilaterally at any time (as confirmed by ESMA) as instruments of the ECB's monetary policy operations. It is not clear how a change in such a rate, no matter if the change is made up in terms of fixed and/or floating components can be determined to be made up of one part that resets to reflect movements in market rates of interest and one part that does not.

### **Modification of financial liability that is prepayable without penalty**

Determining whether a modification has taken place and applying the appropriate accounting for modifications is an area of some diversity in practice. One area of debate relates to the derecognition of a liability when it matures in accordance with the original contractual terms of the instrument and whether that also extends to cover the contractual acceleration of maturity that occurs through the exercise of a prepayment option. We do not believe that the requirements of modifications and exchanges of debt instruments extend to the usual repayment of a loan at maturity and its replacement by a new loan on arm's length terms even if the new loan is with the same lender. However, if the original terms of the liability include a prepayment option exercisable without significant penalty, then it is possible to view a replacement of old debt with new debt on arm's length terms as contractual maturity of the original instrument in accordance with its original terms. If an entity views the replacement of prepayable old debt with arm's length new debt in such a way, it may conclude that it has derecognised its old debt without performing any analysis in respect of substantive or non-substantive modification. The new debt would be subject to normal IFRS 9 accounting including determining a new original effective interest rate for the new debt.

It is our understanding that TLTRO III loans are prepayable without significant penalty.

Alternatively, it may also be possible to view a loan that is prepayable without significant penalty wholly as a floating rate. In such circumstances the borrower would be free to refinance with the same or other lenders at the new market rate as opposed to modifying the contract.

The TAD implies that approaches such as the ones noted above are not permitted by being too prescriptive as to when B.5.4.6 is applied without considering the prepayable nature of the instruments. We believe that the nature of the loans (being prepayable without significant penalty) is an important part of the analysis that is not discussed in

the TAD. We believe that the TAD could be made more concise without changing its conclusion by not detailing the mechanics of modifications for these exposures. We further believe that issues arising (including a detailed consideration of the effects of prepayment features without significant penalty on the analysis) should be addressed in the comprehensive PIR of IFRS 9 as the implications of forming a view in these particular circumstances could have wide ranging repercussions for many other situations.

### **Whether or not the ECB meets the definition of government in IAS 20**

We note that the TAD observes that making the determination of whether the ECB meets the definition of government in IAS 20 is a judgement based on specific facts and circumstances. The implication is that entities could come to different conclusions as to whether the ECB is, or is not, a government per the definition in IAS 20. We do not believe that consistent application is best served by such a response. There is a single set of facts available to all in order to make that assessment and we believe that there should be a single answer to that question. By not forming a view on that specific question, we believe that the Committee is permitting practice diversity to persist in an area where it could easily rectify the situation. This would not affect the other judgements that would need to be made before an entity could conclude on whether TLTRO III tranches contain a government grant within scope of IAS 20.

### **The recognition of a government grant subsequent to initial recognition of a loan**

The TAD discusses the impact of subsequent changes in cash flow estimates under IFRS 9 but not whether, and if so how, subsequent changes in cash flow estimates affect the identification and accounting for a government grant under IAS 20. This omission could be read to imply that it is not necessary to consider IAS 20 after initial recognition of the loan. While IAS 20.10A describes how to measure the benefit arising from a loan at initial recognition, the general requirements of IAS 20 may, depending on the facts and circumstances, require recognition of a government grant subsequently.

For example, IAS 20.7(a) and IAS 20.8 require that no grant is recognised until there is reasonable assurance that the entity will comply with the conditions attached to the grant. Should an entity be granted a below market rate loan by a government conditional on meeting certain conditions, and the entity does not initially have reasonable assurance that it will comply with the conditions, it is not clear how the difference, between fair value<sup>1</sup> and the cash received for the loan should be treated on day 1 and subsequently.

<sup>1</sup> While we agree that what to consider in estimating the expected future cash flows for the purpose of calculating the effective interest rate in IFRS 9 is a wider issue and should not be considered by the Committee solely in the context of TLTRO III transactions, the fair value of the liability considers the same set of cash flows. That is, the probability of whether an institution will meet or will not meet the lending criteria of the TLTRO III scheme is an integral part of the fair value calculation. An entity that market participants assume has a 100% chance of meeting the criteria would have a different fair value to an entity that market participants assume has a 0% chance of meeting the criteria because each would use a different set of cash flows. The implication is that there will be a difference between fair value and cash advanced for a least a portion, if not the majority, of borrowers.

We also believe that it may be appropriate to recognise a government grant in respect of a loan subsequent to initial recognition when the entity gains reasonable assurance that it will meet the conditions (i.e. its assessment changes) – as required by IAS 20.7(a) and IAS 20.8.

We further believe that when a government changes the terms and conditions of loan that was issued at a market rate to an instrument that will bear interest at a below market rate contingent upon the borrower meeting specified conditions, that government is providing assistance “...in the form of [a] transfer of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity...” (IAS 20.3 definitions of a government grant). The assessment under IFRS 9 as to whether the modification is substantial does not affect whether the definition in IAS 20 is met.

We therefore recommend that the section of the TAD addressing IAS 20 should address subsequent changes in cash flow estimates. We also recommend that the section of the TAD headed “Subsequent measurement of the financial liability at amortised cost” be reviewed to ensure it does not conflict with IAS 20.

Please contact Reinhard Dotzlaw at [rdotzlaw@kpmg.ca](mailto:rdotzlaw@kpmg.ca), Brian O’Donovan at [brian.odonovan@kpmgifrg.com](mailto:brian.odonovan@kpmgifrg.com) or Colin Martin at [colin.martin@kpmgifrg.com](mailto:colin.martin@kpmgifrg.com) if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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