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ESG Bonds
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Environmental, Social, and Governance (ESG) Bonds

Beautiful concept, complicated accounting?

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The popularity of Environmental, Social, and Governance bonds (or "ESG Bonds") has risen in recent years. But could the appeal of social responsibility translate into additional complexity for companies who report under International Financial Reporting Standards (IFRS)? How can companies promote good social behavior and mitigate the risk of having a negative impact on an organization's bottom line?

Deloitte is actively navigating the accounting complexities of ESG Bonds working with clients to help ensure unpredictable business climates do not unexpectedly translate to volatile income statements.

The importance of assessing risk

ESG Bonds often comprise of debt instruments with principal and interest cash flows. Unlike other forms of green bonds they can provide general use funding rather than the financing of a specific project. One form of ESG Bonds, a 'Sustainability Linked Bond,' gains its credentials from linkage to certain Sustainable Development Goals (SDG) of the issuer. Failure to meet the specified SDG criteria may entail a penalty (or loss of discount) in the form of a step-up in the bond's interest rate. This can cause variability in the cash flows of the instrument and can have potentially unforeseen IFRS accounting implications.

What are common issues?

Most IFRS reporting issuers and investors do not welcome income statement volatility. With some exceptions, they prefer to account for their financial assets and liabilities with a predictable accruals (or 'amortized cost') basis, avoiding the need to mark-to-market (or 'fair value through profit or loss'). This circumstance holds true provided the instrument qualifies for such accounting.

When might an ESG Bond not qualify for cost accounting?

Potential problems can arise when the terms of the bond include cash flow variation features—e.g., a margin step-up feature, if the specified SDG criteria are not met. IFRS standards do not permit such features to be ignored. They have to be considered when assessing the measurement basis of the instrument. In some cases, accrual accounting could be prohibited, and trigger mark-to-market accounting—in whole or in part—causing unwelcome income statement impacts.

What do investors need to consider?

Assuming the investor has a portfolio strategy that is generally to invest and hold, the ability of the IFRS investor to secure cost accounting is determined by the IFRS 9 concept of whether the asset's cash flows represent 'solely payments of principal and interest' (SPPI) on the principal amount outstanding. Failure to meet SPPI means the entire asset must be marked-to-market through the income statement. This can lead to high levels of volatility, especially for otherwise fixed rate instruments with longer tenors.

Why might a well-meaning SDG step-up feature within an ESG bond cause the SPPI test to fail?

This is due to the IFRS 9 principles that can be very restrictive regarding features that can cause cash flows to vary. If variation features are not consistent with the basic concept of SPPI then cost accounting is disqualified. In this respect, the cash flow variation features that are on safe ground for the SPPI test tend to include those found in vanilla instruments—e.g., variable rate assets whose cash flows reference an interest benchmark, those that provide additional spread for deterioration in credit risk, certain inflation linked assets, and certain prepayment terms. Variations that fall outside those simple examples, such as certain SDG step-ups, will require more careful analysis.

What makes for a SPPI compliant step-up feature?

SPPI cash flows are those of a basic lending agreement—broadly interest and credit risk. IFRS 9 goes on to explain that interest can include consideration for other basic lending risks—

examples being liquidity risk, costs such as administrative costs, and profit margin. It follows that step-ups designed to provide compensation for such basic lending factors do not necessarily cause the SPPI test to fail and so, do not condemn the financial asset to mark-to-market accounting. In contrast, step-ups that respond to, or provide compensation for, economic events that are not those of basic lending (e.g., the price of oil) would typically result in non-SPPI cash flows.

However, IFRS 9 is not an exact science and demands the use of judgment. Positions and conclusions need documenting, with advice and assurance sought when in doubt.

What do issuers need to consider?

IFRS for issuers continues to be based on the old IAS 39 principles—meaning a step-up clause in an ESG Bond liability will need to be assessed as to whether it represents a separable embedded derivative such that the issuer has two financial instruments, a host bond instrument that is measured at accrual/cost and a derivative that is mark-to-market (unless the issuer elects to account for the combined hybrid on a mark-to-market basis). Whether this is required depends on (1) does the SDG step-up meet the definition of a derivative and (2) whether the step-up is deemed to be closely related to the underlying risks in the bond. If any derivative is not separated, then the activation of any step-up could potentially trigger a remeasurement of the balance sheet liability with a corresponding income statement impact. The ultimate treatment will depend on the specific facts and circumstances.

Some step-ups may not meet the definition of a derivative at all because the underlying variable that drives the feature's value is 'non-financial' and 'specific' to the issuer. An example might be an interest adjustment that activates if a specific social pledge of the issuer is not met. Alternatively, some features may be derivatives but deemed closely related to the host instrument (e.g., those that can be deemed to effectively reflect changes in the credit worthiness of the issuer). Furthermore, other step-ups that are closely related to the risks inherent in the ESG Bond would not require separation. Their identification can be judgmental. One potential reference point to start such an analysis may be IFRS 9 B4.1.7A's description of 'basic lending risks.'

It is important that issuers pay close attention to these features and analyze, document, and conclude taking appropriate measures where necessary.

What makes for a SPPI compliant step-up feature?

Both issuers and investors may wish to enter into hedging transactions to address market risks inherent in ESG Bonds. For example, it may be desirable to enter into interest rate swaps to hedge interest rate mismatches associated with fixed rate issuances. Assuming the issuance achieved accrual accounting, a new income statement volatility exposure risk arises from the interest rate swap that would be marked-to-market. Formal IFRS hedge accounting is needed to mitigate the volatility.

IFRS hedge accounting requires the documentation and monitoring of the hedging instrument vs. the hedged item. In this respect, SDG step-ups present in the bond may not be present in the interest rate swap. As such, careful designation of the hedged risk may be required. For example, an issuer seeking to cash flow hedge a variable rate bond may designate only those cash flow changes attributable to changes in the applicable benchmark and leave the margin (and step-up feature) unhedged. Alternatively, there is the emergence of interest rate swaps that incorporate SDG step-ups thereby enabling the bond margin (or portion thereof) to be incorporated into the hedge.

Deloitte is a leading Assurance provider

Deloitte is at the forefront of ESG developments. In particular, for IFRS compliance, we work with both issuers and investors, including providing assurance advisory services in relation to the measurement basis of the instruments, assistance with fit for purpose management documentation, calculation of booking entries, and advising on the maximization of hedging efficiency.

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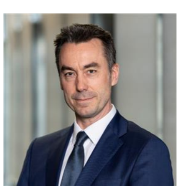

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