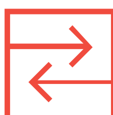
Green Loans

Talking points for episode 119

Green loans, also referred to as sustainability-linked loans, include loans to fund "green" projects, as well as loans with clauses where the interest rate varies based on an ESG metric.

Borrower's incorporate these clauses in their loans to demonstrate that they are concerned about the impact their business has on the environment. Similarly, lenders also want to be able to demonstrate that they are considering the nature of the businesses they are lending to and how this aligns with their targets for sustainability-linked lending.

This is a challenging area from an accounting perspective for the lender, in particular with respect to the Solely Payment of Principal and Interest (SPPI) test in IFRS 9. This is also an area of evolving practice, which requires thoughtful analysis and consideration.

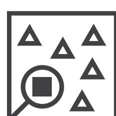


Factors to consider from a lender's perspective include:

- Understanding the commercial rationale for the inclusion of the clause linked to ESG metrics in the financial instrument.
- Where the feature has a very small impact on the contractual cash flows, i.e. **it is de-minimis**, then the clause would not impact the SPPI analysis. However, this would need to be consistent with the discussion in other aspects of the entity's reporting to ensure that this represents a fair and balanced view. An area that the regulators are challenging is **greenwashing** in other aspects of the entity's reporting.
- Consider linkage to **credit risk**, and whether the change in the interest rate due to the sustainability linked-metric is **commensurate with the change in credit risk**. This analysis leverages the guidance in IFRS 9 related to the accounting of credit-ratchet loans. Where the extent of the change is more than the amount that would be commensurate with the change in credit risk, this would indicate there is leverage which would result in failing the SPPI test.

Factors to consider from a borrower's perspective include:

- Are the sustainability linked features required to be separated as an **embedded derivative** measured at fair value through P&L?
- Where the variable is **specific to a party** to the contract and is a **non-financial variable** (e.g. CO_2 emissions), it will not be required to be separated as an embedded derivative. In this scenario, changes in the variable are measured as follows:
    - Changes in expected cash flows reflecting changes in **credit risk** would be reflected in the period in which the change occurs (B5.4.5 of IFRS 9).
    - Changes in expected cash flows that do not reflect credit risk require the gross carrying amount to be recalculated as the **present value of the estimated future contractual cash flows** (including the sustainability linked feature) discounted at the original effective interest rate. Any adjustments would then be recognised in the P&L (B5.4.6 of IFRS 9)



Accounting for green loans is an area of focus for the IASB, who have raised this issue in the post-implementation review ('PIR) of IFRS 9. This is an area of potential future development following the PIR. This is also an area of focus by regulators.

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