IASB Meeting Agenda reference **3A2**

Staff Paper Date **June, 2009**

Project **Financial Instruments – Recognition and Measurement**

Topic **Classification – concentrations of credit risk**

Introduction

Background

1. At the 1 and 5 June 2009 meetings the IASB discussed the classification of financial instruments. The Board decided to discuss at the main IASB June meeting:

   (a) the interaction between the classification criteria and the current embedded derivative requirements for financial host contracts in IAS 39; and

   (b) issues relating to concentrations of risk.

2. At its 5 June 2009 meeting the Board tentatively concluded that all financial instruments should be classified at fair value except for those that (both):

   (a) only have basic loan features; and

   (b) can be demonstrated to be managed on a contractual yield basis.

   This approach is referred to as the 'new classification criteria' in this paper.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Purpose of this paper

3. This paper addresses the issues relating to concentrations of credit risk. It provides an overview of different types of concentrations of credit risk and discusses their implications for the classification of financial instruments.

4. This paper includes a staff recommendation (see paragraph 23 below) and asks the Board for decisions on how to address concentrations of credit risk under the new classification approach (see the section 'Questions to the Board' below).

Concentrations of credit risk

Objective of classification

5. The objective of classification is to allocate financial instruments to the different measurement categories in such a way that the resulting information is useful to users.

6. The Board has tentatively decided that measurement at amortised cost provides useful information for some financial instruments that have only basic loan features–namely those whose cash flows only represent *principal and interest* (basic lending type arrangements).

7. As this paper is about the implications of concentrations of credit risk for the classification of financial instruments it looks at concentration of credit risk as a phenomenon at the *individual* financial instrument level. The concentration of credit risk resulting for a group of financial instruments (eg at a portfolio level) from a high relative exposure to a particular instrument, debtor or similar is a different issue that is not relevant for classification.

Subordination

8. At the individual financial instrument level concentration of credit risk arises from prioritising payments that are due under different instruments issued by the same debtor (subordination).

9. Subordination can be effected in different ways. For example, the ranking of an entity's creditors is one form of subordination that applies very generally and affects almost any lending transaction. Conversely, waterfall structures used for structured investment vehicles are a very specific form of subordination that affects particular types of financial investments such as collateralised debt obligations (CDOs).

10. If the Board wants to distinguish different forms of concentration of credit risk it needs to identify features of subordination that differentiate between forms of credit concentration.

11. One approach is to look at how the payments by the issuer to the holders of the financial instruments are prioritised. Two basic forms of subordination that differ in how they prioritise the payments are a 'waterfall' structure in a structured investment vehicle and the creditor ranking in corporate lending.

12. On a typified basis, differentiating features of these two basic forms of subordination are summarised below:

	Waterfall structure	**Creditor ranking**
Allocation of losses	Direct *allocation* of the *issuer's losses* to different tranches	Allocation of the issuer's assets and liquidation proceeds to creditors
Method of ranking	Ranking governs solely *contractual* rights and obligations	Ranking governs contractual *and non-contractual* rights and obligations
Changes in payments to tranche holders/creditors	Changes in payments to tranche holders resulting from this loss allocation neither constitute a default nor trigger bankruptcy of the issuer	Changes in payments to creditors because of the ranking result from a default and typically trigger bankruptcy of the issuer
Effect of subordination	Changes the *contractual* payments due on a tranche if the issuer incurs losses (ie the amounts that become due are reduced)	Does *not* change the *contractual* payments due to a creditor if the issuer is unable to service its debt (ie the full contractual amounts become due and the shortfall in the issuer's payments are a breach of contract)

Waterfall structures

13. Previous agenda papers on credit linked financial instruments[1] and the classification of financial instruments[2] described a 'waterfall'. To recap, waterfall structures prioritise the payments by the issuer to the holders of the financial instruments using different tranches of instruments with a subordination ranking that specifies the order in which any losses that the issuer incurs are allocated to the different tranches(ie losses incurred by the issuer are allocated to tranches). Hence junior tranches bear some of the risk of senior

[1] The IASB discussed the waterfall feature in the context of CDO structures in its November 2008 meeting (see agenda paper 11B).
[2] See agenda paper 2C of the 1 June 2009 IASB meeting.

tranches regarding the credit risk of the reference assets (in consideration for a higher return).

14. Thus, a waterfall structure results in a senior tranche being paid in full before any subordinated tranche is paid. Therefore, the most junior tranche of the structure is commonly known as the *first loss tranche* because it absorbs all losses up to its investment or nominal amount[3] (when the next–second most junior–tranche takes over). Consistent with its economic characteristics the first loss tranche is often described as the equity (tranche) of the CDO.

15. The new classification criteria require that financial instruments at amortised cost must only have basic loan features that represent a basic lending transaction. Thus, first loss tranches would be measured at fair value given their residual nature, which is not consistent with a basic lending transaction.[4]

16. The classification of other tranches would be determined by their leverage. As a previous agenda paper[5] explained, a waterfall structure creates leverage between different tranches for both credit risk exposure as well as returns compared to a symmetrical structure[6]. Thus, all tranches that *provide* protection for other tranches (rather than receive protection are classified as at fair value because they are not basic lending transactions with only basic loan features.

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[3] In securitisation jargon this amount is defined using attachment and detachment points.
[4] This is consistent with the accounting for 'traditional' equity instruments (outside a structured finance context). These equity instruments (eg ordinary shares) are the residual category that ranks below any debt instruments that are part of the creditor ranking (see the section 'Creditor ranking' below).
[5] See agenda paper 2C of the 1 June 2009 IASB meeting.
[6] A symmetrical structure has tranches whose credit exposure is proportional to the principal amount just like the credit exposure of an equivalent direct investment in the reference assets.

Creditor ranking

17. A creditor is any party to whom money is owed. Generally, commercial law (including bankruptcy law) sets out a basic ranking for creditors. This is required because not all creditors' claims are contractual (eg claims regarding damages for unlawful behaviour but also for tax liabilities or social insurance contributions–depending on each jurisdiction). Within the bounds of compulsory provisions set by law, the ranking can then typically be adjusted by contractual agreements between the debtor and specific creditors. Commercial law typically also sets minimum capital requirements for equity (for limited liability companies) or establishes unlimited liability for the owners of the business (for partnerships and sole proprietorships). This establishes a residual category below the creditor ranking (as equity holders or owners with unlimited liability are no creditors).

18. This results in a creditor ranking structure that can be classified for example as follows:

    (a) secured versus unsecured: this determines whether a creditor has the right to take a specific property of the debtor and dispose it in the event of a default (eg a collateralised loan may give the lender the right to take control of the collateral and dispose of it in the event of bankruptcy).

    (b) senior (preferential) or junior: this determines whether a creditor's claim takes precedence over other creditors' claims to the property of the debtor in the event of bankruptcy (eg the social security liabilities may have to be services before the claims of general creditors are settled).

19. For a creditor ranking structure it is difficult to precisely determine the leverage of the different financial instruments involved. For example, for general

creditors[7] the ranking is often determined on a statutory legal basis rather than an individual contractual basis.[8] It is also often difficult to gauge the effects of any secured or preferential claims that rank above as well as equity instruments that rank below.

20. Thus, the implications of the creditor ranking structure for leverage can only be derived rather broadly:

    (a) Secured and senior creditors have claims that have some credit enhancement; thus, they are usually not leveraged[9]. Consequently, the credit risk associated with these financial instruments would usually be consistent with the criterion of 'having only basic loan features'.

    (b) General creditors have a higher credit risk compared to those under (a) above but also receive some protection because of the equity (or personal liability of business owners); while the exact degree of leverage that results from this situation depends on the specific circumstances, a key differentiating factor to junior tranches in a waterfall structure is that typical general creditors are not *contractually* leveraged but reflect the default ranking established by commercial law. The staff believes that it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for general creditors such as trade creditors but provides evidence that the degree of credit risk associated with general creditors is consistent with a normal commercial lending transaction. Thus, the staff believes general creditors would typically satisfy the criterion of 'having only basic loan features'.

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[7] A general creditor has a claim that is not secured by means of collateral (or liens). Typical examples are trade creditors.

[8] See paragraph 17 above.

[9] For the purpose of classification leveraged means amplified exposure (ie in a notion of larger than one or higher than symmetrical risk–see agenda paper 2C of the 1 June IASB meeting).

(c) Equity (ie claims ranking below all creditors) is not subject to *credit* risk because equity holders are not creditors. However, all equity instruments are measured at fair value anyway as amortised cost by virtue of its nature does not apply to such financial instruments.

Such an approach is consistent how users of financial statements view 'financial leverage' or gearing to assess the ratio of debt versus *equity*.

Staff recommendation

21. The first question regarding concentrations of credit risk is whether it is an aspect that is so different or important (compared to other characteristics) that it warrants to be explicitly addressed as part of the new classification criteria. The characteristics of financial instruments relate to many different aspects and separate explicit guidance for credit risk raises the question whether similarly explicit and extensive guidance would then be required for other characteristics in order to avoid an undue emphasis on any single aspect.

22. If the Board wants to explicitly address the concentration of credit risk then the analysis provided in this paper is one possible way. However, because of the various different legal frameworks that exist and the opportunities to structure the subordination of claims the circumstances will not always be as clear cut as set out above.[10] For example, there might be CDO structures in which the waterfall cash flow allocation mechanism only takes effect in the event of a default.

23. On balance, the staff believes that it would help applying the new classification criteria if the application guidance explained how a solely contractually

[10] See paragraph 12 above.

structured waterfall sequence on the one hand and the creditor ranking under a stylised corporate structure on the other hand relate to the ‘only have basic loan features’ requirement.

Questions to the Board

Concentrations of credit risk
1. Does the Board agree with the staff recommendation to provide application guidance on concentration of credit risk for the new classification approach? If the Board does not agree with the staff recommendation what does the Board prefer instead, and why? 2. If the Board agrees with the first staff recommendation of providing application guidance on concentration of credit risk, does the Board also agree to use the analysis of waterfall structures and the creditor ranking as a basis? If not, what analysis would the Board use, and why?