Project **Financial Instruments – Replacement of IAS 39**

Topic **Concentrations of credit risk**

Objective of the paper

1. **This paper discusses the accounting for concentrations of credit risk created by using multiple contractually linked and subordinated interests (ie tranches) proposed in the exposure draft *Financial Instruments: Classification and Measurement* (‘the ED’).**

2. To meet this objective the paper provides:

   (a) an overview of the proposals in the ED

   (b) an analysis of the comments received in the comment letters and during the outreach programme

   (c) a staff analysis

   (d) ways forward for the Board for the issuer’s accounting (including a staff recommendation)

   (e) ways forward for the Board for the holder’s accounting (including a staff recommendation).

3. Before proceeding, the staff wishes to highlight that subordination in itself was not the focus of the Board’s proposals. Rather, it was the *concentration* of credit risk.

4. Subordination (by law) is present in almost every creditor-debtor relationship and knowledge about subordination, in particular in case of insolvency, is vital to price credit risk appropriately.

5. By contrast, *concentrations* of credit risk arise from the contractual linkage between tranches of investments that creates a reallocation of credit risk from the default ranking position, ie there is a contractual prioritisation of the cash flows from an underlying instrument pool (a 'waterfall'). The ED discussed this credit concentration effect in terms of 'leverage' that was not part of a normal lending transaction.

6. In contrast to subordination in a creditor-debtor relationship, often non-payment by the issuer of tranches with a waterfall structure is *not* a breach of contract, and for as long as the issuing entity has *any* cash inflows from the assets held, the waterfall structure remains in place (although of course, only the top-rated tranche or tranches may receive anything).

7. Some of the features we discuss are similar to those in non-recourse arrangements. It is not the purpose of this paper to discuss non-recourse arrangements. Depending on today's decisions by the Board we will bring back a separate paper on the interaction of these decisions with non-recourse arrangements.

Overview of the proposals in the ED

8. The ED contains specific guidance for transactions where concentrations of credit risk are effected by employing multiple contractually linked instruments (ie tranches).[1]

9. In such situations the ED proposes that only the most senior tranche *may* have basic loan features (and *may* qualify for amortised cost accounting if it has basic loan features and is managed on a contractual business cash flow model basis) as it receives credit protection in **any** situation.

10. Any other tranches would fail the 'basic loan features' criterion as they provide credit protection to other tranches and would be accounted for at fair value

[1] See Appendix B6-B8 of the ED.

through profit or loss. The Board concluded that in these situations the cash flows do not only represent payments of interest and principal, but also a return on the credit protection provided to other tranches (less the cost of any credit protection provided to it).

11. In the Basis for Conclusions[2] the Board highlighted that subordination can arise in different ways. Ranking by **operation of law** (including bankruptcy law) was identified as a basic form of legal subordination. The Board noted that such a ranking usually is not intended to create leveraged credit exposure and hence such a ranking is consistent with the notion of basic loan features.

12. However in typical waterfall structures using multiple contractually linked instruments that effect concentrations of credit risk, payments to holders are prioritised and thus such structures specify the order in which any losses that the issuer incurs are allocated to the tranches. The Board concluded that tranches providing credit protection (albeit on a contingent basis) to other tranches are leveraged[3] and hence do not have basic loan features.

13. The Board dismissed an approach assessing credit risk at initial recognition because this would have required setting an investment risk threshold. This would inevitably have resulted in bright-line rules (by guidance or practice) and operational challenges. Such an approach would also have been inconsistent with the rest of the proposed model whereby levels of credit risk do not drive classification.

14. In arriving at the proposals in the ED, the Board considered three possible approaches:

    (a) whether in *any* possible outcome a tranche could provide credit protection to any other tranches

[2] See BC25-BC28 of the ED.

[3] This is because all other tranches expose themselves to higher credit risk by writing (net) credit protection to other tranches – except for the most senior tranche which is a receiver of credit protection.

(b) whether on a *probability-weighted* basis, a tranche could provide credit protection to any other tranches

(c) an approach that *looked through* to the underlying instrument pool.

15. The Board concluded that the classification principle should be based on possible rather than probability-weighted outcomes because making an assessment based on probability-weighted outcomes may be difficult and requires significant judgement.

16. Approaches looking through an investment in order to determine the underlying instruments and the relative credit risk were dismissed by the Board on grounds of operational challenges. In addition, such approaches would still require an assessment of the credit risk of the investment relative to the instruments in the underlying pool. That is, a probability-weighted analysis would also be required.

Analysis of the comments received in the comment letters and during the outreach programme

17. **Almost all respondents disagreed** with the proposed approach in the ED. In addition, some respondents offered alternative approaches for this type of interest. They will be discussed in paragraph 29.

18. Only a few respondents agreed with the proposed approach.

19. Many questioned the rationale of the cut-off chosen by the Board. They stated the approach would be an exception to the overall classification model and driven by anti-abuse considerations. Many respondents saw no conceptual merits in the approach, except superficial simplicity, and claimed that the approach would not faithfully represent the economic characteristics of the instruments (especially when compared to similar instruments that would be measured at amortised cost).

20. The main reasons for disagreement are set out in the following paragraphs.

Concerns of respondents

21. **An exception to the overall classification approach.** Respondents stated that the proposed accounting for instruments was not consistent with the overall classification approach. Under the proposals, some 'waterfall' tranches that would be measured at fair value would have credit risk that is lower than the average credit risk arising from the underlying assets of waterfall structures. However, the underlying assets may be eligible to be measured at amortised cost if they had not been embedded in a waterfall structure.

22. **Focus on form and legal structure.** Many respondents believe that the proposed treatment of waterfall structures focuses on legal structure and form, rather than reflecting the economic characteristics of the instruments. Such a focus, they argue, impairs the usefulness of financial statements as the economic characteristics of the instruments are not faithfully represented.

23. Some also noted that a waterfall structure with liquidation triggers had exactly the same effect as a normal credit ranking. That is, focusing on the existence (or otherwise) of a waterfall structure in the way proposed in the ED is too 'blunt' an approach given the variety of features that may exist.

24. **Structuring opportunities.** Many highlighted the structuring opportunities that would arise from the proposed treatment of waterfall structures. Such respondents noted that such opportunities arise because of the sole focus on the existence of a waterfall structure, but no consideration of the characteristics of the underlying instrument pool.

25. One frequently mentioned example was the issuance of serial investment vehicles. Each vehicle would issue one class of notes that are secured by one of the tranches that rank junior to the most senior tranche (ie each vehicle would hold one of these tranches). The holding entity of these second tier instruments could conclude that it has not invested in a waterfall structure and can potentially claim amortised cost treatment.

26. Some also highlighted the structuring opportunities created by a classification assessment on initial recognition only. For example, an investment vehicle

issues two tranches – a senior and a (minor) junior tranche. The maturity of the junior tranche is very short. Therefore the senior tranches would potentially qualify for amortised cost, despite absorbing virtually all credit risk arising from the reference instrument pool.

27. **Issuer's accounting.** Many were concerned over the accounting from the perspective of the issuer of the contractually linked instruments that effect concentrations of credit risk. They believed that the proposals imply that the investors' accounting has to be mirrored by the issuer – even though waterfall credit transfer mechanism only impacts the investors and has no effect on the issuer.

28. Many believe that any instruments issued that create contractual subordination should be subject to the normal classification criteria and no specific guidance should be required.

Alternative approaches

29. Some respondents offered alternative approaches. Almost all of these alternatives involved some form of 'look through' to the underlying instruments of the waterfall structure.

30. Such approaches would assess:

    (a) the characteristics of the underlying instruments, and

    (b) the exposure to credit risk that each tranche of investments issued would have *relative* to the pool of the underlying instruments.

31. Let's first consider the characteristics of the underlying instruments, in terms of respondents' views on practicability, complexity and the mechanics. Then we will turn to the relative exposure to credit risk issue.

32. **The practicability of looking through.** Most commentators proposed to require measurement at fair value if looking through was not possible. Respondents noted that the securitisation transactions which the guidance aimed to address were generally over-the-counter transactions in which the parties involved had

sufficient information about the assets to perform an analysis of the underlying instruments. In many cases the instrument pool and possible changes in the pool are specified in the contracts of the tranches.

33. **The complexity of looking through.** Respondents agreed with the Board that looking through added complexity. However, most felt that such complexity was necessary (and unavoidable) if the economic characteristics of the investments was going to be reflected in the accounting. Some also noted that having fair value as the default would allow an entity to avoid the complexity associated with looking through if either they did not want to incur the costs associated with the analysis or if the entity believed that the answer of looking through would be fair value anyway.

34. **The mechanics of looking through and the nature of the pool of underlying instruments.** The approaches presented often involved an assessment of the type of the underlying instruments in the structure. Some respondents proposed that amortised cost measurement should only be available if all of the underlying pool of instruments themselves had basic loan features. (The staff notes that the effect of such a narrow definition would be that *all* tranches of instruments based on pools of underlying instruments that included derivatives or other non-basic instruments would be measured at fair value).

35. Others suggested that the inclusion of any instrument that reduced credit or other risk, or that simply aligned currency/interest rates with the issued notes should not taint the overall assessment.

36. Some questioned what the outcome of a ‘look through’ approach would be if the issuance vehicle also contained non-financial assets.

37. **The relative exposure to credit risk.** Most favoured use of a probability-weighted approach to assess whether an instrument has a lower or higher exposure to credit risk than the average credit risk of the underlying assets.

Staff analysis

38. First the staff will provide some summary observations. Then we will address possible ways forward.

39. **Focus on terms and conditions of the instrument.** The contractual cash flow characteristics ('basic loan features') are determined by the terms and conditions of the instrument being assessed for classification. The staff believes that the ED proposals regarding waterfalls were consistent with such an approach. That is, the ED proposals were not an exception to the classification approach, but the outcome of applying the classification approach.

40. The ED approach applied the concept of interest and principal in a strict manner. If the contract contains subordination features that created subordination on an ongoing basis (and not only in a liquidation scenario) some of the payments represent an insurance premium received for providing protection to other tranches. Only the most senior tranche does not receive such a premium.

41. Clearly many respondents felt that for contractually linked instruments that effect concentrations of credit risk a focus on the contractual cash flow characteristics, as determined by the terms and conditions of the instrument, did not best reflect the economic characteristics of the instrument. That conclusion shifts the focus of the analysis of the 'basic loan features' criterion to looking through to the underlying instruments pool to assess whether the contractual cash flows are consistent with this criterion.

42. **Subordination.** Many respondents believed that subordination *per se* should not preclude amortised cost measurement. The staff agrees.

43. However, the staff notes that waterfall structures effect subordination on an ongoing basis and **by operation of contract**, while a general creditor ranking is created **by operation of law** (which, depending on the jurisdiction, can be amended between the creditors – see comments below) in insolvency/bankruptcy/liquidation situations.

44. The staff wants to highlight one major difference between **a general creditor ranking** and waterfalls. A “normal” creditor generally **does not lose part** of its contractual entitlement if the counterparty does not have sufficient funds to service the debt. Non-payment might or might not be a breach of contract, but the entitlement/claim stays the same and can usually be legally enforced (finally by liquidation of the counterparty).

45. However, generally a waterfall structure remains in place for as long as the issuing entity has *any* cash inflows from the assets held (although of course, only the top-rated tranche or tranches may receive anything).

46. In the staff’s view it is not subordination that matters. The ED proposals focused on the *concentration* of credit risk – or leverage – created by the contractual relationship between the tranches.

47. However, the staff notes that in some lending transactions the ranking mandated by law is overwritten by specific provisions in the contract. This does create a problem, because it may be that contractual linkage alone is not a sufficiently discriminating feature.

48. **Structuring.** The staff acknowledges that the proposed approach may create structuring opportunities. This does not specifically result from the waterfall structures themselves, but rather arises because of the focus on the contractual cash flow characteristics of the instrument being assessed for classification. The definition of a financial instrument (ignoring cash) is all about the contract. Such a focus is inevitable. However, as soon as you set the boundary of a contract and a unit of account of an individual contract, then that is inevitably form-driven to some extent.

49. **Summary.** The ED approach in this area focused on the form of the transaction (contractual cash flow characteristics of the instrument being assessed for classification) and the existence of a concentrated credit risk arising through contractual linkage. If the Board believes such a focus does not appropriately capture the economic characteristics of the instrument in such situations, then the Board should reconsider the proposals in the ED.

Ways forward for the Board for the issuer's accounting

50. Let's first try to deal with the most straight-forward issue here. The accounting by the issuer.

51. Many respondents asked the Board to clarify whether the accounting by the issuer would have to mirror holder's accounting in subordination structures[4]. Some respondents noted that the guidance in the ED implies that this was the case and was intended by the Board. However, others noted that the guidance was not sufficiently clear from the ED.

52. We think the Board has two choices:

    (a) require symmetrical accounting for interests in contractually linked instruments that effect concentrations of credit risk for both issuer and holder; or

    (b) require a separate assessment of the classification criteria for the issuer of contractually linked instruments that effect concentrations of credit risk from the issuer's perspective.

Staff recommendation

53. The staff recommends choice (b) – to require separate assessment of the classification criteria by the issuer of the contractually linked instruments that effect concentrations of credit risk.

54. We think the argument is convincing that the subordination effect created by a waterfall structure does not apply to the issuer when looking at the *overall* obligation of the issuer. The overall obligation of the issuer to pay cash flows to the tranches does not change because of the waterfall. The existence of the waterfall was one of the key differentiating factors when the Board considered

[4] We assume the issuer does not derecognise the reference assets.

the accounting of *investments* issued. The existence of such a feature is not relevant for the overall obligation of the issuer.

55. However, this approach means that the assessment by the issuer of contractually linked instruments that effect concentrations of credit risk has to be performed at the overall obligation level, rather than at the individual obligation (tranche) level. That is, by exception, the unit of account is considering the different tranches as being one obligation.

Question to the Board – issuer's accounting
Does the Board agree with the staff recommendation to require separate assessment of the classification criteria for the issuer of contractually linked instruments that effect concentrations of credit risk? If not, what do you propose instead and why?

Ways forward for the Board for the holder's accounting

56. The staff think the Board has the following alternatives for the accounting by the holder of contractually linked instruments that effect concentrations of credit risk:

    (a) state that contractual subordination that reallocates credit risk between different instruments is not a 'basic loan feature', and whether such subordination results in writing or receiving credit protection is irrelevant. This would mean every tranche does not have basic loan features and is measured at fair value

    (b) finalise the guidance in the ED (and explain more clearly the rationale)

    (c) permit or require a 'look through' approach to assess the underlying cash flow characteristics of the instrument and to assess the credit risk of the instruments relative to the underlying pool of instruments.

57. A further alternative would be to provide no guidance. However, these types of instruments have been specifically identified by the Board as troublesome. We do not believe this approach is feasible.

58. Before moving on, we want to emphasise that in all of the identified approaches there are two criteria to be met to be classified as a financial asset measured at amortised cost. We are talking about the first one in this paper – contractual cash flow characteristics. However, to be measured at amortised cost, any instrument also has to be part of a business model with the objective to collect or pay contractual cash flows rather than to realise fair value changes.

Contractual subordination that reallocates credit risk is not a basic loan feature

59. The Board could state that contractual subordination that reallocates credit risk between different instruments is not a 'basic loan feature' – regardless of whether such subordination results in writing or receiving credit protection.

60. The *ex ante* agreement of all tranche holders (including the most senior tranche) that their entitlement will be reduced based on the performance of the underlying pool of instruments is not a normal feature in a lending transaction.

61. This is consistent with the guidance in Appendix B1 and B3(c) of the ED. (However, the ED went on to state that "deleveraging" by the senior tranche should not preclude amortised cost).

62. The staff also notes that this is consistent with the analysis of instrument D in appendix A of agenda paper 3A of the 29 September 2009 meeting in the context of a non-recourse loan.

Finalise the guidance in the ED

63. The Board could retain the proposed guidance in the ED for the final IFRS.

64. While many respondents disagreed with this approach, the staff highlights that the most senior tranche in such arrangements is the only one that does not get (implicit) additional cash flows from providing **explicit** credit protection to

another tranche. Instead it receives credit protection in return for a lower than average interest rate.

65. The wording in the application guidance could be strengthened to better articulate how this approach is consistent with the overall classification approach.

66. This approach would also avoid all difficulties with a 'look through' approach.

67. However, the staff does note the structuring opportunities and does not have any obvious answers to them.

Permit or require 'look through' approach

68. The Board could permit or require looking to the underlying instruments for holders in the situation that a debtor issues contractually linked interests hence creating a contractual subordination waterfall.

69. Such approaches would assess:

(a) the characteristics of the underlying instruments, and

(b) the exposure to credit risk that each tranche of investments issued would have *relative* to the pool of the underlying instruments.

70. This approach would be an exception to the focus on the contractual cash flow characteristics of the assessed instrument itself, because we would be looking beyond the instrument itself.

71. The staff thinks this approach would address some of the concerns raised in the comment letters with regard to structuring opportunities, and the comments regarding over-emphasis on contractual form of the instrument as opposed to economic characteristics of the instrument. However, structuring opportunities may still be available in different ways.

72. Some might argue this approach would create an exception to the overall classification approach. Normally an entity would not be required to look through a contract to the underlying assets that the counterparty holds.

73. However, the staff thinks the nature of contractually linked instruments that effect concentrations of credit risk could justify this approach under the overall classification model. The underlying rationale would be that variability of cash flows from the pool of assets is a reference point and tranching only reallocates credit risk. Using this rationale, any tranche that is exposed to the same or lower credit risk (as evidenced by the cash flow variability of the tranche relative to the overall cash flow variability of the underlying instrument pool) would be deemed to meet the 'basic loan features' criterion.

74. If the Board pursues a 'look through' approach several issues have to be addressed:

(a) whether to require or permit a 'look through' approach

(b) what type of underlying instruments can be held by the issuer

(c) how far to look through

(d) should an entity look through on a continuous basis.

75. The staff recommendations below are relevant if the Board decides on this approach.

Whether to require or permit a 'look through' approach

76. Any 'look through' approach could be mandatory or voluntary. We think that due to the very specific nature of the investment looking through to the underlying instruments in case of contractually linked instruments that effect concentrations of credit risk should be **required**, unless such an assessment is not practicable**.**

77. Permitting a look through would be an explicit accounting option and impair comparability. The staff acknowledges that different entities could reach different conclusions whether looking through is practicable and this already impairs comparability.

78. However, we note the arguments made by many respondents that fair value should be the fallback position if such an approach is not practicable.

79. We therefore recommend that the Board to require looking through to the underlying assets under this approach and require fair value measurement for the instrument in question if such a 'look through' is not possible.

What type of underlying instruments the issuer can hold

80. Permitting looking through to the underlying instruments raises the question what type of assets the issuer can hold and what instruments would taint all instruments issued that are referenced to the underlying instruments.

81. We think it is necessary to assess the underlying instruments in the context of the 'basic loan features' criterion. That assessment could be based on the overall instrument pool or at an individual instrument level.

82. The anchor would always be instruments with basic loan features. Identify those first, and then consider the effects of any other instruments on the instruments with basic loan features – would the overall cash flows of the underlying pool of instruments still be consistent with the 'basic loan features' criterion?

83. So the choices include:

    (a) an instrument pool that contains **only** instruments that have basic loan features

    (b) an instrument pool that contains instruments with basic loan features, and instruments that change the cash flow variability of the instruments with basic loan features in accordance with the 'basic loan features' criterion

    (c) an instrument pool that contains instruments with basic loan features, and (1) instruments that change the cash flow variability of the instruments with basic loan features in accordance with the 'basic loan features' criterion, and/or (2) instruments that align the cash flows (eg for interest rates or currencies) of the issued notes with the instruments with basic loan features in the pool.

84. The question of the effect of an instrument pool that also contains non-financial items also has to be considered.

85. **An instrument pool that only contains any instruments that have basic loan features.** Many waterfall structures contain some instruments that would fail the 'basic loan features' criterion. So this approach would result in almost all contractually linked instruments that effect concentrations of credit risk being accounted for at fair value.

86. **An instrument pool that contains instruments with basic loan features, and instruments that change the cash flow variability of the instruments with basic loan features in accordance with the 'basic loan features' criterion.** Under this broader approach, no instrument could be used to create additional leverage. For example, an the instrument pool could contain variable rate instruments that create cash flow variability – the entity could enter into a contract to swap the variable rate into a fixed rate – fixed rate instruments are consistent with the notion of basic loan features.

87. **An instrument pool that contains instruments with basic loan features, and (1) instruments that change the cash flow variability of the instruments with basic loan features in accordance with the 'basic loan features' criterion, and/or (2) instruments that align the cash flows (eg for interest rates or currencies) of the issued notes with the instruments with basic loan features in the pool.** Many instrument pools include instruments that align the cash flows of the instruments with basic loan features with the cash flows of the instruments being issued. For example, the instrument pool could contain an instrument that aligns the currency of the cash instruments (eg EUR) with the denomination of the notes (eg GBP). No instrument could be used to create additional leverage.

88. **Non-financial items.** Some instrument pools may contain non-financial assets. Clearly, the contractual cash flow characteristics test ('basic loan features') cannot be applied to such instruments. Therefore, unless more guidance was

created, an instrument pool that contains non-financial items would taint all interests issued by the waterfall structure.

89. In summary, we think it is important to start an assessment from the perspective of the instruments with basic loan features. If there are no such instruments, then clearly fair value measurement would be required.

90. Let's assume that there are basic loan instruments, but also some instruments that do not have basic loan features. If there are instruments that do not meet the 'basic loan features' criterion in the underlying pool then these instruments would have to be assessed whether they (a) change the cash flow variability of the portfolio in accordance with the notion of basic loan features and/or (b) align the cash inflows (from the underlying pool of instruments) with the cash outflows (to the holders of the issued instruments).

How far to look through

91. Some constituents noted that in a 'look through' approach the Board would have to answer the question of how far to look through. This issue has already been identified by the Board during the deliberations of the ED. This is of particular relevance if securitisation vehicles are connected in series. In that case the underlying assets creating the cash flow variability might emerge only after a series of issuance vehicles.

92. The staff thinks that an entity has to look through until it can identify the assets creating (rather than passing through) the cash flows and assess for the qualification criteria. An entity would stop looking through as soon as it identified an instrument in the pool that did not meet the criteria discussed previously – the eligible instruments in the pool. If it is not possible to look through far enough, we think the same guidance should apply as for cases where looking through is not practicable, ie the instrument in question is to be measured at fair value.

Should an entity look through on a continuous basis

93. Depending on the structure of the waterfall the issuing entity can change the asset mix depending on the circumstances and usually within the confines of the investment policy. In some cases this flexibility could lead to instruments being in the instrument pool subsequent to acquisition of an interest that would prohibit the instruments issued to be accounted for at amortised cost. So the question is whether an entity continuously would have to assess whether the instrument pool still only contains non-tainting instruments.

94. The staff thinks that the Board will not generally permit reassessment of classification regarding the contractual cash flow characteristics ('basic loan features') criterion[5].

95. However, as a look through approach already changed the level of assessment for the basic loan feature criterion, it would not be in absolute conflict with that requirement.

96. Continuous reassessment is burdensome and often an entity does not have sufficient information about the actual asset mix after initial recognition.

97. The staff believes that if the underlying instruments, at a date subsequent to initial recognition, **could** change so that the interest would not meet the criterion for amortised cost treatment anymore, this should preclude the interest to be accounted for at amortised cost. Otherwise it would be very easy to start the instrument pool with instruments meeting the criterion and then churn the portfolio to only have, say, equities. We do not think amortised cost in that instance would render decision-useful information.

Staff recommendation

98. The staff have differing views as to the approach that the Board should take.

[5] See agenda paper 5 of this meeting.

99. Some staff believe that **all** contractually linked interests that effect concentrations of credit risk should be measured at fair value. This includes the most senior tranche. These staff believe that such a feature is not a normal lending feature.

100. Other staff believe that to assess the credit risk, and return for credit risk, of many instruments it is implicitly necessary to understand what you are investing in. This is especially the case in the situations discussed in this paper. Those staff agree that looking through is complex, but that the instruments that we are discussing in this paper are complex, and to obtain a full understanding of the *effects* of the terms and conditions – and to make a judgement as to whether the instrument has basic loan features – an investor should understand the underlying pool of instruments.

101. The following recommendation is based on an approach of looking through. If the Board does not agree with that recommendation, the staff will ask the Board what other approach they wish to pursue.

102. That ‘look through’ approach would be designed as recommended in the preceding paragraphs. To summarise:

(a) looking through to the underlying assets would be required, but if looking through is not practicable, fair value measurement would be mandated

(b) an entity would have to look through until it identifies the assets generating the cash flows (rather than passing them through) – if this is not practicable, fair value measurement would be mandated

(c) the instrument pool must only contain instruments with (1) basic loan features, (2) that change the cash flow variability of the instruments with basic loan features in accordance with the ‘basic loan features’ criterion, and/or (3) that align the cash flows (eg for interest rates or currencies) of the issued notes with the instruments with basic loan features in the pool.

(d) if the instrument pool can change subsequently in a manner that would prohibit classification of the issued interests at amortised cost this would prohibit measuring any interests at amortised cost.

Question to the Board – holder's accounting

Does the Board agree with the recommendation to require a 'look through' approach designed as follows:

(a) Looking through the underlying instruments would be required, but if this is not practicable, the instrument would be measured at fair value

(b) an entity would have to look through until it identifies the assets generating the cash flows (rather than passing them through) – if this is not practicable, the instrument would be measured at fair value

(c) the instrument pool can contain instruments with
  (1) basic loan features,
  (2) that change the cash flow variability of the instruments with basic loan features in accordance with the 'basic loan features' criterion, and/or
  (3) that align the cash flows (eg for interest rates or currencies) of the issued notes with the instruments with basic loan features in the pool

(d) reassessment would not be required, but if the instrument pool could change as to contain instruments that would not meet condition (c) than any interest would have to be measured at fair value.

If not, what would you propose instead and why?