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

Topic **Interaction between decisions on concentrations of credit risk and other non-recourse instruments**

Objective of the paper

1. **This paper discusses the interaction between the Board's tentative decisions on concentrations of credit risk[1] and the accounting for some non-recourse instruments.**

2. At the 29 September 2009 meeting the Board tentatively decided that some non-recourse instruments most likely fail the 'basic loan features' criterion because the lender does not have a contractual right to unpaid amounts of principal and interest on that principal.

3. At the 16 October 2009 meeting the Board tentatively decided to require a 'look through' approach for holders of contractually linked instruments that create concentrations of credit risk to determine their relative credit risk. To be eligible for amortised cost accounting the instrument must have the same or better credit risk than the average credit risk of the underlying pool of instruments (ie it is unleveraged or deleveraged).

What is a non-recourse instrument?

4. Before we can discuss any interaction, we need to have a common reference point. So what do we mean by "non-recourse" in this paper?

[1] See agenda paper 7 from the 16 October 2009 Board meeting.

5. Typically, non-recourse refers to the missing personal liability of a debtor beyond any asset or asset(s) pledged as collateral. Hence, by non-recourse we do not mean ‘normal’ collateralised debt where the creditor has a claim on the debtor and in addition, the protection of the security. That is, in a non-recourse instrument the creditor’s ultimate claim is limited to the value of the asset.

6. In other words, the creditor absorbs the asset-specific risk. If the debtor does not provide any other form of guarantee or only uses cash flows that arise from the pledged asset(s) to meet the obligation that means that the creditor recovers its investment only through the performance of the asset(s).

7. Put different, the creditor does not benefit from any protection provided by general creditor ranking or any loss-absorption potential of the debtor’s equity. Further, it does not benefit from the potential risk diversification effects of the debtor’s other assets.

8. Hence generally, non-recourse instruments receive a higher yield to compensate for the higher risk. Unless, of course, the pledged assets provide greater protection than general creditor ranking or from any loss-absorption created by the debtor’s equity (for example, if the value of the assets was well in excess of the receivable and was expected to be in all circumstances).

9. Non-recourse can be contractually established or it can be created by legal structure (eg using a special purpose vehicle - SPV), or both. The latter is often necessary to shield the pledged assets from other creditors of the issuer.

10. For the remainder of this paper we assume that the pledged assets are not derecognised.

Similarity of contractually linked instruments effecting concentrations of credit risk and non-recourse arrangements

11. Some features of contractually linked instruments effecting concentrations of credit risk are similar to some non-recourse arrangements[2]:

    (a) the debtor pledges an asset or a pool of asset(s)

    (b) that asset(s) is ring-fenced so it is "isolated" from the other net assets of the debtor

    (c) any payments on the debt instruments are sourced by the cash flows generated by the ring-fenced asset(s) (ultimately by liquidating them)

    (d) The legal entitlement to payments of principal and interest may or may not be reduced depending on the performance of the ring-fenced asset(s). **However, generally the creditor has no further rights to such payments except for any cash flows arising from liquidating the ring-fenced asset(s).**

What is different from the credit concentration 'waterfall'?

12. Generally speaking, non-recourse instruments participate in the performance of the ring-fenced asset(s) proportionately. If there are multiple instruments (eg notes) that have recourse only to the pledged assets, they share any loss fully proportionate. That is, there is no concentration of credit risk[3].

13. This is different from what we commonly refer to as 'waterfall' structures. In such structures, contractual linkage reallocates credit risk amongst the instrument holders by creating a cash flow waterfall determining the order in which instruments receive the first cash flows. That is, any loss is shared disproportionately. The most junior instrument receives any cash flows only if

---

[2] The Board has discussed non-recourse arrangements in agenda paper 3A, Appendix A of the 29 September 2009 meeting.

[3] From the perspective of the creditor the performance risk of the pledged assets (or asset-specific risk) are representing its credit risk from the instruments the creditor holds.

all other more senior tranches are paid off - it has a loss absorption potential akin to equity (hence, it is often referred to as 'equity tranche').

Staff analysis

14. From the holder's perspective non-recourse changes its risk compared to a normal loan to the debtor. In a perfect market the interest received would be reflective of this changed credit risk. However, the creditor waives its right to hold the debtor personally liable in the situation that the ring-fenced asset(s) do not perform as expected. In the case that cash flows are not sufficient, the entitlement is reduced to zero after liquidation of ring-fenced asset(s).

15. It could be argued this is **not** reflective of a normal lending activity. The creditor waives its right to receive payments after liquidation of the pledged assets without seeking further legal action[4].

16. Others think this is no different to lending to a single company entity that has exactly the pledged assets and no equity.

17. The Board tentatively decided in agenda paper 3A of the 29 September 2009 meeting that **non-recourse instruments generally do not meet the 'basic loan features' criterion** because of the non-recourse element.

18. At the 16 October meeting the Board decided that for waterfall structures that created leveraged (and deleveraged) exposures to credit risk, **for some instruments (tranches) the criterion of 'basic loan features' can be met** from the holder's perspective – to determine this the issuer has to look through to the underlying asset(s). As explained above the only distinguishing feature is the disproportionate allocation of credit risk from the holders' perspective.

---

[4] From a group perspective, often intra-group guarantees are granted to ensure all entities within the group have sufficient access to funds at similar conditions. In addition, even without such a guarantee structure creditors generally seek legal action against other members of the issuing group. This is generally not the case in non-recourse situations if the parties acted in good faith.

19. The staff believes that the non-recourse feature challenges the notion of 'basic loan features'. In such situations this may make looking through to the ring-fenced assets a necessity to understand the cash flow characteristics of the instrument held, and to make the judgement whether the payments under contract in substance represent payments of principal and interest.

20. We are not talking about non-recourse situations that are akin to a collateralised borrowing. That is, situations in which the asset(s) the creditor has recourse to will provide cash flows sufficient to service the non-recourse debt instrument and the investor will receive in full the payments of principal and interest on the principal outstanding.

21. We are focussing on situations in which the notion of 'basic loan feature' is challenged because the credit risk of the issuer of the instrument is exchanged for the performance risk of the ring-fenced assets.

22. For example, take an entity that issues a non-recourse loan to an entity. The only asset of that entity is an equity instrument and the entity's only funding is the non-recourse loan. In that case, we do not think the payments represent payments of principal and interest. The cash flow variability from the equity instrument in the issuer is the sole source of cash inflows (the instrument is more akin to an equity-linked note). In such a situation it is necessary to look through in order to understand the contractual cash flow characteristics of the investment held, and to make the judgement as to whether the payments that arise under the contract are payments of principal and interest as defined.

23. Conversely, assume that the entity holds a pool of credit card receivables. In this case we think the entity might conclude that the payments that arise under the non-recourse instrument represent payments of principal and interest. However, to make that conclusion, the entity will have to understand the assets underlying their investment.

24. We think the final guidance should be clear that we do not mean you **never** have to look through, and in many cases you will have to understand the underlying ring-fenced assets in order to understand the cash flow characteristics, and

whether the payments under contract in substance represent payments of principal and interest.

Holder's accounting for proportionate non-recourse instruments
Does the Board agree with the staff recommendation that the IFRS includes guidance that an entity must ensure that any payments arising under the contract are consistent with the principle of all payments being payments of principal and interest – which may often require looking through to the ring-fenced instruments in non-recourse instruments? If not, why and what do you propose instead, and why?