Topic

Feedback on IFRS 9—non-recourse assets and constant maturity assets

1. IFRS 9 *Financial Instruments* was issued in November 2009 and contains requirements for the classification and measurement of financial assets. Since its issuance, we have continued our outreach program and have met with a number of constituents. During those meetings we have received some questions about how those requirements should be interpreted.

2. In particular, we have received questions on the following two items:

   (a) **non-recourse assets**, which are discussed in paragraphs B4.15–B4.17 of IFRS 9; and

   (b) **constant maturity assets**, which are not explicitly discussed in IFRS 9 but the analysis of Instrument B in paragraph B4.13 is relevant.

   The paragraphs relevant to those two items are included as an appendix to this paper.

3. **This paper is to update the Board on the feedback that we have received on those two items. This paper is for informational purposes only and will not be discussed at a board meeting.**

4. We will update the Board further as we continue our outreach program.

Requirements in IFRS 9

5. IFRS 9 requires financial assets to be measured at amortized cost (unless the fair value option is elected) if both of the following conditions are met:

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

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

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(a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

6. For the purposes of the condition in (b) above, *interest* is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.

7. Both of the issues discussed in this paper relate to the condition in (b)—the contractual cash flow characteristics of a financial asset. Therefore, the condition in (a) is not discussed further in this paper.

Non-recourse assets[1]

8. There is no 'special' guidance in IFRS 9 for non-recourse assets—that is, the general principles set out in IFRS 9 apply. Paragraphs B4.15–B4.17 reinforce that the focus should be on whether the contractual cash flows represent solely payments of principal and interest.

9. IFRS 9 (paragraph B4.17) notes that the fact that an asset is non-recourse does not in itself preclude the asset from being measured at amortized cost. The fact that an asset is non-recourse should simply raise a red flag to alert the reporting entity that it needs to look closer at the financial instrument to make the judgement whether its contractual cash flows are solely payments of principal and interest. Specifically, the reporting entity would be required to understand

[1] As noted in agenda paper 12C for the October 2009 board meeting, typically 'non-recourse' refers to the missing personal liability of a debtor beyond any asset(s) pledged as collateral. Hence, non-recourse does **not** refer to 'normal' collateralized debt where the creditor has a claim on the debtor and in addition, the protection of the underlying asset(s). In a non-recourse instrument, the creditor's ultimate claim is limited to the value of the underlying asset(s).

the underlying asset(s) and link to the cash flows of the asset being classified to make such a determination.

10. That guidance was included in IFRS 9 because the Board was concerned about cases where cash flows are described as ‘principal and interest’ but, economically, are not consistent with how those terms are used in IFRS 9.

11. Some constituents have interpreted the guidance in IFRS 9 to mean that many (or most) non-recourse assets would **not** qualify for amortized cost. For example, some have told us that they think non-recourse residential mortgages would rarely (or never) qualify for amortized cost.

12. The rationale underpinning that view seems to be that ultimately the debtor might default on its obligation and the creditor is exposed to credit risk.

13. We understand that the Board believed that many non-recourse assets *will* satisfy paragraph 4.2(b).

14. By discussing such assets in the application guidance, the Board did not intend to imply that an entity’s analysis of those assets would be any different (or stricter) than its analysis of other assets within the scope of IFRS 9. That is, the Board did not intend that the application of IFRS 9 should be changed as a result of the addition of the clarifying paragraphs referring to non-recourse arrangements. The Board simply sought to reinforce that the words being used to describe payments should not determine classification – rather the economic nature of those payments should satisfy the concept of principal and interest as set out in IFRS 9. For example, if a loan were made on a non-recourse basis to finance a toll road project, the fact that the loan is stated to pay interest and principal is not sufficient to satisfy paragraph 4.2(b) if the amount of interest is calculated to vary in proportion to the number of vehicles using the toll road. That conclusion should be reached even in the absence of paragraphs B4.15-B4.17.

15. We believe that the language used in IFRS 9 supports the preceding paragraph, although we also acknowledge that the drafting could be improved.

Constant maturity assets

16. The fundamental concept underpinning the analysis of contractual terms in IFRS 9 is that to qualify for amortized cost measurement the contractual cash flows on an asset must relate only to principal and interest. In turn, interest must comprise consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time (IFRS 9.4.3). The notion of interest is thus central to the operation of IFRS 9.

17. In order to assist those applying IFRS 9 to understand the notion of interest intended by the Board some examples are provided in the Application Guidance that forms part of the IFRS.

18. In paragraph B4.14, Instrument B is a variable rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis (eg at each interest rate reset rate, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term). The analysis of Instrument B notes that the fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument from being measured at amortized cost. However, it is noted that the way in which the floating interest rate is determined can affect whether an instrument is eligible for amortized cost measurement.

19. In particular, the analysis goes on to say that 'if the instrument has a contractual interest rate that is based on a term that **exceeds** the instrument's remaining life, its contractual cash flows are not principal and interest….'

20. Given the wording in the example, some have asked whether an instrument is **always** disqualified from being measured at amortized cost if the contractual interest rate is based on a term that exceeds its remaining life – or if there are cases where the instrument would still qualify.

21. In addition, constituents have asked whether consideration can be given to the characteristics of a particular jurisdiction—for example where a constant maturity loan is the primary source of funding and whether, in those

circumstances, the rate on those instruments could be regarded as the rate of compensation for the time value of money and credit risk in that market.

22. The staff understands that the Board included Instrument B to reinforce that consideration needs to be given to whether payments on the instrument reflect consideration only for the time value of money and credit risk. That is the underlying principle of IFRS 9, and that is the principle on which an entity needs to make a judgment.

APPENDIX—Relevant paragraphs from IFRS 9

Non-recourse financial assets

B4.15 In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.2(b) and 4.3 of this IFRS.

B4.16 This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, the contractual cash flows may include payment for factors other than consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. As a result, the instrument would not satisfy the condition in paragraph 4.2(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).

B4.17 However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraph 4.2(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraph 4.2(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

Constant maturity assets

Instrument B (excerpt from paragraph B4.13)

Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term.

The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects

consideration for the time value of money and for the credit risk associated with the instrument. The fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument. However, if the borrower is able to choose to receive one-month LIBOR for three months and that one-month LIBOR is not reset each month, the contractual cash flows are not payments of principal and interest. The same analysis would apply if the borrower is able to choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate.

However, if the instrument has a contractual interest rate that is based on a term that exceeds the instrument's remaining life, its contractual cash flows are not payments of principal and interest on the principal amount outstanding. For example, a constant maturity bond with a five-year term that pays a variable rate that is reset periodically but always reflects a five-year maturity does not result in contractual cash flows that are payments of principal and interest on the principal amount outstanding. That is because the interest payable in each period is disconnected from the term of the instrument (except at origination).