
IASB meeting

Date	November 2022
Project	Amendments to the Classification and Measurement of Financial Instruments
Topic	Contractually linked instruments—sweep issue
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Introduction

1. In [September 2022](#), the IASB tentatively decided to make clarifying amendments to the requirements in IFRS 9 *Financial Instruments* for assessing whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding (SPPI), including clarifying the scope and unique characteristics of contractually linked instruments (CLIs).
2. The purpose of this paper is to consider a sweep issue the staff became aware of subsequent to the IASB's discussion in September 2022. We are asking the IASB whether it agrees with our recommendation to further clarify the scope of transactions to which the CLI requirements are applied.
3. The paper is structured as follows:
 - (a) [scope of transactions to which the CLI requirements apply](#); and
 - (b) [question for the IASB](#).

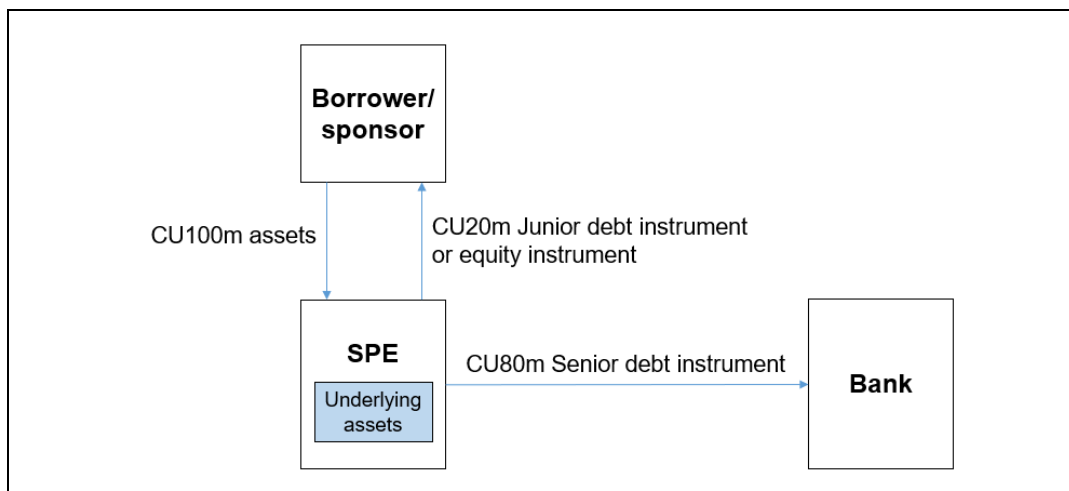
Scope of transactions to which the CLI requirements apply

4. As discussed in paragraph 21 of [Agenda Paper 16B](#) for the September 2022 IASB meeting, the scope of transactions to which the CLI requirements apply can be clarified by including application guidance on the unique characteristics of CLIs that distinguish them from other transactions.
5. The IASB therefore tentatively decided that the unique characteristics of a CLI structure are:
 - (a) the use of multiple contractually linked instruments;
 - (b) with non-recourse features;

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- (c) that establishes the prioritisation of payments through a waterfall payment structure; and
 - (d) creates concentrations of credit risk resulting in a disproportionate allocation of losses between investors in the event of cash flow shortfalls.
6. Subsequent to the tentative agenda decision in September 2022, a few stakeholders asked how the non-recourse and CLI requirements are applied when there are only two debt instruments and the borrower/sponsor of a special purpose entity (SPE) holds the junior debt instrument.
 7. It is quite common to make use of SPEs to obtain a loan from a bank that is secured by specified assets of the borrower, for example as a form of project finance. To ringfence the borrower's assets and protect the bank's claim against the underlying assets from claims by other creditors, the borrower transfers the underlying assets into an SPE (which the borrower will consolidate) and the bank makes a loan to the SPE. Even though the loan is made to the SPE, the bank is negotiating the contractual terms with, and assessing its risk exposure to, the borrower sponsoring the SPE (hereafter referred to as the sponsor).
 8. The bank is only financing a portion of the assets transferred into the SPE (for example 80%) and the sponsor is required to 'contribute' the remainder (for example 20%). The investment from the sponsor could be in the form of either equity instruments such as shares or a debt instrument that is sub-ordinated to the loan from the bank.
 9. The staff also observed that in some structures, to further protect the bank's contractual right to recover the principal amount provided to the SPE, the sponsor is required, or has an option, to either increase its debt or equity investment in the structure or to transfer additional assets to the SPE if the value of the underlying assets falls below a predefined level (ie top up the underlying assets).
 10. Consistent with the IASB's tentative agenda decision to provide further application guidance on financial assets with non-recourse features, the staff are of the view that contractual terms of a financial asset that require the sponsor to 'top-up' the underlying assets, could be indicative that the lender has recourse to the sponsor and therefore the financial asset does not have non-recourse features. This is because if the lender could require the sponsor to keep the value of the underlying assets at a minimum amount that would be needed to repay the principal and interest on the loan, the lender's contractual right to claim the principal is not solely based on the performance of the underlying assets. Therefore, the staff are of the view that such features result in the transaction not being a CLI as one of the key characteristics

described in paragraph 5 of this paper, is not present. For the remainder of this paper, we are assuming that this is not the case and that the transaction does have non-recourse features.

Example: commonly used structure for secured lending arrangements



11. If the sponsor's investment in the SPE is in the form of equity instruments, the structure will not be a CLI because the bank is the only 'investor' and debt holder (ie there is a single debt instrument), and therefore no 'multiple contractually linked instruments' that create a concentration of credit risk. The bank will therefore apply the general SPPI requirements including determining whether the loan to the SPE has non-recourse features (also see paragraph 10 of this paper) regardless of the nature of the underlying assets.
12. However, stakeholders are concerned that if the sponsor's investment in the SPE is in the form of a debt instrument, the structure might be considered a CLI because the structure seemingly has the unique characteristics described in paragraph 5 of this paper, being:
 - (a) the senior and junior debt instruments are issued by the SPE and therefore the structure appears to make use of multiple (ie more than one) contractually linked instruments;
 - (b) the debt instruments may have non-recourse features depending on the contractual terms; and
 - (c) there might be a waterfall structure for the payment of contractual cash flows resulting in the junior debt instrument absorbing the first losses from the underlying assets, thereby providing credit protection to the senior debt instrument. In other words, the structure may be considered to create a concentration of credit risk.
13. If the structure is considered a CLI, the senior and junior debt instruments would not have contractual cash flows that are SPPI if the underlying assets include instruments that do not

have cash flows that are SPPI (as per paragraph B4.1.23 of IFRS 9). This would be the case for example if the underlying assets are not financial assets.

14. However, the staff think these types of lending arrangements are distinct from investments in CLIs and we do not believe that it was the IASB's intention to apply the CLI requirements to such secured lending arrangements when developing IFRS 9 or with the tentative agenda decision made in September 2022 as summarised in paragraph 5 of this paper.
15. In these structures, the holder of the junior debt instrument (ie the sponsor) is not an investor in the structure or the underlying assets that is willing to take higher risks in exchange for the higher returns than the senior debt instrument. Instead, the sponsor of the SPE can be regarded as the ultimate counterparty to the lending bank since the terms and conditions of the lending arrangement, including the creation of the SPE, would have been negotiated between the sponsor and the bank. From the sponsor's perspective, the SPE will be consolidated, resulting in the junior debt instrument being eliminated and the financing provided by the bank as the only debt instrument outstanding. The staff therefore believe that the debt instrument held by the sponsor does not constitute a separate debt instrument or 'tranche' when assessing whether a particular structure is within the scope of the CLI requirements.
16. As stated in page 7 of [Agenda Paper 3](#) for the May 2022 meeting, one of the main reasons the IASB decided to clarify the scope of transactions to which the CLI requirements are applied, is to ensure that the requirements are applied only to instruments for which the CLI requirements will provide useful information to the users of financial statements.
17. Therefore, the staff recommend clarifying that when determining whether a transaction is in the scope of the CLI requirements, an entity excludes any instruments held by the sponsor that has transferred the underlying assets to the issuer.

Question for the IASB

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Do you agree with the staff's recommendation as set out in paragraph 17 of this paper?