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Project	Contractual Cash Flow Characteristics of Financial Assets (Amendments to IFRS 9)
Paper topic	Financial assets with non-recourse features and contractually linked instruments

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Introduction

1. In July 2022, the IASB discussed the staff analysis of the characteristics of financial assets with non-recourse features and contractually linked instruments (CLIs) to inform possible amendments to IFRS 9 *Financial Instruments* to clarify the requirements relating to the assessment of the contractual cash flow characteristics of such instruments.

2. This paper further considers the potential clarifications that could be made, taking into consideration the views and questions from IASB members shared at that meeting and is structured as follows:
   (a) staff recommendations and questions for the IASB;
   (b) staff analysis regarding:
      (i) financial assets with non-recourse features; and
      (ii) the CLI requirements.

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Staff recommendations and questions for the IASB

Financial assets with non-recourse features

3. To assist with the consistent application of the SPPI assessment, the staff recommend clarifying that in the case of a financial asset with non-recourse features:
   (a) the lender is exposed to the performance risk of the underlying asset(s) throughout the life of the instrument both for the payment of the contractual payments as well as in default; and
   (b) the lender's contractual right to receive contractual payments over the life of the instrument is restricted to the cash flows generated by the underlying asset.
4. The staff further recommend including examples of relevant factors an entity could consider when assessing the particular underlying assets or cash flows, such as:
   (a) the legal or capital structure of the borrower;
   (b) the extent to which the expected cash flows from the underlying assets exceeds the contractual cash flows on the financial asset; or
   (c) whether there are other sources of finance (ie loans) that are subordinated to the loan from the lender.

Question for IASB
Do you agree with the staff's recommendations in paragraphs 3 and 4 of this paper to clarify the application of the SPPI requirements in IFRS 9 to financial assets with non-recourse features?

CLI requirements

5. The staff recommend including distinguishing characteristics of CLIs as part of the application guidance of IFRS 9 to assist with the consistent application of the CLI requirements. The unique characteristics of a CLI structure are:
   (a) use of multiple contractually linked instruments;
   (b) non-recourse features;
   (c) prioritisation of payments through a waterfall payment structure; that creates
   (d) concentrations of credit risk resulting in a disproportionate reduction in contractual rights in the event of cash flow shortfalls.
6. The staff further recommend clarifying that the reference to 'instruments' in paragraph B4.1.23 of IFRS 9 also includes financial instruments that are not fully in the scope of IFRS 9 such as lease receivables.

Question for IASB
Do you agree with the staff's recommendations in paragraphs 5 and 6 of this paper to clarify the requirements in IFRS 9 for contractually linked instruments?

Staff analysis

Financial assets with non-recourse features

Characteristics of financial assets with non-recourse features

7. When developing IFRS 9, the IASB was concerned about instruments with contractual cash flows that are described as 'principal and interest' but, that economically are not consistent with how those terms are used in IFRS 9. Thus, the IASB decided to include application guidance in paragraphs B4.1.15–B.4.1.17 of

IFRS 9 to respond to the concerns instead of developing any specific requirements for such financial instruments.[1]

8. Paragraphs B4.1.15 and B.4.1.16 of IFRS 9 refer to financial assets with contractual cash flows that are described as principal and interest but that are not SPPI because the lender's claim is limited to specified assets of the borrower or the cash flows from specified assets, as 'non-recourse' financial assets.

9. As discussed at the July 2022 IASB meeting, the staff note that some respondents to the *Request for Information Post-implementation Review of IFRS 9—Classification and Measurement* (the PIR) had difficulty in determining whether or not the loan is a 'non-recourse financial asset'.

10. Agenda paper 12C for the October 2009 IASB meeting, noted that 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' collateralised 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).

11. In the context of a financial asset with a non-recourse feature, the contractual terms of a financial asset would be inconsistent with a basic lending arrangement if the lender is, in addition to (or instead of) the credit risk of the borrower, exposed to the performance risk of an underlying asset (or pool of assets). In this scenario, the lender is not only exposed to basic lending type risks but also has exposure to risks associated with an investment in the underlying assets.

12. Although the lender in a full recourse loan collateralised by another asset, might be relying on the collateralised asset for the recovery of the outstanding principal and interest in the event of default, this exposure is only to the extent that the borrower is unable to make the contractual payments through other means.

13. The staff therefore recommend clarifying that, in the case of a financial asset with non-recourse features, the lender is exposed to the performance risk of the underlying asset(s) throughout the life of the instrument; both for the payment of the contractual payments as well as in default. The lender's contractual right to receive

[1] Consistent with paragraph 8 of AP5C reported to the IASB in September 2010

contractual payments over the life of the instrument is therefore restricted to the cash flows generated by the underlying asset.

14. Paragraph B4.1.17 of IFRS 9 requires the lender to 'look through to' the particular underlying assets to determine whether a non-recourse feature of a financial asset gives rise to contractual cash flows that are SPPI, (ie is consistent with a basic lending arrangement). Even before the start of the PIR, stakeholders have been asking for additional application guidance on what an entity needs to consider for the purposes of 'looking through'. Although the staff are of the view that determining whether a financial asset with non-recourse features has contractual cash flows that are SPPI, requires judgement based on the specific facts and circumstances, we think it would be useful to include examples of factors an entity might consider.

15. This will especially be the case when the non-recourse feature is not an explicit contractual term but resulting from the substance of the contractual cash flows. For example, a loan to a special purpose entity (SPE) may have contractual cash flows that are described as payments of principal or interest, but the lender's contractual right to the cash flows is limited to a specified portfolio of assets of the SPE.

16. One relevant consideration in determining whether the contractual cash flows are SPPI, might be the legal structure of the borrower. Although the staff do not consider it appropriate to conclude that all financial instruments with SPEs are financial assets with non-recourse features that result in cash flows that are not SPPI, we think the legal structure could be an indicator of whether the lender is exposed to the performance risk of the underlying asset rather than the credit risk of the SPE. SPEs are typically established with only nominal equity and therefore with very little loss absorbency capacity. If the loan provided by the lender is acting as quasi-equity such that any or all losses from the underlying assets are absorbed by the lender, the contractual cash flows are not SPPI.

17. Another relevant consideration could be the extent to which the expected cash flows from the underlying assets exceeds the contractual cash flows (ie loan-to-value ratio). If the underlying assets are funded entirely by the loan from the lender (ie a 100% loan-to-value ratio), the lender would be exposed to any and all losses from the underlying assets and the loan would represent an investment in the underlying

assets rather than cash flows that are SPPI. On the other hand, if the loan from the lender only funds a portion of the underlying assets and other loans to the SPE are subordinated to the loan from the lender, the contractual cash flows could be SPPI despite the non-recourse feature.

18. Therefore, the staff recommend including examples of relevant factors an entity could consider when assessing the particular underlying assets or cash flows as required by paragraph B4.1.17 of IFRS 9, such as:

    (a) the legal or capital structure of the borrower;

    (b) the extent to which the expected cash flows from the underlying assets exceeds the contractual cash flows on the financial asset; or

    (c) whether there are other sources of finance (ie loans) that are subordinated to the loan from the lender.

19. However, it is important to note that these examples are not exhaustive and none of the factors is determinative on its own. Determining whether the cash flows of a financial asset with non-recourse features are SPPI depends on the specific facts and circumstances.

Contractually linked instruments

20. As noted in Agenda Paper 3C for the April 2022 IASB meeting, feedback received on the RFI with regards to CLIs, mainly asked for clarification of two specific areas of the requirements, being:

    (a) the scope of transactions to which the CLI requirements apply; and

    (b) the requirements in paragraphs B4.1.23 and B4.1.24 for the underlying pool of assets.

Scope of transactions to which the CLI requirements apply

21. As discussed in Agenda Paper 16B for the July 2022 IASB meeting, the staff are of the view that the scope of instruments 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.

22. We therefore continue to think that the unique characteristics of a CLI structure are:

    (a) use of multiple contractually linked instruments (see paragraphs 24–28);

    (b) non-recourse features (see paragraphs 29 and 30);

    (c) prioritisation of payments through a waterfall payment structure (see paragraphs 30 and 31); that creates

    (d) concentrations of credit risk resulting in a disproportionate reduction in contractual rights in the event of cash flow shortfalls (see paragraphs 33–37).

23. We note that these characteristics are inter-related, rather than independent from each other. Therefore, for a CLI instrument to be in the scope of the requirements in paragraphs B4.1.20–B4.1.26 of IFRS 9, an instrument should have all these characteristics. For example, many instruments include a waterfall payment structure that specifies the order in which cash flows from the underlying pool of assets are distributed among investors. However, these waterfall payment structures do not create concentrations of credit risk that lead to a disproportionate share of losses between investors. The sections below summarise the staff's analysis of the proposed characteristics.

Multiple contractually linked instruments

24. The first key characteristic is that a CLI transaction consists of *multiple contractually linked instruments* (as stated in paragraph B4.1.20 of IFRS 9).

25. In the staff's view, the meaning of 'multiple' in this context, is consistent with the generally accepted notion of 'having more than one and usually several of something'[2]. While it is common for typical structured transactions to have 3 or more tranches (ie senior, mezzanine and junior), we do not believe it was the IASB's intention for the CLI requirements to apply only to transactions with 3 or more tranches. If that was the IASB's intention, the requirements would have specified as

[2] As defined in the Cambridge Dictionary

such. Therefore, the staff do not see any benefit in clarifying or qualifying the meaning of ‘multiple’ in this regard.

26. The staff are also of the view that the phrase ‘contractually linked’ is self-explanatory and requires no further clarification. We believe the IASB’s intention was to refer to a transaction where the relationship between, and the rights and obligations associated with, the different tranches (including the order in which cash flows are allocated), are specified in the transaction’s contractual terms.

27. In a typical CLI transaction, the specification of the contractual rights and obligation of each tranche and their ranking, is done in contemplation of each other. Therefore, each tranche holder knows the contractual rights and obligations, not only of the tranche they have invested in, but also those of the other tranches, including the ranking in the waterfall structure. This is the case even if a tranche holder invests in the CLI subsequent to the establishment of the structure.

28. In our view, this is an important structural difference between CLIs and general subordination or creditor rankings. The creditor ranking is one form of subordination that affect almost all lending transactions.[3] An entity may enter into a subordinated loan which ranks below all other loans in the event of default. However, this loan would not be contractually linked to the entity’s other loans. Furthermore, a new financial instrument with a higher or lower creditor ranking could be issued subsequent to an investor investing in an instrument, without the investor being aware of the change in ranking.

Non-recourse features

29. Another key characteristic is that CLIs have non-recourse features as discussed in paragraphs 7–19 of this paper. This is because CLIs are structured such that tranche holders’ contractual right to cash flows are limited to the cash flows generated by the underlying pool of assets, which are ring-fenced from the issuer’s other assets. Thus, the tranche holders have ‘no recourse’ to other assets or cash flows apart from the underlying pool of financial assets.[4]

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[3] Paragraph BC4.27 of the Basis for Conclusions on IFRS 9

[4] This is consistent with the IASB’s previous discussions when developing IFRS 9 as set out in paragraph 11 of AP12C for the October 2009 meeting

30. Although paragraph B4.1.20 of IFRS 9 already includes reference to the fact that the holders of a tranche only have a right to payments if the issuer generates sufficient cash flows to satisfy the higher-ranking tranches, we think it would be helpful to clarify that CLIs have non-recourse features; in other words, non-recourse is one of the characteristics of a CLI, rather than the only characteristic.

Prioritisation of payments through a waterfall payment structure

31. The third characteristic of a CLI transaction, is the presence of a waterfall structure that prioritises the payments by the issuer to the holders of the different tranches. Paragraph BC4.26 of the Basis for Conclusions on IFRS 9 states that in a typical waterfall structure, multiple contractually linked instruments effect concentrations of credit risk in which payments to holders are prioritised. Such structures specify the order in which any losses that the issuer incurs are allocated to the tranches.

32. For each set of interest or principal payments due, payments to the most senior tranche are prioritised over any payments to more junior tranches. We therefore recommend clarifying that this waterfall structure affects the prioritisation of payments to the tranches on an ongoing basis (not only in a liquidation scenario as with subordinated instruments).

Concentrations of credit risk

33. Arguably one of the most important characteristics of a CLI, is the 'concentrations of credit risk' that are created through the combination of the non-recourse features and the prioritisation of the payments between the tranches as stated in paragraph B4.1.20 of IFRS 9. However, even before the start of the PIR, many stakeholders have asked for clarification about what 'concentration of credit risk' means and how the requirement should be applied in determining whether a transaction is in the scope of the general SPPI requirements or the CLI requirements.

34. Typically, financial assets with non-recourse features participate in the performance of the underlying assets (ring-fenced assets) proportionately. If there are multiple instruments that have recourse only to the underlying assets, they share any loss fully proportionate, that is there is no concentration of credit risk.[5]

[5] Paragraph 12 of AP12C for October 2009 meeting

35. However, in a CLI, the contractual linkage between the tranches (see paragraphs 24–28 of this paper) reallocates credit risk amongst the tranche holders by creating a concentration of credit risk that results in any loss being shared disproportionately between the tranches. The most junior instrument receives any cash flows only if all other more senior tranches are paid off. In other words, the most junior tranche has a loss absorption potential akin to equity (hence, it is often referred to as 'equity tranche') and can therefore be viewed as providing credit protection to the more senior tranches as explained in paragraph BC4.27 of the Basis for Conclusions on IFRS 9.[6]

36. A concentration of credit risk is therefore derived from the other characteristics of a CLI. The waterfall structure specifies not only the order in which payments are made but also the order and proportion in which any losses are allocated to the tranches.[7]

37. In a scenario that the underlying pool performs poorly, insufficient cash flows from the underlying pool of financial assets to make payments of interest and principal on the tranches according to their place in the waterfall payment structure do not trigger a default of the issuer, but rather reduce the contractual rights of the holders of the affected tranches to receive cash flows. This feature distinguishes a CLI structure from other forms of subordination such as the creditor ranking, whereby the contractual rights to receive cash flows would generally remain unaffected.[8]

Consideration of economic substance

38. Respondents to the RFI also questioned the usefulness of information to users of the financial statements when transactions with similar economic substance (for example financial assets with non-recourse features and CLIs), are classified differently, depending on whether the general SPPI or CLI requirements are applied.

39. However, based on the analysis of financial assets with non-recourse features in paragraphs 7–19 of this paper and the characteristics of CLIs analysed in paragraphs 21–37 of this paper, we think the economic substance of these transactions are significantly different. This is because, even though one of the characteristics of a CLI is that it has non-recourse features, CLIs have the additional characteristic of a

[6] Paragraph 13 of AP12C for October 2009 meeting
[7] Paragraph BC4.26 of the Basis for Conclusions on IFRS 9
[8] Paragraph 12 of AP3A2 for the June 2009 IASB meeting

concentration of credit risk resulting in a disproportionate reduction in contractual rights in the event of cash flow shortfalls. Therefore, the staff are of view that CLIs do not have the same economic substance to other financial assets with non-recourse features. As such, the application of the relevant requirements in IFRS 9 leads to an accounting outcome that is relevant and a faithful representation of the economic substances of the transaction as described in paragraph 2.4 of the *Conceptual Framework for Financial Reporting*.

Characteristics of underlying pool of financial instruments in a CLI structure

40. The CLI requirements only apply to transactions with all the characteristics discussed in paragraphs 21–37 of this paper. For any other transactions or instruments, an entity should apply the general SPPI requirements in IFRS 9. If a transaction is in the scope of the CLI requirements, an entity must apply paragraphs B4.1.21–B4.1.26 of IFRS 9 to determine whether the contractual cash flows of a specific tranche are SPPI.

41. Paragraph B4.1.21 states that a tranche has cash flows that are SPPI only if:

    (a) the contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to SPPI cash flows;

    (b) the underlying pool of financial instruments contain one or more instruments with SPPI cash flows and only particular types of instruments as described in paragraph B4.1.24 of IFRS 9; and

    (c) the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments.

42. When developing IFRS 9, the IASB considered different kinds of leverage which are not consistent with a basic lending arrangement including ‘concentrations of credit risk through subordination’. As an example, the IASB considered the concentration of credit risk that results from a collateralised debt obligation (CDO) structure

commonly referred to as a 'waterfall'.[9] Typically, the underlying assets of a CDO structure consisted of loans or other debt instruments.[10]

43. The IASB was persuaded that classification solely on the basis of the contractual features of the financial asset being assessed for classification would not capture the economic characteristics of the instruments when a concentration of credit risk arises through contractual linkage. Thus, the IASB decided to add the requirement to look-through to the underlying pool considering the nature of CLIs that effect concentrations of credit risk.[11]

44. As a result, paragraph B4.1.22 of IFRS 9 states that:

> An entity must look through until it can identify the underlying pool of instruments that are creating (instead of passing through) the cash flows. This is the underlying pool of financial instruments.

45. The IASB concluded that the nature of CLIs, that effect concentrations of credit risk, justifies this approach because the variability of cash flows from the underlying pool of instruments is a reference point. Thus, if the contractual cash flows of the underlying pool represent SPPI, any tranche that is exposed to the same or lower credit risk would also be deemed to have cash flows that are SPPI.[12]

46. Paragraph B4.1.23 of IFRS 9 therefore requires the underlying pool to contain one or more instruments that have contractual cash flows that are SPPI, while paragraph B4.1.24 specifies the nature of other instruments that can be included in the underlying pool. Paragraph B4.1.25 states that:

> If any instrument in the pool does not meet the conditions in either paragraph B4.1.23 or paragraph B4.1.24, the condition in paragraph B4.1.21(b) is not met…

47. Some stakeholders asked whether, for the purpose of that requirement, the underlying pool is only permitted to include financial instruments that are in the scope of the classification requirements in IFRS 9 (ie fully in the scope), or also

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[9] Paragraph 31 of AP2B for the June 2009 IASB meeting

[10] The IASB discussed aspects of CDO structures–including this feature, which relates to the 'location of the reference asset'– in its meetings in November and December 2008 (see agenda papers 11B and 6E, respectively). The focus of those discussions was the application of IAS 39.AG30(h).

[11] Paragraph BC4.33 of the Basis for Conclusions on IFRS 9

[12] Paragraph BC4.34 of the Basis for Conclusions on IFRS 9

other instruments such as lease receivables that are only in the scope of the derecognition and impairment requirements in IFRS 9. They said that it is common for CLI-type transactions to be structured around investment properties that generate lease income and where the cash flows on the more senior tranches are akin to SPPI. If these types of transactions do not satisfy the conditions in paragraphs B4.1.23 and B4.1.24 of IFRS 9, all tranches will be required to be measured at fair value through profit or loss. In their view, this would result in economically similar instruments being accounted for differently simply because of the scope of the accounting requirements rather than a difference in economic substance.

Nature of the instruments in the underlying pool

48. When developing IFRS 9, the IASB determined that for the purpose of assessing the characteristics of the underlying pool, the assessment should start from the perspective of a 'basic lending arrangement'.[13] The IASB also concluded that an underlying pool that contains non-financial items would taint all cash flows of tranches, so non-financial items are not eligible in the underlying pool for tranches to have SPPI cash flows.[14]

49. As discussed in paragraph 42 of this paper, when developing the CLI requirements in IFRS 9, the IASB considered a CLI structure where the underlying pool of instruments generally consists of financial instruments that are 'fully' in the scope of IFRS 9 (ie CDOs).

50. Given the nature of CLIs, ie to distribute cash flows from an underlying pool of assets to the tranche holders, we think it is important for the instruments in the underlying pool to be financial instruments. In other words, the underlying pool must generate contractual cash flows that can be allocated among the tranche holders. However, we do not believe that it was the IASB's intention to limit the scope to only those financial instruments that are fully in the scope of IFRS 9.

51. Instruments such as lease receivables are still financial instruments, ie they represent the right to receive contractual cash flows, even though they are not in the scope of IFRS 9 for classification purposes. In the staff's view, lease receivables in IFRS 16

[13] Consistent with paragraphs 80–90 of AP7 for the October 2009 IASB meeting
[14] Consistent with paragraphs 88 of AP7 for the October 2009 IASB meeting

Leases could have cash flows that are similar to SPPI even if the contractual terms described the cash flows using different terms. This is consistent with the IASB's view during the development of the impairment requirements in IFRS 9. As stated in paragraph BC5.131 of the Basis for Conclusions on IFRS 9, the IASB was of the view that the requirements in IAS 17 *Leases* (now IFRS 16) result in a measurement of a lease receivable in a manner that is similar to financial assets that are measured at amortised cost. The IASB therefore concluded that despite some differences in the cash flows of lease receivables, these differences do not justify applying a different impairment model.

52. The staff therefore recommend clarifying that for the purposes of paragraph B4.1.23 of IFRS 9, the reference to 'instruments' in the underlying pool may include financial instruments such as lease receivables that are not fully in the scope of IFRS 9, but that have cash flows that are similar/akin to payments of principal and interest. In our view, such clarification would not be inconsistent with the requirement that the underlying pool should consist of instruments with cash flows that are SPPI and would enable economically similar transactions to be accounted for consistently.

53. The staff think it is important to note that such proposed clarification would not mean that any tranche linked to an underlying pool of assets that include lease receivables will automatically have cash flows that are similar to SPPI. For example, many finance lease receivables are subject to residual value risk which is typically not consistent with a basic lending arrangement; or some leases might have variable lease payments that may be linked to an index that would not be consistent with a basic lending arrangement.

54. Therefore, consistent with the requirements for contractual cash flows that are described as payments of principal and interest, an entity would be required to assess whether the contractual terms of the lease receivables actually give rise to cash flows that are similar to SPPI. For example, an entity needs to assess the effects of features such as residual value guarantees on the nature of the contractual cash flows.