IFRS Accounting

Staff paper

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Topic	**Feedback analysis—Financial assets with non-recourse features and contractually linked instruments**

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Purpose of this paper

1. Questions 3 and 4 of the Exposure Draft *Amendments to the Classification and Measurement of Financial Instruments* (ED) asked for feedback on the proposed requirements regarding the classification and measurement of financial assets with non-recourse features and contractually linked instruments (CLIs).

2. This paper analyses the feedback on these proposed amendments and asks whether the IASB agrees with the staff recommendations for responding to this feedback.

3. This paper is structured as follows:

   (a) summary of staff recommendations and a question to the IASB;

   (b) background and proposals in the ED;

   (c) feedback on proposals;

   (d) staff analysis and recommendations; and

   (e) appendix—extract from the ED.

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Summary of staff recommendations

4. The staff recommend finalising the proposed amendments to the requirements for financial assets with non-recourse features (paragraphs B4.1.16A, B4.1.17 and B4.1.17A of the ED) and CLIs (paragraphs B4.1.20, B4.1.20A, B4.1.21 and B4.1.23 of the ED), subject to:

   (a) requiring in paragraph B4.1.20A of the ED that the junior debt instrument is held by the debtor (the sponsoring entity) throughout the life of the transaction; and

   (b) minor drafting suggestions to further clarify the proposed amendments.

Question for the IASB
Does the IASB agree with the staff's recommendations as summarised in paragraph 4 of this paper?

Background and proposals in the ED

5. In response to the feedback received relating to non-recourse features as part of the post-implementation review (PIR) of the classification and measurement requirements in IFRS 9 *Financial Instruments*, the IASB proposed:

   (a) clarifying the meaning of the term 'non-recourse' (paragraph B4.1.16A of the ED); and

   (b) providing factors that an entity may need to consider when assessing the contractual cash flow characteristics of financial assets with those features (paragraph B4.1.17A of the ED).

6. With regards to the requirements for CLIs, the IASB proposed:

(a) clarifying the description of transactions containing CLIs (paragraph B4.1.20 of the ED);

(b) specifying the characteristics of particular secured lending arrangements that are not subject to the CLI requirements (paragraph B4.1.20A of the ED); and

(c) clarifying that the reference to instruments in the underlying pool include financial instruments that are not within the scope of the classification requirements of IFRS 9 (paragraph B4.1.23 of the ED).

Feedback on proposals

Financial assets with non-recourse features

Description of non-recourse features (B4.1.16A of the ED)

7. As outlined in Ageda Paper 16 for the September 2023 IASB meeting, most respondents supported the proposed amendments in paragraphs B4.1.16 and B4.1.16A of the ED to enhance the meaning of the term ‘non-recourse’. They said that the proposed amendments clarify the difference between financial assets with non-recourse features and other types of financial assets such as a collateralised loan.

8. However, some respondents, mostly standard-setters and auditors, expressed concerns that the proposed description of non-recourse features is narrower than how this term is commonly interpreted in practice. These respondents said that a financial asset is currently understood to have non-recourse features if the asset’s contractual right to receive cash flows is limited to those generated by the specified asset only in the case of default (ie residential mortgages in some jurisdictions). Some of these respondents were concerned that those assets could have different accounting outcomes if those assets would not be deemed non-recourse assets. They also asked for further guidance on how to assess the contractual cash flow characteristics of assets if their cash flows are limited to the cash flows generated by specified asset only in the case of default.

9. On the other hand, a few respondents mentioned that a situation in which a special purpose entity (SPE) has only one source of income with nominal equity described in paragraph BC76 of the Basis for Conclusions on the ED would expand the meaning of non-recourse. They said that this could be interpreted that loans to small and medium-sized entities that have single source of income would have non-recourse features and would require entities to perform a look through assessment.

10. In addition, a few respondents asked the IASB to clarify whether:

   (a) a financial asset has non-recourse features only if such features are explicit in the contractual terms as opposed to being structurally implied;

   (b) a guarantee to cover any shortfalls from the underlying asset provided to the creditor is considered similar to a right to require a debtor to pledge additional assets as described in paragraph BC77 of the Basis for Conclusions on the ED; and

   (c) 'over the life' of the asset refers to the entire contractual life or the remaining life from the acquisition date.

11. To further enhance the understandability of non-recourse features, a few respondents made suggestions to the IASB to include explanations from the Basis for Conclusions on the ED in the main text of IFRS 9, for example:

   (a) the explanation of the difference between financial assets with non-recourse features and a collateralised loan, including the absence of liability for the debtor beyond the assets pledged as collateral in paragraph BC75 of the Basis for Conclusions on the ED;

   (b) an illustration of a financial asset that has non-recourse features, such as a loan to a SPE with specified assets and where the creditor has no recourse to the entity that has transferred the assets to the SPE (paragraph BC76 of the Basis for Conclusions on the ED); and

   (c) an illustration of a financial asset that does not have non-recourse features, such as when a creditor has the contractual right to require a debtor to pledge

additional assets if specified assets do not generate sufficient cash flows (paragraph BC77 of the Basis for Conclusions on the ED).

Look through assessment (B4.1.17A of the ED)

12. Whilst almost all respondents generally supported the inclusion of examples of what to consider when assessing the contractual cash flow characteristics of financial assets with non-recourse features, some respondents, mostly standard-setters and auditors, suggested the IASB consider including additional guidance and/or illustrative examples on how to apply the proposed amendments in paragraph B4.1.17A of the ED. Their suggestions include providing:
    (a) more explanations on how to consider factors such as 'the legal and capital structure of the debtor';
    (b) greater clarity on whether a qualitative or quantitative assessment is required; and
    (c) clarity on the extent to which subordinated debt or equity instruments need to absorb any shortfall in cash flows generated by the underlying assets for a financial asset to have solely payments of principal and interest ('SPPI') cash flows.

Contractually linked instruments (CLIs)

Scope (B4.1.20 of the ED)

13. As summarised in Ageda Paper 16 for the September 2023 IASB meeting, almost all respondents agreed with the IASB's approach to clarify the scope of instruments to which the CLI requirements are applied. However, some respondents, including standard-setters and auditors, made suggestions to further enhance the clarity of the scope of the CLI requirements, including:
    (a) clarifying that even though CLIs have non-recourse features, the CLI requirements in paragraphs B4.1.21–B4.1.26 of IFRS 9 (as amended by the

ED) continue to be applied to those instruments and not the requirements relating to financial assets with non-recourse features in paragraphs B.4.1.17 and B4.1.17A of the ED;

(b) incorporating explanations about the reduction in the contractual rights to receive cash flows that were included in paragraph 37 of Agenda Paper 16B for the September 2022 IASB meeting into the main text of IFRS 9; and

(c) providing more illustrative examples of transactions that contain multiple contractually linked instruments.

Lending arrangements that are not CLIs (B4.1.20A of the ED)

14. Most respondents agreed with the proposed amendments in paragraph B4.1.20A of the ED that particular secured lending arrangements do not contain CLIs. However, a few respondents said that the rationale behind this conclusion is not adequately explained. In addition, some respondents, mostly preparers, auditors and standard-setters, expressed concerns over the proposed amendments and asked further clarification to enhance consistent application, including:

(a) whether transactions contain CLIs if the senior debt instrument is syndicated among multiple creditors, which hold pro-rata rights to the cash flows;

(b) whether the junior debt instrument should be held by the sponsoring entity for the entire life of the instrument;

(c) whether B4.1.20A of the ED could be applied if the junior debt instrument is held by another party (other than the sponsoring entity) and/or whether reassessment is needed when the junior debt holder subsequently sells its junior debt instrument; and

(d) whether the general SPPI requirements (paragraphs B4.1.7–B4.1.19 of IFRS 9 (as amended by the ED)) apply to the junior debt instrument when assessing its contractual cash flows characteristics.

Eligible financial instruments in the underlying pool (B4.1.23 of the ED)

15. Almost all respondents supported the IASB's decision relating to the eligible financial instruments in the underlying pool for the purpose of the assessment required in paragraph B4.1.23 of IFRS 9. They said that this clarification was helpful, although some respondents said that more clarity would be needed to promote consistent application by asking:
    (a) application guidance on how to consider the impact of residual value guarantee and how to determine whether residual value risk has a de minimis effect as noted in paragraph B4.1.25 of IFRS 9;
    (b) the definition of 'lease receivables'. Respondents said that the term 'lease receivables' is not defined in IFRS 9 and it could be read that lease receivables will automatically have SPPI cash flows. They suggested the IASB clarify what 'lease receivables' refers to and include some of the explanations in paragraph 53 of Agenda Paper 16B for the September 2022 IASB meeting into the main text of IFRS 9;
    (c) how to interpret the meaning of 'equivalent to'; and
    (d) additional examples of instruments that have contractual cash flows that are equivalent to SPPI.

Other comments

16. A few respondents reiterated some of the questions raised as part of the PIR and suggested the IASB:
    (a) clarify 'tranche' and 'contractually linked';
    (b) simplify the SPPI assessment for the most senior tranche in a CLI transaction; and
    (c) clarify whether it is the IASB's intention to have different accounting outcomes between CLIs and non-recourse assets of which the underlying pool

includes non-financial instruments or financial instruments that do not have SPPI cash flows, especially for a senior tranche or senior debt instrument.

Staff analysis and recommendations

Financial assets with non-recourse features

17. Although most respondents were in favour of the proposed clarifications to the requirements for financial assets with non-recourse features, the staff acknowledge stakeholder feedback that the term 'non-recourse' is used in various ways in practice, some of which may be broader than the description proposed in the ED. We also acknowledge stakeholder feedback that the proposed reference to 'throughout the life of the financial asset' carries a risk of unintended consequences as it could be interpreted to extend the meaning beyond what the IASB initially intended.

18. The staff think these concerns could be resolved by refining the wording of the proposed amendments, by drawing from the previous discussions on non-recourse features, rather than requiring a fundamental change from what was proposed in the ED.

19. As noted in paragraph 7 of Agenda Paper 16B for the September 2022 meeting, when developing IFRS 9, the IASB was concerned about instruments with contractual cash flows that are described as 'principal and interest' but are not economically consistent with how those terms are used in IFRS 9, for example some financial assets with non-recourse features. Thus, the IASB included application guidance in paragraphs B4.1.15–B.4.1.17 of IFRS 9 to reinforce that the focus should be on whether the contractual cash flows represent SPPI.[1]

20. The term 'non-recourse' is used in paragraph B4.1.16 of IFRS 9 to refer to a financial asset where the lender's ultimate claim is limited to the value of the asset pledged as

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

collateral. In other words, the lender does not benefit from any protection provided by general creditor ranking or any loss-absorption potential of the borrower's equity.[2] Paragraph 5 of Agenda Paper 12C for the October 2009 IASB meeting stated 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 in which the creditor has a claim on the debtor and in addition, the protection of the underlying asset(s). That is, in a non-recourse instrument the creditor's ultimate claim is limited to the value of the asset.

21. At the time, the IASB noted that there is no 'special' guidance in IFRS 9 for non-recourse assets—that is, the general principles set out in IFRS 9 apply. The fact that a financial asset has non-recourse features, should simply raise a red flag to alert the reporting entity that it needs to look closer at the financial instrument to determine whether its contractual cash flows are SPPI.[3] Paragraph B4.1.17 of IFRS 9 therefore requires the entity to 'look through to' the underlying assets to understand the link between the underlying asset(s) and the contractual cash flows of the asset being classified to make such a determination.

22. As noted in Agenda Paper 16B for the July 2022 IASB meeting, this rationale is explained in paragraphs 19–21 of Agenda Paper 12C discussed at the October 2009 IASB meeting:

> The staff believe 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.
>
> We are not talking about non-recourse situations that are akin to a collateralised borrowing. That is, situations in which the asset(s) the

[2] Consistent with paragraphs 5–7 of AP12C for October 2009 meeting

[3] Consistent with paragraphs 8 of AP12C for October 2009 meeting

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. 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.

23. With regards to questions raised by respondents in paragraph 10 of this paper, the staff are of the view that the Standard and the proposed amendments are clear that non-recourse features are contractual, rather than structural. Said differently, the assessment of whether a financial asset has cash flows that are SPPI is based on the contractual cash flows and not on the expected cash flows. This is because, for the purposes of assessing whether the cash flows of a financial asset are SPPI, paragraphs 4.1.2 and 4.1.2A of IFRS 9 requires "*the contractual terms of the financial asset to give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding*". An entity's expectations about the non-recovery of contractual cash flows are considered when applying the impairment requirements in IFRS 9.

24. This is consistent with paragraph 21 of Agenda Paper 16B for the July 2022 IASB meeting that the term 'non-recourse' is used in IFRS 9 to refer to a 'contractual feature' of financial instruments rather than a separate category of financial assets. For example, although cash flows from a collateralised loan that is credit-impaired are expected to be limited to the proceeds from the sale of the collateral, the creditor's *contractual right* to cash flows is not limited to the value of the collateral. Therefore, this loan does not have non-recourse features.

25. The proposed amendments in the ED aimed to clarify these underlying principles and we continue to be of the view that the proposed amendments are consistent with the IASB's original intention with regards to non-recourse features. We therefore do not recommend making fundamental changes to the clarifications proposed in the ED. However, to clarify the amendments and minimise the risk of unintended

consequences, we think the amendments could be refined by removing the reference to 'throughout the life of the instrument' in paragraph B4.1.16A of the ED.

26. In response to PIR participants' request to clarify how to do the 'look through' assessment required in B4.1.17 of IFRS 9, the IASB decided to include factors an entity may need to consider when looking through to the particular underlying assets or cash flows to determine whether financial assets with non-recourse features have cash flows that are SPPI.

27. The IASB proposed these clarifications to the application guidance because the effect of the underlying assets on the contractual cash flows of the financial asset being classified could be mediated by other financial instruments issued by the debtor, such as equity or subordinated debt instruments which are expected to absorb any shortfalls in cash flows generated by the underlying assets.

28. This is consistent with the rationale explained in paragraphs 6 and 7 of Agenda Paper 12C for the October 2009 meeting, which stated:

> 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).
>
> 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.

29. Paragraph 9 of that paper further stated that:

> 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.

30. The staff remain of the view that the proposed explanations in paragraph B4.1.17A of the ED are consistent with the IASB's original intention and rationale, however, we acknowledge that the wording could be improved so as not to create a perceived inconsistency with the discussion in paragraphs 23 and 24 of this paper. The staff therefore recommend refining the proposed amendments to better explain that purpose of the look through assessment in paragraph B4.1.17 of IFRS 9 is to understand the link between the underlying assets and the contractual cash flows of the financial asset. This is needed because contractually, the entity is absorbing the asset-specific risk and does not benefit from any protection provided by general creditor ranking or any loss-absorption potential of the debtor's equity.

31. In response to the request to ask further illustrative examples, the staff are of the view that the IASB's intention was not to provide comprehensive examples to consider when doing a look through assessment. We are of the view that by better explaining the purpose of the look through assessment and what to consider, further application guidance would not be necessary and might not even be helpful.

Contractually linked instruments

Scope (B4.1.20 of the ED)

32. The staff note that most respondents agreed with the IASB's approach to clarify the scope of the transactions to which the CLI requirements is applied. As mentioned in paragraph BC82 of the Basis for Conclusions on the ED, PIR participants said that for some types of financial assets, it is unclear whether an entity applies the CLI requirements or the requirements for financial assets with non-recourse features. Respondents to the ED agreed that the proposed clarifications in the ED would be helpful to understand the difference between CLIs and other financial assets such as financial assets with non-recourse features.

33. However, some respondents said that the proposed clarification that CLIs have non-recourse features and the reference to paragraph B4.1.16A of the ED could

unintentionally be interpreted as a requirement to apply the requirements for non-recourse features (paragraphs B4.1.17 of IFRS 9 and B4.1.17A of the ED) in addition to, or instead of, the CLI requirements (paragraphs B4.1.21–B4.1.26 of IFRS 9). The staff note that this was not the IASB's intention, as the non-recourse features are only one of the characteristics of CLIs and cannot be considered in isolation from the other characteristics.

34. With regard to the request to include explanations about the reduction in the contractual rights to receive cash flows that were included in paragraph 37 of Agenda Paper 16B for the September 2022 IASB meeting, the staff are of the view that this principle is already implied in the statement in paragraph B4.1.20 of IFRS 9 that 'the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy the higher-ranking tranches.'

35. We agree with respondents that the proposed wording in paragraph B4.1.20 of the ED could be refined or further clarified to avoid any unintended consequences and will consider respondents' drafting suggestions when finalising the amendments.

Lending arrangements that are not CLIs (B4.1.20A of the ED)

36. As discussed in Agenda Paper 16A for the November 2022 IASB meeting, some lending transactions may contain multiple debt instruments, which do not constitute CLIs. In those structures, a debtor (the sponsoring entity) typically establishes an SPE to obtain a loan from a creditor (ie bank) and transfers specified assets to the SPE to ringfence those assets as collateral on a loan provided by the creditor. The creditor usually finances a portion of the assets, and the debtor contributes the remainder in the form of either holding an equity instrument or a debt instrument that is subordinated to the loan from the creditor.

37. In these structures, the SPE is created to facilitate the lending transaction from a creditor. The holder of the remainder portion, the sponsoring entity, 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 creditor. The purpose of contribution from the debtor is to provide a credit protection to the creditor.

38. The staff acknowledge respondents concerns about potential structuring opportunities to avoid the application of the CLI requirements. This could be the case for example, if at initial recognition the junior debt instrument is held by the 'sponsoring entity' but is sold to a third party subsequently. As the CLI requirements, similar to the general SPPI requirements are assessed by the lender (the reporting entity) only at initial recognition, the sale of the junior instrument would not trigger a reassessment and could result the CLI requirements are not being applied to a transaction that really is a CLI.

39. In a typical lending arrangement, there would normally be contractual conditions meant to prevent the sponsoring entity from selling the junior debt instrument to a third party without the senior debt instrument holder's approval, because the purpose of the junior debt instrument is to provide credit protection to the senior debt instrument. In most cases, the lender might also have recourse to the debtor (the sponsoring entity) to increase its equity interest in the SPE or top-up the underlying assets to protect the lender's right to receive repayments of the principal and interest.

40. The proposal in paragraph B4.1.20A of the ED was intended to clarify that such lending arrangements are not CLIs and therefore, the CLI requirements do not apply. The staff are of the view that the IASB did not intend to change the scope of the CLI requirements nor to create an exception to the CLI requirements by this clarification.

41. However, we acknowledge the potential risk of unintended consequences and think this could be resolved by requiring the junior debt to be held by the debtor (the sponsoring entity) throughout the life of the transaction. The staff think that this would help prevent the inappropriate application of this requirement.

42. We also acknowledge respondents' comment that in practice, the senior debt instrument could be provided through a syndication of lenders, rather than just a

single lender. In our view, this clarification could be made through refining the drafting of the final amendments.

43. The staff are also of the view that it would be helpful for paragraph B4.1.20A of the ED to be explicit that in such transactions all debt instruments, including the junior debt instrument, need to be assessed by applying the general SPPI requirements instead of applying the CLI requirements.

Eligible financial instruments in the underlying pool (B4.1.23 of the ED)

44. The staff note that almost all respondents supported the IASB's decision relating to the eligible financial instruments in the underlying pool for the purpose of the assessment required in paragraph B4.1.23 of IFRS 9. However, some respondents said that more clarity would be needed in order to promote consistent application.

45. With regards to respondents' comments that lease receivables are not defined term in either IFRS 9 or IFRS 16 *Leases,* the staff note that paragraph 2.1(b)(i) of IFRS 9 already refers to 'finance lease receivables' and 'operating lease receivables' which are within the scope of the derecognition and impairment requirements of IFRS 9. In addition, lease receivables are simply given as an example of financial instruments that could be eligible to be included in the underlying pool in a CLI if they have contractual cash flows that are equivalent to SPPI. Therefore, the staff do not think it is necessary to define 'lease receivables'.

46. The staff note that a few respondents asked for further guidance to determine whether lease receivables have contractual cash flows that are equivalent to SPPI. As explained in Agenda Paper 16B for the September 2022 IASB meeting, instruments such as lease receivables could have cash flows that are equivalent to SPPI even if the contractual terms described the cash flows using different terms. Thus, the staff believe that the assessment of those instruments (ie lease receivables) to determine whether the contractual cash flows are equivalent to SPPI should not be different from those applying the general SPPI application guidance as required by paragraphs B4.1.7–B4.1.19 of IFRS 9. Similarly, the assessments of lease receivables subject to

residual value risk or exposed to variable lease payments should be performed in the same manner. Thus, the staff believe that additional guidance or illustrative examples are not necessary.

47. In addition, the staff note that a few respondents raised a concern that the proposed wording in paragraph B4.1.23 of the ED could be interpreted as suggesting that lease receivables always have SPPI cash flows. As explained in Agenda Paper 16B for the September 2022 IASB meeting, the proposed amendments do not suggest that an underlying pool of assets that include lease receivables will automatically have cash flows that are equivalent to SPPI. Thus, the staff think the concern could be resolved by refining the wording of the proposals.

Other comments

48. With regards to the other comments mentioned in paragraph 16 of this paper, the staff note that these are consistent with some of the comments received on the PIR of the classification and measurement requirements in IFRS 9.

49. The staff continue to be of the view that defining the term 'tranche' is unnecessary and would not provide any more clarity on the scope and nature of the transactions to which the CLI requirements are applied. In addition, the staff think the phrase 'contractually linked' is self-explanatory and requires no further clarification as noted in paragraph 26 of Agenda Paper 16B for the September 2022 IASB meeting.

50. As noted in Agenda Paper 16B for the July 2022 IASB meeting, the scope of the CLI requirements could be clarified by analysing the similarities and differences between CLIs and other similar structure (ie financial assets with non-recourse features) as well as the unique characteristics of CLIs instead of defining the terms used to describe a CLI transaction. As indicated by the feedback on the ED, most respondents agreed that the proposed amendments would clarify the scope of the requirements and we therefore do not consider any further clarifications (beyond those discussed in the paper) to be needed.

51. With regards to the question of whether it is the IASB's intention to have different accounting outcomes between CLIs and non-recourse assets of which the underlying pool includes non-financial instruments or financial instruments that do not have SPPI cash flows, he staff continue to agree with the IASB's conclusion that the economic substance of financial assets with non-recourse features and CLIs are significantly different as noted in paragraph 39 of Agenda Paper 16B for the September 2022 IASB meeting. Because CLIs have the additional characteristic of a concentration of credit risk resulting in a disproportionate reduction in contractual rights in the event of cash flow shortfalls. Thus, different accounting outcomes between CLIs and non-recourse assets would be a faithful representation of the economic substances of those transactions.

52. With regard to the request to simplify the SPPI assessment for the most senior tranche in a CLI transaction or scope it out from the CLI requirements, the staff continue to agree with the rationale for the IASB's rejection of such an approach as explained in paragraphs BC4.26–BC4.36 of the Basis for Conclusions on IFRS 9. In addition, as discussed in paragraph 33 of Agenda Paper 3C for the April 2022 IASB meeting, the staff think even if the IASB amended IFRS 9 to scope out the most senior tranche from the CLI requirements, it is still required to assess the effects of the cash flows of the underlying pool of instruments by applying B4.1.17 of IFRS 9. Thus, scoping out the most senior tranche from the CLI requirements would not necessarily alleviate the need for assessing the effect of the cash flows.

Appendix A—Extract from the ED

A1. For ease of reference, this Appendix includes an extract of the proposals in the ED in relation to financial assets with non-recourse features and CLIs.

Financial assets with non-recourse features

B4.1.16 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, if the contractual terms stipulate that the financial asset's cash flows increase as more automobiles use a particular toll road, those contractual cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not satisfy the condition in paragraphs 4.1.2(b) and 4.1.2A(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).~~

B4.1.16A This may also be the case if a financial asset has 'non-recourse' features. A financial asset has non-recourse features if an entity's contractual right to receive cash flows is limited to the cash flows generated by specified assets both over the life of the financial asset and in the case of default. In other words, throughout the life of the financial asset, the entity is primarily exposed to the specified assets' performance risk rather than the debtor's credit risk.

B4.1.17 However, the fact that a financial asset ~~is~~ has non-recourse features does not in itself necessarily preclude the financial asset from meeting the condition in paragraphs 4.1.2(b) and 4.1.2A(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 paragraphs 4.1.2(b) and 4.1.2A(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

B4.1.17A When assessing whether the contractual cash flows of a financial asset with non-recourse features are payments of principal and interest on the principal amount outstanding, in accordance with paragraph B4.1.17, an entity may also need to consider factors such as the legal and capital structure of the debtor, including, but not limited to, the extent to which:

(a) the cash flows generated by the underlying assets are expected to exceed the contractual cash flows on the financial asset being classified; and

(b) any shortfall in cash flows generated by the underlying assets is expected to be absorbed by subordinated debt or equity instruments issued by the debtor.

Contractually linked instruments

B4.1.20 In some types of transactions, an issuer may prioritise payments to the holders of financial assets using multiple contractually linked instruments ~~that create concentrations of credit risk~~ (tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. The prioritisation of payments to the holders of these tranches is established through a waterfall payment structure. That payment structure creates concentrations of credit risk and results in a disproportionate allocation of losses between the holders of different tranches. In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches, which means the tranches have non-recourse features (see paragraph B4.1.16A).

B4.1.20A Some transactions may contain multiple debt instruments without having all of the characteristics described in paragraph B4.1.20. For example, an entity (the creditor) may enter into a secured lending arrangement whereby the debtor (the sponsoring entity) establishes a structured entity which issues senior and junior debt instruments. The debtor may hold the junior debt instrument to provide credit protection to the entity holding the senior debt instrument. Such transactions do not contain multiple contractually linked instruments because the structured entity is created to facilitate the lending transaction from a single creditor. The contractual cash flows of the senior debt instrument in such transactions shall be assessed by applying the requirements in paragraphs B4.1.7–B4.1.19.

B4.1.21 In ~~such~~ transactions that contain multiple contractually linked instruments, as described in paragraph B4.1.20, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:

(a) ...

B4.1.22 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.

B4.1.23 The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. For the purpose of this assessment, the underlying pool can include financial instruments that are not within the scope of the classification requirements (see Section 4.1 of this Standard), for example, lease receivables that have contractual cash flows that are equivalent to payments of principal and interest on the principal amount outstanding.