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Project	**Post-implementation Review of IFRS 9—Classification and Measurement**
Paper topic	Contractual cash flow characteristics assessment—contractually-linked instruments

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Introduction

1. This paper provides a summary of the feedback and preliminary staff views on applying the contractual cash flow characteristics assessment in IFRS 9 *Financial Instruments* to contractually linked instruments (CLIs). We are not asking the IASB for any decisions at this meeting, but welcome questions and suggestions for further analysis. The staff will consider those suggestions when preparing the analysis and recommendations for the May 2022 IASB meeting.

2. This paper is structured as follows:

   (a) background on the CLI requirements in IFRS 9; and

   (b) summary of feedback, staff analysis and preliminary views.

Question for IASB
Do you have questions or comments about the feedback summarised or the preliminary staff views in this paper?

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Background on the CLI requirements in IFRS 9

IFRS 9 requirements (paragraph B4.1.20-B4.1.21)
IFRS 9 describes contractually linked instruments as types of transactions in which an issuer prioritises payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches). IFRS 9 explains that each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. 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. IFRS 9 states that in such transactions, a tranche has SPPI cash flows 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.

3. In this section, the staff summarise the history of the CLI requirements and what the IASB considered in finalising them. Further detail can be found in paragraphs BC4.26–BC4.36 and paragraphs BC4.205–BC4.208 of the Basis for Conclusions on IFRS 9.

4. In the 2009 *Classification and Measurement* Exposure Draft (the 2009 C&M ED), the IASB proposed that only the most senior tranche of CLIs could have basic loan features and might qualify for measurement at amortised cost, because only the most senior tranche would receive credit protection in all situations. This was because the IASB concluded that tranches providing credit protection to other tranches are leveraged as they expose themselves to higher credit risk by writing credit protection to other tranches. Hence their cash flows are not SPPI.

5. In proposing this approach, the IASB concluded that subordination in itself should not preclude amortised cost measurement. The ranking of an entity's instruments is a common form of subordination that affects almost all lending transactions. Commercial law (including bankruptcy law) typically sets out a basic ranking for

creditors. In the IASB's view, it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for general creditors such as trade creditors.

6. Almost all respondents to the 2009 C&M ED disagreed with the approach proposed in the ED for investments in CLIs because, among other reasons, it focused on:

   (a) form and legal structure instead of the economic characteristics of the financial instruments; and

   (b) the existence of a waterfall structure, without consideration of the characteristics of the underlying instruments, and therefore could create structuring opportunities.

7. Respondents to the 2009 C&M ED suggested alternative approaches in which an investor 'looks through' to the underlying pool of instruments of a waterfall structure and measures the instruments at fair value if looking through is not possible. They made the following points:

   (a) *Practicability:* the securitisation transactions the IASB intended to address were generally over-the-counter transactions in which the parties involved had sufficient information about the assets to perform an analysis of the underlying pool of instruments.

   (b) *Complexity:* significant accounting judgement was appropriate to reflect the complex economic characteristics of the instrument. In particular, to obtain an understanding of the effects of the contractual terms and conditions, an investor would need to understand the underlying pool of instruments. Also, requiring fair value measurement if it were not practicable to look through to the underlying pool of instruments would allow an entity to avoid such complexity.

   (c) *Mechanics:* amortised cost measurement should be available only if all of the instruments in the underlying pool of instruments have contractual cash flows that represent SPPI.

   (d) *Relative exposure to credit risk:* many favoured the use of a probability-weighted approach to assess whether an instrument has a higher or lower than average exposure to credit risk of the underlying pool of instruments.

8. In response to the feedback, the IASB decided to add the requirement to look-through to the underlying pool. 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 concentrated credit risk arises through contractual linkage.

9. The IASB concluded that the nature of contractually linked instruments 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, and tranching only reallocates credit risk. Thus, if the contractual cash flows of the assets in the underlying pool represent SPPI, any tranche that is exposed to the same or lower credit risk would also be deemed to represent SPPI. The IASB also took the view that such an approach would address many of the concerns raised with regard to structuring opportunities and the focus on the contractual form of the financial asset, instead of its underlying economic characteristics. The IASB also noted that to understand whether particular types of financial assets have the required cash flow characteristics, an entity would need to understand the characteristics of the underlying instruments to ensure that the instrument's cash flows are SPPI.

Summary of feedback, staff analysis and preliminary views

10. Many respondents to the RFI provided comments on the CLI requirements. In addition to the feedback on the RFI, the IASB and the staff are aware that since IFRS 9 was implemented stakeholders have been raising questions about the application as well as the cost and benefits of applying the CLI requirements.

11. This section summarises questions and examples commonly raised by respondents. Respondents' questions and examples are grouped into three broad categories. Some examples illustrate challenges relating to more than one category:

    (a) the clarity of the scope of instruments to which the CLI requirements apply (paragraphs 14–20);

    (b) the usefulness of the information resulting from applying the CLI requirements (paragraphs 21–30); and

(c) the cost and practicability of assessing the underlying pool of instruments (paragraphs 31–36).

12. This section also includes a preliminary analysis of the feedback provided by respondents and what actions, if any, the staff think the IASB could take to address the feedback if it were to begin a standard-setting project with respect to assessing contractual cashflow characteristics (paragraphs 37–42).

13. In general, the staff acknowledge that that the CLI requirements are relatively brief. In our view, clarifying the scope of the instruments to which the requirements apply would assist in resolving some of the concerns around the usefulness of information and the cost of applying the requirements. The IASB could also consider providing illustrative examples to further support consistent application.

Scope of CLIs

Respondents' feedback
Respondents requested the IASB clarify the scope of the CLI requirements. They said that there are diverse interpretations of the meaning of particular terms used to describe the scope such as “multiple”, “tranche”, the “issuer”. These respondents said that clarity about the scope is particularly important given the differences in the financial reporting outcomes resulting from applying the CLI requirements or the general SPPI requirements. Some respondents said that for some types of financial assets, it is unclear whether an entity needs to apply the CLI requirements or the application guidance for non-recourse features. Respondents noted that during the development of the CLI requirements, the IASB discussion suggested that the defining characteristic of CLIs is the loss of (or a part of) a tranche's contractual entitlement to cash flows upon a shortfall in funds from the underlying pool after satisfying higher ranking tranches. In their view, the CLI requirements in IFRS 9 do not reflect this principle clearly. This lack of clarity has led to questions in practice and diverse interpretation. Respondents question whether, and to what extent, the substance of the contractual arrangements must be considered as opposed to the financial instruments' legal form. In their view, the IASB intended the CLI requirements to be applied for public securitisation and not for other types of transactions such as project financing involving a SPV or the subordination of a holder's claim in liquidation.

14. Many of the respondents who commented on CLIs raised questions about specific terms used in IFRS 9 to describe CLIs. The examples in the following paragraphs illustrate their questions.

Example: the meaning of 'multiple tranches' and 'contractually linked instruments'

Special Purpose Vehicle (SPV) A, B and C each hold a portfolio of loans as their assets. The sole purpose of the SPVs is to collect the contractual cash flows from the loans and to pass them to their investors. They are identical except for the way they are funded:

- SPV A issued equity instruments that meet the definition of equity in IAS 32 and debt instruments
- SPV B issued junior (subordinated) debt instruments that meet the definition of a financial liability in IAS 32 and senior debt instruments.[1] Junior and senior debt instruments each have separate contracts. The junior debt contract states that the debt instruments are subordinated to senior debt instruments issued by SPV B.
- SPV C issued collateralised debt obligations that have two tranches – senior and junior tranches. Both tranches were issued in a single contract.

15. Respondents ask whether the CLI requirements would apply to the holders of the debt instruments issued by SPV B as well as SPV C, noting diverse views in practice. They observe the economic substance of the debt instruments of SPV A, the senior debt instruments of SPV B and the senior tranche of SPV C is similar. Some also question whether 'multiple' tranches were meant for three or more tranches.

[1] In this paper, junior debt instruments or subordinated debt instruments refer to debt instruments that have been issued with lower priority than senior debt instruments. Junior debt instruments will only be repaid in the event of default or bankruptcy after more senior debts are repaid in full.

Example: the meaning of the 'issuer'

Bank D establishes an SPV (SPV E) with ring-fenced assets. SPV E issued a CLI with two tranches, senior and junior tranches. Bank D consolidates SPV E and holds the junior tranche. Investor F holds the senior tranche.

16. Respondents question whether the senior tranche held by Investor F is a CLI. They observe that IFRS 9 describes CLIs as 'transactions in which an issuer prioritises payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches)'. In their view, if SPV E were considered the issuer, the senior tranche is a CLI because SPV E has issued a CLI with two tranches. If the consolidated group of Bank D were considered the issuer on the other hand, the CLI requirements in IFRS 9 would not apply. That is because the CLI does not have multiple tranches as the junior tranche held by Bank D would be eliminated on consolidation.

Example: the composition of the underlying pool: business in the underlying pool

Company G owns 100% of the equity issued by an operating company, OpCo and does not have any other assets. Company G issues multiple tranches of debt instruments where investors' only recourse is to the shares of OpCo. Investor F holds one of the tranches.

17. A question was raised, if the underlying pool includes a business, whether the tranche held by Investor F would be a CLI (ie from the holder's perspective).

Other questions

18. Questions were also raised about other specific terms used in IFRS 9 to describe CLIs. They include:

    (d) *contractually linked instruments*—would a financial instrument be considered a CLI if subordination is created structurally (e.g. through a group entity hierarchy) without contractual terms specifying this?

    (e) *prioritise payments*— would a financial instrument be considered a CLI if prioritisation of payments applies only in the event of default such as in a subordination?

(f) *any cash flows*— would a financial instrument be considered a CLI if some of the cash flows generated by the underlying pool will be used to settle operating expenses prior to being allocated to tranches?

(g) '*The holders only have the right to payments […] only if the issuer generates sufficient cash flows to satisfy higher ranking tranches*'—— would a financial instrument be considered a CLI if:

  (i) the contractual terms set out a waterfall in the distribution of cash flows but not the contractual reduction of the holders' claim in the event insufficient cash flows are generated? For example, a junior tranche will not be paid if there are no sufficient cash flows after satisfying higher-ranking tranches but the junior tranche holder's claim is not contractually reduced.

  (ii) the contractual terms allow the sponsor to inject additional cash flows into the underlying pool to prevent an event of default? The question arises because this would mean the repayment of the CLI can come from sources other than cash flows generated by the issuer (or from the underlying pool).

Preliminary staff views

19. In the staff view, the key defining characteristics of a CLI is the creation of credit concentrations through the contractual reduction in the tranche holder's right to receive cash flows (including repayment of the principal) after satisfying any tranches that have higher priority of payment than the tranche being assessed.

20. In the staff view, the description of the CLI as currently drafted is consistent with this notion but there is room for further clarification given the questions raised by stakeholders. The staff think the IASB could clarify the key characteristics of a CLI to clarify for what types of contractual arrangements the requirements were intended. The staff think that such clarification would help ensure entities apply the relevant requirements consistently and to only those financial instruments the IASB intended the requirements for.

Usefulness of the resulting information

Respondents' feedback
Respondents observed that transactions with similar economic substance can be structured as a CLI or another type of financial instrument. They expressed the view that: • if structured as a CLI, the CLI would need to be measured at fair value through profit or loss because the instruments in the underlying pool do not have SPPI cash flows; and • if structured as another financial instrument (for example, as a non-recourse financial asset that finances a pool of non-financial assets), an entity might conclude that some such assets have SPPI cash flows. Respondents also observed that the CLI requirements in IFRS 9 refers to both 'financial instruments' and 'instruments' in describing the conditions required for the underlying pool for the CLI to have the SPPI cash flows. In their view, this has resulted in differing interpretations of what types of instruments can be present in the underlying pool, which led to differing measurement outcomes. In respondents' view, differing measurement outcomes for economically similar investments do not provide useful information. They requested the IASB clarify whether these differing measurement outcomes were intended.

Example: CLIs and non-recourse financial assets

Company H establishes an SPV (SPV I). SPV I issues equity instruments, junior and senior debt instruments. Company H holds the equity instruments and junior debt and Bank J holds the senior debt instruments. SPV I uses this funding to purchase properties. The sole purpose of SPV I is to collect the contractual cash flows from leasing the properties and pass them to investors. All investors have the right to payments only if SPV I generates sufficient cash flows from leasing the properties. All investors have recourse only to the assets held by SPV I.

Respondents asked how Bank J would assess the contractual cash flows of the senior debt instruments issued by SPV I.

In a variation of the above fact pattern, Company H creates another SPV (SPV K). SPV K has the same purpose as SPV I but is different in how it is financed. SPV K issues collateralised debt obligations with senior, mezzanine and junior tranches. Bank J holds the senior tranche.

Assume the contractual terms of the senior debt instruments of SPV I and the senior tranche of SPV K give rise to SPPI cash flows.

21. Respondents are of the view that Bank J would be able to measure the senior debt instruments issued by SPV I at amortised cost or at fair value through other comprehensive income (subject to the business model assessment). On the other hand, Bank J would be required to measure the senior tranche issued by SPV K at fair value through profit or loss:

    (a) for senior debt instruments issued by SPV I, Bank J would assess whether the debts represent an investment in properties and whether the terms of the senior debt instruments limit the cash flows in a manner inconsistent with SPPI. Bank J could conclude the senior debt instruments have SPPI cash flows for example, if the underlying properties are expected to generate sufficient cash flows and there is sufficient equity and subordinated debt in SPV I so that the contractual cash flows of the debts are not limited in a way that is inconsistent with SPPI.

    (b) for the senior tranche issued by SPV K, Bank J would conclude the senior tranche does not have SPPI cash flows. This is because IFRS 9 allows only particular types of instruments in the underlying pool of CLIs that have SPPI cash flows and does not allow non-financial assets to be present.

22. In their view, Bank J's investments in SPV K's senior tranche and SPV I's senior debt instruments have similar economic substance. Respondents asked whether these differing measurement outcomes were intended and would provide useful information about investments in these debt instruments.

23. Respondents requested the IASB clarify the types of financial instruments to which the IASB intended the CLI requirements to apply. In their view, the CLI definition was intended for public securitisations structures with many debt tranches issued. Respondents do not think this was intended for bilateral (or trilateral) non-recourse lending arrangements over specific assets the borrower has ring fenced in an SPV. They noted that many common real estate, transportation and infrastructure lending arrangements have this type of structure. In their view, measuring all investments in such debt instruments at fair value through profit or loss applying the CLI requirements would not provide useful information to users of the financial statements.

Example: the application of the 'de minimis' requirements to CLIs

> Consider a CLI for which the underlying pool of instruments is determined to have SPPI cash flows except for one possible type of 'eligible investments'. The issuer has the contractual right to invest cash flows received on the underlying instruments into 'eligible investments' before the cash is disbursed to the CLI holders at the next periodic payment date. One of the possible eligible investments is money market funds which would not have SPPI cash flows due to the ability to put the instrument at fair value. The money market funds are held for a very short period, have a very high credit rating and form a very small proportion of the underlying pool at any point in time.

24. Respondents asked whether an entity can apply the notion of 'de minimis' in assessing the cash flow characteristics of CLIs. They questioned whether the particular contractual right of the issuer in the example above should require the holder of the CLIs to measure the CLIs at fair value through profit or loss, and they question the usefulness of the information resulting from the FVPL measurement.

Preliminary staff views

25. The staff acknowledge respondents' concern about the usefulness of differing classification outcomes for economically similar transactions and we think it is worth the IASB's consideration. Clarifying the scope of CLIs as discussed in paragraphs 19–20 of this paper would respond to some concerns. However, we are of the view that there are significant differences in the economic substance of CLIs and other types of financial instruments and therefore different classification outcomes are often required to faithfully represent the underlying economics.

26. We are of the view that concerns about different classification outcomes are symptomatic of the lack of sufficient application guidance on the scope of instruments to which the CLI requirements apply. As also noted in Agenda Paper 3A for this meeting, questions were also raised about what a non-recourse financial asset is, how this is different from CLIs and the application the SPPI requirements in this regard.

27. The staff consider it important to note that a CLI in IFRS 9 is *a type* of structured financial instruments whereas having no or limited recourse to the borrower's assets is *a feature* of a financial instrument. While IFRS 9 includes application guidance

that refers to non-recourse financial assets (paragraphs B4.1.15–B4.1.17), that application guidance is not meant to only apply to non-recourse financial assets. As noted in Agenda Paper 3A for this meeting, the objective of that application guidance is to require the holder of financial instruments to assess the nature of the cash flows and what the holder is being compensated for, rather than simply relying on how those cash flows are described or labelled in the contract. Non-recourse financial assets are an example of assets for which such consideration would be particularly relevant.

28. In contrast, IFRS 9 contains specific requirements that apply only to CLIs. The staff think it is useful to remember that the underlying principle of the SPPI requirements in IFRS 9 is that amortised cost measurement is for financial assets with ‘simple’ contractual cash flows, which are described as solely payments of principal and interest in IFRS 9. CLIs are structured products and would not necessarily be regarded as ‘simple’ financial instruments. However, the IASB recognised that some tranches of CLIs can have SPPI cash flows and hence amortised cost can provide useful information about them. The IASB developed specific requirements for CLIs to ensure only those part of CLIs that have SPPI cash flows are eligible to be measured at amortised cost (see paragraphs 3–9 of this paper).

29. Therefore, we think there is an opportunity for the IASB to clarify the requirements and application guidance for both non-resource financial assets and CLIs.

30. In addition, the staff note that in describing the CLI requirements for the underlying pool, IFRS 9 does not explicitly require the financial instruments to be those within the scope of IFRS 9. This has led to some stakeholders asking whether some financial instruments that are not (fully) within the scope of IFRS 9 can be present in the underlying pool of CLIs that have the SPPI cash flows, for example lease receivables. The staff think it would help improve the clarity of the scope of the CLI requirements if the IASB could clarify this point.

Cost of preparation and practicability of the look-through assessment

Respondents' feedback
Respondents requested the IASB scope out the most senior tranche from applying the CLI requirement so that the senior tranche is assessed applying the general SPPI requirements including the requirement for non-recourse financial assets. These respondents expressed the view that applying the CLI requirement to these tranches can require an unnecessary level of judgement and effort, and does not always result in useful information. Some respondents noted that detailed information about the underlying pool is not always available to perform the look-through assessment. They noted that the SPPI assessment requires having access to the details of underlying contracts to understand how some contractual features, such as early redemption clauses or interest rates with a modified time value element, may affect the contractual cash flows. In their view, an investor rarely has access to such level of details. This assessment is even more complicated in a situation in which the underlying assets can change subsequent to initial recognition.

Preliminary staff views

31. IFRS 9 already acknowledges that the extent of the assessment required varies depending on the specific circumstances. In relation to the look-through assessment of the underlying pool, paragraph B4.1.25 of IFRS 9 states that:

    > […] in performing this assessment, a detailed instrument-by-instrument analysis of the pool may not be necessary. However, an entity must use judgement and perform sufficient analysis to determine whether the instruments in the pool meet the conditions in paragraphs B4.1.23–B4.1.24. […]

32. In the staff view, it is generally expected that a more extensive assessment of the underlying pool would be required for lower-ranking tranches than senior-ranking tranches. The staff further note that the CLI requirements as drafted in IFRS 9 were the result of the IASB responding to the concerns raised by respondents to the 2009 C&M ED.

33. Furthermore, the staff note that even if the IASB amended IFRS 9 to scope out the most senior tranche from the CLI requirements, IFRS 9 would still require the holder to assess the effects of the cash flows of the underlying pool of instruments. Scoping out the most senior tranche from the CLI requirements would not necessarily

alleviate the need to consider the effect of the cash flows of the underlying pool on the senior tranche.

34. The staff understand that another reason some respondents are requesting the most senior tranches to be scoped out of the CLI requirements stem from their concern over the requirements about the underlying pool discussed in paragraphs 21–24 of this paper. The staff think a potential clarification to the underlying pool requirements such as that discussed in paragraph 30 would respond to concerns at least to some extent.

35. Lastly, when developing the CLI requirements, the IASB was made aware that in some cases, it would not be practicable to look through to the underlying pool of financial instruments and that the instruments in the underlying pool can change subsequently. As a result, paragraphs B4.1.25 and B4.1.26 of IFRS 9 contains explicit requirements to measure the tranche at fair value through profit or loss if the holder cannot assess the underlying pool at initial recognition and if the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the required condition.

36. This is consistent with the IASB's view explained in paragraph BC4.34 of the Basis for Conclusions on IFRS 9 that to understand and make the judgement about whether particular types of financial assets have the required cash flow characteristics, an entity would need to understand the characteristics of the underlying issuer to ensure that the instrument's cash flows are SPPI.

Is standard-setting needed?

37. In the staff view, providing clarity as requested by respondents in this area would most effectively be done through standard-setting. Should the IASB begin a standard setting project to address the accounting for financial assets with ESG-linked features, we think it would be a good opportunity for the IASB to consider whether any targeted improvements in this area would be appropriate.

38. As explained in Agenda Paper 3A, we think that if PIR feedback raises many application questions in one area with significant diversity in practice, such feedback is indicative that standard-setting—rather than interpretation or educational

material—is needed. The staff expect that issuing educational material or adding illustrative examples would supplement but not replace the need to clarify the scope and the requirements that apply to CLIs.

39. Stakeholders have been raising questions and concerns about CLI requirements well before the IASB started this PIR. The staff observe that questions on other areas of the SPPI assessment were generally not continuously raised by stakeholders, indicating that practice has been established. Unlike those questions, stakeholders have been raising questions about CLIs for many years and the questions continue to exist. In the staff view, this indicates that standard-setting would be required to support consistent application of the requirements.

40. We also note that the CLI requirements in IFRS 9 are specific to CLIs. We think the IASB could make clarification to the CLI requirements without disrupting practice on other general SPPI requirements.

41. Finally, we acknowledge that investments in CLIs in isolation are not generally the most significant part of entities' financial assets. However, if the scope of instruments to which the requirements are applied is not clear and there is diversity in practice (for example the requirements are applied more broadly to all subordinated debt instruments), the resulting effect could be significant and pervasive.

42. If the IASB decides to undertake standard-setting in this area, the staff think the IASB could consider whether and how the scope of the requirements and application guidance for non-recourse financial assets and CLIs can be clarified. In our view, such clarification will help ensure that the relevant requirements are applied consistently and that the resulting classification outcomes will faithfully represent the underlying economics and substance of the financial instruments.