STAFF PAPER

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IASB® meeting

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. This paper provides the staff's 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 is structured as follows:

   (a) a reminder of the IFRS 9 requirements for financial assets with non-recourse features and CLIs and the IASB's rationale for those requirements; and

   (b) preliminary staff views and analysis.

Question for IASB
Do you have questions or comments about the preliminary staff views and analysis?

IFRS 9 requirements

Financial assets with non-recourse features

References
Paragraphs B4.1.15–B4.1.17 of IFRS 9

3. Paragraphs B4.1.15–B.4.1.16 of IFRS 9 discuss financial assets whose contractual cash flows are described as principal and interest but are not 'solely payments of principal and interest' (SPPI) because the lender's claim is limited to specified assets of the borrower or the cash flows from specified assets, referred to as 'non-recourse' financial assets.
4. However, paragraph B4.1.17 of IFRS 9 explains that the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from having cash flows that are SPPI and it may be necessary to 'look through' to the particular underlying assets to assess whether cash flows on the financial assets are SPPI.

The scope of the CLI requirements

References
- Paragraph B4.1.20 of IFRS 9
- Paragraphs BC4.26 of the Basis for Conclusions on IFRS 9

5. CLIs are described 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). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche.
6. 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 the rights of the higher-ranking tranches.
7. The CLI structure is also referred to as a 'waterfall' by the nature of prioritising the payments to different tranches. Waterfall structures specify the order in which any losses that the issuer incurs are allocated to the tranches. IFRS 9 contains specific requirements that apply only to structures within the scope of the CLI requirements.

Assessment of the contractual cash flow characteristics of CLIs

References
• Paragraphs B4.1.20–B4.1.26 of IFRS 9 • Paragraph BC4.35 of the Basis for Conclusions on IFRS 9

8. An entity shall assess the contractual cash flow characteristics of a tranche within a structure of CLIs by applying paragraphs B4.1.21–B4.1.26 of IFRS 9. 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.

9. An entity is required to 'look through' until it can identify the underlying pool of instruments that are creating the cash flows. A tranche is measured at fair value if:

   (a) any of the financial instruments in the underlying pool:

      (i) have cash flows that do not represent SPPI cash flows or meet the requirements in paragraph B4.1.24 of IFRS 9; or

      (ii) could change so that cash flows may not represent SPPI cash flows at any point in the future.

   (b) the tranche's exposure to credit risk in the underlying pool of financial instruments is greater than the exposure to credit risk of the underlying pool of financial instruments; or

   (c) the holder cannot assess the conditions in paragraph 8 of this paper.

Why did the IASB develop the specific requirements for CLIs?

References
Paragraphs BC4.22, BC4.26–BC4.36 and BC4.205–BC4.208 of the Basis for Conclusions on IFRS 9

10. When developing IFRS 9, the IASB noted that an instrument has 'basic loan features' only if the contractual cash flows are principal and interest on the principal outstanding, which is consistent with the objective of amortised cost accounting and the effective interest method. In the IASB's view, interest is mainly compensation for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time and may also include consideration for other basic lending risks and costs. See Agenda Paper 16A for this meeting for a discussion of the concept of a 'basic lending arrangement'.

11. CLIs are structured products, and the holders of some tranches receive a premium in return for providing credit protection to other tranches. Thus, CLIs would not necessarily be regarded as financial instruments with 'basic loan features'.

12. In the IASB's view, a CLI structure that contains credit concentration features that create ongoing subordination (not only in a liquidation scenario) is different from subordination that is typically set by commercial law. The IASB believes that it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for either general creditors or senior liabilities ranking. Thus, the IASB concluded that subordination in itself should not preclude amortised cost measurement.

13. The IASB recognised that some tranches of CLIs, despite the description in paragraph 11 of this paper, can have SPPI cash flows and hence amortised cost can provide useful information about them. When assessing the contractual cash flow characteristics of tranches in a CLI structure, the IASB noted that classification solely on the basis of the contractual features of the financial asset being assessed for classification (ie the specific tranche) would not capture the economic characteristics of the instruments when a concentrated credit risk arises through contractual linkage.

14. The IASB also noted that in order to understand and assess whether particular types of financial assets have the required cash flow characteristics, an entity would have

to understand the characteristics of the underlying instruments to ensure that the instrument's cash flows are SPPI.

15. The IASB therefore decided to add a requirement to 'look through' to the underlying pool of financial instruments that are creating the cash flows and to assess the exposure to credit risk of those financial assets relative to the underlying pool of instruments.

16. This approach is based on the nature of CLIs that effect concentrations of credit risk. The variability of cash flows from the underlying pool of instruments is a reference point, and tranching only reallocates credit risk. Any tranche that is exposed to the same or lower credit risk could have SPPI cash flows if the underlying pool represents SPPI cash flows.

Preliminary staff views and analysis

17. At its June 2022 meeting, the IASB agreed that the key areas for clarification in relation to non-recourse features and the CLI requirements are:
    (a) the meaning and characteristics of non-recourse features (including consideration of the need to assess the underlying assets or cash flows);
    (b) the meaning and scope of instruments to which the CLI requirements are applied (paragraph B4.1.20 of IFRS 9); and
    (c) the requirements for the underlying pool of instruments for a CLI to have SPPI cash flows (paragraphs B4.1.23 and B4.1.25 of IFRS 9).

18. In this paper, the staff set out our preliminary views and analysis of the meaning and characteristics of non-recourse features and CLIs. Clarifying the requirements for the underlying pool of instruments for CLIs and consideration of the need to assess the underlying assets of financial assets with non-recourse features will be discussed at a future meeting.

Financial assets with non-recourse features

19. As reported in Agenda Paper 3A discussed at the April 2022 IASB meeting, respondents to the PIR provided examples of fact patterns where they had difficulty in determining whether or not the loan represented a 'non-recourse financial asset', including:

    (a) a bank issues a loan to a company to finance a construction project. In the event the company cannot repay the loan, the bank's claim is limited to the proceeds from the sale of the construction, which may be lower than the outstanding loan balance.

    (b) a bank purchases a credit-impaired loan that is secured against a building. At the purchase date, the level of impairment is such that it is reasonably likely that the only cash flows the bank will receive will be the proceeds from the sale of the building, which is expected to be much lower than the outstanding loan balance.

    (c) a bank issues a loan to a special purpose entity that has only a limited set of assets. The contract does not include a non-recourse feature; however the nature of the borrower means that the repayment of the loan would directly depend on the performance of the specific assets.

20. Notwithstanding the reference to a 'non-recourse financial asset' in IFRS 9, the staff believe it may be more helpful to consider 'non-recourse' a feature of the contractual terms of certain financial assets, rather than a separate category of financial assets.

21. The term 'non-recourse' is used in IFRS 9 to refer to a contractual feature of some financial instruments (including, but not limited to CLIs) where the lender's claim is limited to specified assets of the borrower or the cash flows from specified assets, as explained in paragraph B4.1.16 of IFRS 9.

22. When developing IFRS 9, the IASB considered that typically, non-recourse refers to the missing personal liability of a borrower beyond any asset or asset(s) pledged as collateral. Hence, non-recourse does not refer to 'normal' collateralised debt where the lender has a claim on the borrower and in addition, the protection of the security. That is, in a non-recourse instrument the lender's ultimate claim is limited to the value of the asset. 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.[1]

23. The non-recourse feature is typically structured as follows:[2]

(a) the borrower pledges an asset (or a pool of assets);

(b) that asset(s) is ring-fenced so it is 'isolated' from the other net assets of the borrower (for example, the assets are transferred to a separate legal entity);

(c) any payments on the debt instruments are sourced by the cash flows generated by the ring-fenced asset(s) (which in the case of default may require the liquidation of the assets); and

(d) the legal entitlement to payments of principal and interest may or may not be reduced depending on the performance of the ring-fenced asset(s). However, generally the lender has no further rights to such payments in the event of default except for any cash flows arising from liquidating the ring-fenced asset(s).

24. The rationale for the application guidance in IFRS 9 relating to non-recourse financial assets is explained in paragraphs 19–21 of Agenda Paper 12C discussed at the October 2009 IASB meeting:

> The staff believes 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 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

[1] Consistent with paragraphs 5–7 of AP12C for October 2009 meeting
[2] Consistent with paragraph 11 of AP12C for October 2009 meeting

> instrument is exchanged for the performance risk of the ring-fenced assets.

25. The contractual terms of a financial asset are therefore inconsistent with those of a basic lending arrangement if it contains a non-recourse feature which exchanges the credit risk of the borrower for the performance risk of an underlying asset or pool of assets.

26. Many loans are secured by other assets (financial or non-financial collateral). Over the life of the loan, the lender is exposed to the credit risk and ability of the borrower to generate sufficient cash flows for the repayment of the loan. In the event of default, the amount of the outstanding principal and interest payments that can be recovered by the lender could depend on the value of this collateral. However, the existence of collateral does not by itself change the contractual cash flows that the lender is entitled to. This principle is illustrated by the example of Instrument D (a full recourse loan secured by collateral) under paragraph B4.1.13 of IFRS 9:

> The fact that a full recourse loan is collateralised does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

27. In contrast, in the case of a financial asset with non-recourse features, the contractual rights of the lender is limited to the ability of the underlying asset to generate sufficient cash flows to repay the loan throughout the life of the financial asset and to the value of the underlying asset in the case of default, which may limit the cash flows the lender receives in a manner that is inconsistent with a basic lending arrangement.

28. The application questions mentioned in paragraphs 19(a) and 19(b) of this paper could be addressed by explaining the difference between non-recourse and full-recourse financial assets, for example:

    (a) non-recourse financial assets represent a direct or indirect investment in another asset and the creditor is exposed to the performance risk of the underlying asset; whereas

    (b) full recourse loans collateralised by other assets constitute a debt investment in the borrower and the lender is primarily exposed to the credit risk of the borrower. In the event of default, the lender is only exposed to the performance risk of the underlying asset to the extent that the borrower is unable to make the contractual payments of principal and interest through other means.

29. In some cases, it may be necessary to consider the context in which a contract is entered into between the borrower and the lender in addition to the explicit terms of the contract. This could be the case where the borrower is a special purpose entity whose only source of cash flows available to make payments on the debt instrument is an underlying asset or pool of assets (see application question in paragraph 19(c) of this paper). In such cases a financial asset may be 'non-recourse' as a result of a combination of contractual arrangements that exposes the lender to the performance risk of an underlying asset or pool of assets, both throughout the life of the instrument and in the event of default.

Summary of feedback on the scope of the CLI requirements

30. As noted in Agenda paper 3C for the April 2022 meeting, most respondents to the *Request for Information Post-implementation Review of IFRS 9—Classification and Measurement* (the PIR) expressed their view that the scope of transactions to which the CLI requirements apply is not clear and suggested that the IASB clarify the scope of the requirements.

31. Specifically, respondents requested the IASB clarify the types of financial instruments to which the IASB intended the CLI requirements to apply. Many respondents also said that the meaning of particular terms used in paragraph B4.1.20 of IFRS 9 such as 'multiple', 'tranche', the 'issuer' is not clearly described.[3]

32. The IASB previously concluded that subordination in itself should not preclude amortised cost measurement, as described in paragraph BC4.28 of the Basis for Conclusions on IFRS 9. However, the staff note that there appear to be some confusion around whether the requirements for CLIs is applicable to other structures, especially financial assets with non-recourse features.

[3] Paragraphs 14–18 of AP3C for April 2022 meeting illustrates the concerns through examples.

33. Some respondents to the PIR argued that there could be different classification outcomes depending on which requirements (general SPPI requirements or the CLI requirements) are applied to a particular financial asset and that it is therefore important to have clarity on the intended scope of the CLI requirements.

Characteristics of CLIs

34. The staff continues to be 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. We think the scope could be clarified by analysing the similarlity and differences between CLIs and other similar structures (especially other financial assets with non-recourse features) as well as the unique characteristics of CLIs that led to the IASB developing specific requirements to assess whether the contractual cash flows of a tranche are SPPI.

35. In the section below, the staff analyse specific aspects of CLIs and how CLIs are different from other financial instruments. In the staff's view, the IASB intended CLIs to refer to financial instruments that:

(a) have non-recourse features;

(b) are contractually linked;

(c) are subject to a waterfall payment structure; and

(d) create concentrations of credit risk resulting from the disproportionate reduction in contractual rights in the event of cash flow shortfalls.

Non-recourse features

36. In a CLI structure, any cash flows generated from the underlying pool of financial assets are allocated to tranche holders. That is, payments on the tranches are sourced by the cash flows which are generated by the ring-fenced underlying pool. Thus, the tranche holders have 'no recourse' to the issuer's other net assets except for the underlying pool of financial assets in the CLI. In the staff's view, because of the structure of cash flows allocations in a CLI, CLIs have the characteristics of 'non-recourse' features described in paragraphs 23-29 of this paper.

Contractual linkage

37. One of the distinguishing characteristics of CLIs is that there is a contractual linkage (relationship) between multiple tranches. In the staff's view, it is important for the relationship between the contractual rights of the different tranche holders, including the order that cash flows are allocated to the different tranches, to be specified in the contract. Therefore, each tranche holder is aware of the relationship of its contractual rights to those of other tranche holders from the outset of the CLI arrangement.

Waterfall payment structure

38. Contractual linkage between multiple tranches determines the order in which tranches receive cash flows and creates 'waterfall' structure in a CLI. For each set of interest or principal payments due, payments to the most senior tranche is prioritised and payments to the more junior tranche has the lowest priority. This waterfall structure affects the payments to the tranches on an ongoing basis (not only in a liquidation scenario).

Concentration of credit risk

39. The waterfall structure specifies not only the order in which payments are made but also the order in which any losses are allocated to the tranches (see paragraph BC4.26 of the Basis for Conclusions on IFRS 9). This creates a concentration of credit risk among tranche holders. The most junior tranche is exposed to the highest amount of credit risk and the most senior tranche is exposed to the lowest amount of credit risk, since payments to the most senior tranche is prioritised. Tranches in between have an intermediate amount of credit risk. In other words, the contractual linkage reallocates credit risk amongst the tranche holders.[4]

40. Because of a concentration of credit risk, the junior tranches can 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. The junior tranches are usually compensated for the credit protection provided to the more senior tranches by having

[4] Paragraph 12 of AP12C for October 2009 meeting

the contractual right to receive a higher interest rate if sufficient cash flows are available.

41. The exposure of the more junior tranches to the performance of the underlying pool of financial instruments therefore contains leverage – if the underlying pool performs well, the more junior tranches is entitled to a disproportionately high return compared to the more senior tranches, but if the underlying pool performs poorly, the more junior tranches is contractually obligated to suffer disproportionate losses. That is, any loss is shared disproportionately.[5]

42. 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 more junior tranches do not trigger a default of the issuer, but rather reduce the contractual rights of the holders of the more junior tranches to receive cash flows. This feature distinguishes a CLI structure from other forms of subordination, whereby the contractual rights to receive cash flows would generally remain unaffected.

Comparison with financial assets with non-recourse features

43. In the staff's view, not all financial assets with non-recourse features have the unique characteristics of CLIs discussed in paragraph 37–42 of this paper. If there are multiple debt instruments that have recourse only to a specific pledged assets, the holders of debt instruments are not necessarily required to know their rankings when they enter into the agreement and there is no contractual linkage among the holders. Furthermore, there may be no waterfall structure which prioritises payments among different debt instruments.

44. Therefore, if the risk and rewards from the underlying pool of financial instruments are distributed proportionately among holders of debt instruments without any concentration of credit risk, these debt instruments are not CLIs.[6]

[5] Paragraphs 13 of AP12C for October 2009 meeting
[6] Paragraphs 5–7 of AP12C for October 2009 meeting

Consideration of economic substance

45. Many respondents who requested to clarify the scope of CLIs requirements also raised a question about the difference between the guidance on financial assets with non-recourse features and the CLIs requirements. They said that accounting for similar transactions may lead to different outcomes depending on whether the CLI requirements or the non-recourse guidance is applied.

46. The staff are of the view that there are significant differences in the economic substance of CLIs and other types of financial instruments considering the characteristics of CLIs discussed in paragraphs 37–42 of this paper. Therefore, we are of the view that different classification outcomes are often required to faithfully represent the underlying economics.

47. The staff will discuss how the characteristics of the underlying pool of instruments affect the SPPI assessment for CLIs and other financial assets with non-recourse features at a future meeting.