Detailed background on Contractually linked instruments – non-recourse

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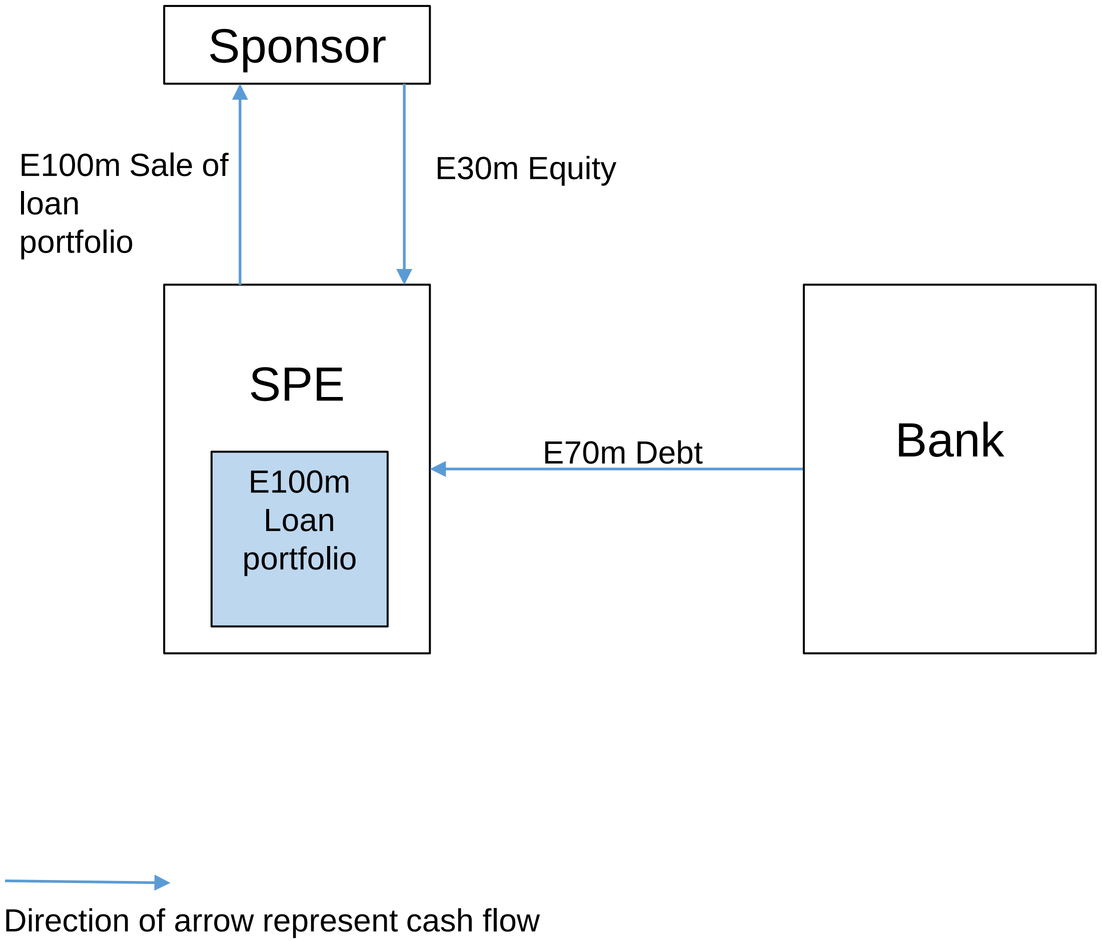
EFRAG
European Financial Reporting Advisory Group

Example 1: Asset Financing through bilateral loan with sponsor investment as equity



- Sponsor originates E100m loans
- Sponsor sells loans to SPE.
- SPE issues equity for E30m back to sponsor. The equity has no maturity and no contractual scheduled payments. The instrument meets equity definition in IAS 32.
- SPE issues E70m debt to Bank at 3mL+2% and is A rated internally. Debt meets definition of liability in IAS 32.
- There is an explicit waterfall of payments in the debt facility agreement ongoing and in default whereby the debt holder is paid prior to any dividends on the equity instrument.
- There are covenants in the debt instrument whereby if the value of the loan portfolio falls such that the Loan to Value (LTV) ratio increases to 80% then there is an Event of Default.
- In an Event of Default the debt holder can enforce on the loan collateral.
- The sponsor is permitted to increase their equity investment so that LTV triggers are not met (cure rights).
- There is no recourse of the debt to the sponsor/originator.
- (Note the same structure exists for financing of commercial real estate and aviation financing)

Accounting Questions:

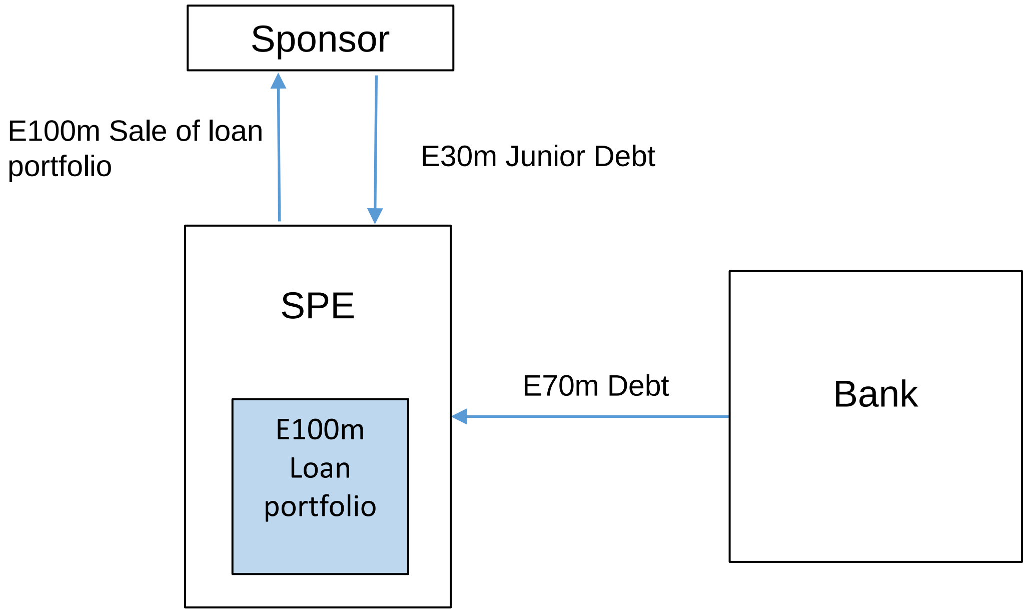
- Should this be assessed as a Contractually Linked Instrument (IFRS 9 B4.1.20) or a Non Recourse Financing (IFRS 9.B4.1.17)?

Assessment

- Since there is only one debt tranche then the contractually linked instrument definition is not met since B4.1.20 requires multiple tranches of credit risk.
- The debt is assessed in accordance with non recourse financing guidance in IFRS 9.B4.1.17

Important: These summarised examples are provided to illustrate the accounting complexity associated with the definition of CLI/NRF. They do not provide guidance on how to structure / execute such lending relationships.

Example 2: Asset financing with bilateral loan with sponsor investment as debt (1)



Direction of arrow represent cash flow

Structure Description

- Sponsor originates E100m loans
- Sponsor sells loans to SPE.
- SPE issues a E30m junior debt instrument to the sponsor, the instrument has a contractual maturity and a coupon rate. The coupon is Payment in Kind (PIK) meaning if the coupon cannot be paid then it is added to principal and accrues until paid or maturity. Therefore the junior loan cannot have an event of default prior to maturity. The term of the debt instrument is past the maturity date of the underlying loan portfolio and allows a period for credit workout process. The cash flows on the debt instrument are identical to equity in the previous example. Structuring as debt is tax efficient (interest is tax deductible) in certain jurisdictions.
- The SPE also issues a E70m senior debt instrument to the bank at 3mL+2% and is A rated internally.
- There is an explicit waterfall of payments in the senior debt facility ongoing and in default whereby the senior debt holder is paid at each coupon date prior to any interest or principal of the junior debt
- There are covenants in the senior debt instrument whereby if the value of the loan portfolio falls such that the Loan to Value (LTV) ratio increases to 80% then there is an Event of Default on the senior loan. There is also an EOD upon failure to pay.
- In an Event of Default the senior debt holder can enforce on the loan collateral.
- The sponsor has the option to increase their junior debt so that LTV triggers are not met and an event of default is prevented (cure rights). Due to the substantial equity contribution and the LTV trigger levels it is economically rational for the sponsor to do this except in the rare situation of a large and sudden fall in collateral value (gap risk event).
- There is no recourse for the senior debt to the sponsor/originator.

Important: These summarised examples are provided to illustrate the accounting complexity associated with the definition of CLI/NRF. They do not provide guidance on how to structure / execute such lending relationships.

Example 2: Asset financing with bilateral loan with sponsor investment as debt (2)

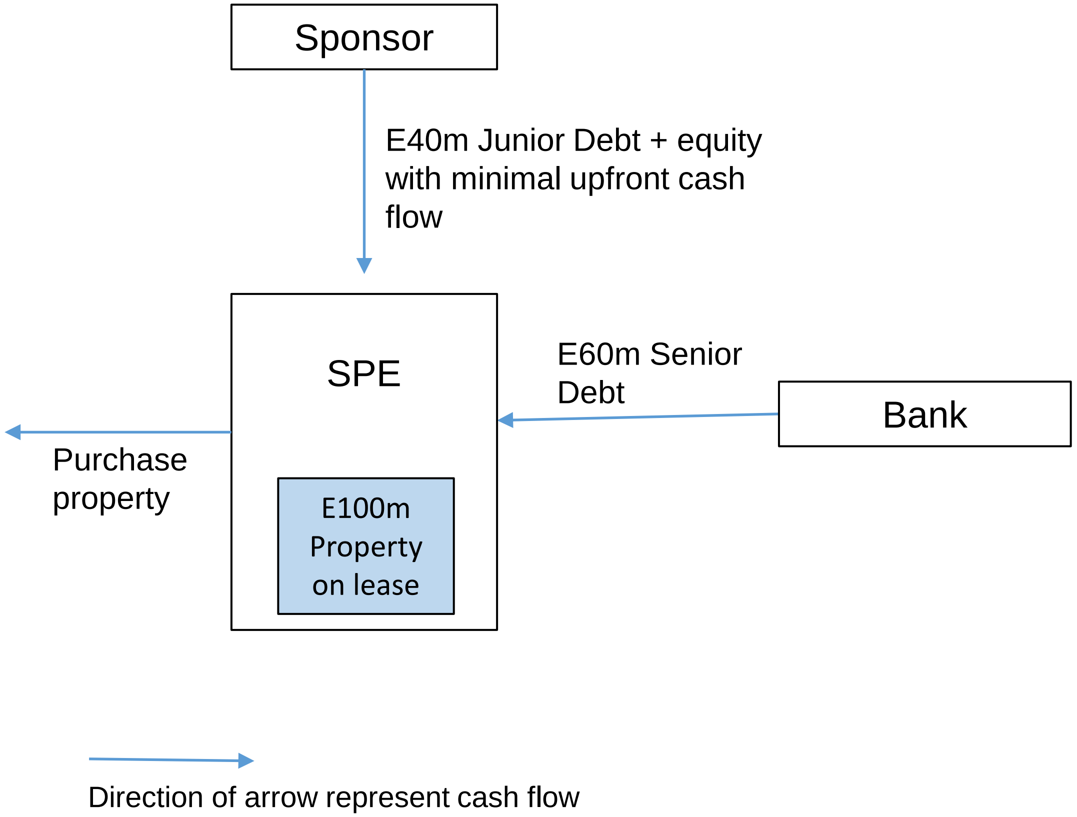
Accounting Analysis:

- The CLI definition is not clear and there is no application guidance. Different conclusions could be reached as to whether the structure is an NRF or CLI

CLI Definition	Arguments for NRF	Arguments for CLI
Issuer may prioritise payments to the holder using multiple contractually linked instruments that create concentrations of credit risk	Condition not met: Whilst there are 2 instruments which meet the financial liability definition in IAS 32 – the junior instrument is 'in substance' equity and has identical cash flows to the previous example. Addtionally, the sponsor consolidates the SPE and so there is only 1 tranche of debt external to the group.	Condition met: There are 2 (i.e. multiple) instruments which meet the definition of IAS 32 liability.
Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche	Condition met – there is a waterfall of payments which allocate both the ongoing and default cash flows to each tranche.	Condition met – there is a waterfall of payments which allocate both the ongoing and default cash flows to each tranche.
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	Condition not met: As the holder of the senior loan may benefit from additional cash flows not initially included in the entity and therefore not generated by the entity, this criteria has not been met. The right to increase the amount invested in the junior loan is a feature akin to a NRF transaction. Although the right is not an obligation, loan covenants are structured with defined LTV trigger levels that make it economically rational for the sponsor to inject more cash in the vehicle to not breach its covenants and protect its investment. If the Sponsor did not invest additional cash into the vehicle, it would lead to an event of default prior to a situation of non-payment of the senior loan and put its junior note at risk.	Condition met: Whilst there is a right for the Sponsor to contribute additional cash or assets to the vehicle, there is no contractual obligation for the sponsor to inject additional junior debt and so the only cash flows may only be those generated by the issuer.
Other considerations	We understood the CLI criteria to be more aimed at public securitisations with many debt tranches than these bilateral senior loan structures. Public securitisations generally have 3+ tranches and do not include rights for the sponsor/junior tranche holder to contribute additional cash flows or assets into the vehicle at a future date. If this is CLI it is unclear what structure would meet the NRF definition as NRF's function in the same manner.	

Impact of decision: CLI more operational effort and more likely to fail SPPI (especially if non financial underlyings).

Example 3: Real Estate Financing with senior loan and sponsor investment as subordinated debt



Structure Description

- Variant on example 2 – but the tranching of the debt instruments is via different mechanism and the underlying is not a financial asset but property on lease.
- SPE purchases a property asset for E100m which is subject to a lease which generates cash inflows.
- The funding for the purchase comes from 2 main instruments into the SPE – senior debt and junior debt. There is also a small injection of cash via equity.
- The sponsors investment into the structure is predominantly via a junior debt instrument (shareholder loan) to SPE. The junior debt will have a high coupon ~15% payment in kind and be long dated maturity e.g. 20 years.
- Bank provides senior lending of 60m 3yr senior to SPE at L+3%. Non payment of interest results in EOD.
- The senior loan agreement has a waterfall for allocation of cash flows. Cash received from the rental agreements comes into a Collection Account. Cash from the collection account is first used to pay operating expenses of the property, then used to pay the interest and principal amortisation on the senior loan, any remaining cash is transferred to a General Account. If the loan is performing and no covenants have been breached then the sponsor can decide upon how cash in the General Account is allocated. They could use cash in the general account to make improvements in the property, pay amounts on the junior debt or pay dividends on the equity (subject to distribution restrictions e.g. Companies Act.) Payments on the junior debt are tax efficient.
- Additionally there is a subordination deed signed by the Sponsor which acknowledges that the junior debt is subordinate to the senior debt. The deed details when cash flows prior to default can be paid to the junior debt – ie from the General Account – it also details that the junior debt is subordinate to the senior debt in EOD. Additionally in an EOD the junior debt is assigned to the senior debt provider.
- There are covenants in the senior debt instrument whereby if the value of the property falls such that the Loan to Value (LTV) ratio increases to 70% then there is an Event of Default on the senior loan.
- The sponsor has the option to increase their junior debt so that LTV triggers are not met and an event of default is prevented (cure rights). Due to the substantial equity contribution and the LTV trigger levels it is economically rational for the sponsor to do this except in the rare situation of a large and sudden fall in collateral value (gap risk event).
- There is no recourse for the senior debt to the sponsor.

Important: These summarised examples are provided to illustrate the accounting complexity associated with the definition of CLI/NRF. They do not provide guidance on how to structure / execute such lending relationships.

Example 3: Real Estate Financing with senior loan and sponsor investment as subordinated debt

Accounting Analysis:

- The CLI definition is not clear and there is no application guidance. Different conclusions could be reached as to whether the structure is an NRF or CLI

CLI Definition	Arguments for NRF	Arguments for CLI
Issuer may prioritise payments to the holder using multiple contractually linked instruments that create concentrations of credit risk	Condition not met: Whilst there are 2 instruments which meet the financial liability definition in IAS 32 – the junior instrument is 'in substance' equity. Additionally, the sponsor consolidates the SPE and so there is only 1 tranche of debt external to the group.	Condition met: There are 2 (i.e. multiple) instruments which meet the definition of IAS 32 liability i.e. the senior debt and the junior debt.
Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche	Condition not met – the waterfall in the senior agreement does not mention the junior debt. Additionally since the facility agreement allows maintenance expenses to be made and also the sponsor can decide on cash flow allocations from the General Account then not ALL cash flows generated by the issuer are allocated between the "tranches"	Condition met – the waterfall in the senior agreement and the subordination deed means that cash flows cannot be paid on the junior debt until the senior loan is paid. Additionally the junior loan is subordinate on default.
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	Condition not met: As the holder of the senior loan may benefit from additional cash flows not initially included in the entity and therefore not generated by the entity, this criteria has not been met. The right to increase the amount invested in the junior loan is a feature akin to a NRF transaction. Although the right is not an obligation, loan covenants are structured with defined LTV trigger levels that make it economically rational for the sponsor to inject more cash in the vehicle to not breach its covenants and protect its investment. If the Sponsor did not invest additional cash into the vehicle, it would lead to an event of default prior to a situation of non-payment of the senior loan and put its junior note at risk.	Condition met: Whilst there is a right for the Sponsor to contribute additional cash or assets to the vehicle, there is no contractual obligation for the sponsor to inject additional junior debt and so the only cash flows may only be those generated by the issuer. The junior loan only gets cash flows once the senior loan is repaid.
Other considerations	We understood the CLI criteria to be more aimed at public securitisations with many debt tranches than these bilateral senior loan structures. Public securitisations generally have 3+ tranches and do not include rights for the sponsor/junior tranche holder to contribute additional cash flows or assets into the vehicle at a future date. If this is CLI it is unclear what structure would meet the NRF definition as NRF's function in the exact same manner.	

Impact of decision: CLI more operational effort and more likely to fail SPPI (especially if non financial underlyings).