EFRAG Secretariat: Sergey Vinogradov, Galina Borisova, Didrik Thrane-Nielsen

Amendments to the Classification and Measurement of Financial Instruments - Feedback analysis – Financial assets with non-recourse features and contractually linked instruments

Objective

1 The objective of this paper is to provide the EFRAG FR TEG with a summary of the feedback analysis on financial assets with non-recourse features and contractually linked instruments performed by the IASB staff and the IASB staff proposals to address the respondents' concerns.

Summary of the IASB staff recommendations

2 The IASB staff recommends **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.

Structure of this paper

3 The background for and the proposals in the ED are summarised in paragraph 9 and 10.

4 Constituents feedback is summarised in paragraph 11 to 20.

5 IASB staff analysis of the feedback is summarised in paragraph 21 to 43.

6 IASB discussion on 23 January 2024 is summarised in paragraph 44 to 48.

7 EFRAG Secretariat assessment of the IASB staff analysis and IASB discussion is provided in paragraph 49 to 54.

8 Questions to EFRAG FR TEG are presented in paragraph 55 and 56.

Background and proposals in the ED

9 In response to the feedback received relating to non-recourse features as part of the 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).

10 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).

Detailed feedback analysis

Financial assets with non-recourse features

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

11 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.

12 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.

13 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, 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.

14 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.

15 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 (eg., paragraphs BC75, BC76 and BC77).

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

16 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 SPPI cash flows.

Contractually linked instruments (CLIs)

Scope (B4.1.20 of the ED)

17 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 into the main text of IFRS 9 (ie., if the underlying pool performs poorly, insufficient cash flows from the underlying pool of financial assets to make payments of interest and principal on the tranches according to their place in the waterfall payment structure do not trigger a default of the issuer, but rather reduce the contractual rights of the holders of the affected tranches to receive cash flows, and this feature distinguishes a CLI structure from other forms of subordination); 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)

18 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)

19 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 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 further explanations 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

20 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.

IASB staff analysis

Financial assets with non-recourse features

21 The IASB staff acknowledges respondents' concerns 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 and also, 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.

22 In the IASB staff view, 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.

23 With regards to questions raised by respondents in paragraph 14 of this paper, the IASB staff is of the view that the Standard and the proposed amendments are clear that non-recourse features are contractual, rather than structural, i.e. 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.

24 In the IASB staff view, the proposed amendments in the ED aimed to clarify the underlying principles and are consistent with the IASB's original intention with regards to non-recourse features (paragraphs B4.1.16 and B4.1.17 of IFRS 9). The IASB staff therefore does not recommend making fundamental changes to the clarifications proposed in the ED. However, to clarify the amendments and minimise the risk of unintended consequences, **the amendments could be refined by removing the reference to 'throughout the life of the instrument' in paragraph B4.1.16A of the ED**.

25 The IASB staff remains 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 in paragraph B4.1.17 of IFRS 9. However, the IASB staff acknowledges that the wording could be improved so as not to create a perceived inconsistency with the discussion in paragraph 23 of this paper. The IASB staff therefore recommends **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.

26 In response to the request to ask further illustrative examples, the IASB staff is of the view that the IASB's intention was not to provide comprehensive examples to consider when doing a look through assessment. In their view, 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)

27 The IASB staff notes that most respondents agreed with the IASB's approach to clarify the scope of the transactions to which the CLI requirements is applied,

notably 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 (which was a concern of the PIR participants as summarised in paragraph 82 of the ED).

28 Some respondents commented 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 in addition to, or instead of, the CLI requirements. The IASB staff notes 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.

29 With regard to the request in paragraph 18(b) the IASB staff is 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.'

30 The IASB staff agrees 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)

31 The IASB staff explains that some lending transactions may contain multiple debt instruments, which do not constitute CLIs. Typically, in these lending transactions, an SPE is established to obtain a loan, while specified assets are transferred to the SPE to ringfence those assets as collateral on a loan provided by the creditor. The debtor holds a remaining portion of the SPE's assets with a higher risk than the creditor by either holding an equity instrument or a debt instrument that is subordinated to the loan from the creditor (e.g., a junior instrument). In this structure, the purpose of the debtor is to provide a credit protection to the creditor rather than to obtain higher returns than the creditor in exchange for investment in tranches with higher level of risks.

32 The IASB staff acknowledges respondents concerns about potential structuring opportunities to avoid the application of the CLI requirements, e.g. by selling the junior instrument subsequent to initial recognition whilst the SPPI assessment (including CLI requirements) is only performed at initial recognition. In the view of the IASB staff, 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.

33 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 IASB staff is 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.

34 The IASB staff acknowledges 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**.

35 The IASB staff also acknowledges respondents' comment in paragraph 18(a) with regards to **holding the senior debt instrument by a syndication of lenders**, and notes that this **clarification could be made through refining the drafting of the final amendments**.

36 The IASB staff is 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)

37 With regards to the comment in paragraph 19(b) the IASB staff does not consider it necessary to further define 'lease receivables' because (a) similar references already exist in paragraph 2.1(b)(i) of IFRS 9; and (b) 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.

38 The IASB staff believes that the assessment of 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, including those subject to residual value risk or exposed to variable lease payments. Thus, the IASB staff believes that additional guidance or illustrative examples are not necessary.

39 Contrary to concerns of some respondents, in the view of the IASB staff, 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 concern could be resolved by refining the wording of the proposals.

Other comments

40 In the view of the IASB staff, 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 IASB staff thinks the phrase 'contractually linked' is self-explanatory and requires no further clarification.

41 The IASB staff notes that the scope of the CLI requirements could be clarified by analysing the similarities and differences between CLIs and other similar structure (i.e. 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. No further clarifications are considered necessary.

42 With regards to the issue in paragraph 20(c), the IASB staff agrees with the IASB's conclusion that the economic substance of financial assets with non-recourse features and CLIs are significantly different. 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.

43 With regards to the issue in paragraph 20(b), the IASB 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, the IASB staff thinks that 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.

The IASB members discussion

44 The IASB discussed the feedback and the IASB staff proposals at its January meeting. Members generally expressed support for the direction of travel and the IASB staff proposals.

45 Several members proposed that some reasoning in the IASB staff paper (notably, the explanations in paragraphs 38 and 42) is included in the Basis for conclusion. The IASB staff agreed.

46 One member proposed to refine the wording that the junior debt instrument is held by the debtor throughout the life of the instrument noting that, in practice, in some extreme cases the instrument may be allowed to be sold, replaced etc. The IASB staff agreed (a wording that it would be impossible to sell the asset without triggering the repayment of the liability).

47 **The IASB tentatively decided to finalise the proposed amendments in the Exposure Draft**, subject to:

(a) requiring, in relation to paragraph B4.1.20A of the Exposure Draft, 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 clarify the proposed amendments.

48 **All 14 IASB members agreed with this decision**.

The EFRAG Secretariat assessment

Financial assets with non-recourse features

49 The EFRAG Secretariat agrees with the IASB staff recommendations as they are generally in line with the EFRAG recommendations in our comment letter and will clarify for preparers and users of financial statements the meaning of the term 'non-recourse' and provide further guidance as to what to consider when assessing the contractual cash flow characteristics of financial assets with non-recourse features.

50 The EFRAG Secretariat notes some possible wording refinements (eg., deleting the reference to "equity instruments" in paragraph B4.1.17A(b) of the ED as equity instruments do not create a shortfall and thus do not have the ability to absorb any shortfall in cash flows generated by the underlying assets).

Contractually linked instruments

51 The EFRAG Secretariat agrees with the IASB staff recommendations with regards to the clarifications proposed by the IASB in paragraph B.4.1.20 of IFRS 9 to the definition of contractually linked instruments, as they are generally in line with the EFRAG recommendations in its comment letter. EFRAG notes that these proposed amendments help to clarify the scope of transactions to which the CLI requirement applies and the distinction between CLI transactions and financial assets with non-recourse features.

52 The EFRAG Secretariat refers to the concerns described in paragraphs 17 (a) and (b) and notes that the wording could be refined to address those concerns.

53 The EFRAG Secretariat welcomes the proposed clarifications in paragraph B4.1.20A of the ED that such transactions do not contain multiple contractually linked instruments. The EFRAG Secretariat agrees that further proposed wording refinements would be helpful, notably those described in paragraphs 34, 35, 36 and 46.

54 Finally, the EFRAG Secretariat welcomes the clarification in paragraph B4.1.23 of IFRS 9 that the reference to instruments in the underlying pool can include financial instruments that are not within the scope of the classification requirements of IFRS 9.

Questions for EFRAG FR TEG

55 Does EFRAG FR TEG have any comments on the IASB staff proposed clarifications concerning financial assets with non-recourse features?

56 Does EFRAG FR TEG have any comments on the IASB staff proposed clarifications concerning contractually linked instruments?