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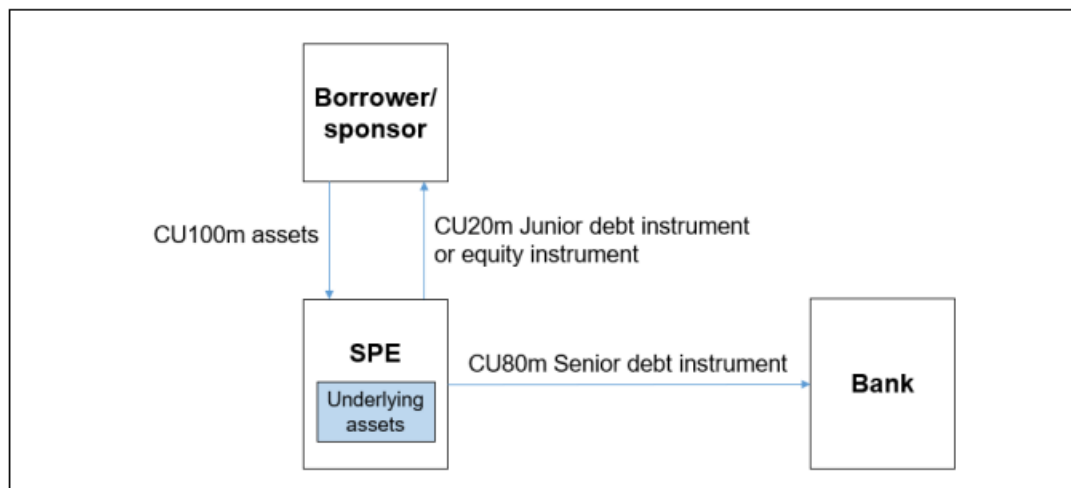
Amendments to Classification and Measurement of Financial Instruments – Contractually Linked Instruments sweep issue Issues Paper

Objective

- 1 To seek views of EFRAG FR TEG on the sweep issue and the IASB recommendations in respect of contractually linked instruments ('CLI').

The description of the issue

- 2 Subsequent to the IASB tentative agenda decision on the CLI instruments in September 2022 ([AP 16B](#)), a few stakeholders asked how the non-recourse and CLI requirements are applied when there are only two debt instruments and the borrower/sponsor of a special purpose entity (SPE) holds the junior debt instrument.
- 3 The following structure for secured lending arrangement was considered:



- 4 The stakeholders were concerned that if the sponsor's investment in the SPE is in the form of a debt instrument, the structure might be considered a CLI because the structure seemingly has the unique CLI characteristics as per IASB tentative decision¹:

¹ The unique characteristics of a CLI structure are:

- (a) the use of multiple contractually linked instruments;
- (b) with non-recourse features;
- (c) that establishes the prioritisation of payments through a waterfall payment structure; and
- (d) creates concentrations of credit risk resulting in a disproportionate allocation of losses between investors in the event of cash flow shortfalls.

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- (a) the senior and junior debt instruments are issued by the SPE and therefore the structure appears to make use of multiple (i.e., more than one) contractually linked instruments;
 - (b) the debt instruments may have non-recourse features depending on the contractual terms; and
 - (c) there might be a waterfall structure for the payment of contractual cash flows resulting in the junior debt instrument absorbing the first losses from the underlying assets, thereby providing credit protection to the senior debt instrument. In other words, the structure may be considered to create a concentration of credit risk.
- 5 If the structure is considered a CLI, the senior and junior debt instruments would not have contractual cash flows that are SPPI if the underlying assets include instruments that do not have SPPI cash flows (paragraph B4.1.23 of IFRS 9). For example if the underlying assets are not financial assets.
- 6 The IASB staff believes that these types of lending arrangements are distinct from investments in CLIs, because the holder of the junior debt instrument (i.e., the sponsor) is not an investor in the structure or the underlying assets that is willing to take higher risks in exchange for the higher returns than the senior debt instrument. Instead, the sponsor of the SPE can be regarded as the ultimate counterparty to the lending bank since the terms and conditions of the lending arrangement, including the creation of the SPE, would have been negotiated between the sponsor and the bank. From the sponsor's perspective, the SPE will be consolidated, resulting in the junior debt instrument being eliminated and the financing provided by the bank as the only debt instrument outstanding. The IASB staff therefore believe that the debt instrument held by the sponsor does not constitute a separate debt instrument or 'tranche' when assessing whether a particular structure is within the scope of the CLI requirements.
- 7 Therefore, the IASB staff recommend clarifying that when determining whether a transaction is in the scope of the CLI requirements, an entity excludes any instruments held by the sponsor that has transferred the underlying assets to the issuer.

IASB discussions

- 8 All 11 IASB members agreed with the IASB staff's recommendations. During the discussions it was clarified that:
- (a) the IASB Staff plans to include all the clarification relating to the scope of the CLIs requirements in Appendix B Application guidance;
 - (b) the term 'sponsor' will not be used in the final drafting of the Exposure Draft.

Background of the EFRAG discussions

- 9 EFRAG FIWG discussed this topic during its meeting on 22 November 2022. Members generally welcomed the proposed clarifications for the scope of the contractually linked instruments (CLIs) and agreed with the analysis of the IASB staff.
- 10 Some members expressed concerns about the real benefits of the proposed clarifications, considering that in general such structures are tailored to avoid the consolidation of the special purpose entity (SPE) by the borrower / sponsor.
- 11 It was also noted that the link established by the IASB staff between the application of the CLI requirements and the sponsor's consolidation of the SPE could lead to application issues. The conclusion whether or not the SPE is consolidated may depend on the interpretation of the consolidation criteria with particular reference to

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the analysis of the 'risk exposure' applied to the SPE's assets which in many cases constitutes an area of judgement. The final draft of the amendments would be important to clarify this aspect.

- 12 One member asked for further application guidelines on the situation where assets are not transferred directly from the sponsor to the SPE. Furthermore, it was noted that the term 'sponsor' could also be better clarified as it is not defined in IFRS 9.
- 13 EFRAG IAWG discussed this topic at its meeting on 24 November 2022. The update from this discussion will be provided to EFRAG FR TEG orally.

The EFRAG Secretariat analysis

- 14 The EFRAG Secretariat agrees with the IASB staff analysis that such types of lending arrangements with only two 'tranches' and the junior of which is eliminated on SPE consolidation do not represent CLI.

Questions for EFRAG FR TEG

- 15 Does EFRAG FR TEG agree with the clarification of the CLI requirements decided by the IASB?