IFRS 9: Classification of Limited Recourse Capital Notes by the Holder

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Under IFRS 9 *Financial Instruments,* holders of financial instruments should measure financial assets after initial recognition at:

(a) amortized cost;

(b) fair value through other comprehensive income (FVOCI); or

(c) fair value through profit or loss (FVTPL).

A financial asset is measured at amortized cost if both of the following conditions are met:

(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows; and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (SPPI).

Contractual cash flows that are SPPI are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest.

Contractual features that introduce exposure to risks or volatility in the contractual cash flows unrelated to a basic lending arrangement, such as exposure to changes in equity or commodity prices, do not give rise to contractual cash flows that are SPPI.

For financial assets where the contractual cash flows are not SPPI, instruments are required to be subsequently measured at FVTPL irrespective of the objective of the business model in which they are held (unless they represent investments in equity instruments, and qualify for and are elected to be measured at FVOCI).

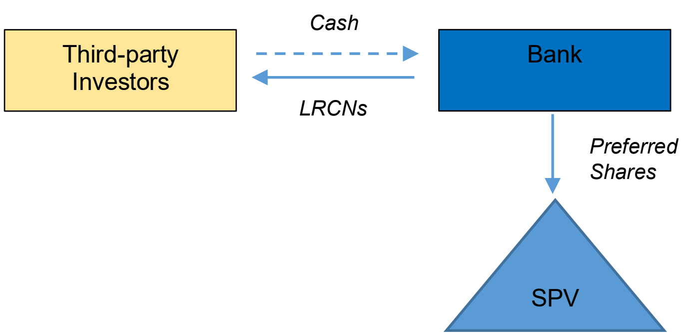
The Group considered the following fact pattern regarding Limited Recourse Capital Notes (LRCN) and discussed the application of the SPPI test to the LRCNs and their classification by the holder.

Fact Pattern

- LRCNs are a new form of financing issued by some financial institutions in Canada to institutional investors only. In July 2020, the Office of the Superintendent of Financial Institutions (OSFI)[1] released a Capital Ruling recognizing LRCN as Additional Tier 1 Capital.
- The LRCNs typically have two instruments:

1. A bond paying interest with a long maturity (typically 60 years); and
2. A perpetual non-cumulative preferred share ("preferred share") the financial institution issued into a special purpose vehicle (SPV) for the benefit of the LRCN holders. Preferred shares have the same terms as the bond except they do not have a maturity date.

The following figure illustrates the LRCN structure:



(Source: OSFI, "Capital Ruling," (July 2020))

- When any of the following recourse event occurs, the sole remedy of the holders of the LRCNs is the delivery of the preferred shares from the SPV in exchange for the LRCNs on a one-to-one basis:

(a) There is non-payment by the issuer of the principal amount of the LRCN, together with any accrued and unpaid interest, on the maturity date,

(b) A failed coupon payment occurs,

(c) In connection with the redemption of the LRCN, on the redemption date for such redemption, the issuer does not pay the applicable redemption price in cash, or

(d) When OSFI announces the issuer is, or is about to become, non-viable or if the federal or a provincial government publicly announces that the issuer has accepted, or agreed to accept, a capital injection, or equivalent support, to avoid non-viability (non-viable contingent capital (NVCC) trigger event).

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[1] OSFI is a Canadian independent federal government agency that regulates and supervises more than 400 federally regulated financial institutions and 1,200 pension plans to determine whether they are in sound financial condition and meet their requirements.

- Preferred shares are not redeemable at the option of holders and pay discretionary non-cumulative dividends. When a recourse event occurs that is also a NVCC trigger event, and the bonds are outstanding, then the preferred shares held by the SPV will be automatically converted into a variable number of common shares based on then trading price of the common shares subject to a floor price. The converted common shares will be automatically used to redeem the bonds of the holders.

Issue 1: Are the contractual cash flow from the LRCNs SPPI?

Analysis

- While the principal and interest payments of the bond component of LRCNs may appear to represent cash flows consistent with SPPI, the sole remedy of the non-payment is the delivery of the preferred shares from the SPV. Therefore, the principal and interest payments are not mandatory or legally enforceable because the Issuer can at its discretion convert the LRCNs into preferred shares instead of making interest or principal payments.

- In addition, LRCN holders should look through to the cash flows from the preferred shares to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. The dividends on the preferred shares are non-cumulative and are paid at the discretion of the Issuer's board. Furthermore, upon the NVCC trigger event, the holder will receive a variable number of common shares based on the then current trading price of the common shares subject to a floor price, which exposes the holder's return to variability in the price of the issuer's common shares.

- The discretionary dividends on the preferred shares and the exposure to risks or volatility through the conversion to preferred and common shares are characteristics that are not consistent with a basic lending arrangement. As a result, the contractual cash flows from the LRCNs are not SPPI.

The Group's Discussion

Group members agreed with the analysis.

Issue 2: Is the FVOCI election available to the LRCN holders?

Analysis

- To determine whether an instrument held is eligible for the FVOCI election, IFRS 9 requires the holder to consider whether the instrument qualifies as equity in its entirety when viewed using the principles of IAS 32 *Financial Instruments: Presentation*.

- The LRCNs are made up of two components: financial liability and equity. The financial liability component represents the delivery of variable number of shares in the case of a NVCC trigger event. Since the LRCNs are not equity instruments in their entirety, they should be measured at FVTPL in their entirely as the FVOCI election is not available to the holders.

The Group's Discussion

Most Group members agreed with the analysis. One Group member considered the LRCN to be economically similar to NVCC preferred shares and noted that the Group discussed the holder's accounting for these preferred shares at its November 2016 meeting. Like the NVCC preferred shares, this Group member noted that from the issuer's perspective the instrument is not equity in its entirety. As such, the FVOCI election is not available to the holders.

The Group's discussion raises awareness about the holder's accounting for the LRCNs. No further action was recommended to the AcSB.