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**International  
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*This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.*

*Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.*

## **INFORMATION FOR OBSERVERS**

**IFRIC meeting: March 2006, London**

**Project: More detailed analysis of the questions the IFRIC has been asked to consider in relation to derecognition of financial assets (Agenda Paper 11B)**

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## **Introduction**

1. The purpose of this document is provide a more detailed analysis of the questions the IFRIC have been asked to consider in relation to the derecognition model of IAS 39.
2. This paper follows-on from paper 11A, which provided an overview of the IAS 39 derecognition model and positioned the questions being asked within that model.
3. This paper is not intended to provide a complete analysis of the different questions. The staff will provide such analysis at later meetings.
4. The questions the IFRIC have been asked to consider can be broadly grouped as follows:
  - a. Topic 1: How do you apply the derecognition provisions of IAS 39 to groups of financial assets?
  - b. Topic 2: Transfers of financial assets within IAS 39.18(a) or IAS 39.18(b) – when does each apply?

## **Topic 1: How do you apply the derecognition provisions of IAS 39 to groups of financial assets?**

5. The questions within topic 1 relate initially to paragraph 16 of IAS 39 (i.e. what ‘similar’ means in the context of a group of assets). This is Step 2 in the Derecognition Flowchart presented in paper 11A. The answer to this question has knock-on effect on steps 5 and 6 – the pass through test and the risk and rewards test.
6. *Question 1: Is one derecognition test required, or are separate derecognition tests required, for transfers involving groups of financial assets - and the group of assets is made up of non-derivative financial assets and*
  - a. *Derivatives which will only represent a future financial asset, such mortgage indemnity guarantee and other purchased options, or*
  - b. *Derivatives which may, depending on the change in underlying variables, represent future financial assets and financial liabilities, such as interest rate swaps and forward exchange contracts (see Question 2).*
7. In securitisations and other similar transactions, an entity originates a portfolio of loans or other receivables and ‘sells’ them to an SPE or a third party buyer (such as a factor). The originating entity will often mitigate the risks of the loans using other contracts such as derivatives, insurance contracts and guarantees. When the loans are transferred, these related other contracts are also transferred.
8. Examples of such risk-mitigating other contracts are:
  - a. Derivatives such as interest rate swaps and currency swaps. For example, a bank may originate a portfolio of variable rate mortgages and enter into an interest rate swap to mitigate the resulting interest rate risk.
  - b. Credit insurance contracts/financial guarantees that are originated with the loans. For example, it is common in the UK for a bank that grants a mortgage with a loan-to-value ratio of higher than a set amount to require, as a condition of the mortgage, that the borrower takes out a ‘mortgage indemnity guarantee’ (MIG). The MIG is an

- insurance contract<sup>1</sup> with a third party which compensates the lender for any loss it incurs if the borrower defaults and the house on which the loan is secured is sold for less than the amount due.
- c. Credit insurance contracts/financial guarantees that are not originated with the loans. For example, a bank might purchase a separate financial guarantee of specified loans from a credit insurer.
9. The issue is about how transferring such other contracts affects whether the loans qualify for derecognition. The issue arises for both the pass through tests in IAS 39.19 (if applicable) and the risks and rewards test in IAS 39.21.
10. Take for example a mortgage indemnity guarantee (MIG) which is a condition of a mortgage contract and would guarantee overall payments on that specific mortgage. The implications of not bundling the MIG with the underlying receivable is that the IAS 39 derecognition provisions would be applied separately to the underlying receivable and the MIG. This may mean that the receivable qualifies for derecognition but the MIG derivative does not (or vice versa) or that both the MIG and the underlying receivables will fail the derecognition test.
11. Therefore it is necessary to understand to which groups of financial assets the derecognition provisions of IAS 39 apply. The relevant references in IAS 39 include:
- a. Paragraph 16 states that the derecognition provisions of IAS 39 should be applied to a part of a financial asset (or a part of a group of *similar* financial assets) or a financial asset (or a group of *similar* financial assets).
- b. Paragraph 16 reiterates this point by defining the term **financial asset** which is used throughout the derecognition provisions of IAS 39
- c. In paragraphs 17-26, the term '*financial asset*' refers to either a part of a financial asset (or a part of a group of *similar* financial assets)...or otherwise, a financial asset (or a group of *similar* financial assets) *in its entirety*'.

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<sup>1</sup>Mortgage indemnity guarantee contracts meets the definition of a financial asset but are outside the scope of IAS 39 as they qualify as financial guarantee contracts. Nevertheless they are mentioned in order to illustrate the most basic relationship between a portfolio of financial assets and hedging derivatives/ insurance. Also IFRS 4 does not contain derecognition provisions for assets and presumably an entity could choose to apply the derecognition provisions in IAS 39 to such instruments in terms of IAS 8 Par 11 (a). An application of IAS 8 Par 11 might indicate that the similar guidance in IAS 39 should be followed in the absence of derecognition provisions in IFRS 4.

- d. Paragraph 19 then defines the term **original asset** in terms of **financial assets** as follows ‘When an entity retains the contractual rights to receive the cash flows of a **financial asset (the ‘original asset’)**....’. Therefore, working backwards, ‘**original assets**’ refers to financial assets, or financial assets or parts of financial assets which are *similar* in nature.

*Impact on pass-through test*

12. If an entity wishes to derecognise a group of financial assets under a pass through transaction in terms of Par 19(a) then the entity should have **no obligation** to pay amounts to the eventual recipients unless it collects equivalent amounts from the **original asset**. This raises the potential problem that if a bundle of derivatives and non-derivatives require independent, separate derecognition tests, that the entity may have **an obligation** (which may be interpreted broadly or narrowly) with respect to other financial instruments in the independent, separate derecognition tests.
13. Therefore it could be argued, that based on the current wording of IAS 39, if two derecognition tests are required the entity would automatically fail the pass through requirements in both separate tests i.e. it is only when both financial instruments are grouped together that the entity would have **no obligation** to pay amounts to the eventual recipients unless equivalent amounts are collected from the **original asset**.

*Impact on risks and rewards test*

14. The question of separate derecognition tests or one derecognition test for groups of derivatives and non-derivatives also has an impact on the risks and rewards test in IAS 39.
15. Paragraph 21 states that the transfer of risks and rewards is evaluated by comparing the entity’s exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset.
16. Assuming that a derivative included in a group of financial assets reduces variability in the amounts and timing of the transferred asset, then it may be that a group of financial assets will more likely pass the risks and rewards test if the derivative is not included in the group i.e. greater variability in the before exposure and less variability in the after exposure<sup>2</sup>.

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<sup>2</sup> The counter-argument states that in the risks and rewards test it is necessary to include in the before and after scenario cash flows only of the derecognised financial asset i.e. if the derivative is excluded in the before analysis, then it should also be excluded in the after analysis. What is less clear is whether

17. Possible views that could be taken in relation to this issue include:
- a. Derivatives can never be similar to non-derivatives and therefore separate derecognition tests are always required,
  - b. Only derivatives which are financial assets can be included in a group with non-derivative financial assets when performing the IAS 39 derecognition test,
  - c. Any derivative can be included in a portfolio of non-derivatives so long as the overall portfolio represents a financial asset,
  - d. In order to make the derecognition provisions operational non-similar financial assets should be grouped together in assessing the pass through test (for example where cash flows are grouped together and passed on) and the risks and rewards test (where the risks and rewards are linked) based on the economics in a particular transaction. For example, if the obligation is to pass on cash collected from both loans and a related third party credit guarantee, the original asset is the combination of the loans and the credit guarantee.
18. ***Question 2: When an entity applies IAS 39 to the derecognition of derivatives that could either be assets or liabilities (e.g. swaps) in the future, is the entity required to apply both the asset and liability derecognition requirements, or only the asset (or liability) derecognition requirements, of IAS 39?***
19. Some derivatives may, depending on the movements in an underlying variable, represent a future financial asset and financial liability. Frequently such derivatives have a value of zero when initially recognised and would presumably not be considered to be either financial assets or financial liabilities.
20. IAS 39 contains different provisions for derecognising financial assets than for derecognising financial liabilities.

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this principle would be applied to the before and after scenario, for example in the separate financial statements, where the eventual recipient enters the same derivative and passes net cash flows back to the entity i.e. in this case the entity would presumably include the net cash flows in the after scenario. This illustrates part of the difficulty, which will be discussed in future papers, associated with applying a risks and rewards analysis to only part of a group of a financial assets.

21. Financial assets may qualify for derecognition where contractual rights to cash flows are *transferred*.
22. Financial liabilities can only be derecognised on extinguishment (IAS 39 Par 39).
23. Hence, if an entity is required to apply both the financial asset and financial liability provisions to such instruments, it will mean that such derivatives will only qualify for derecognition when the contractual rights and obligations to the derivative are extinguished.
24. Possible approaches to this question include:
- a. As the derivative may be a financial asset or a financial liability both the financial asset and the financial liability derecognition tests are applicable.
  - b. IAS 39 does not require application of both derecognition tests to a single financial instrument as the provisions of IAS 39 focus on whether the instrument is a financial asset or financial liability only at the time of derecognition.
  - c. Such derivatives should not be eligible for the pass through test (because it is not clear whether the counterparty to the derivative qualifies as an ‘eventual recipient’ when the derivative counterparty is paid from proceeds on the group of assets), but may be derecognised under the other tests for derecognising financial assets assuming that the derivative is a financial asset at the time of the derecognition transaction.

## **Topic 2: Transfers of financial assets within IAS 39.18(a) or IAS 39.18(b) – when does each apply?**

25. Paragraph 18 of IAS 39 is referred to as steps 4-5 in the Derecognition Flowchart presented in paper 11A. This paragraph sets out the two types of transfers to which the subsequent steps in the derecognition model can then be applied.
26. *Question 3: Can a transfer qualify under IAS 39 Par 18(a) if the debtor is not notified that the transferor has entered a contract in which it is agreed that all cash flows that are collected are contractually payable to a new eventual recipient i.e. the debtor continues to pay the transferor while the transferor loses the right to retain any cash collected from the debtor?*

27. If such a transfer does not meet the requirements of a transfer in IAS 39 Par 18(a) then it would have to meet the pass-through requirements in IAS 39 Par 19 to be considered further for derecognition.
28. Circumstances in which the underlying debtor is not notified of the transaction (with the result that the debtor continues to pay the seller, who then acts as servicer) include:
- a. The buyer of the receivable is given details about the underlying receivables (amount, identity of the debtor etc), but the underlying debtor is not notified of the transaction in order to preserve a customer relationship.
  - b. The buyer is not given details about the underlying receivables (for example, because of local banking secrecy laws). However, the transaction includes a third party ‘data trustee’ who is given these details and whose role is to ensure that cash collected is passed to the buyer and the servicing is carried out as specified in the contract.
  - c. There is no legal transfer to the buyer until a pre-specified event occurs, such as the bankruptcy of the seller or the servicer. Until such bankruptcy occurs the ‘buyer’ cannot enforce payment against the debtor (and may not even know the identity of the debtor).
29. In September 2005, the IFRIC Update contained the following wording:

*The IFRIC was asked to provide guidance on whether an arrangement under which an entity has transferred the contractual rights to receive the cash flows of a financial asset but continues to provide servicing on the transferred asset would fail the definition of a transfer of cash flows in terms of IAS 39 paragraph 18(a).*

*The IFRIC noted that paragraph 18(a) focuses on whether an entity transfers the contractual rights to receive the cash flows from a financial asset. The determination of whether the contractual rights to cash flows have been transferred is not affected by the transferor retaining the role of an agent to administer collection and distribution of cash flows. Therefore, retention of servicing rights by the entity transferring the financial asset does not in itself cause the transfer to fail the requirements in paragraph 18 (a) of IAS 39. [The IFRIC decided] not to add the issue to its agenda as it did not expect significant diversity in practice to arise.*

30. An argument in favour of accounting for transfers where debtors are not notified of the new eventual recipient under IAS 39 Par 18(a) is that the focus in IAS 39 Par 18(a) is on the contractual rights to cash flows and not on the overall contractual rights to the financial asset. In this case the transferor operates in a capacity as an agent/servicer, which has been previously agreed in the IFRIC Update not to preclude the transfer qualifying under 18(a).
31. An argument against accounting for transfers under IAS 39 Par 18(a) where debtors are not notified of the transfer is that the focus in IAS 39 Par 18(a) is on the contractual rights to cash flows with the debtor, which have not changed as a result of the transfer. In addition it could be argued that it is clear that IAS 39 Par 18(b) is applicable because the entity retains a contractual obligation to pay cash flows to one or more recipients in the arrangement.
32. ***Question 4: What, if any, conditions are permitted to be included in a transfer of assets under paragraph 18(a)?***
33. Conditions which may exist in a transfer of assets include:
- a) Normal warranties as to the condition of the asset at the date of transfer, rather than to its future performance (e.g. that the counterparty is X, that the loan has a specified maturity, interest rate etc, is backed by specified collateral, is not in arrears at the date of transfer etc).
  - b) For trade receivables, warranties covering credit notes issued because the goods delivered that gave rise to the receivable were faulty or because there was a mistake in the original invoice. (Some see these as an example of (a)).
  - c) For trade receivables, guarantees covering volume discounts which, if met, are offset against the receivables balance at (say) the end of the year.
  - d) For trade receivables, guarantees covering credit notes issued at the discretion of the seller (e.g. as a goodwill gesture in the case of disputes).
  - e) Other guarantees covering the existence and the accuracy of the amount of the receivable (e.g. a tax receivable transferred to a bank where the bank is indemnified for any loss incurred if the amount of the receivable is decreased by the Tax Authorities<sup>3</sup>, or

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<sup>3</sup> We appreciate that tax receivables are not in the scope of IAS 39, but have included this example illustrate the point.

guarantees of documentation risk, i.e. the risk that the debtor cannot be made to pay because of mistakes in the documentation that established the receivable).

- f) Guarantees covering future performance that might invalidate the receivable, e.g. in a long term contract where past work has been invoiced, but failure to complete the next stage to defined standards could result in a reduction in the receivable; or assets/goods have been delivered and invoiced, but failure to perform future maintenance could result in a reduction of the receivable.
- g) Guarantees covering changes in tax, legal or regulatory requirements. These may take the form of either the transaction being 'reversed' in the event of such changes, or additional payments being made to cover any increased costs of the buyer that result from such changes.
- h) Guarantees covering future default/late payment/ credit downgrade of the debtor.
- i) Offset arrangements where the original debtor has the right to offset amounts that it owes to 'seller' against its receivables from seller, with the seller compensating the buyer if such offset occurs.
- j) Offset arrangements where a third party (e.g. a sub-contractor) has the right to offset amounts it is owed by the 'seller' against the receivable (even though the receivable is to the seller and not to the sub-contractor), with the seller compensating the buyer if such offset occurs.

34. The following categorisation of the conditions may be useful:

- a. Conditions relating to the asset at the time of the transfer (e.g. a guarantee that the financial asset existed at the time of sale and was a valid claim on the debtor),
- b. Conditions relating to the performance of the asset after the time of transfer,
- c. 2-Party offset agreements, and
- d. 3-Party offset agreements.

35. Principles which could be used to determine whether a transfer falls within IAS 39 Par 18 include:

- a. Can the transferee force the debtor to pay?

- b. Has the seller lost the contractual right to receive the cash flows from the debtor (other than in a capacity as servicer/agent for the transferee)?
- c. Has there been a 'true sale' at law, such that if the seller becomes bankrupt, the asset would not be available to pay its creditors?
- d. Is there an unconditional transfer of contractual rights, such that the transfer is not dependent on any conditions being met? For example, assume that the seller transfers (unconditionally) all of its contractual rights to receivables of 100, but those contractual rights are conditional on the quality of the goods sold that gave rise to the receivable. This would be viewed as a transfer of conditional rights and would not preclude 18(a). On the other hand, if the transfer of contractual rights itself is conditional – for example the 'buyer' can claim legal title only in the event of seller's default, or the transfer can be reversed for changes in tax or regulatory requirements – then, in this view, the rights have not been transferred and the entity should apply 18(b).
- e. Is paragraph 18(a) merely a short-cut way of identifying those transactions for which the pass-through tests need not be applied? Therefore, if the transfer would clearly pass the tests in IAS 39.19, it is in 18(a). Alternatively, if the transfer would not clearly pass the tests in IAS 39.19, it is in 18(b).
- f. Do any conditions relate solely to the existence or condition of the transferred asset at the time of sale (rather than to its future performance)?