



30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: <http://www.iasb.org>

**International
Accounting Standards
Board**

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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: May 2006, London

Project: IAS 39 *Financial Instruments: Recognition and Measurement* –
Securitisations: Derecognition of groups of financial assets
(Agenda Paper 6)

Introduction

1. At its March 2006 meeting, the IFRIC preliminarily concluded that one interpretation could be issued relating to the following two questions as summarised in the IFRIC Update:

The first issue was how the derecognition provisions of IAS 39 should be applied to groups of financial assets. The staff noted that, in practice, entities may transfer groups of financial assets which comprise non-derivative financial assets and derivatives. The staff noted that the key issue in this question was whether one derecognition test should be applied to such groups of financial assets, or whether separate derecognition tests should be applied (even though economically such groups of financial assets may be viewed as a single unit and cash flows from the financial instruments are grouped together).

The second issue was whether certain transfers of financial assets, as detailed below, should fall within paragraph 18(a) or paragraph 18(b) of IAS 39. IAS 39 differentiates two types of transfers: transfers of contractual rights to cash flows are set out in paragraph 18(a); and transfers in which the entity retains the contractual rights to cash flows and assumes a contractual obligation to pay cash flows to a recipient are set out in paragraph 18(b). If the transfer falls within

paragraph 18(b), all of the ‘pass through’ conditions set out in paragraph 19 must be met. The transfers at issue include those where an entity can contractually agree to pass on cash flows without notifying the debtor; and those in which an entity may transfer contractual rights to cash flows subject to certain conditions, eg (i) conditions relating to the existence and legal status of the asset at the time of the transfer, (ii) conditions relating to the performance of the asset after the time of transfer, and (iii) offset agreements. The question arose whether, in these cases, the ‘pass through’ provisions set out in paragraph 19 should be applied.

2. We wish to discuss the first question with the IFRIC in May.

Background

3. IAS 39 Par 16 (Step 2 in the Flowchart in the Appendix) states:

Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17–23, an entity determines whether those paragraphs 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) in its entirety, as follows.

- (a) *Paragraphs 17–23 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.*

.....

- (b) *In all other cases, paragraphs 17–23 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 17–23 are applied to the financial asset (or a group of similar financial assets) in its entirety.*

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) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety. (Emphasis added on groups of similar financial assets)

4. IAS 39 does not give guidance on:
 - a. What is a group of ‘similar financial assets’?
 - b. How the derecognition provision in IAS 39 Par 17 – 23 should be applied to transfers of groups of financial assets which are not considered similar?

Why is an interpretation required?

5. In securitisations and 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.
6. 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 contract¹ 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.
7. The issue is how transferring such other contracts affects whether the loans qualify for derecognition. The issue arises for both the risks and rewards test in IAS 39.21 and the pass through tests in IAS 39.19 (if applicable).
8. Take, for example, a MIG which is a condition for granting a mortgage contract and guarantees overall payments on that specific mortgage. If the mortgage and the MIG

¹Mortgage indemnity guarantee contracts and other credit insurance contracts may meet 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 financial 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).

are not considered ‘similar’, then the derecognition test should be applied separately to the individual financial assets. Conversely if the mortgage and the MIG are considered ‘similar’, then the derecognition provisions are applied to the group of assets which comprise the MIG and the mortgage. If the derecognition test is applied separately to the individual financial assets it may mean that either the MIG or the mortgage do not qualify for derecognition, or that both assets automatically do not qualify.

Objective of this paper

9. The objective of this paper is to present chapter outlines for the following Interpretation Options:

- a. Option A: Apply separate derecognition tests to non-similar financial assets which are transferred in the same arrangement.
- b. Option B: Apply single derecognition tests to entire groups of financial assets which are transferred in the same arrangement.
- c. Option C: Par 16 of IAS 39 should be applied to determining whether the derecognition provisions are applicable to a portion of the asset, or to a portion of a group of similar assets, transferred in their entirety. The derecognition provisions of IAS 39 should be judgementally applied to the assets identified in Par 16 individually or on a combined basis.

Question for the IFRIC

Does the IFRIC believe that Option A, Option B, Option C or another Option is the correct basis for interpretation?

Scope

10. The proposed interpretation considers the application of the derecognition provisions in IAS 39 Par 17 – Par 23 to transfers of groups of financial assets. Alternatively, the scope could be that the interpretation considers the application of the derecognition provisions in IAS 39 Par 17 – Par 23 to transfers of groups of financial assets which contain derivatives and non-derivatives.

11. The proposed interpretation does not address how the derecognition provisions are applied to individual assets, except to the extent to which they impact the derecognition of a group of assets.
12. We have not been asked to consider the derecognition implications for transfers of groups of financial assets relating to Control or Continuing Involvement (see IAS 39 Par 20 (c)).

Staff view

13. In the staff opinion, all Options contain interpretational challenge.
14. The weakness of Option A is that it is not clear how to apply the derecognition test, and in particular the risks and rewards test, to the individual components of assets which are transferred in the same arrangement.
15. The weakness of Option B is in developing a definition for ‘groups of similar financial assets’, and in particular whether a liability could be included in a group of ‘similar financial assets’ - which would be inconsistent with the wording in IAS 39.
16. The weakness of Option C is that different groups of financial assets are considered in the same derecognition test, which is inconsistent with the wording in IAS 39.
17. The staff consider that Option A represents the most promising approach. If the IFRIC agrees, the staff will do further research on Option A.

Option A: Apply separate derecognition tests to non-similar financial assets which are transferred in the same arrangement

18. The staff considers that such an interpretation could contain the following outline
 - a. Definition of ‘similar asset’
 - b. Application of a separate risks and rewards tests to groups of non-similar financial assets
 - c. Application of separate pass through tests to groups of non-similar financial assets

Definition of 'similar asset'

19. Option A requires that 'groups of similar financial assets' means that each asset in the group is individually sufficiently similar. Therefore assets would not be considered similar simply because they are grouped in the same transfer (which is discussed in Option B).

20. The Compact Oxford Dictionary defines 'similar' as follows:

Similar. adjective 1 of the same kind in appearance, character, or quantity, without being identical. 2 (of geometrical figures) having the same angles and proportions, though of different sizes.

21. Of 'appearance', 'character' or 'quantity' financial assets should have the same characteristics to be considered 'similar'.

22. IAS 39 Par 83 states that:

Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. (Emphasis added)

23. This paragraph indicates that similar assets or similar liabilities should individually be similar with respect to risk exposure (such as changes in fair value for the purposes of grouping assets for hedge accounting).

24. In order for assets or liabilities to be similar they do not need to be identical. However, derivatives normally have the opposite risk exposure when compared individually to other non-derivative financial assets included in the same transfer. Also, beyond a common 'hedged risk', the entity is exposed to different risks. The staff do not consider that the entity's exposure to risks on derivatives and non-derivatives would normally individually be considered similar.

Use of the word 'Similar' in other IFRS'

25. Under International Financial Reporting Standards the word 'similar' has been used in the following contexts:

- IAS 36 Par 127 & IAS 38 Par 73 defines a class of assets to be a grouping of assets of **similar nature** and **use** in an entity's operations.
- IAS 18 Par 12 states that revenue is not generated when goods or services are exchanged or swapped for goods or services that are of a **similar nature** and **value**.
- IAS 14 Par 36 (b) states that two or more business segments or geographical segments are **similar** if they share a **majority of the factors** in the definition in IAS 14 Par 9.
- IAS 36 Par A6 states that the characteristics of another asset's cash flows must be **similar** to those of the asset being measured, if it is used in the impairment test. The asset should have **similar cash flow characteristics** (for example, are both sets contractual cash flows, or is one contractual and the other an estimated cash flow), and behave (ie vary) in a **similar** fashion in **changing economic conditions**.
- IAS 2 Par 29 states that in some circumstances it may be appropriate to group **similar** or related items for write-downs. For this purpose items of inventory relating to the same product line that have **similar** purposes or end uses, are produced and marketed in the same geographical area, and **cannot be practicably evaluated separately from other items in that product line**.
- IAS 8 Par 13 states that an entity shall select and apply its accounting policies consistently for **similar** transactions, other events and conditions, unless a Standard or an Interpretation specifically requires or permits categorisation of items for which different policies may be appropriate. It is clear that alternative accounting treatments are available to derivatives and non-derivatives in terms of IAS 39.

- IAS 1 Par 29 states that each material class of **similar** items shall be presented separately in the financial statements. IAS 32 Par 55 states that in general, classes distinguish items measured at cost or amortised cost from items measured at fair value.

26. Based on these excerpts it would appear that derivatives are not similar to non-derivatives in the following respects:

- a. Similar nature.
- b. Similar use.
- c. Similar value.
- d. Similar cash flow characteristics.

27. Alternatively IFRIC may consider that certain derivatives, based on their nature or use, are similar to non-derivatives such as:

- a. Derivative contracts that are originated as a condition of the non-derivative financial asset (see example of the MIG in paragraph 8 above).
- b. Derivative contracts whose terms link them to the non-derivative financial assets.

28. For the remainder of Option A we assume that derivatives are not similar to non-derivatives. This means that the derecognition tests in IAS 39 Par 17 - 23 are applied separately to derivatives and non-derivatives in a group of financial assets which are transferred in the same arrangement. Option B considers a wider definition of 'similar'.

Application of a separate risks and rewards tests to groups of non-similar financial assets (Step 6 and Step 7 of the Flowchart)

29. IAS 39 Par 20 states that when an entity transfers a financial asset (see paragraph 18) that it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset.

30. IAS 39 21 states:

The transfer of risks and rewards (see paragraph 20) 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. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (eg because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (eg because the entity has sold a financial asset subject only to an option to buy it back at its fair value at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 19). (Emphasis added)

31. IAS 39 Par 16² makes it clear that the term 'financial asset' should be used consistently throughout IAS 39 Par 17- 23. Therefore the reference to 'financial asset' in IAS 39 Par 21 relates to groups of financial assets which are similar in nature. This means that the entity should separately compare for derivatives and non-derivatives 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.

Possible interpretation

32. In this section the staff propose principles for interpreting how the entity's overall exposure to risks and rewards on a transfer of financial assets can be allocated between the non-similar financial asset components. In the next section we will apply these principles to 3 progressively more difficult examples.

33. IAS 39 Par 22 states the following:

Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison is made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.

² IAS 39 Par 16 states: ...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) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

Interpretation: application of IAS 39 in individual risks and rewards tests of non-similar financial assets

Where an entity transfers a group of assets which are non-similar and where the entity is exposed after the transfer to net variability in cash flows on all the assets, then in the individual tests for risks and rewards the entity should allocate variability in cash flows between the non-similar financial assets on the following basis:

1. Only the entity's exposure to actual variability in cash flows should be considered.
2. Expected variability in cash flows should entirely be allocated between the non-similar financial assets.
3. Variability in the net cash flows should be allocated across the different groups of financial assets using all reasonably possible variability in net cash flows with greater weight given to those outcomes that are more likely to occur.

Example A: Offsetting risks in transferred asset: No variability in net cash flows on one financial asset

34. Option A requires separate tests for risks and reward for non-similar financial assets.

In this example we show how to allocate cash flows when after the transfer the entity continues to be exposed to risks and rewards on only a single financial asset in the transferred group.

35. **Example A:** Bank A owns a mortgage worth £100, and a mortgage guarantee on the same mortgage (referred to as the 'guarantee'). If the mortgage defaults then an insurance company would compensate Bank A for credit losses³. Bank A transfers the contractual rights to receive cash flows on both the mortgage and the mortgage indemnity guarantee to Company B. Furthermore, Bank A separately guarantees the first £2 of losses on the portfolio which may arise apart from credit losses (whether they arise on the mortgages or on non-performance under the guarantee). Assume

³ Financial guarantee contracts held are not within the scope of IAS 39 (see IAS 39 IN6). In the absence of derecognition provisions in another applicable Standard it would be acceptable to apply the derecognition provisions in IAS 39 in terms of IAS 8 Par 11 (a) to such financial guarantee contracts.

that credit losses represent substantially all the expected risks and rewards relating to the portfolio.

36. In Example A, the entity's exposure before the transfer on the separate guarantee and mortgage are observable. However after the transfer there is a single cash flow.
37. The third principles states that variability in the net cash flows should be allocated across the different groups of financial assets using all reasonably possible variability in net cash flows with greater weight given to those outcomes that are more likely to occur. In Example A the entity will has no exposure to variability in cash flows relating to credit losses after the transfer i.e. the entity does not have exposure to variability in cash flows after the transfer relating to guarantee. Therefore variability in net cash flows in Example A should be allocated entirely to the mortgages.
38. Therefore the mortgage and the guarantee would qualify for derecognition. The transfer of the guarantee qualifies for derecognition because Bank A is exposed to all risks and rewards on the guarantee before the transfer and no risks and rewards after the transfer. The transfer of the mortgages qualifies for derecognition because Bank A is exposed to all risks and rewards before the transfer and is not exposed to variability relating to credit losses after the transfer (in Example A credit losses represent substantially all the risks and rewards).
39. The alternative to performing separate tests of risks and rewards (as required in Option A) is to group both the mortgage and the guarantee and see them as one asset (this is discussed in Option B). Therefore if the risks and rewards test was applied to the group of assets then it likely that neither financial asset would qualify for derecognition i.e. on a group basis the entity has eliminated the exposure to credit losses both before and after the transfer. Therefore, assuming the £2 guarantee is sufficient to cover non-credit related risks on the portfolio, the entity would not have been considered to have transferred substantially all the risks and rewards relating to the portfolio. Arguably a weakness of grouping the assets is that either both assets are derecognised or both assets continue to be recognised, which does not reflect that separate financial assets were transferred.

Example B: Offsetting risks in transferred asset: Reasonably assessing probability of different outcomes

40. Option A requires separate tests for risks and reward for non-similar financial assets.

In this example we show how to allocate cash flows between non-similar financial assets by probability-weighting different outcomes where one scenario is highly likely.

41. **Example B:** Bank A owns a portfolio of amortising mortgages worth £100, and mortgage guarantees on the same mortgages (referred to as the ‘guarantee’). Historically, bad debt losses on the mortgages equalled £2 per year. If the mortgage defaults then an insurance company would compensate Bank A for all credit losses⁴. Bank A then transfers the contractual rights to receive cash flows on both the mortgage and the mortgage indemnity guarantee to Company B. Company B has bought assets of £1,000 from 10 originators like Bank A. Company B merges the cash flows from all the assets together and pass them on to the same eventual recipients (Note holders), who are seeking a diversified return on a portfolio of assets. In order to meet the rating criteria, Bank A has agreed to provide a 5 year interest bearing loan to Company B for £5, which would be reduced by any losses that may arise on the net portfolio of transferred assets, as well as for losses relating to assets which are transferred by Bank A in the future. Assume that credit losses represent substantially all the expected risks and rewards relating to the portfolio.

42. In Example B we presume that Bank A would not consolidate Company B. Therefore in terms of the derecognition flowchart Step 1, we apply the derecognition provisions to the mortgages and guarantees in the separate financial statements of Bank A.

43. The maximum amount of loss in Example B to which Bank A is exposed is £5. If a mortgage defaults and the insurance company settles the loss in terms of the guarantee then Bank A would have no exposure to variability in cash flows relating to the credit loss. Conversely Bank A may only be exposed to a loss in respect of credit

⁴ Financial guarantee contracts held are not within the scope of IAS 39 (see IAS 39 IN6). In the absence of derecognition provisions in another applicable Standard it would be acceptable to apply the derecognition provisions in IAS 39 in terms of IAS 8 Par 11 (a) to such financial guarantee contracts.

losses, to the extent of £5 arising, when the mortgage and insurer (who wrote the mortgage guarantee) simultaneously default.

44. The third principle states that variability in the net cash flows should be allocated across the different groups of financial assets using all reasonably possible variability in net cash flows with greater weight given to those outcomes that are more likely to occur.
45. On this basis the entity allocates by far the majority, say 99.9%, of expected variability in cash flows to the mortgage and a small amount, say only 0.01%, of expected variability to the guarantee. This is based on the assumption that 0.01% is the probability of both a mortgage and the insurer defaulting at the same time, as well as Bank A incurring a loss.
46. Therefore both the mortgages and the guarantee would qualify for derecognition. The transfer of the guarantee qualifies for derecognition because Bank A is exposed to all risks and rewards on the guarantee before the transfer and very little risk (i.e. the probability that the mortgage and the insurer defaulting simultaneously) after the transfer. The transfer of the mortgages qualifies for derecognition because Bank A is exposed to all risks and rewards before the transfer and is not exposed to variability relating to credit losses after the transfer.
47. The staff would like to note a potential problem with this proposed interpretation model. In terms of the 'principles' all variability in cash flows are entirely allocated between the non-similar financial assets. This implies that losses can be allocated on a linear basis between the financial assets. When a mortgage and an insurer simultaneously default this means that both transferred assets have losses after the transfer ('double loss'). However, ZZ would only have a single cash outflow to the maximum of £5 in respect of the double loss. Therefore, should the actual cash outflow by ZZ be allocated to either the mortgage or the guarantee, or both (i.e. there are 2 losses which result in a single outflow of cash)? This type of allocation problem is discussed in the next section where there are non-offsetting risks.
48. This potential problem highlights that the principles above are still rudimentary and that further examples need to be considered.

49. The alternative to performing separate tests of risks and rewards (as required in Option A) is to group both the mortgage and the guarantee and see them as one asset (this is discussed in Option B). Therefore if the risks and rewards test was applied to the group of assets then it likely that neither financial asset would qualify for derecognition i.e. on a group basis the entity has eliminated the exposure to credit losses both before and after the transfer. Therefore, assuming the £5 guarantee is sufficient to cover non-credit related risks on the portfolio, the entity would not have been considered to have transferred substantially all the risks and rewards relating to the portfolio. Arguably a weakness of grouping the assets is that either both assets are derecognised or both assets continue to be recognised, which does not reflect that separate financial assets were transferred.

Example C: The entity's exposure after a transfer is dependent on the performance of non-similar assets: Allocation process

50. Option A requires separate tests for risks and reward for non-similar financial assets.

In this example we consider a difficult allocation problem and show how an allocation can be made using the Principles in the proposed interpretation.

51. **Example C:** An investor (ZZ) in venture capital companies owns a £100 portfolio of shares and risky bonds. ZZ transfers the portfolio⁵ to another venture capital entity (AA) and simultaneously provides a guarantee for the first £5 of losses that arise on the portfolio irrespective of whether they arise on the shares or on the bonds. Investor ZZ does not benefit from increases in the value of the portfolio.

52. In Example C the entity's exposure to variability in cash flows after the transfer is dependent on the performance of both financial assets. In order to isolate variability in net cash flows after the transfer relating to the shares it is necessary to make assumptions relating to variability in the net cash flows on the bonds.

53. The third principle states that variability in the net cash flows should be allocated across the different groups of financial assets using all reasonably possible variability in net cash flows with greater weight given to those outcomes that are more likely to

⁵ For instance ZZ may be prohibited from selling the shares in the portfolio and therefore agrees to transfer the cash flows AA.

occur. ZZ could simulate the portfolio of shares and bonds by running 1000 scenarios⁶ with the following rules:

- a. The variability in cash flows to ZZ (i.e. performance under the guarantee) attributable to either the shares or the bonds after the transfer have to be less than or equal to £5 (Principle 1) (i.e. any other allocation would result in exposure to variability greater than the entity's actual exposure to variability in cash flows).
- b. ZZ's total exposure to variability in cash flows (i.e. performance under the guarantee) in each scenario is allocated between the shares and the bonds (Principle 2).
- c. In scenarios where ZZ does not pay out cash flows (i.e. no loss on the portfolio) the entity probability weights a cash payment of zero in the separate test of risks and rewards for each separate financial asset (Principle 3), and
- d. In scenarios where ZZ pays out cash flows, then the cash flows used in the separate tests of risks and rewards of each separate financial asset could be allocated as follows⁷:
 - i. Where both financial assets are loss-making, that the entity's exposure to variability in cash flows on both financial assets should be allocated in proportion to their respective losses.⁸
 - ii. Where either financial asset is loss-making, then all variability in cash flows should be allocated only to the loss-making asset.⁹

⁶ The value of the portfolio is simulated by considering the prices movements of shares and bonds in terms of appropriate statistical distributions. In each case the variability in cash flows to ZZ based on the value of the portfolio is calculated as being the lower of the actual loss and £0 limited to -£5.

⁷ These allocated cash flows are probability weighted in the separate risks and rewards tests for each financial asset (Principle 3).

⁸ For example in a single scenario, losses on shares equal £3 while losses on bonds equal £7. In this case variability in the net cash flows allocated with the shares would equal £1.5, while variability in the net cash flows allocated with the bonds would equal £3.5.

⁹ For example in a single scenario, losses on shares equal £3 while profit on bonds equal £1. In this case the total variability in the net cash flows of £2 on the guarantee is allocated to the shares.

54. The staff would like to state that they are not certain about the applicability of the principles above to other examples (for example when a large portfolio of very different assets are transferred). In order to assess the applicability of the approach outlined above, it would need to be further developed.
55. Alternatively the IFRIC may consider that this type of analysis is creating cash flows which don't exist. Example C shows that assumptions are needed in order to allocate single cash flows to separate financial assets which may result in alternative allocation of the net variability in cash flows associated with individual financial assets included in the same transfer. In this case there are infinite ways of splitting a single cash flow into separate net cash flows. Furthermore, any split appears to be largely hypothetical, in that the exposure to the entity after the transfer is dependent on the transfer of both financial assets, and it is not known what the entity's exposure to cash flows would have been if only one of the financial assets was transferred. As a result, the only realistic approach of interpreting what is meant by IAS 39 Par 21 is to group cash flows in the derecognition test. This is discussed in Option B.

Application of separate pass through tests to groups of non-similar financial assets (Step 5 of the Flowchart)

56. This section discusses transfers of non-similar financial assets that individually qualify for pass through in IAS 39 Par 19 (Step 5 of the Flowchart).
57. IAS 39 Par 19 (relating to 'pass through' of cash flows to the transferee) states that

When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.

...

58. As noted above, an interpretation of IAS 39 Par 16 is that separate derecognition tests are required for non-similar financial assets. This would mean that pass through

provisions in IAS 39 Par 19 are applied separately to the mortgages and to the guarantee in Example A.

59. Specifically, IAS 39 Par 19(a) states then the entity should have ***no obligation*** to pay amounts to the eventual recipients unless it collects equivalent amounts from the **original asset**.
60. However, in the separate derecognition test for the mortgages in Example A, the entity has an obligation to pay amounts to the eventual recipients in respect of the guarantee. Similarly in the separate derecognition test for the guarantee, the entity has an obligation to pay amounts to the eventual recipients in respect of the mortgages. Consequently in either separate derecognition test it could be argued that the entity has an obligation to pay amounts to the eventual recipients other than the obligation in respect of the original asset which is the subject of the particular derecognition test.
61. 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**.
62. The alternative view is that IAS 39 Par 19 (a) actually means that the entity has no obligation to pay amounts to the eventual recipients with respect to the original asset unless it collects equivalent amounts from the original asset.
63. This alternative view is supported by the emphasis on the cash flows of the transferred asset in IAS 39 Par 18 and Par 19. i.e. IAS 39 Par 18 (a) and Par 19 states that:
 - a. An entity transfers a financial asset if it retains the contractual rights to the receive cash flows of the financial asset, but assumes a contractual obligation to pay **the** cash flows one or more recipients in an arrangement which meets the conditions in Par 19.
 - b. When an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay **those** cash flows to

one or more entities, the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.

64. Therefore if these excerpts are an appropriate basis for interpretation, it follows that the ‘obligation to pay cash flows’ relates to obligations to pay cash flows on the transferred asset.
65. Also consider a transferor which routinely transfers new financial assets into a securitisation structure. In the first transfer it is clear that the entity has no obligation to pay amounts to the eventual recipients other than on the transferred assets. However, when a subsequent transfer occurs the entity may still have obligations to pay amounts to eventual recipients in respect of the earlier transfer. The staff considers in this case that obligations to pass cash flows to eventual recipients in respect of the earlier transfer should not affect the entity’s ability to subsequently qualify for pass through for new transfers.

Option B: Apply single derecognition tests to entire groups of financial assets which are transferred in the same arrangement.

66. The staff considers that such an interpretation could contain the following outline:
- a. Definition of ‘groups of similar assets’
 - b. Derivative liabilities
 - c. Derivatives which may represent assets or liabilities

Definition of ‘groups of similar assets’

67. In Option A the IFRIC could define groups of similar financial assets based on the similarities of the individual financial assets. On this basis most, if not all, derivatives would not be considered ‘similar’ to non-derivatives.
68. Option B proposes that groups of similar financial assets are not defined solely based on the characteristics of the individual instruments, but based on which financial assets are included in the same transfer.

69. The difficulty with Option B is in defining the characteristics of a ‘group of similar financial assets’. The options available to IFRIC include that “For the purposes of IAS 39 Par 16, ‘groups of similar financial assets’ means groups of assets:
- a. Transferred in the same arrangement.
 - b. Transferred in a single transaction, and that the financial assets share or mitigate the risks of the group.
 - c. Transferred in the same arrangement and ultimately passed on to the same eventual recipients.
 - d. Transferred in the same arrangement to which the entity is exposed after the transfer to net variability in cash flows.

Derivative liabilities

70. IAS 39 contains separate derecognition tests for financial assets and financial liabilities. While the derecognition provisions for financial assets permit derecognition for ‘transfers’, no such provision is applicable to financial liabilities. Therefore unless a financial liability is extinguished or modified, it would not qualify for derecognition separately under IAS 39.
71. In Option A it is possible to be of the view that it is not clear how to apply a separate test of risks and rewards to derivatives and non-derivatives included in the same transfer. In this case, it is argued that the entity should ‘group financial assets’ in the derecognition test, and therefore favour Option B.
72. It may be argued that if it is not possible to apply separate risks and rewards tests to individual financial assets which are transferred, it would also not be possible to apply separate risks and rewards tests without including financial liabilities that are also part of the same transfer arrangement.
73. The implication of stating that a financial liability could qualify for derecognition when transferred with a group of financial assets, would mean that financial liabilities may qualify for derecognition under IAS 39 even though they are not extinguished or

modified. This may be criticised for circumventing strict derecognition rules relating to financial liabilities in IAS 39 as well as creating structuring opportunities.

74. The staff considers that consistency is required on this issue:

- a. If IFRIC determine that a group of similar financial assets means ‘individually similar financial assets’ (i.e. Option A) then it is consistent that transferred financial liabilities should not qualify for derecognition.
- b. If IFRIC determines that a group of similar financial assets means ‘financial assets which are transferred in the same arrangement’, then financial liabilities which are transferred in the same arrangement should qualify for derecognition along with the rest of the group of assets. The staff suggests a requirement however that the overall portfolio of financial instruments which are transferred in the same arrangement represent a financial asset.

75. If the IFRIC wishes to exclude a financial liability from a group of similar financial assets, then it is necessary to interpret how the test of risks and rewards should be performed while excluding the financial liability (as in Option A).

76. We proceed on the assumption that a financial liability transferred in the same arrangement should be included in the derecognition test.

Derivatives which may represent assets or liabilities

77. Some derivatives can represent an asset or a liability at different stages of its life. For example, a receive fixed/ pay floating interest rate swap could be a liability when interest rates go up, and an asset when interest rates go down.

78. IAS 39 Par 19 (see Step 5 of Flowchart) only discusses the situation where cash flows are collected on the original asset and passed on to eventual recipients. Consequently it does not state how the pass through provision are applied where the entity may pay or receive cash flows during the life of the derivative.

79. IAS 39 Par 16 states that in IAS 39 paragraphs 17–26, the term ‘financial asset’ refers to either a part of a financial asset... or otherwise a financial asset (**or a group of**

similar financial assets) in its entirety. Furthermore IAS 39 Par 19¹⁰ indicates that the term ‘financial asset’ and ‘original asset’ are used interchangeably. Therefore if an entity transfers a mortgage and an interest rate swap which represents the ‘original asset’, then

- a. Should the group of financial assets qualify for pass through, or
- b. Can some of the individual financial assets qualify for pass through, while other individual financial assets do not?

80. The staff view is that if a similar asset is defined as a group of assets which are transferred in the same arrangement, then all of the assets in the group should be meet the pass through requirements in order to qualify for derecognition where IAS 39 Par 18 (b) is applicable¹¹.

81. If this assumption is correct, then it means that the question on whether the group of financial assets qualify for pass through is the same as whether an individual asset would qualify for pass through.

82. The options available to the IFRIC are that derivatives that may represent assets or liabilities should:

- a. View 1: Qualify for derecognition only where both the derecognition provisions for financial assets and financial liabilities are simultaneously met,
- b. View 2: Qualify for pass through only in respect of amounts paid to the eventual recipients,
- c. View 3: Qualify for pass through in respect of payments made both to the eventual recipients and to the derivative contract counterparty.

¹⁰ IAS 39 Par 19 states: *When an entity retains the contractual rights to receive the cash flows of a financial asset (the ‘original asset’), but assumes a contractual obligation to pay those cash flows to one or more entities (the ‘eventual recipients’), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met...*

¹¹ The IFRIC are reminded that only those transfers within the scope of IAS 39 Par 18 (b) have to meet the pass through provisions of IAS 39 in order to qualify for derecognition. The question on whether a transfer falls within IAS 39 Par 18 (a) or 18 (b) is the subject of the second question for IFRIC- see the introductory section of this document.

83. The derecognition provisions for financial liabilities do not permit transfers. Therefore if an entity is required to meet both the derecognition requirements for financial assets and financial liabilities, it means that the contractual rights to the derivative must have expired/ been extinguished in order to be derecognised.
84. The staff considers that the wording IAS 39 does not indicate circumstances in which both the financial asset and financial liability test would be required to be met. Consequently the staff do not support View 1.
85. IAS 39 Basis of Conclusion states the following:

BC59 The Board concluded that the following three conditions must be met for treating a contractual arrangement to pass through cash flows from a financial asset as a transfer of that asset:

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. However, the entity is allowed to make short-term advances to the eventual recipient so long as it has the right of full recovery of the amount lent plus accrued interest.

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, during the short settlement period, the entity is not entitled to reinvest such cash flows except for investments in cash or cash equivalents and where any interest earned from such investments is remitted to the eventual recipients.

BC60 These conditions follow from the definitions of assets and liabilities in the Framework. Condition (a) indicates that the transferor has no liability (because there is no present obligation to pay cash), and conditions (b) and (c) indicate that the transferor has no asset (because the transferor does not control the future economic benefits associated with the transferred asset).

86. The staff notes that the intention of the pass through provisions is to ensure that an entity does not have an asset or a liability. Consequently, based on these paragraphs the staff supports View 3 i.e. a 'financial asset' should only qualify under the pass through provisions when those requirements are met both for cash received and cash paid.
87. The staff do not support View 2, and consider this to be inconsistent with the Boards stated objectives for pass through transactions.

88. The staff notes that they have not had time to consider the implications of applying the pass through provisions to both cash receipts and cash payments.

Option C: Par 16 of IAS 39 should be applied to determining whether the derecognition provisions are applicable to a portion of the asset, or to a portion of a group of similar assets, transferred in their entirety. The derecognition provisions of IAS 39 should be judgementally applied to the assets identified in Par 16 individually or on a combined basis.

89. The staff considers that such an interpretation could contain the following outline:

- a. Assets in their entirety

Assets in their entirety

90. Option A and Option B required consistent use of the definition of ‘similar financial assets’, as being either an individual financial asset or a ‘group of financial assets transferred in the same arrangement’ throughout the derecognition test.

91. Option C considers that the focus on ‘similar assets’ is not what was intended by the Board as evidenced by the Basis for Conclusions. Consequently, under Option C, IAS 39 allows an entity to apply judgement in the application of the test of risks and rewards and pass through.

92. IAS 39 BC 53 states:

The original IAS 39 also did not contain guidance on when a part of a financial asset could be considered for derecognition. The Board decided to include such guidance in the Standard to clarify the issue. It decided that an entity should apply the derecognition principles to a part of a financial asset only if that part contains no risks and rewards relating to the part not being considered for derecognition. Accordingly, a part of a financial asset is considered for derecognition only if it comprises:

- (a) only specifically identified cash flows from a financial asset (or a group of similar financial assets);*
- (b) only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets); or*
- (c) only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).*

In all other cases the derecognition principles are applied to the financial asset in its entirety.

93. This paragraph indicates that the objective of IAS 39 Par 16 was not to define the application of the derecognition provisions to groups of assets, but to define when a part of an asset (or a part of a group of assets) can qualify for derecognition.

94. Therefore ‘in all other cases the derecognition principles should be applied to the financial asset in its entirety’.

95. As IAS 39 Par 21 does not give guidance on how the risks and rewards test should be applied to either individual assets or to groups of assets ‘in their entirety’, the derecognition provisions of IAS 39 provide the flexibility for a transferor to establish a policy and apply the test of risks and rewards either individually or to groups of assets.

96. Under this Option, the other questions on the treatment of derivative liabilities, and derivatives which may or may not be liabilities would still need to be addressed.

97. We note that this is intention is at odds with the wording in IAS 39 Par 16 which states that:

...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) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

98. This wording seems to indicate that the same financial assets or group of financial assets should be used consistently throughout the different stages of the derecognition test.

Appendix: Derecognition flowchart

Derecognition of a Financial Asset (paragraphs 15-37)

AG36. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.

