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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 September 2006, London**

Project: **IAS 39 *Financial Instruments: Recognition and Measurement:* Derecognition application issues**

Subject: **Issue 1 - Groups of assets (Agenda Paper 13A)**

Purpose of this paper

1. This Paper discusses the possible meanings of the phrase 'group of similar assets' contained in IAS 39 Par 16 (or Step 2 of the Flowchart which is included in the appendix to this document).

Background

2. IAS 39 states that a 'group of similar assets' can be removed from the balance sheet (i.e. derecognised) when the derecognition requirements are met. IAS 39 does not discuss what is meant by 'similar', nor does it discuss how the derecognition requirements apply to a group of financial assets which are 'not similar'.

3. Derivative contracts are used to hedge risks in financial assets. In some cases there is a close 'link' between the specific risks in the financial asset and the derivative, such as the specific credit risk exposure on a particular debtor. In other cases the derivative will hedge more generic risks of the financial asset, such as interest rate risk or foreign exchange rate risk.

4. Most questions about ‘groups of similar assets’ arise in the context of groups of assets that include derivative contracts. In practice most transfers of assets include non-derivative assets which have similar characteristics such as groups of mortgage loans, credit card receivables, lease receivables etc. Derivative contracts on the other hand tend to have offsetting cash flow characteristics to the hedged financial assets, and have little or no initial net investment. Therefore it has been asked whether derivatives can be ‘similar’ to non-derivative financial assets, and therefore be included in the same derecognition test.

5. It makes a difference whether assets are grouped together or assessed separately in the derecognition test in IAS 39. If a derivative and the related financial asset (‘financial asset’) are seen as ‘similar’ and grouped together in the derecognition test, then the group (that is the financial asset and the derivative) would either be derecognised or remain on the entity’s balance sheet. If a derivative is seen as ‘not similar’ to the related financial asset, and the derivative and the financial asset are assessed separately in the derecognition test, then either the derivative or the financial asset may pass or fail the separate derecognition test.

6. In this paper we illustrate using two examples the implications of applying the IAS 39 derecognition test either to a group of financial assets or to the assets separately. The first example discussed in this paper is when a mortgage and a mortgage guarantee are transferred as a group. The second example discussed in this paper is when a portfolio of floating interest rate loans is transferred together with an interest rate swap.

7. There may be other questions which arise in practice relating to the application of the derecognition provisions to groups of similar assets which are not discussed in this paper, such as:

    a. Transfers of a group of assets plus a liability[1].

    b. Transfers involving more than two types of assets (e.g. mortgage loans and equity instruments).

    c. Transfers in which the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset (Step 8 of the Flowchart included in the Appendix).

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[1] In the examples in this paper we assume that all derivatives, such as interest rate swaps, are financial assets at the date of transfer.

Examples of hedging derivative contracts

8. Examples of risk-reducing derivative contracts included in the same transfer with non-derivative financial assets include:

   a. Credit insurance contracts/financial guarantees that are originated with certain 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[2] 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.

   b. Interest rate swaps and currency swaps. For example, a bank may originate a variable rate mortgage portfolio and then swap the portfolio from a variable to a fixed interest rate using an interest rate swap.

   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.

The derecognition tests in IAS 39

9. The IAS 39 derecognition test is summarised in the Flowchart which is included as an Appendix to this document.

10. IAS 39 Par 16 states that the derecognition provisions in <u>Par 17-23</u> 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). Therefore the question discussed in this paper is how to determine in Step 2 of the Flowchart, whether the 'derecognition principles are applied to a part or all of an asset (<u>or group of similar assets</u>)' (Emphasis added).

11. In all of the examples in this paper we assume that the contractual rights to the cash flows from the financial asset have not expired (Step 3 of the Flowchart), but

[2]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). Furthermore application of IAS 8 Par 11 may indicate that the similar guidance in IAS 39 should be followed due to the absence of derecognition provisions in IFRS 4.

that the entity 'transfers the financial asset' (Step 4 of the Flowchart) (IAS 39 Par 17). IAS 39 states that an entity transfers a financial asset if it either:

a. Transfers the contractual rights to receive the cash flows of the financial asset (no pass through test is required); or

b. Retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19 (Step 5 of the Flowchart – pass through test is required)

12. IAS 39 contains three tests to determine whether a transfer of a 'financial asset' or a 'group of similar financial assets'[3] will qualify for derecognition, namely the pass through test in IAS 39 Par 19 (Step 5 of the Flowchart), the test of risks and rewards in IAS 39 Par 20 (a) and Par 20 (b) (Step 6 and in Step 7 in the Flowchart) and the test of control in IAS 39 Par 20 (c) (Step 8 of the Flowchart).

13. The pass through test only applies if an entity 'transfers the contractual rights to receive the cash flows of the financial asset'. The pass through test does not apply if the entity 'retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19'. We will discuss this in greater detail in Paper 2.

14. All three requirements for the pass through test (Step 5 of the Flowchart), if applicable, must be met in order for a transfer to qualify for derecognition:

a. The entity must have no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.

b. The entity must be 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 must have an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.

15. IAS 39 Par 21 (Step 6 and Step 7 of the Flowchart) 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

[3] These tests also apply to parts of assets or parts of groups of similar assets. In this paper we focus on assets and 'groups of similar assets'.

transferred asset. 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 (IAS 39 Par 22).

16. The accounting for a transfer of a group of financial assets in terms of the test of risks and rewards (Step 6 and Step 7 of the Flowchart) depends on the extent to which risks and rewards have been retained. If the entity:

    a. Transfers substantially (Step 6 of the Flowchart) all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

    b. Retains substantially (Step 7 of the Flowchart) all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.

    c. If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset (Step 8 of the Flowchart). In this case:

        - if the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

        - if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset.

Applying the derecognition tests to two examples

17. We discuss the following two examples:

- Example A: An entity transfers a group of assets comprising a mortgage indemnity guarantee (MIG) and a mortgage loan to Transferee X. The MIG is an insurance contract (see footnote 1 on page 2) with a third party that 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.

- Example B: An entity transfers an interest rate swap and a portfolio of floating interest rate loans to transferee Z. The interest rate swap hedges the portfolio for variability in cash flows due to changes in interest rates.

18. This paper only discusses the application of the pass through test and the risks and rewards test to the two examples. We do not discuss the test of control because it is less of an issue in practice.

Applying the pass through test (if applicable) to the two examples

Example A

19. In Example A the entity would accumulate all cash flows that are received on the MIG and the mortgage loans and pay them to X. Therefore there is commingling of the cash flows on the financial assets.

20. Par 19 (a) of IAS 39 states that 'the entity should have no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.'

21. If an entity groups the MIG and the mortgage then it is clear that the entity could have no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts on the original asset (i.e. either the MIG or the mortgage). In this case there is a single obligation to pay cash flows for the group of assets to the eventual recipients, and if nothing is collected on the group of assets then no other obligation to the eventual recipients may exist.

22. If an entity treats the MIG and the mortgage as separate assets, then the pass through test should be applied to each asset individually. This would mean that an entity would have to determine whether the entity has an obligation to pay amounts to the eventual recipients in respect of each asset separately (in addition to the other tests for pass through). For example, when the pass through is

separately applied to the MIG, then the entity will consider whether there is no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts on the MIG. Similarly, in the pass through test on the mortgage the entity will consider whether there is no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts on the mortgage.

23. If the MIG and the mortgage loans are not seen as part of the same group of assets, then one view in practice is that the entity will automatically fail the pass through test on both assets. Even if the entity does not collect amounts on the mortgage, the entity has an obligation to pay amounts to the eventual recipients in respect of the MIG. Similarly even if the entity does not collect amounts on the MIG, the entity has an obligation to pay mounts on the mortgage. Therefore because in both separate tests the entity has another obligation to pay cash flows to the eventual recipients, even if nothing is collected on that specific financial asset, both assets could be considered to immediately fail the pass through test.

24. Another view is that if the entity applies two separate pass through tests the entity would not automatically fail the pass through test. If the entity applies two pass through tests it should also separate the obligations to pass on cash flows with respect to the mortgage and with respect to the MIG. Therefore in the separate test for the mortgage the entity will consider whether if the mortgages aren't collected, and assuming that there is no obligation to pay cash flows on the MIG, whether the entity may have an obligation to pay cash flows to the eventual recipients. Similarly in the pass through test for the MIG the entity would only consider whether there is an obligation to pay cash flows on the MIG unless it collects equivalent amounts on the MIG. In this case either of the assets could pass the separate pass through tests for the mortgage and the MIG

Example B

25. An interest rate swap may be a financial asset or financial liability depending on whether and how interest rates change.

26. It is not possible for a financial liability to qualify for 'pass through' in IAS 39. IAS 39 contains separate derecognition tests for financial assets and financial liabilities. A financial liability can only be derecognised if the entity extinguishes its obligation or there is a substantial modification to the contractual terms. Therefore there is no equivalent of a 'pass through test' for financial liabilities which are transferred.

27. Furthermore an interest rate swap may result in the entity paying or receiving cash flows in the future. For example in the swap in Example B, if interest rates go up, then the entity may pay cash flows at the next reset date, and if interest rates go down then the entity may receive cash flows at the next reset date.

28. The pass through test in IAS 39 only discusses if an entity passes on cash flows to the eventual recipients. For example, Z would be the eventual recipient if the entity receives cash flows on the swap. However, the swap counterparty would be the eventual recipient if the entity pays cash flows on the swap.

29. One view is that in order for an interest rate swap to qualify for derecognition that it must meet the financial asset and the financial liability derecognition test; in effect this means that the interest rate swap must be extinguished in order to qualify for derecognition. Arguably, the pass through test in IAS 39 was not designed for when an entity could pay or receive cash flows on an interest rate swap.

30. Consequently, if an interest rate swap is seen as part of the same group of assets as the floating rate loans, then the entire group of assets may automatically fail the pass through test. The three pass through requirements must be met for all of the financial assets in the group. If an interest rate swap would fail the pass through test on its own, this would effectively cause the rest of the portfolio to fail pass through.

31. Another view is that the interest rate swap should be seen as part of the overall economic group of ‘assets’, and that it should be permissible for the overall group of assets to qualify for pass through.

32. If an interest rate swap is not part of the same group of assets, then the entity may also automatically fail the pass through test. As discussed for the mortgages, a view in practice is that because the obligation to pay cash flows are commingled the entity may have an obligation to pay cash flows on the interest rate swap even though no amounts are collected on the floating rate loans, and therefore fail IAS 39 Par 19 (a) (and vice versa).

Applying the risks and rewards test (if applicable) to the two examples

Example A

33. The risks and rewards test requires an entity to compare its exposure to variability in cash flows before and after the transfer to determine the extent to which risks and rewards have been retained.

34. If the MIG and the mortgage are seen as a group of assets then the entity has effectively eliminated variability in cash flows due to mortgage default risk before and after the transfer. The purpose of the MIG is, after all, to offset losses when mortgage default occurs.

35. Therefore if the MIG and the mortgage are seen as a group then entity would need to transfer substantially all the other risks and rewards of the group in order to qualify for derecognition. For instance the receivables would qualify for derecognition if the entity transferred substantially all of the remaining risks in the mortgage, such as prepayment risk and interest rate risk.

36. If the MIG and the mortgage are seen as separate assets then the entity would be exposed to variability in cash flows before the transfer relating to mortgage default, but be exposed to no variability in cash flows after the transfer relating to mortgage default risk. Before the transfer the entity would have a reduction in cash flows when a mortgage defaults, and separately receive compensation on the MIG. After the transfer the entity is assumed to retain no variability on the mortgage or the MIG because all cash flows are transferred to X.

37. *[Paragraph omitted from observer note].*

Example B

38. Similar to Example A, if the interest rate swap and the floating rate loans are seen as part of the same group of assets then the entity has effectively reduced interest rate variability in the portfolio, both before and after the transfer.

39. Therefore if the interest rate swap and the floating rate loans are seen as a group then entity would need to transfer substantially all the <u>other</u> risks and rewards in order to qualify for derecognition. For instance the entity may retain the default risk. If default risk is significant in the portfolio then both the interest rate swap and the mortgage may not qualify for derecognition.

40. If the interest rate swap and the floating rate loans are not part of the same group then it is likely that the interest rate swap will qualify for derecognition, but uncertain as to whether the floating rate loans will qualify for derecognition. The entity retains no variability in cash flows on the interest rate swap after the

transfer. As this represents virtually all of the risk in an interest rate swap, it will qualify for derecognition. Conversely the floating rate loans contain variability of cash flows before the transfer relating to interest rates, and no exposure to variability in cash flows after the transfer relating to interest rate risk. If interest rate risk is not a significant risk, when compared to the other risks such as default risk, in the floating rate loans, then the floating rate notes may not qualify for derecognition.

Examples of how the derecognition test is applied in practice to groups of assets or to individual assets

41. *[Paragraph omitted from observer note].*
42. *[Paragraph omitted from observer note].*
43. *[Paragraph omitted from observer note].*

The possible intention of the Board

44. Arguably the intention of the Board was that Par 16 should define when a part of an asset (or a part of a group of assets) qualifies for derecognition and not to prescribe the groups of assets to which the derecognition test should be applied. For example, 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.*

45. Consequently, a possible intention of the Board was that 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.

46. This possible intention may be at odds with the wording in IAS 39 Par 16 which defines the application of the derecognition provisions to groups of assets. Par 16 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.*

47. This possible intention may also be at odds with how the word 'similar' has been used in IFRS. For example 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. Also, 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**.

Question 1 for the Board

48. **The staff considers that there are two questions the Board needs to answer:**

    - **Question 1A: Does IAS 39 allow (or require) the derecognition tests to be applied to transfers of groups of financial assets (such as loans, mortgages, etc) that include the following derivative contracts:**

        - **Credit insurance contracts/financial guarantees that are originated with certain loans.**

        - **Interest rate swaps and currency swaps.**

        - **Credit insurance contracts/financial guarantees that are not originated with the loans.**

    - **Question 1B: Does the Board believe that such requirements result in an appropriate accounting result?**

49. *[Paragraph omitted from observer note].*

Appendix: IAS 39 derecognition flowchart (IAS 39 AG 36)

Derecognition of a Financial Asset (paragraphs 15-37)

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