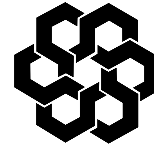

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**16 November 2007, London**
Project:	**Consolidation**
Subject:	**Education session: Application of the Proposed Consolidation Framework – characteristics of structured arrangements (Agenda paper 8B)**

Introduction

1. This paper explores the characteristics and fact patterns of structured arrangements, and discusses how those characteristics and fact patterns might help assess which assets and liabilities should be recognised by which parties involved in the arrangement.

2. The paper uses an asset-backed securitisation as a base example to discuss the different fact patterns. We think, however, that the issues discussed in this paper are relevant for most, if not all, structured arrangements. Other arrangements such as conduits, collateralised debt obligations and structured investment vehicles (SIVs) all have similar characteristics—assets are isolated in a legal entity; investors with varying risks and rewards invest in the entity; the activities are often in some way predetermined; the assets of the entity will often require some level of servicing.

General approach

3. Our objective is to develop an approach that results in an entity recognising the assets that it controls and the liabilities for which it is responsible. When an entity has a controlling interest in another entity, that entity controls all of the assets and liabilities of the other entity and should recognise all of its assets and liabilities by means of consolidation.

4. To have a controlling interest in another entity, an entity should:

    (a) have the ability to direct the strategic financing and operating policies of the other entity (the *power* criterion).

    (b) have the ability to access benefits flowing from the entity (the *benefits* criterion).

    (c) be able to use its power so as to increase, maintain or protect the amount of its benefits.

5. However, it is not always clear who has control. Difficulties arise when the activities of the entity are predetermined, decision-making power is shared and the types of activities make it difficult to assess who has power.

Predetermined activities

6. Based on the above control criteria, when an entity's activities have been predetermined such that any decision-making that remains could not be considered to be strategic, it could be argued that no one controls the entity. In this situation, our approach proposes that each party involved should assess which assets and liabilities it should recognise based on its contractual rights and responsibilities.

7. There is likely to be a spectrum of predetermined activities. The level of predetermination is often linked to the types of assets and liabilities of the entity:

8. The diagram above illustrates the two extremes of predetermination, which are discussed in the examples below. Example 1: the asset of the entity is a specialised machine. It is likely that one party will control, or have rights to, that asset because the nature of the machine is such that it cannot operate, and therefore, create benefits without significant actions of an external party. That party may control the machine by controlling the entity as a whole. If this is the case, the party would consolidate the entity and recognise all of its assets and liabilities, including the machine. However if the party has rights to the machine other than by strategic control of the entity (eg through a lease agreement), the party would recognise their rights to the machine and a corresponding obligation to make payments in accordance with the lease agreement. If the entity does not control the entity as a whole, and does not have any responsibility to pay the liabilities and expenses of the entity, it would be misleading for the party to recognise the liabilities of the entity as its liabilities.

9. Example 2: the assets of an entity are entirely made up of risk-free securities (eg government bonds). The entity's activities could be almost entirely predetermined such that no-one has decision-making power over those assets after formation of the entity. The parties involved would recognise their respective interests in the entity, rather than recognising the risk-free securities unless they controlled the securities by having particular rights to them. Without any rights to the cash flows or the ability to use the cash flows for its own purposes, another party should not recognise the assets in its financial statements.

10. Of course, financial assets such as mortgage receivables or securities fall somewhere other than the extremities of the scale. When such assets are sold to

an entity, the entity's activities might be largely predetermined but some decision-making powers are likely to exist.

11. We will explore these further using the scenarios in paragraphs 27-88.

Joint control

12. Many securitisations and other structured arrangements are formed to isolate particular assets from the rest of an entity. Assets are isolated in order to offer investors investment opportunities with particular risks involved in return for particular rewards. The isolation of assets also has benefits for the transferor of the assets—it can generate short term cash flows for the entity that originally held the assets (ie substituting the assets for cash) or it can improve the credit rating of the business. Often, the assets being securitised have a particular risk profile that makes it advantageous to separate them from the rest of the business. They could be riskier or less risky than the other assets of the business.

13. Some of these securitisation entities have predetermined activities with no decision-making power, as discussed above. However, many have limited activities that allow some flexibility in the entity's activities. This flexibility often requires agreement by all parties involved in the arrangement, ie all note holders or investors. Investors in a securitisation agree to take on particular risks; therefore, their consent is often required in order to change the entity's activities because any change might subsequently change the risk profile of the entity and alter the risks to which those investors are exposed. For example, the entity's incorporation documents might require that, when funding is raised, all (or a majority of) financiers would have to consent to any changes. Or the offering documents relating to debt issued by the entity might require investor consent (unanimous or majority) to modify the contract (the contract being the terms in the offering document). A change in the activities of the entity might change the risk profile of the investment and thus, modify the contract with the investors.

14. In this situation, we are of the view that control of the entity will often be shared among various investors, such that no one party controls the entity. In effect, the entity would be a joint venture because no one party has the ability to direct the activities of the entity without the consent of others. Obviously, if one party holds enough capital at risk in the entity (eg if the party is the only debt financier), that party could be a position to control without the consent of any other party.

Servicing

15. Often assets isolated in securitisation transactions require some level of servicing or management. The securitisation vehicle might not have any servicing facilities and therefore, outsources that to a bank or another party. Servicers can provide different levels of servicing, from collecting cash flows on behalf of another party, to making decisions about what assets can be sold and having rights to the cash flows from those sales. There is a scale of servicing activities that can be provided by servicers. The amount of servicing provided will influence, and can determine, whether the servicer has control of the serviced assets.

16. In this paper, we have focussed on the services provided as servicer, rather than on whether the servicer previously owned the assets. If a servicer services CU1 million of previously-owned assets, and CU2 million of assets that it never owned, we are of the view that it should account for that servicing, and those assets, in the same way. The question is whether the services that it provides are such that it controls the assets. If a servicer usually provides more servicing activities when it previously owned an asset, our focus will be on those servicing activities provided.

17. Servicing activities are discussed further in the scenarios in paragraphs 44-88.

Asset-backed securitisations - Generic fact pattern

Originator

18. The **originator** or **transferor** is an entity that holds, and has the rights to, assets that it intends to securitise. The originator sells the assets to a separate legal entity to isolate them from the rest of the business and to make cash available to the originator.[1]

19. Step 1: Originator establishes a legal entity (**Subordinate**).

20. Step 2: Originator sells the assets to Subordinate. In consideration for the assets, Subordinate pays some cash and settles the balance by issuing shares or a subordinated interest to Originator. Subordinate incurs debt to a third party (**Investors**) using the assets as security.

Originator
Dr Interest in Subordinate
Dr Cash
Cr Assets

[1] Assets are not always sold to a securitisation vehicle by an originator. The assets might be purchased from the market or sold to the vehicle by a party or parties other than the originator.

To record sale of assets to Subordinate and the retained interest in Subordinate.

Subordinate

Dr Assets

Cr Cash

Cr Equity / subordinated interest

To record purchase of assets and issue of equity / subordinated interest to Originator.

Dr Cash

Cr Liability

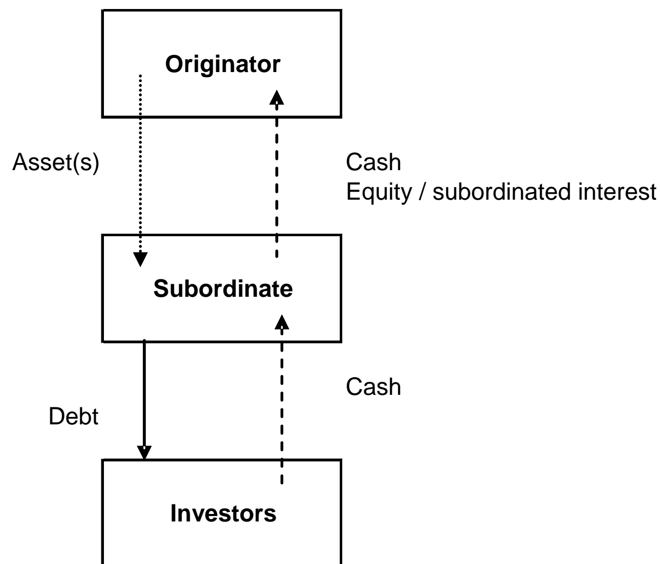
To record the liability (investors) and receipt of cash.

21. As a result, Subordinate has assets, cash (possibly), liabilities and equity.

22. In all scenarios, neither Investors nor Originator have voting rights, or can operate or manage Subordinate unless stated otherwise.

Analysis

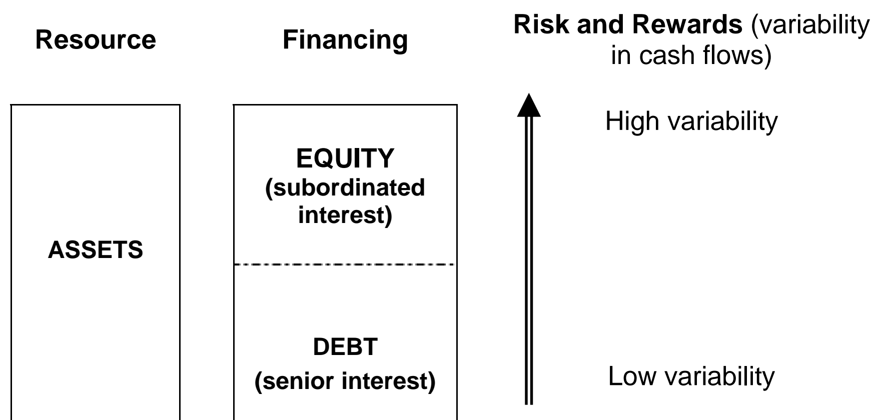
23. The flow of resources is summarised in the diagram that follows:



24. The following table summarises the rights and responsibilities (and the related risks and rewards) of each of the parties:

Party	Interest	Risks	Rewards
Originator	Equity / subordinated interest in Subordinate.	Bears the first loss on the negative variability in fair value of, or cash flows from, the asset(s). Often absorbs the majority of *expected* losses.	Residual amount after settling liabilities of Subordinate toward Investors and any other parties.
Investors (debt holders)	Interest and principal payments on debt.	Exposed to the risk after Originator. *Potentially* absorb most losses, but *expected* losses should be insignificant. Exposure to the risk would differ according to the rating of the tranche.	Principal and interest at market rates proportional to the risk profile of the tranche.

25. The purchase of assets by Subordinate is financed by capital with different risk and reward profiles. The extent to which the purchase of assets is financed by equity (or other subordinated interests) is likely to depend on the variability in cash flows the assets create. The more variability in the types of activities undertaken or in the future cash flows (fair value) of the assets, the more equity or subordinated funding would be required to absorb the expected losses.



Derecognition

26. In all scenarios it is assumed that the derecognition criteria are met by Originator. We have made this assumption in order to focus on which assets and liabilities should be *recognised* by each party, rather than on which should be derecognised.

Scenario 1 – Risk-free securities

Description

27. Originator sells risk-free government bonds of CU500 to Subordinate, in return for cash of CU499 and an equity interest of CU1. Subordinate funds the purchase of the assets by issuing commercial paper of CU499 to various investors, unrelated to Originator. Subordinate cannot sell the bonds, because the right to sell has been removed as a consequence of the contract with the commercial paper holders.

Nature of the assets

28. The government bonds have contractual fixed cash flow streams that are matched with cash payments to the commercial paper holders (principal and interest at a fixed rate).

29. Originator has isolated the cash inflows and outflows relating to the government bonds and commercial paper in Subordinate. The payments on commercial paper can be made only from cash flows received on the government bonds—the commercial paper holders do not have recourse against any other assets.

30. Government bonds, unlike other investments, do not create variability. There will be no unexpected returns or losses because cash inflows are contractually determined, with virtually no risk of default by the government. For this reason, the commercial paper holders do not require another party to retain any significant portion of equity (or similar subordinated interest in Subordinate) as security and protection against expected losses.

Scenario 1A

31. Subordinate is set up with restricted and predetermined activities, such that neither Originator nor any other party can change its activities. Subordinate does not require any decision-making policies because its activities do not need to be managed. The assets produce an expected and isolated stream of cash flows, the timing of receipt of which is matched with cash outflows to the providers of financing. Neither the timing nor the amount of cash flows on the government bonds can be changed.

32. After formation and issue of the commercial paper, no decisions need to be made in order for the activities to be carried on. The securitisation vehicle is, effectively, on 'autopilot'.

33. In this scenario, what would each party recognise?

34. [Paragraph omitted from observer notes].

35. [Paragraph omitted from observer notes].

36. [Paragraph omitted from observer notes].

Scenario 1B

37. Consider a scenario in which Subordinate's activities are not restricted. Through its equity interest, Originator might retain the ability to direct the activities of Subordinate. What effect would that have on the amounts recognised by each party?

38. [Paragraph omitted from observer notes].

Scenario 2 – Specialised machinery

Description

39. Originator sells specialised machinery to Subordinate, with a value of CU1000 (assumed to be the carrying amount of the machine), in return for cash of CU400 and an equity interest of CU600. Subordinate funds the purchase by issuing debt securities to Investors of CU400; Investors' investment in Subordinate is secured on the machine.

Journal entries by Originator

	Dr.	Cr.
Dr. Cash	400	
Dr. Investment in Subordinate	600	
Cr. Machine		1000

40. Although there could be a number of reasons for selling the specialised machine to Subordinate, one of those reasons is unlikely to be because the asset is no longer of use to Originator. If that were the case, it would appear more sensible to sell the machine to an unrelated third party, in which Originator has no continuing equity interest.

Nature of the asset

41. The structure of the sale (to an entity in which it continues to hold a substantial equity interest) seems to rule out the fact that Originator wants to stop using the machine—the nature of specialised machinery is such that it is difficult to imagine that Originator could sell such an asset to Subordinate without some form of

continuing involvement or control of the asset. The asset cannot generate cash flows alone; it must either be used with other assets and resources to manufacture products that can be sold, or it must be sold or leased to another party. All of these uses require decision-making. Therefore, Originator would require the ability to control Subordinate through strategic power, or Originator would need to enter into a lease or rental agreement with Subordinate for rights to use the asset.

42. There is much less certainty of a return for investors in Subordinate than in Scenario 1, because the asset is not a risk-free financial asset (with a contractual cash flow stream) and is specialised in nature. It may not be easily sold in the market, and the future economic benefits to be generated by the machine are subjective and dependent upon how the asset is used [unlike Scenario 1, where the asset represents a guaranteed and known stream of cash flows]. Therefore, it is unlikely that Investors would finance the estimated value of the machine, without some form of security or guarantee other than the asset itself.

43. If Originator retains control of the asset through its control of Subordinate, Originator would consolidate Subordinate and recognise all of its assets and liabilities. Through its strategic power, Originator would be able to control the use of the machine and direct decision-making about the debt securities.

Journal entries by Originator (consolidated financial statements)

Dr. Specialised machine	1000	
Cr. Debt securities		400
Cr. Investment in Subordinate		600

Scenario 3 – Portfolio of residential mortgage receivables

Description

44. Originator sells a portfolio of residential mortgage receivables of CU500 million to Subordinate, in return for cash of CU450 million and an equity interest in Subordinate of CU50 million. Originator absorbs first losses on default of the receivables up to the value of its retained interest of CU50 million. Originator is also entitled to the difference (the excess spread) between the interest received on the receivables and the interest paid to Investors, after deducting servicing fees and other expenses.

45. The mortgage receivables have different maturity dates and ratings. Subordinate finances the purchase of the receivables by issuing to Investors different classes of bonds with amounts and maturities that match those of the mortgage receivables.

46. Servicer provides administrative services such as the collection and distribution of the mortgage receivables in accordance with parameters set out in a servicing agreement. Servicer is an unrelated party of Originator and receives a fixed servicing fee that is at market rates.

Nature of the assets

47. The transaction is structured such that the amounts of cash flows to be collected on the mortgage receivables are expected to meet the claims of Investors. Mortgage holders have a contractual obligation to make payments at agreed amounts and dates, and therefore the cash flow streams are predictable. The maximum potential future cash inflows attributed to each party can be determined at the formation of the arrangement.

48. An investment in mortgage receivables has variability in future cash flows, unlike risk-free securities. There is a risk that all payments will not be collected from the mortgage holders (credit risk), although diversification of the types of loans in the portfolio and the security on the mortgage assets can reduce significantly the credit risk. There is also a risk that the interest and principal payments on the mortgages will not be collected in accordance with the payment schedule (liquidity risk). Investor's exposure to those risks can be minimised in a number of ways: (a) higher equity or subordinated financing (b) credit enhancement (c) liquidity support.

49. The activities of Subordinate can be predetermined because the variability in the types of activities undertaken is limited. There is no need for active strategic management because the future cash flows are contractually determined and Servicer's duties are performed in accordance with predetermined procedures and guidelines. The activities of Servicer can be limited to those that ensure Investors' claims to those cash flows are satisfied. The cash flows generated by the receivables can be separated from the business of Originator and do not require interaction with other assets to generate benefits.

50. Alternatively, the activities might be partially predetermined with some ongoing strategic decision-making that results in the entity either being controlled by one party, or jointly controlled by all with capital at risk (ie Investors and Originator).

Scenario 3A - Role of the servicer

51. In accordance with market practice, Servicer carries out the day-to-day management of receivables on behalf of Investors and Originator.

52. Servicer's main responsibility is to collect cash flows from receivables (principal, interest, tax and insurance payments) and remit them to Investors, tax authorities, Originator and other parties. The nature and extent of actions to be taken by Servicer are specified in the servicing agreement. The majority of those responsibilities are administrative in nature and ensure that the servicer is acting to maximise the benefits of those with capital at risk.

53. Servicer might also be required:

    (a) to monitor overdue payments (ie contacting mortgage holders, negotiating to collect amounts overdue, and modifying the payment terms—timing, amount, substitution of collateral—in accordance with predetermined criteria);

    (b) on default, to decide what action to take based on the predetermined process that would maximise the net present value of the proceeds to Investors (ie whether to sell the loan, foreclose on and sell the asset or renegotiate the terms of the loan with the mortgage holder);

    (c) after default, to execute foreclosure (ie execute foreclosure on a date set forth in the loan documents, deciding when to foreclose after loan documentation permits foreclosure and deciding when and to whom to sell the mortgage assets);

    (d) to invest funds pending distribution to Investors (ie invest in short term, risk-free investments with a maturity date before the distribution date to Investors (the investment returns not being retained by Servicer)).

54. [Paragraph omitted from observer notes].

55. [Paragraph omitted from observer notes].

56. [Paragraph omitted from observer notes].

Scenario 3B – Servicer provides liquidity support

57. Suppose that Servicer provides liquidity support. If the cash flows from the receivables are not collected before the distribution date to Investors, Servicer pays amounts to Investors when due, effectively providing a loan facility to Subordinate to cover short-term cash shortfalls. Servicer is entitled to repayment

of the amounts advanced plus interest before other creditors of Subordinate (ie the loan would represent a senior interest in Subordinate). The liquidity facility might also be secured on non-defaulted assets.

58. The question is: would the provision of liquidity support by Servicer mean that it controls the assets or controls Subordinate?

59. [Paragraph omitted from observer notes].

60. [Paragraph omitted from observer notes].

Scenario 3C – Servicer has additional rights

61. Suppose that Servicer's activities go beyond delegated decision-making. If Servicer's decision-making results in having discretion over the use of the assets to any great extent and obtaining benefits from those activities (eg above market rates for services provided), Servicer might not be acting solely on behalf of Investors. For example, assume that Servicer has the following rights:

    (a) the ability to commingle the cash inflows (that will be distributed at a later date) with its own resources to invest the funds for its own benefit, and retain the returns from the investment; or

    (b) is permitted to actively manage foreclosed property to obtain benefits on its capital appreciation.

62. [Paragraph omitted from observer notes].

63. If Servicer is permitted to carry out more extensive activities that require using its discretion (ie there is little predetermination in the formation documents of Subordinate), Investors and Originator would be exposed to increased risk. Those parties might have rights to protect their interest (eg 'kick out' rights[2]). Otherwise, the increased variability in economic outcome might result in Investors requiring additional subordinated funding to absorb that variability.

Scenario 3D - Servicer provides credit enhancement

64. Suppose that Servicer provides credit enhancement and is paid a market fee for that service. Does this mean that Servicer controls either the assets of Subordinate or Subordinate itself?

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[2] 'Kick-out rights' give the holders of those rights the ability to replace the servicer. They are often a form of shared control in that a majority of investors are required to vote and no-one party alone can decide to replace the servicer.

65. [Paragraph omitted from observer notes].

66. [Paragraph omitted from observer notes].

Scenario 3E - Originator acting as servicer

67. Suppose that Originator and Servicer are the same entity. Does this mean that Originator controls the assets of Subordinate or Subordinate itself?

68. The answer is 'it depends'. It depends on whether the activities performed as the servicer are so extensive that Originator would be considered to control the assets, or meet the power criterion in terms of controlling Subordinate. If the decision-making ability of Originator is such that it has rights to the assets, similar to those that it would have if it owned the assets, then it should recognise those assets.

69. [Paragraph omitted from observer notes].

70. In addition, suppose that Originator services the mortgage receivables of Subordinate, of which half was sold by Originator and the other half was sold by a third party. If Originator is acting as the administrator of all receivables in the pool, providing identical servicing activities to all receivables, the accounting for the assets it originated should be the same as for the assets originated by the other party. Recognition of the assets should be based on the rights of Originator and whether those rights are such that Originator controls the assets.

Scenario 3F – Originator issues bonds to Subordinate rather than selling receivables

71. Suppose that Originator did not sell the mortgage receivables to Subordinate, but issued bonds secured on the retained mortgage receivables. In this case, Originator retains control over the cash flows from the receivables and can comingle the payments received with its own resources to obtain benefits from those cash flows. Originator is also responsible for the claims of Investors. On default of the mortgage receivables, the bond holders have recourse to the other assets (other than mortgage assets) of Originator to satisfy their claims. [Reminder of this paragraph omitted from observer notes].

Scenario 4 – Single receivable

Description

72. Originator sells a lease receivable of CU10 million (on a lease of a corporate aircraft) to Subordinate, in return for cash of CU8 million and a subordinated

interest in Subordinate of CU2 million. Subordinate finances the purchase by issuing bonds of CU8 million to Investors. Originator has rights to any difference between interest received and interest paid (excess spread) after settling all liabilities of Subordinate.

73. The amounts and timing of payments (interest and principal) to be received on the lease are expected to match with those to be made to bonds holders.

74. Servicer administers the collection and distribution of the lease receivables in accordance with parameters set in the servicing agreement. In return it receives a servicing fee at market rates.

Nature of the asset

75. This scenario is similar to the purchase of a portfolio of mortgage receivables. The amount and timing of the lease payments is contractually agreed so that future cash flow streams can be determined on formation of the arrangement. The activities of Subordinate do not require active decision making because the actions to be taken to administer the cash flows are determined in the servicing agreement. The cash flows from the receivable are separated from the resources of Originator, and Investors do not have recourse against the assets of Originator.

76. The difference from the scenario with the portfolio of receivables is in the types of risks to which the parties to Subordinate are exposed. Investors and Originator's exposure to risks relies on the credit standing of one counterparty—the lessee. The concentration of risk is much greater than on a portfolio of receivables. However, cash flows will be derived from a single stream of contractual payments, so the risk of mismatch in the timing or amounts of payments is insignificant. The effort required to service the lease receivable will be minimal, assuming that the counterparty pays on time.

77. [Paragraph omitted from observer notes].

Scenario 5 – Portfolio of securities

Description

78. Originator sells a portfolio of debt and equity securities to Subordinate for CU100 million. In exchange Originator receives cash of CU85 million and retains a subordinated interest in Subordinate of CU15 million. Subordinate finances the purchase of the portfolio of securities by issuing non-investment grade bonds of CU35 million and investment grade bonds of CU50 million (different tranches of

bonds according to Investors' risk and return profile). Investment grade bond holders receive fixed returns in proportion to their exposure to risk. Non-investment grade bond holders and Originator receive a share of proceeds on the portfolio proportionally to their exposure to risks.

79. Portfolio manager is appointed to manage the portfolio of securities. The debt and equity securities have predetermined risk and return profiles. Portfolio manager makes investment decisions about the purchase and sale of assets based on its assessment of market conditions. It receives a fixed fee, and variable fee based on the market value of the assets in the portfolio.

Nature of the assets

80. There is more variability in the cash flows generated by the portfolio of securities than in Scenarios 3 and 4. The future cash flows on the equity securities are not contractually guaranteed and depend upon factors that are outside the control of Portfolio manager. The volatility in the value of shares increases the variability of the future economic outcome of Subordinate and the need for subordinated financing to absorb some of that variability.

81. The types of activities carried on by Subordinate are narrow; its results are dependent on the experience and skills of Portfolio manager. The cash flows generated from the portfolio of securities can be obtained independently, without any interaction with other assets or resources. However, the portfolio of securities has to be actively managed to create the benefits.

Scenario 5A

82. [Paragraph omitted from observer notes].

83. Portfolio manager receives fees for its services that are commensurate with services provided. Part of the fee is variable and based on the performance of Subordinate. This serves as an incentive to maximise the benefits to Investors and Originator.

84. The future benefits of Investors and Originator depend on the investment decisions exercised by Portfolio manager. As providers of the capital at risk, with significant exposure to the variability in Subordinate's future outcome, they are likely to have some rights to control the activities of Subordinate (eg 'kick out rights' in relation to Portfolio manager or shared voting rights as described in paragraphs 12-14).

85. [Paragraph omitted from observer notes].

Scenario 5B – Originator is the portfolio manager

86. Suppose that Originator is the portfolio manager. In this situation, does Originator control Subordinate?

87. [Paragraph omitted from observer notes] .

88. [Paragraph omitted from observer notes].