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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**December 2008, London**
Project:	**Derecognition of Financial Assets and Liabilities**
Subject:	**'Practical Ability to Transfer' Test: Impact of Put Options (Agenda Paper 10C)**

Background

1. At the IASB and IASB/FASB meetings in October 2008, the staff indicated to the boards that a transferee who purchased a non-readily obtainable financial asset together with a put option might be deemed not to have the *practical* ability to transfer the asset to an unrelated third party without attaching a similar option. This was because the transferee might be unlikely to forfeit the benefit of the option by transferring the asset in isolation. (It is important to note that we are assessing the asset for derecognition, and the existence of a put is only relevant in so far as it may have an effect on the transferee's ability to transfer the asset).

2. Accordingly, such a transfer would fail the 'practical ability to transfer' test in the staff's proposed Flowchart 1 and Flowchart 2. It would therefore not qualify for

derecognition in Flowchart 2. It may qualify for derecognition in Flowchart 1 because of the subsequent ‘other access to the asset’s cash flows’ test.

3. At the IASB meeting in November 2008, the staff provided more guidance about the circumstances in which a transferee is (or is not) deemed to have the practical ability to transfer a financial asset. Most Board members agreed with the staff’s guidance about how to assess the ‘practical ability to transfer’ test. However, some questioned the conclusion that for a transfer involving a non-readily obtainable financial asset and a written put option, such a transfer would fail the ‘practical ability to transfer’ test. Those Board members believed that the purpose of the ‘practical ability to transfer’ test was to determine whether the transferor had passed control over a financial asset’s cash flows to the transferee and that for the fact pattern involving a sale and a written put option all of the control was with the transferee. This might be for reasons including the fact that a put option purchased by a transferee creates only rights for the transferee, not obligations (and, conversely, obligations for the transferor, not rights).

4. This paper:

    a. describes the reasons why a put option written by a transferor in connection with a sale of a financial asset might cause the transfer to fail the ‘practical ability to transfer’ test,

    b. emphasises why that treatment is important for Flowchart 2, and

    c. includes a staff recommendation.

5. An appendix to this paper also illustrates the application of the ‘practical ability to transfer’ test to some transfer transactions involving written put options.

Why might a put option cause a transfer to fail the ‘practical ability to transfer’ test?

6. As previously noted, a transfer of a financial asset might fail the ‘*practical* ability to transfer’ test if the asset is not readily obtainable in the marketplace and is transferred subject to a right by the transferee to put the asset back to the

transferor. As the staff wrote in November Agenda Paper 15C, this might be the case

> if a transferee stands to incur losses on the transfer to a third party [because] it would economically be impeded from, and therefore judged not to be practically free and able to, transfer the asset to a third party.
>
> For example, a put option held by the transferee will constrain the transferee's ability to dispose of the asset unless replacement assets are readily available. The transferee is likely to be economically impeded from transferring the asset unencumbered by an option or right to reacquire, since the transferee would not then be able to exercise its retained put option.
>
> Although a transferee is, in theory, always free to choose not to exercise a put option, in reality a put option will convey benefits to the transferee that it is unlikely to be prepared to give up lightly, so its existence is likely to constrain the transferee.
>
> A case in point will be a transfer with a deep in the money put option. In this case, at the transfer date, one can conclude that there is no practical possibility that it will be out of the money at the exercise date (and hence would be exercised). The transferor is unlikely to forfeit the benefit of the option by transferring the 'asset' in isolation (i.e. without attaching the option or a similar option).
>
> Some believe that this is not appropriate because the transferee would generally be able to sell the asset and put option together to another party and, in that circumstance, the put option would not represent an additional restriction imposed on the transfer.
>
> The staff does not believe that in the above case the transferee has the practical ability to transfer the 'asset' being assessed for derecognition without imposing a restriction (i.e. a call or a put option) on the transfer. The impact of attaching the option to the transfer is that the transferee would be obliged to transfer the 'asset' subject to a similar option and would not be able to transfer the 'asset' in isolation (see paper 15B for a discussion about the 'asset').
>
> Hence the ability of the transferee to transfer the 'asset' and the put option together does not prove that the transferee has the practical ability to transfer the 'asset' being assessed for derecognition in isolation but rather confirms the transferee's lack of practical ability to transfer the 'asset' in isolation.

7. The staff also notes that the view that a written put option could be an economic constraint on a transferee that might preclude the transferee from having the ability to transfer a financial asset to a third party is consistent with the existing guidance in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). Paragraph AG 44 of IAS 39 states (emphasis added):

> That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, <u>if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive condition</u>. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

Why is that treatment (written put = lack of 'practical ability to transfer') important for Flowchart 2?

8. The inclusion of economic constraints (rather than only contractual constraints) in the analysis of whether a transferee can transfer a purchased financial asset to a third party reflects the lack of agreement amongst Board members on whether control of a transferred financial asset has passed to a transferee if the asset is not readily obtainable and the transferor's rights and obligations after the transfer significantly exposes the transferor to the risks and/or rewards of that asset.[1] It is those transfers that Board members (and others) cannot agree on the substance of the arrangement.

[1]Another reason for the inclusion of economic constraints in the 'ability to transfer' test is to reduce opportunities for structuring. For example, a transferor who seeks to account for a transfer of a financial asset as a failed sale (ie secured borrowing) might include a clause in the transfer contract that prohibits the transferee from selling a financial asset to third parties. The transferee might agree to include that prohibition in the contract because it knows that replacement assets are readily obtainable and that it thus could transfer the asset to someone else and still satisfy the prohibition by obtaining a replacement asset.

9. If economic constraints are not included in the '*practical* ability to transfer' test, a transfer (or is it a sale?) of an originated loan with any written put or guarantee would qualify for derecognition even though the asset-specific risk (for example, the credit risk relating to the debtor underlying the loan) would remain with the transferor.

10. Some Board members favour this outcome. Others (the ones that view those types of sales as being, in substance, secured borrowings) do not.

11. Therefore:

    a. both flowcharts require consideration of economic constraints in the evaluation of whether a transfer has resulted in the transferee having obtained the ability to transfer the purchased asset to a third party; and

    b. Flowchart 2 requires no derecognition if the transferee has not obtained that practical ability.

12. Flowchart 1 addresses the concern of those Board members who would like to account for a financial asset that a transferor sells subject to a written put as the derecognition of that asset and the recognition of the put as a derivative.

13. Flowchart 1 (unlike Flowchart 2 - which draws a line if a transferee lacks the practical ability to transfer) has an additional derecognition test. If the transferee has access to the financial asset's cash flows by means other than a transfer (because it might be entitled by contract or otherwise to hold onto the asset and receive (and keep) all of the cash flows that the asset generates), then the transferred asset will be derecognised.

Staff recommendations

14. The staff continues to recommend that the analysis of the 'practical ability to transfer' test in both flowcharts include considerations of economic constraints.

Question for the Board

15. Does the Board agree with the staff's recommendation in paragraph 14? If not, why not and what does the Board wish to do?

Appendix 1

Illustrations

1. Assume the following arrangement: Company A (the transferor) sells a 5-year, CU100-principal loan it originated to Company B (the transferee) and at the same time writes a put to Company B. The put has a strike price of CU100 (this applies to Scenarios 1-3). The arrangement does not impose any contractual prohibitions on the transferee from transferring the loan to a third party. The term of the put matches the term of the loan.

2. Assume the following scenarios involving different fair values of the loan and put (and in Scenario 1A, a different term of the put) at the date of transfer:

   a. **Scenario 1**: The fair value of the loan is CU100 and the fair value of the put is CU5 (all time value).

   b. **Scenario 1A**: The fair value of the loan is CU100 and the fair value of the put is CU4 (all time value). The transferee can exercise the put only upon a default by the debtor underlying the loan (ie the written put is a financial guarantee).

   c. **Scenario 2**: The fair value of the loan is 80 and the fair value of the put is CU25 (comprising of CU20 intrinsic value and CU5 time value).

   d. **Scenario 3**: The fair value of the loan is 120 and the fair value of the put is CU2 (all time value).

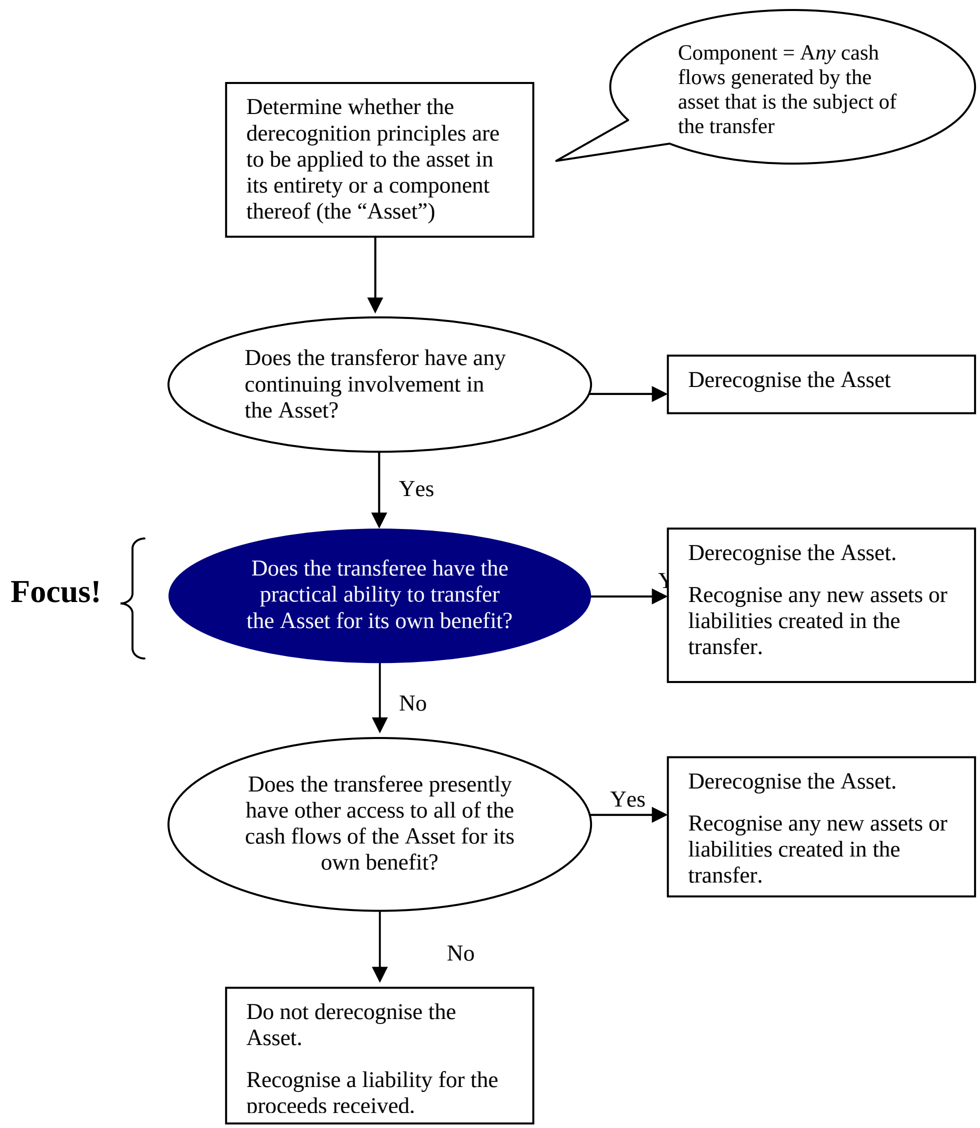
   e. **Scenario 4**: The fair value of the loan is CU100 and the fair value of the put is nil (this is because the put has a strike price equal to the fair value of the referenced loan).

3. The put seems to economically constrain the transferee in Scenarios 1, 1A and 2 and the related transfers thus seem to fail the ‘practical ability to transfer’ test. However, in Scenario 3, the put is deeply out of the money and thus it appears as if (at the date of transfer) it is unlikely that the transferee will exercise the put

over the term of the loan. Also in Scenario 4, the put does not seem to economically impede the transferee from selling the loan in light of the fair value of the put being nil (and in fact the fair value put arguably would not even constitute continuing involvement under the current definition of that term – see Agenda Paper 15E at the November IASB meeting).

Appendix 2

FLOWCHART 1



FLOWCHART 2