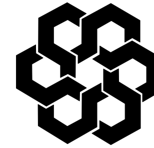

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International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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:	**23 July 2008, London**
Project:	**Consolidation**
Subject:	**Illustrative case 2 (Agenda paper 14B(2))**

Case title

Residential Mortgage Backed Securitisation

FACT PATTERN

Issuer

1. A retail bank (Seller) sets up a limited liability company (Issuer) for the purpose of carrying out restricted activities as described below. The initial set up costs of Issuer were funded by Seller in form of a loan of CU1 million to Issuer.

2. Seller sells a portfolio of mortgage loans to Issuer at par value of CU265 million, which mature in 20-25 years. All loans were originated by Seller and must remain in the portfolio until maturity.

Bondholders

3. Issuer funds the purchase of the mortgage assets through the issue of three categories of bonds with different ratings and level of subordination: senior (CU250 million), mezzanine (CU13 million) and junior (CU2 million). Bonds are issued to various investors, all of which are unrelated to Seller. All tranches of bonds mature

after the longest maturity of securitised assets (ie bonds will not be rolled over in the market).

4. Significant changes to structural features of the transaction can be made only by the agreement of a majority of bondholders. Bondholders do not have rights to exchange, pledge or sell the loans.

Credit enhancement

5. Seller funded a reserve fund of CU4 million. The reserve fund was established to ensure distribution of the principal and interest payments to bondholders in accordance with the priority of payments and provides a source of credit and liquidity support. The reserve fund, when drawn, is replenished from any available excess spread. [The excess spread represents the difference between cash inflows from mortgage holders and cash outflows to bondholders and other Issuer's expenses.] Amounts collected above the required level on the reserve fund are distributed to Seller. Upon liquidation of Issuer, the residual amounts are paid to Seller.

6. The reserve fund is sufficient to cover the expected defaults on mortgage loans. Seller has no obligation to make payments to bondholders on non-performance of loans.

Liquidity provider

7. A liquidity support provider, independent from Seller, has committed to make cash advances available to cover any temporary interest shortfalls. The funds borrowed are secured on non-defaulted assets and do not carry credit risk. Fees paid to the liquidity support provider are at market rates.

Trustee

8. An independent party, a trustee, holds all Issuer's nominal equity that does not carry voting rights. It receives a senior fee at market rates and ensures that the counterparties to Issuer are in compliance with the transaction agreements and legal requirements.

Servicer

9. Seller services the pool of mortgage loans on behalf of bondholders. In return, it receives a servicing fee at market rates. The servicer is obliged to act in accordance with servicing standards and transaction agreements. The servicer's responsibilities are as follows:

- To collect cash flows on loans from mortgage holders (ie interest and principal payments, tax and insurance liabilities) and distribute the payments to entitled parties in accordance with the priority of payments;
- To monitor overdue payments (ie contact mortgage holders, negotiate collection of overdue amounts and modify the payment terms—timing, amount or substitution of collateral);
- On default, to decide what action to take based on the procedure that maximises the net present value of the proceeds to bondholders (ie foreclose on and sell the mortgage asset or renegotiate the terms of the loan with the mortgage holder);
- After default, if the loan was not restructured, execute foreclosure (ie deciding when to foreclose, and when and to whom sell the mortgage assets);
- Invest funds pending distribution in short term, risk-free investments with a maturity date before the distribution date to Investors (the investment returns are not retained by Servicer);
- Preparation of reports and other administrative functions.

10. On behalf of Issuer, the trustee can terminate the servicer's appointment on the occurrence of certain events of default of the servicer or a breach of servicing obligations. In such events the trustee appoints a designated stand-by servicer.

Swap counterparty

11. To fund the floating rate interest due on the bonds with the fixed rate interest on the mortgage loans, Issuer enters into a fixed-for-floating interest rate swap with an unrelated counterparty at market rates.

Priority of payments

12. The amounts collected on mortgage loans are distributed according to the following waterfall of payments:

    1 fee to the trustee and payments due under the interest rate swap agreement;

    2 payments due under the liquidity facility and fee to the servicer;

    3 interest due on the senior and mezzanine bonds in order of seniority;

    4 principal due on the senior and mezzanine bonds in order of seniority;

5 interest and principal due on the junior bonds;

6 replenishment of the reserve fund to its required amount;

7 principal and interest due under the loan to fund the initial costs;

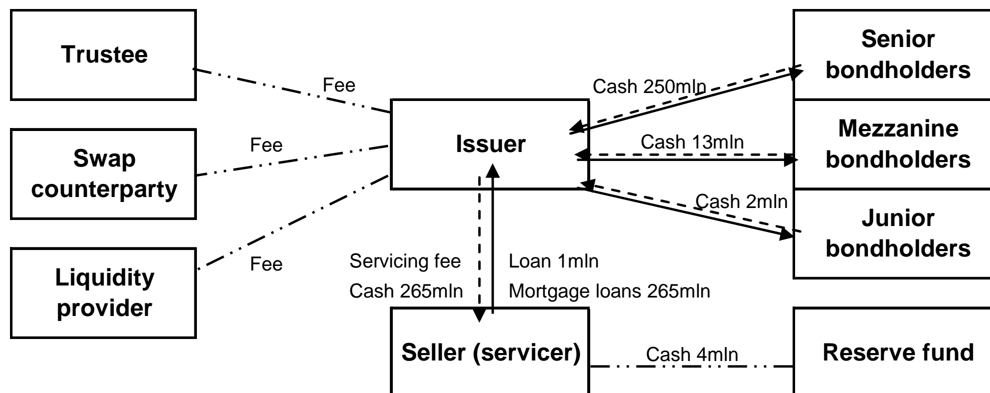
8 distribution of excess spread to Seller.

Earlier termination provisions

13. Seller, in its role as the servicer, has a 'clean-up call' that gives it the right to redeem all remaining bonds through a purchase of Issuer's loans when the outstanding principal on the bonds is less than 2% of the original amount; it results in the liquidation of Issuer. [This is to prevent the costs of servicing the mortgage assets and bonds becoming burdensome. The call option does not provide credit support for non-performing loans, because the loans would be purchased at the lower of their fair value or par value including accrued interests.]

14. Upon occurrence of events specified in the agreement, the activities of Issuer may be terminated earlier to protect the interest of bondholders. As a result the portfolio would be liquidated in the market and bonds redeemed before their scheduled maturity. Seller has priority to purchase the portfolio at market value. Early termination provision can be exercised by the majority of bondholders for example the portfolio deteriorates below a predetermined level, material breach of any covenants, representations and warranties specified in the agreement, or failure to repay Issuer's obligations on maturing bonds.

15. The flow of the resources is summarised in the diagram:



ANALYSIS IN ACCORDANCE WITH THE PROPOSED EDX

16. The purpose of setting up Issuer is to provide liquid funds to the seller of the loans and investment opportunities for the bondholders. The strategic financing and operating policies of Issuer were initially agreed by the parties and the circumstances to change those policies or ability to access the transferred loans are restricted severely. The bondholders and the trustee have limited power that does not affect the benefits generated of Issuer. The party controlling Issuer should have power over decisions that affect the performance of Issuer and benefits it receives from Issuer's activities.

Swap counterparty and liquidity provider

17. The swap counterparty and liquidity provider act as agents to Issuer. They are not able to participate in management of Issuer's activities. They receive return at market rates commensurate with servicers provided and risks assumed.

Bondholders

18. The bondholders have rights to approve some decisions regarding Issuer's activities. However, their ability to manage or use the assets of Issuer is limited and the decision making rights they held represents protective rights. Their exposure to risks is minimised by the reserve fund provided by Seller that absorbs the expected losses. The bondholders receive contractually agreed returns that correspond with the level of risk they assume. None of the bondholders controls Issuer.

Seller (servicer and support provider)

19. Seller restricted its rights to use the transferred loans in order to obtain benefits from the securitisation (proceeds from the sale would be used to finance its business). The ability of the bondholders and other parties to Issuer to use or manage the loans and change the established policies of Issuer is very limited unless it is exercised to provide protective rights.

20. Seller's benefits obtained from the securitisation depend on the Issuer's performance and vary with the level of provided financial support. This is because Seller holds the most subordinated interest in Issuer that entitles it to receive the residual amounts (ie the excess spread) and absorbs the lower than expected returns (losses on default of mortgage holders).

21. Seller retained servicing of defaulted loans, the area of Issuer's activities that requires decisions affecting the performance of Issuer. Seller, by managing the

loans in default, is able to affect the benefits derived from Issuer and effectively the level of benefits it receives. Seller is exposed to Issuer's variability that it can affect through servicing and therefore controls Issuer. The fact that Seller could be removed as the servicer would not negate its control, because the circumstances when the right might be exercised are limited and is provided to protect the bondholders from servicer's negligence or default.

Conclusions

22. Seller's retained involvement in Issuer enables it to conduct activities of Issuer for its benefit. In order to protect the interest of the bondholders, Seller had to limit its rights to use the loans. Although the strategic financing and operating policies of Issuer were established at the inception with strict restrictions on subsequent changes, Seller retains the management of the loan portfolio—the major decisions affecting Issuer's benefits. It is also exposed to variability of Issuer outcome through the reserve fund and excess spread.

23. Seller has sufficient power to affect Issuer's performance and the level of benefits it receives. Seller should consolidate Issuer, and therefore recognise the loans and liability toward bondholders in its financial statements.

Variation 1: Seller did not originate the loans

24. A party different from the seller might have originated the securitised loans. Provided that the seller's role in the securitisation transaction, with associated rights and obligations, benefits and risks, stayed unchanged, the conclusions reached about control should be similar. If the originator of the loans ceased its involvement with the loans and the seller acquired the rights to service the loans, obtains benefits from and is exposed to risks of the securitisation, the seller would control Issuer. This is because control should be assessed based on the *present* rights and obligations of the parties.

Variation 2: Seller has no servicing rights

25. The seller of the loans to Issuer may have purchased the loans from the originator to benefit from the securitisation. The originator may have retained servicing, whereas the seller arranged the transaction and provides financial support. The seller may agree with the originator that the originator will service the loans due to practical reasons rather than to control the loans (eg because of its expertise, existing infrastructure or cost savings on the transfer).

26. The originator that services the loans would cease control over the loans provided that it is no longer exposed to the variability on loan performance (eg its financial involvement, if any, is limited to short-term advances). The originator-servicer acting as an agent should receive a senior fee at market terms, commensurate with services provided. In addition, the originator's discretion may be constrained by standardised procedures followed in servicing of the loans. In such circumstances, the originator would derecognise the loans and not consolidate Issuer.

27. Similarly, the seller that cannot manage the loans and credit defaults would not consolidate Issuer, even if it arranged the securitisation transaction and retained exposure to variability of the mortgage loans. The seller would control the loans and consolidate Issuer if it obtains a variable return (eg receives residual profits or subordinated fees, provides credit enhancement or substantive liquidity facility) *and* can direct the servicing of the defaulted loans (special servicing). The seller may retain control over the special servicing by: carrying out activities of a special servicer, purchasing back defaulted loans or imposing servicing procedures with removal right over a special servicer.

Variation 3: Expected defaults absorbed by an external guarantor

28. The seller may organise the securitisation transaction and retain servicing of the mortgage loans without holding the subordinated notes or providing financial support. Credit enhancement that absorbs all or the majority of the expected defaults on loans (ie the reserve fund) may be provided by a third party guarantor.

29. The guarantor whose interest is limited to bear losses on mortgage loans without entitlement to share in any benefits and management of defaulted loans would act as an agent. The guarantor in the agency role should receive a return at market rates in portion to the risk exposure and any decision making rights over the loans or Issuer's activities should be limited to protect its interest (eg right to approve decisions that change guarantor's exposure to risks). The following factors might in addition indicate that the guarantor acts as an agent:

    - it receives a fixed and senior fee for the service;
    - it is able to withdraw the support (eg support renewable periodically);
    - its service can be provided on the market at similar terms by a third party.

30. The guarantor without the ability to benefit from and affect Issuer's activities should not consolidate Issuer, but recognise a financial liability. Similarly, the seller-servicer that is not exposed to the variability in performance of the mortgage loans should not consolidate Issuer. However, the seller-servicer should be deemed

to be exposed to variability if it provides financial support after the third party guarantor steps down (eg to retain access to the securitisation market when it represents its major source of financing).

ANALYSIS IN ACCORDANCE WITH CURRENT GAAPs

[Paragraphs 30-37 omitted from observer note.]