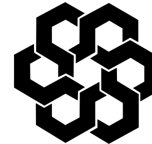

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International Accounting Standards Board

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:	**November 2008, London**
Project:	**Derecognition of Financial Assets and Liabilities**
Subject:	**'The Asset' (Agenda Paper 15B)**

Background

1. Agenda Paper 15A summarises the issues that board members raised at the IASB and IASB/FASB meetings in October and that the staff believes must be addressed before an exposure draft on derecognition of financial assets or liabilities can be issued. This paper deals with the first issue: what is 'the Asset' that Flowchart 1 and Flowchart 2 assess for derecognition?

2. At the October meetings, some board members requested greater clarity about the asset being referred to in application of the derecognition principle and related flowcharts - especially in the context of transfers of something other than the entire financial asset (a 'component').

3. This paper:

a. explains the importance of 'the Asset' for the staff's derecognition flowcharts;

b. puts parameters around (and recommends to the Board) what qualifies as 'the Asset' when a transfer involves all or part of the asset that the transferor recognised before the transfer;

c. illustrates the application of 'the Asset' in some examples; and

d. asks the Board to decide on the staff's recommendations.

Why is it important to know what 'the Asset' is?

4. Most financial assets are capable of being unbundled into "smaller" assets (possibly down to the individual (net) cash inflow). Normally there is no need to distinguish between components of a financial asset, the financial asset as a whole or even a portfolio of similar financial assets. However, the identification of 'the Asset' is important in the context of the derecognition tests in the flowcharts.

5. Both flowcharts ask the questions about (a) whether the transferor has any continuing involvement in the Asset and, if so (b) whether the transferee has the practical ability to transfer the Asset for its own benefit. If the transferee does not have the practical ability to transfer the Asset for its own benefit, Flowchart 1 asks further whether the transferee has presently other access to all of the cash flows of the Asset for its own benefit.

6. Determining 'the Asset' is relatively straightforward if a transfer involves the entire asset that the transferring entity recognised on its statement of financial position before the transfer. However, it becomes more complicated and more important when a transfer involves not the asset that the transferor recognised on its books before the transfer, but a right to all or some of the cash flows of that asset.

Right to all of the cash flows of an asset, but not the Asset (contract) itself

7. For example, if a bank sells a right to 100% of the cash flows of a portfolio of loans it originated to someone else, does that right qualify as the 'the Asset'? If

so, the derecognition tests in Flowchart 1 and Flowchart 2 are applied to 'the right to 100% of the cash flows of the loan portfolio'. Although the transferor continues to be the counterparty to the contract with the debtors underlying the originated loans, it does not have any continuing involvement in the right to all of (or benefits from) the cash flows that that portfolio generates. As a result, if 'the right to all of the cash flows' qualifies as 'the Asset', the transfer of that right would result in the transferor derecognising the loan portfolio under both Flowchart 1 and Flowchart 2.

8. However, if 'the right to 100% of the cash flows of the loan portfolio' does not qualify as 'the Asset' but rather 'the Asset' is the actual contracts with the debtors underlying the loan portfolio, the accounting outcome would be different for Flowchart 2. Why? As the transferor did not transfer the actual contracts underlying the loan portfolio, it continues to receive the cash flows from the debtors. Accordingly, the transferor continues to be involved in the loan portfolio ('the Asset'). Furthermore, as the transferee acquired a right to the loan portfolio but not the loan portfolio itself, it will not have the practical ability to transfer the loan portfolio for its own benefit. As a result, the application of Flowchart 2 would result in the transfer not qualifying for derecognition.

9. Contrary to Flowchart 2, Flowchart 1 would allow for the transferor to derecognise the loan portfolio because the transferor has to pass on all of the cash flows from the debtors, evidencing that the transferee presently has other access to the cash flows of the loan portfolio.

Right to some of the cash flows of an asset

10. If one were to accept for a moment that transferring a 'right to cash flows' is equivalent to transferring the asset to which the cash flows relate, determining 'the Asset' becomes also important when a transfer involves a right not to all but only to some of the cash flows of that asset.

11. Depending on the criteria used to define whether the right to some cash flows qualifies as a component (and thus as 'the Asset') will affect whether more or fewer transfers qualify for derecognition. If components are defined broadly,

more transfers will qualify for derecognition. If components are defined narrowly, fewer transfers will qualify for partial derecognition. This is because of the ‘continuing involvement’ step and the ‘practical ability to transfer’ test in the flowcharts.

12. Let’s change our previous example of a bank selling a right to 100% of the cash flows of a portfolio of loans that it originated. Now say that the bank transferred the right to the *first 80%* of the cash flows from the portfolio. If the ‘right to the first 80% cash flows’ qualifies as a component of the loan portfolio, the derecognition tests in Flowchart 1 and Flowchart 2 are applied to the ‘right to the first 80% cash flows’ (‘the Asset’). In that case, the transfer would qualify for derecognition either because:

    a. the transferor would not have any continuing involvement in the ‘component’ (the transferor’s residual subordinated 20% interest would be a separate component apart from the credit-enhanced 80% component transferred), or

    b. the transferee would have the practical ability to transfer ‘the right to the first 80% of cash flows’ to someone else for its own benefit.

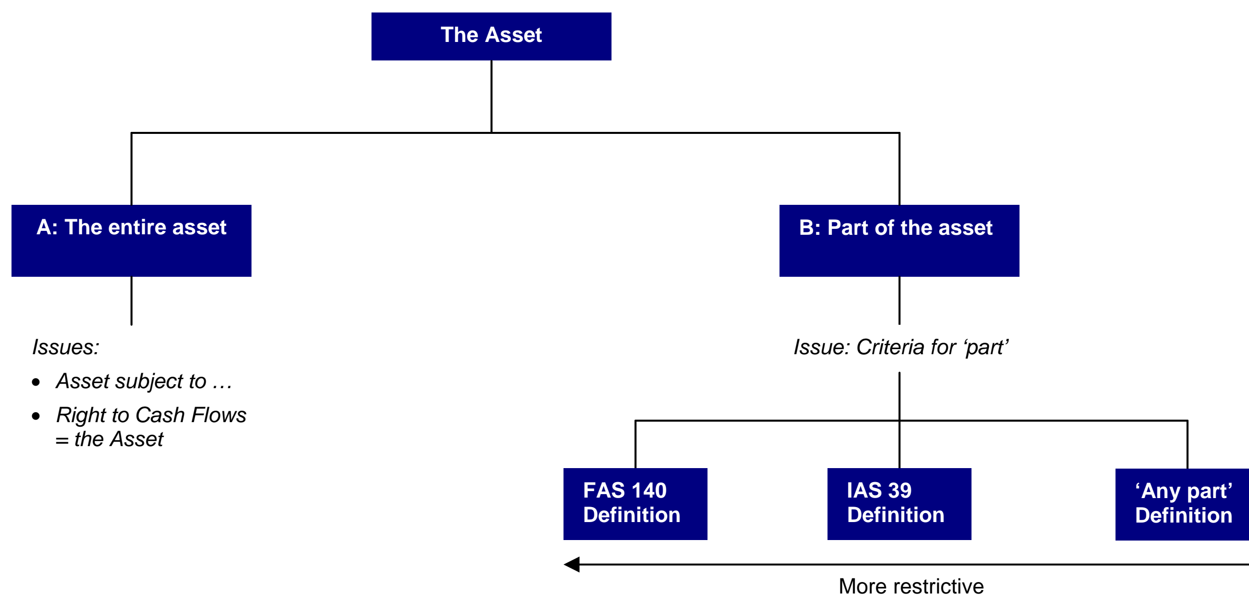
13. On the other hand, if the ‘right to the first 80% cash flows’ does not qualify as a component of the loan portfolio, the derecognition tests are applied to the entire loan portfolio. In that case, the entire loan portfolio is ‘the Asset.’ As a result, the transfer would not qualify for derecognition because the transferor’s retained subordinated interest indicates that:

    a. it has continuing involvement in the loan portfolio, and

    b. the transferee does not have the practical ability to transfer the loan portfolio.

So what is ‘the Asset’?

14. We can break down the analysis of ‘the Asset’ as follows:



A: The entire asset

15. As mentioned earlier, for transfers of the entire asset that the transferor recognised in its statement of financial position before the transfer, it is typically not difficult to determine 'the Asset' that is to be pushed through the derecognition tests in the flowcharts.

16. For example, if a bank originates a loan and sells that loan to someone else (eg via assignment of the related contract), 'the Asset' is the loan. If a bank originates 20 loans and sells all of them to someone else, 'the Asset' is each loan because each loan is as a separate asset (arguably, assuming no further strings are attached to the sale, whether the derecognition tests are applied in this case to each loan separately or to the loan portfolio as a whole will not yield a different outcome under the two flowcharts).

17. However, some board members have raised two issues in the context of transfers of entire financial assets:

    a. whether for a transfer of a financial asset with a call option, the Asset to which the derecognition tests are applied might be the financial asset subject to the transferor's call;

b. whether a transfer of a right to the cash flows of a financial asset rather than the asset itself qualifies as 'the Asset'.

A1: 'The Asset' = The asset subject to…

18. The staff believes that any contracts or other involvement that the transferor enters into in conjunction with the transfer of a financial asset that it previously recognised on its statement of financial position are not part of 'the Asset' being assessed for derecognition. However, the existence of 'other things' may have an impact on whether the asset being assessed for derecognition is derecognised.

19. These 'other things' constitute continuing involvement and are to be considered in both flowcharts in terms of their impact on the transferee's practical ability to transfer the financial asset and additionally in Flowchart 1 in whether the transferee has other access to the cash flows of that asset. However, they are not included in 'the Asset'.

20. Say a transferor transfers a loan and at the same time obtains a right to repurchase the loan at a fixed price. In this case, 'the Asset' is not 'the loan subject to the transferor's call' but rather the loan only. This is because the call option was added in conjunction with the transfer of the loan.

21. On the other hand, if a transferor transfers a convertible bond (ie a debt instrument with an embedded written call option on the debtor's equity), 'the Asset' is the convertible loan. This is because the embedded call option was already present when the transferor recognised the convertible bond on its statement of financial position. It was not added in connection with the transfer.

22. We will also discuss this point when we analyse a transferee's practical ability to transfer a financial asset for its own benefit in Agenda Paper [15C].

A2: 'The Asset' = Right to cash flows

23. As indicated in paragraphs 7-9, whether 'the Asset' could be the right to all of the cash flows of a financial asset vs. the asset itself is critically important for Flowchart 2. This is because (unlike Flowchart 1) Flowchart 2 allows for derecognition only if the transferee has access to the cash flows of that asset by

means of transfer of that asset to a third party (the 'practical ability to transfer' test). However, if the transferee cannot transfer the asset to a third party, Flowchart 2 does not allow for derecognition even though the transferee might have access to the asset's cash flows by means other than a transfer.

24. The staff sees two approaches:

a. **Approach 1:** *Transferring the right to the cash flows of a financial asset is akin to transferring the asset (the contract) itself (ie 'the Asset' would be 'the right to the cash flows')*

After the transfer, the transferee is in a similar economic position as it would be if the transferor transferred to it the asset (contract) itself. The economic position is similar but not the same because if the cash flows underlying the asset continue to be made through the transferor to the transferee, the transferee might be exposed to both the credit risk of the debtor underlying the asset and that of the transferor (this would be the case if the debtor cash flows were not segregated from the other assets of the transferor). Arguably, the transferee would pay less for the right to the cash flows of the asset than for the asset itself if that meant that it would be exposed to the transferor's credit risk.

Stated differently, by transferring a right to the cash flows of a financial asset, a transferor effectively transferred the asset itself because none of the cash flows paid by the underlying debtor will stay with the transferor but would rather end up with the transferee. That is, the transferor does not benefit from any of the cash flows coming from the underlying debtor.

b. **Approach 2:** *Transferring the right to the cash flows of a financial asset is NOT akin to transferring the asset (the contract) itself (ie 'the Asset' could only be the entire asset/contract that the transferor has recognised on its statement of financial position)*

Some argue that by transferring the right to the cash flows of a financial asset but by keeping the contract with the underlying debtor, the transferor

has undertaken an obligation to pass on cash flows to the transferee but has not given up the asset itself. After the transfer, the transferor continues to be the entity that can enforce the contract with the debtor. As a result, 'the Asset' that is assessed for derecognition cannot be the 'right to the cash flows of a financial asset.'

25. Under Approach 2, the obligation to pass on to the transferee any cash flows received from the debtor underlying the asset is a *future* obligation does not meet the definition of a liability in the Framework. That is, the transferor does not have "a present obligation …arising from past events, the settlement of which is expected to result in an outflow from the [transferor] of resources embodying economic benefits." The present obligation only arises if and when the transferor receives cash from the underlying debtor. In essence, after the transfer, the role of the transferor would appear to be that of an agent.

26. The staff reiterates that this issue is much more relevant for Flowchart 2 than for Flowchart 1 (see paragraph 23).

27. The staff recommends that the Board adopt Approach 1.

B: *Part of the asset*

28. In the October papers the staff used two different definitions of 'components' for purposes of illustrating how the two flowcharts would be applied to transfers of portions of financial assets. For Flowchart 1, the staff defined component as *any* cash flows that are generated by the financial asset that a transferor recognised on its books before the transfer. For Flowchart 2, the staff used the definition of a part of financial asset in paragraph 16 of IAS 39 *Financial Instruments: Recognition and Measurement*, which is more restrictive.

29. The staff believes that for Flowchart 1, components should encompass any cash flows that are generated by the financial asset that the transferor recognised on it statement of financial position before the transfer. This is because defining components in that way is consistent with the staff's underlying premise that a transfer of part of a financial asset should qualify for derecognition when the

transferor no longer has control over that part; that is when the transferor no longer has the ability to obtain the future cash flows underlying the transferred part and/or restrict others' access to those cash flows.

30. In that regard, if a transfer results in the transferee being entitled, by contract or otherwise, to the first 80% of cash flows of a portfolio of financial assets, then applying the staff's derecognition principle would lead to treating the first 80% of cash flows as a component because, irrespective of when they occur, those cash flows are generated by the original portfolio.

31. Accordingly, the staff does not believe that for Flowchart 1, components should be defined with the goal in mind of being abuse-preventive (which arguably is the case for the definition of a part of or participating interest in a financial asset in IAS 39 or the proposed amendment to FAS 140 *Accounting for Transfers of Financial Assets*, respectively).

32. However (unlike Flowchart 1) Flowchart 2 represents a comprise in that it follows the staff's derecognition premise for those arrangements for which it is relatively easy to determine where control lies, but it deviates from that premise (and no derecognition occurs) if a transferor's continuing rights and obligations with respect to the transferred assets or defined components thereof are so significant that it is unclear whether control over the assets or components thereof has passed to the transferee.

33. Because of this, the staff believes components need to be more tightly defined in Flowchart 2 than for Flowchart 1.

34. In that regard, the staff proposes three main approaches to define components in Flowchart 2:

    a. **Approach 1:** Define components similarly to the definition of a 'participating interest' in the proposed amendment of FAS 140

    b. **Approach 2:** Define components similarly to the definition of a part of a financial asset in IAS 39

c. **Approach 2A:** Define components similarly to the definition of a part of a financial asset in IAS 39 but incorporate some or all of the FAS 140 prohibition on derivatives, embedded derivatives that require bifurcation or equity instruments from qualifying as components

d. **Approach 3:** Define components to be any cash flows generated by a financial asset recognised by the transferor before the transfer (in essence, this is the definition of components proposed for Flowchart 1)

35. The definitions of parts or participating interests in financial assets in IAS 39 and FAS 140 are reproduced in Appendix 2 and Appendix 3, respectively, to this paper.

36. Some issues to consider include:

a. The definition of participating interests in financial assets in FAS 140 is similar yet more restrictive than the definition of parts of financial assets in IAS 39. For example, transfers of principal-only (P/O) and interest-only (I/O) strips would qualify as transfers of parts of the underlying (original) debt instrument in IAS 39. This is because each - the P/O and I/O strip - comprises specifically identified cash flows from the underlying debt instrument.

On the other hand, P/O and I/O strips would not qualify as participating interests in the underlying debt instruments under the proposed amendment to FAS 140 because (a) they do not represent proportionate ownership interests in those debt instruments and (b) the rights of the P/O strip holder and of the I/O strip holder do not have the same priority because in the case that the debtor underlying the debt instrument pays off the debt instrument early that cash flow goes to the P/O strip holder.

The staff notes that IAS 39 does not require that the part of a financial asset has to be *both* specifically identified and proportionate cash flows for it to constitute a component to which the IAS 39 derecognition tests can be

applied (hence P/O and I/O strips qualify as parts of the underlying debt instrument).

b. The definition of a participating interest in the proposed amendment to FAS 140 explicitly precludes equity instruments, derivatives or hybrid instruments with non-closely related embedded derivatives. IAS 39 has no specific guidance on this point. Examples might be

    i. a transfer of the cash flows of the receive leg of an interest rate swap asset to someone else (the transfer would involve specifically identified cash flows); or

    ii. a transfer of the dividend stream of perpetual preferred shares (say, the first two years of dividends).

c. The staff notes that the IFRIC was asked to clarify the meaning of 'similar' in paragraph 16 of IAS 39 (this is the paragraph that deals with transfers of a part of a financial asset, a financial asset, or a group of similar financial assets). At the November 2006 meeting, IFRIC decided not take this issue onto its agenda but published the view of the Board that derivatives are not similar to non-derivative financial assets and, accordingly, the derecognition tests in IAS 39 must be applied to each type separately if a transfer involved both.

   In the context of transfers of groups of financial assets that include derivatives, the IASB also indicated that transferred derivatives that could be assets or liabilities (such as interest rate swaps) would have to meet both the financial asset and financial liability derecognition criteria (this might help with the example in paragraph 35(b)(i) although the view by the IASB could be interpreted to apply only to a transfer of the entire derivative).

   Comment letters received by IFRIC after it rejected to take on the issue seem to indicate that practice continues to believe that paragraph 16 of IAS 39 is not clear enough. In light of that, the Board might have to

provide clarifying guidance on transfers involving groups of similar financial assets to the extent it decides on Approach 2 or Approach 2A.

37. **The staff recommends the Board decide**

  a. **for Flowchart 1, on *any* cash flows that are generated by the financial asset or group of financial assets that a transferor recognised on its statement of financial position before the transfer, and**

  b. **for Flowchart 2, on Option 2A described in paragraph 34 (whereby the Board specifically address**

    i. **transfers of groups of similar financial assets and**

    ii. **transfers of interests in derivatives, embedded derivatives that require bifurcation and/or equity instruments).**

Applications of 'the Asset'

38. Appendix 2 illustrates the staff's views of 'the Asset' in the context of transfers of a right to the cash flows underlying a financial asset.

Staff Recommendations

39. In summary, the staff proposes

  a. for transfers involving the entire asset, the Board decide on Approach 1 (see paragraph 27) (ie transferring the right to the cash flows of a financial asset is akin to transferring the asset itself (ie 'the Asset' would be 'the right to the cash flows')).

  b. for transfers involving part(s) of a financial asset(s), the Board decide (see paragraph 37)

    i. for Flowchart 1, on *any* cash flows that are generated by the financial asset or group of financial assets that a transferor recognised on its statement of financial position before the transfer (ie, 'the Asset would be any cash flows), and

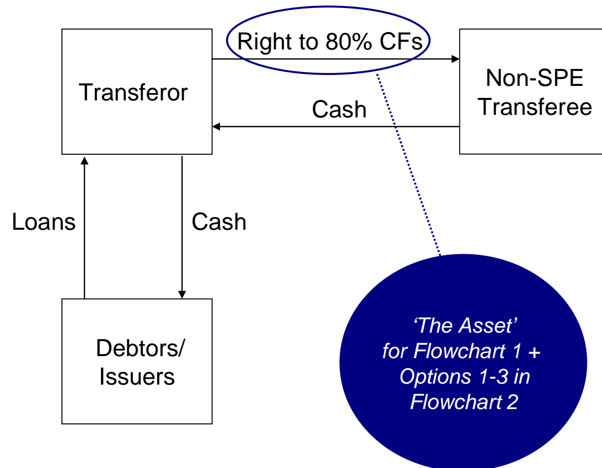
ii. for Flowchart 2, on Approach 2A (ie, ‘the Asset would be the component definition in paragraph 16 of IAS 39, with specific guidance about transfers of groups of similar financial assets and derivatives, embedded derivatives that require bifurcation and equity instruments).

Questions for the Board

40. Do you agree with the staff’s recommendation in paragraph 39. If not, why not and what would you prefer to do instead and why?

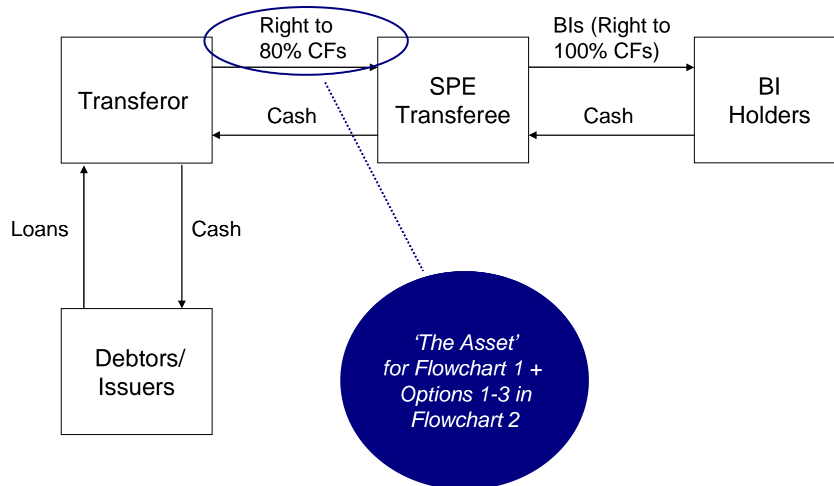
Appendix 1: Applications of 'the Asset'

Transaction 1: Transfer of 80% interest (i.e. proportionate) in a loan portfolio to a non-SPE



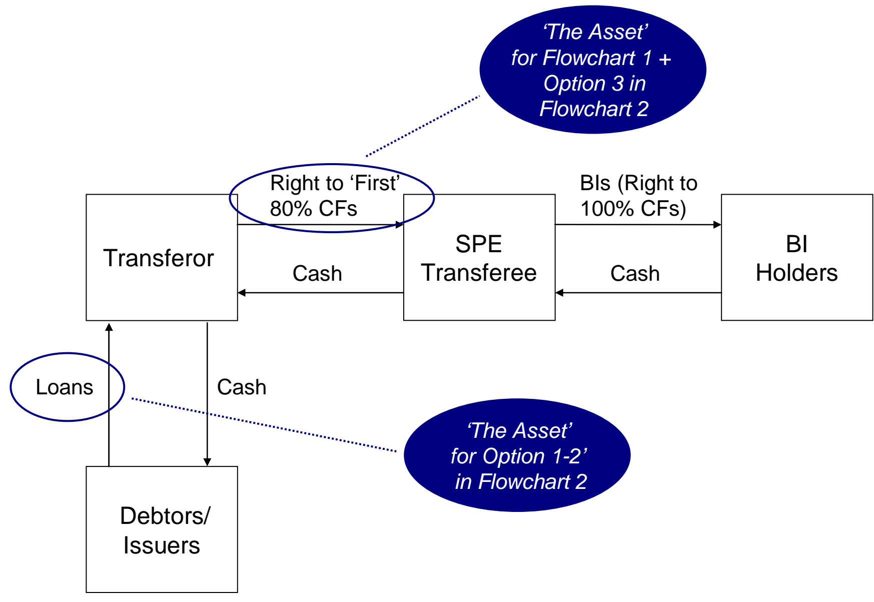
	Flowchart 1	Flowchart 2 Options 1-2A	Flowchart 2 Option 3
The Asset	Right to 80%	Same as in Flowchart 1	Same as in Flowchart 1
Continuing Involvement?	No	Same as in Flowchart 1	Same as in Flowchart 1
Practical Ability to Transfer the Asset?	N/A	N/A	N/A
Other Access to the Asset's Cash Flows for Own Benefit?	N/A	N/A	N/A
Linked Presentation?	N/A	N/A	N/A
Accounting Result?	• Derecognise 80% of loan portfolio • Continue to recognise remaining 20% of the portfolio	Same as in Flowchart 1	Same as in Flowchart 1

Transaction 2: Transfer of 80% interest (i.e. proportionate) in a loan portfolio to an SPE



	Flowchart 1	Flowchart 2 Options 1-2'	Flowchart 2 Option 3
The Asset	Right to 80%	Same as in Flowchart 1	Same as in Flowchart 1
Continuing Involvement?	No	Same as in Flowchart 1	Same as in Flowchart 1
Practical Ability to Transfer the Asset?	N/A	N/A	N/A
Other Access to the Asset's Cash Flows for Own Benefit?	N/A	N/A	N/A
Linked Presentation?	N/A	N/A	N/A
Accounting Result?	• Derecognise 80% of loan portfolio • Continue to recognise remaining 20% of the portfolio	Same as in Flowchart 1	Same as in Flowchart 1

Transaction 3: Transfer of 'first' 80% interest (i.e. non-proportionate) in a loan portfolio to an SPE



	Flowchart 1	Flowchart 2 Options 1-2'	Flowchart 2 Option 3
The Asset	Right to first 80%	Loan portfolio	Right to first 80%
Continuing Involvement?	No	Yes	Same as in Flowchart 1
Practical Ability to Transfer the Asset?	N/A	No	N/A
Other Access to the Asset's Cash Flows for Own Benefit?	N/A	N/A	N/A
Linked Presentation?	N/A	Yes	N/A
Accounting Result for Transferor?	• Derecognise 80% of loan portfolio • Continue to recognise remaining 20% of the portfolio (measurement would reflect subordination)	• Continue to recognise the entire loan portfolio • Recognise a liability for the proceeds received • Present the liability as a contra-asset to the loan portfolio on balance sheet	Same as in Flowchart 1

Appendix 2: Definition of a Part a Financial Asset in IAS 39

Paragraph BC53

[The Board] 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...

Paragraph 16

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.

    (i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 17-23 are applied to the interest cash flows.

    (ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 17-23 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

    (iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 17-23 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.

(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.'

Appendix 3: Definition of a Participating Interest in a Financial Asset in the proposed amendment to FAS 140

Paragraph 8B

The requirements of paragraph 9 apply to transfers of an individual financial asset in its entirety, transfers of groups of financial assets in their entirety, and transfers of a **participating interest** in an individual financial asset (which are referred to collectively in this Statement as *transferred financial assets*). A participating interest has the following characteristics:

a. It represents a proportionate ownership interest in an entire individual financial asset other than an equity instrument, a **derivative financial instrument,** or a hybrid financial instrument with an embedded derivative that is not clearly and closely related as described in Statement 133.

b. All cash flows received from the asset are divided among the participating interests (including any interest retained by the transferor, its **consolidated affiliates** included in the financial statements being presented, or its **agents**) in proportion to the share of ownership represented by each. Cash flows allocated to a servicer as compensation for servicing activities, if any, shall not be included in that determination. The transferor's ownership shares must remain pro rata over the life of the original financial asset. Participating interests may be further apportioned by the transferor as long as the resulting portions meet the definition of a participating interest.

c. The rights of each participating interest holder (including the transferor if it retains a participating interest) have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder. Participating interest holders have no recourse, other than standard representations and warranties, to the transferor (or its consolidated affiliates included in the financial statements being presented or agents) or to each other, and no participating interest holder is subordinated to another. That is, no participating interest holder is entitled to receive cash before any other participating interest holder in its role as a participating interest holder.

d. No party has the right to pledge or exchange the entire financial asset.

If a transfer of a portion of an individual financial asset meets the definition of a participating interest, the transferor shall apply the guidance in paragraph 9. If a transfer of a portion of an individual financial asset does not meet the definition of a participating interest, the transferor

and transferee shall account for the transfer in accordance with the guidance in paragraph 12.