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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: November 2008, London
Project: Derecognition of Financial Assets and Liabilities
Subject: Continuing Involvement (Agenda Paper 15E)

This paper

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 and liabilities can be issued. This paper deals with the second issue outlined in paper 15A - the definition of 'continuing involvement'
2. Agenda Paper 15A stated that the staff would bring the issue addressed by this paper to the Board at the December meeting. However, the staff has managed to finalise this paper ahead of our expectations, and so would therefore like to discuss it at this meeting.

Background

3. The first question in Flowchart 1 and Flowchart 2 asks whether the transferor has any continuing involvement in the Asset (as so determined in the first step – see Agenda Paper 15A for a discussion of ‘the Asset’).
4. This question serves to filter out those transfers for which it is easy to determine that the transferor should derecognise the transferred Assets and for which it is thus not necessary to apply the subsequent derecognition tests. This is because the transferor has no further ‘relationship’ with those Assets. As a result, the transferee’s ability to obtain and restrict others’ access to the Asset’s future cash flows is not constrained and hence control has passed to the transferee.
5. The notion of continuing involvement includes capturing any contractual rights that the transferor retains or new rights or obligations that the transferor obtains in connection with a transfer of financial assets, as evidenced by the transfer agreement or other contracts entered into by the transferor and the transferee at the time of the transfer.
6. In the October papers, the staff did not conclude on a definition of continuing involvement.
7. This paper provides
 - a. some possible definitions of continuing involvement;
 - b. some possible exceptions from the definition of continuing involvement;
and
 - c. a staff recommendation.

Possible definitions of continuing involvement

8. The following are possible definitions of continuing involvement (this is in relation to ‘the Asset’, ie, the whole or a predefined component of the financial asset that the transferor recognised on its statement of financial position before the transfer) that the Board might want to consider:

a. **Definition 1:** Continuing involvement in the Asset represents

retention of any contractual rights that resulted in the Asset or the acquisition of any new contractual rights or contractual obligations relating to the Asset (eg, any interest in the future performance of the Asset or a responsibility to make payments in the future in respect of the Asset under any circumstance).¹

b. **Definition 2:** Continuing involvement in the Asset represents

contractual provisions relating to the transfer that

- i. may result in the transferor reacquiring control of its previous contractual rights (for example, through a repurchase agreement, a call option held by the transferor or a put option written by the transferor); or
- ii. gives the transferor an obligation to pay subsequent decreases, or a right to receive subsequent increases, in the value of its previous contractual rights (for example, through a credit guarantee, a total return swap or a cash-settled put or call option).

A continuing involvement in the transferred Asset may result from contractual provisions incorporated in the transfer agreement itself or a separate agreement with the transferee or a third party entered into in connection with the transfer. Normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action do not constitute a continuing involvement in a transferred financial asset. The retention of the right to service a transferred financial asset does not in itself constitute continuing involvement in that asset.²

c. **Definition 3:** Continuing involvement in the Asset represents

any involvement with the transferred Asset that permits the transferor to receive cash flows or other benefits that arise from the transferred Asset or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer. Examples of continuing involvement

¹Paragraph 52, draft standard *Financial Instruments and Similar Items* developed by the Joint Working Group of Standard Setters and issued for comment in December 2000

²Paragraphs 37-38, exposure draft *Amendments to IAS 32 Financial Instruments: Disclosure and Presentation and IAS 39 Financial Instruments: Recognition and Measurement*, issued for comment in October 2002

include, but are not limited to, servicing arrangements, recourse or guarantee arrangements, agreements to purchase or redeem transferred financial assets, derivative instruments related to the transferred financial assets, implicit commitments to provide financial support, pledges of collateral or the transferor's beneficial interests.³

d. **Definition 4:** Continuing involvement in the Asset represents exposure to changes in the value of the transferred Asset⁴

9. Among the four definitions, the staff prefers Definition 1. It does not have some of the shortcomings of the other definitions (see following discussion) and generally fits the two derecognition flowcharts.
10. Definition 2 brings in the notion of control which seems to be circular because the purpose of the staff's derecognition tests and the underlying principle is to determine where control over the Asset's cash flows lies. It also does not refer to retention of any of the contractual rights that gave rise to the Asset, therefore leaving out components of the Asset that the transferor retains (thus, Definition 2 does not address retained subordinated interests in the Asset in Flowchart 2).
11. However, the staff likes the paragraph following the definition of continuing involvement in Definition 2. That paragraph:
 - a. emphasises the need to look for 'other things' in determining whether a transferor continues to be involved after the transfer (a procedure that is also important for the subsequent derecognition tests); and
 - b. provides exceptions for standard representations and warranties and servicing arrangements, which the staff agrees with (see discussion in following 'possible exceptions' section of this paper).
12. The staff is not opposed to Definition 3 other than it starts off with 'any involvement' and thus seems to define 'continuing' more so than both 'continuing' and 'involvement'. Also, the references to 'other benefits' that an

³Glossary, exposure draft of amendment to FASB Statement No. 140, *Accounting for Transfers of Financial Assets*, issued for comment in September 2008

⁴Paragraph 30, *IAS 39 Financial Instruments: Recognition and Measurement*

- involvement permits a transferor to receive and to ‘additional’ cash flows or other assets that an involvement obliges a transferor to provide are subject to diversity in interpretation and thus not clear enough for purposes of a definition.
13. Definition 4 seems to be too short and thus might not be specific enough. Most would argue that a guarantee that a transferor writes in connection with a transfer of financial assets to a transferee and that obliges the transferor to make the transferee whole for any losses upon a default by the underlying debtors is continuing involvement. However, the wording of Definition 4 arguably does not capture such types of guarantees.
 14. The staff recommends Definition 1. The staff also recommends clarifying guidance similar to the wording in Definition 2 about the need to consider not only contractual provisions incorporated in the transfer agreement itself but also separate agreements with the transferee or third parties entered into in connection with the transfer.
 15. The definition of continuing involvement would thus be as follows:

<p>Continuing involvement in a transferred financial asset or component thereof (the Asset) represents retention of any contractual rights that resulted in the Asset or the acquisition of any new contractual rights or contractual obligations relating to the Asset (eg, any interest in the future performance of the Asset or a responsibility to make payments in the future in respect of the Asset under any circumstance).</p> <p>A continuing involvement in the transferred Asset may result from contractual provisions incorporated in the transfer agreement itself or a separate agreement with the transferee or a third party entered into in connection with the transfer.</p>

Possible exceptions from continuing involvement

16. The staff believes that some exceptions must be made to Definition 1 to allow for derecognition in Flowchart 2 of transfers for which the transferor is in a similar position after the transfer as that of a:
 - a. seller that provides customary representations and warranties;
 - b. third party servicer; or

- c. third party buyer (see discussion in ‘Fair value forwards and options’ section below).
- 17. The consequence of not providing those exceptions is that such transfers are ‘kicked’ into the ‘practical ability to transfer’ test, which they might fail because either:
 - a. the ‘involvement’ might require the transferee to attach it to the financial asset to be able to sell the asset to someone else; or
 - b. the transferee is precluded by contract or otherwise to transfer the financial asset.
- 18. An example of the latter point in the preceding paragraph is an entity transferring financial assets to a trust (transferee) that then issues beneficial interests to third party investors. If the trust is precluded from transferring those assets (which is often the case in securitisations), the transferor could not derecognise the assets even though the only involvement it has with the assets might be standard representations and warranties, fiduciary servicing, or fair value forwards and options.
- 19. Failing the ‘practical ability to transfer’ test is typically not of similar significance in Flowchart 1 because the transfer may qualify for derecognition under the subsequent ‘other access to the asset’s cash flows’ test.
- 20. In light of the foregoing, the staff proposes the following three exceptions to the continuing involvement definition:
 - a. standard representations and warranties;
 - b. fiduciary servicing; and
 - c. fair value forwards and options.

Standard representations and warranties

- 21. Standard representations and warranties technically would meet the staff’s proposed definition of continuing involvement. However, similar to Definition 2, the staff proposes to make an exception for them from its proposed definition.

- This is because virtually every transfer agreement includes representations and warranties relating to the accuracy of the information provided about the assets that are the subject of the transfer (eg, the underwriting procedures performed).
22. As highlighted earlier, the consequence of not providing an exception for standard representations and warranties is that for Flowchart 2 some transfers might not qualify for derecognition because they would fail the ‘practical ability to transfer’ test even though the only involvement a transfer has after the transfer are those representations and warranties.
23. If the Board were to agree with excluding standard representations and warranties from the continuing involvement definition, the staff would propose to incorporate in the exposure draft the wording from Definition 2:
- [n]ormal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action do not constitute a continuing involvement in a transferred financial asset.

Fiduciary servicing

24. Based on the staff’s proposed definition of continuing involvement, servicing retained by the transferor will constitute continuing involvement in the transferred asset. The staff believes that similar to standard representations and warranties, the Board should make an exception for servicing contracts that qualify as fiduciary or agency relationships.
25. A servicer stands in a fiduciary or agency position if the servicer’s role is that of a service provider that is contractually obliged to perform its duties (at market rates for such services) in the best interest of the transferee (ie the entity that owns the Asset).
26. Additionally, it would seem that a fiduciary’s/agent’s fees should be senior in priority to any payment to the transferee from the serviced assets. Otherwise, the fiduciary or agent seems to hold a similar interest in the serviced assets as the transferee.

27. If the Board were to agree to an exception for fiduciary servicing, the staff would propose to make the concept of ‘fiduciary or agency servicing’ operational by providing similar factors to those used to determine whether fees paid to a decision maker constitute variable interests in an entity in accordance with FASB Interpretation No. 46(R) *Consolidation of Variable Interest Entities*.
28. Paragraph B19 of that Interpretation lists the following factors (as modified for the purpose of determining whether servicing by a transferor qualifies as fiduciary or agency servicing):
- a. The fees paid to the transferor are compensation for services provided and are commensurate with the level of effort required to provide those services (eg, the service arrangement does not include terms, conditions or amounts that are not customarily present in arrangements for similar services negotiated at arm’s length).
 - b. The fees are senior in priority to any payment to the transferee from the serviced/transferred assets.
 - c. The transferee has the right to terminate the transferor as a servicer.
 - d. The transferor does not have any other continuing involvement with the transferred assets than the servicing arrangement.

Fair value forwards and options

29. The staff proposes to make an exception for forward purchases, purchased calls and written puts for which the contract price is the fair value of the asset transferred. The staff believes even though a fair value forward or option that a transferor obtains in connection with a transfer of a previously recognised financial asset is a new right obtained and thus would be continuing involvement under the staff’s proposed definition, the transferor in repurchasing the asset under the forward, call or put is economically in the same position as a third party that purchases the asset from the transferee.

Staff Recommendations

30. The staff proposes that the Board adopts Definition 1 with the added clarification that ‘other things’ beside the transfer contract should be considered in determining continuing involvement (see paragraphs 14-15).
31. The staff also proposes that the Board excludes standard representations and warranties, fiduciary/agency servicing, and fair value forwards and options from the definition of continuing involvement.

Questions for the Board

32. Do you agree with the staff’s recommendation in paragraphs 30-31? If not, what would you like to do, and why?