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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **February 2009, London**

Project: **Derecognition of Financial Assets and Liabilities**

Subject: **Summary of Approach 2 (Agenda paper 2B)**

Introduction

1. Paper 2A summarised the key features of Approach 1. This paper

   a. summarises the key features of Approach 2 (the summary is on the basis of the Board's tentative decisions made at previous Board meetings – see extract of IASB Updates in Appendix 1);

   b. includes an overview of the disclosures that would accompany Approach 2 (Paper 2C includes a more detailed review of the disclosures); and

   c. asks which approach the Board would like to adopt as the basis for the Exposure Draft.

2. This paper also applies both approaches to some transactions (those which the staff discussed with the Board throughout this project). The transactions and corresponding accounting outcomes (including those under the derecognition criteria in IAS 39 and the proposed FAS 140 exposure draft) are included in Appendix 2. (Appendix 3 contains the detailed analysis of how the models are applied to arrive at the accounting outcomes summarised in Appendix 2).

3. The staff does not propose to discuss the analysis of the transactions and related accounting outcomes in Appendix 2 and Appendix 3 at this meeting. **If Board members do not understand or have questions on these appendices, please ensure you contact the staff before the meeting**

Background

4. At the October joint meeting with FASB, the Board supported the need to replace the derecognition requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. The Board decided that the Standard is difficult to understand and apply, and is internally inconsistent (the Standard combines the requirements of a control approach with those of a risks and rewards approach).

5. The Board members who supported Approach 2 agree that if a transferee has the practical ability to transfer an asset for its own benefit, control has passed to the transferee. However (and unlike Approach 1), in the absence of such an ability the transferor is deemed to have maintained control over the asset.

6. Approach 2 is similar in some ways to the current derecognition model in IAS 39 in that:

   a. the same definition of a 'component' (or part of an asset) is used, with some clarifications to address known application issues;

   b. the test of control is still used, although unlike the IAS 39 model that test has primacy;

   c. many of the derecognition outcomes will be similar under Approach 2 as compared to IAS 39 (the notable exceptions being transfers, such as repos, involving readily obtainable assets).

7. Approach 2 does differ from IAS 39 in some important ways, and as a result is less complex to understand (and arguably to apply). The differences include:

   a. no test of 'risks and rewards' and

   b. no pass-through requirements.

8. Approach 1 proposes far-reaching changes to accounting for derecognition of financial assets. Approach 2 can be seen as an evolution to IAS 39 that improves that model.

Flowchart for Approach 2

9. Approach 2 requires an entity to derecognise a financial asset or a pre-defined component thereof (the 'Asset') if:

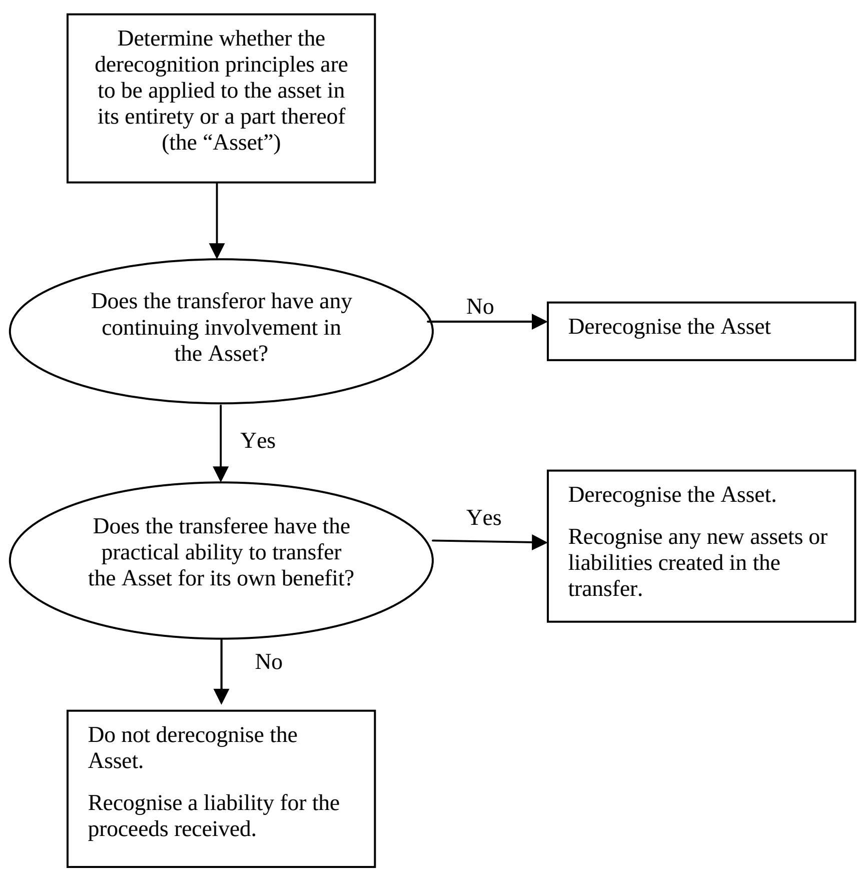
   a. the contractual rights to the cash flows from the Asset expire; or

   b. the entity transfers the Asset and:

      (i) the entity is not involved in the Asset after the transfer; or

      (ii) the transferee has the practical ability to transfer the Asset for its own benefit.

10. The Approach 2 flowchart is as follows:



Summary of Approach 2

What is 'the Asset' to be assessed for derecognition?

11. The 'continuing involvement' step and 'practical ability to transfer' test are applied to a transferred part of a financial asset (or of a group of financial assets) only if that part comprises specifically identified cash flows and/or a proportionate share of the cash flows from that financial asset (or that group of financial assets). If there is more than one transferee, each transferee is not required to have a proportionate share of the cash flows provided that the transferring entity has a proportionate share.

12. A transferred part of a financial instrument that can be either an asset or liability over its life (eg an interest rate swap) or that involves future economic benefits other than cash flows (eg an equity investment) does not qualify as a component and hence does not qualify as the 'Asset'.

13. For a transfer of a group of financial assets, the assets can be evaluated for derecogniton as a group only to the extent that none of them are instruments that can be either an asset or liability over its life (eg an interest rate swap) or that involve future economic benefits other than cash flows (eg an equity investment).

14. Transferring the right to the cash flows of an entire financial asset (or a part thereof that meets the component definition in paragraph 11) is akin to transferring the asset (component) itself. Stated differently, the 'Asset' for purposes of Approach 2 could be the 'right to the cash flows' in some circumstances.

'Continuing involvement' step

15. An entity is deemed not to be involved in a transferred financial asset or component thereof (ie in the Asset) after the transfer if it neither retains any of the contractual rights and/or obligations inherent in the Asset nor obtains any new contractual rights and/or obligations relating to the Asset (eg, if it does not have any interest in the future performance of the Asset or any responsibility to make payments in the future in respect of the Asset under any circumstance).

16. The following items are exceptions to the principle in paragraph 15 (that is, any one of them would not constitute continuing involvement in the Asset):

   a. 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;

   b. the retention of the right to service the Asset if

      (i) 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);

      (ii) the fees are senior in priority to any payment to the transferee from the serviced/transferred Asset; and

      (iii) the transferee has the right to terminate the transferor as a servicer.

   c. forward, option and other contracts for which the contract price is fair value of the transferred Asset.

17. Continuing involvement in the 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.

'Practical ability to transfer' test

18. For a transferee to have the practical ability to transfer the Asset it purchased from a transferor, it must be in a position immediately after the purchase to transfer the Asset to a third party unilaterally and without having to impose additional restrictions on that transfer.[1]

19. Determining whether a transferee has the practical ability to transfer a financial asset requires judgment considering all the relevant facts and circumstances. Some factors to consider in making that determination are:

[1] The meaning of 'unilaterally' and 'without additional restrictions' in the context of whether a transferee has the practical ability to transfer the Asset is explained in more detail in the section 'Other details about Approach 2'.

a. the terms of the transfer (contractual) arrangement;

b. other contracts or arrangements entered into in relation to the transfer

c. the nature of the asset

d. the market for the asset

e. the transferee's ability to obtain the full economic benefits

f. economic constraints.[2]

20. A transfer that does not qualify for derecognition because the transferee is deemed not to have the practical ability to transfer the Asset to a third party will qualify for derecognition if conditions subsequently change so as to give the transferee that ability. Exceptions to this principle are the following:

a. subsequent events that change the probability of an option being exercised (other than the exercise or expiration of the option itself) would not result in a change to the assets and liabilities recognised and derecognised.

b. once a transferor derecognises the Asset because it judges that the transferee has the practical ability to transfer that asset to a third party, it will not have to re-recognise the asset if conditions subsequently change resulting in the transferee no longer having the practical ability to transfer the asset.

Treatment of retained component

21. For a transfer of a component of a financial asset (or of a group of financial assets) that qualifies for derecognition, the transferor accounts for the component retained as part of the asset (or group of assets) recognised before the transfer.

22. As a result, the transferor would allocate the carrying amount of the asset (or group of assets) previously recognised between the component retained and the component transferred (and derecognised) on the basis of the relative fair values of those components on the date of transfer.

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[2] These factors are explained in more detail in the section 'Other details about Approach 2'.

23. Subsequent to the transfer, the transferor would use the same measurement attribute to measure the component retained as the attribute it used to measure the previously recognised asset (or group of assets).

24. On the other hand, a transferor that purchases an investment from (ie beneficial interest in) transferee securitisation vehicle accounts for the investment as a new asset (rather than as a component of the assets that the transferor previously recognised before it transferred them to the vehicle). As a result, the transferor would measure the investment according to the initial measurement requirements of IAS 39. Subsequently, the transferor would measure the investment following the classification it selected in accordance with IAS 39.[3]

Meaning of 'for its own benefit'

25. 'For its own benefit' in the context of the 'practical ability to transfer' test means that if a transferee were judged to have the practical ability to transfer the asset it purchased from the transferor to a third party, could it keep the consideration received from the third party for itself or would it have an obligation to pass the consideration onto the transferor? If the answer is the former, the transferee would be deemed to have the practical ability to transfer the asset for its own benefit; if the answer is the latter, then not. (The Board did not make an explicit decision on the 'for its own benefit' part of the 'practical ability to transfer' test, but we think it is important to explain it as part of this summary so the Board has a complete understanding of Approach 2).

[3]The same measurement guidance (described herein for a transferor's purchase of an investment in a securitisation vehicle) would apply to a transferor's continuing involvement in an entire financial asset (or group of financial assets) that qualifies for derecognition.

Summary of disclosures

26. Agenda Paper 2C splits the proposed disclosure requirements into two distinct sections, for which there are different disclosure objectives:

Disclosure requirements about:	**Disclosure objectives** **To provide users of financial statements with information:**
transferred financial assets that are derecognised (**both Approach 1 and Approach 2)**	(1) about the nature and risks associated with an entity's continuing involvement with derecognised financial assets.
	(2) that will help to reconstruct an entity's financial statements on the basis of a 'no continuing involvement' approach to derecognition.
transferred financial assets that are not derecognised **(Approach 2 only)**	(3) about the relationship between assets and associated liabilities when an entity transfers but continues to recognise financial assets.

All the disclosure objectives are relevant for Approach 2.

Disclosure objective (1): Risks and rewards associated with continuing involvement

27. Both Approach 1 and Approach 2 permit, in some instances, the derecognition of financial assets, when an entity retains continuing involvement. When an entity retains continuing involvement in financial assets that it has derecognised, we think that users of financial statements should be informed about the risks and rewards to which the entity remains exposed. Information about the risks and rewards associated with an entity's continuing involvement provides users with information relevant in assessing the amount, timing and uncertainty of the entity's future cash flows.

Disclosure objective (2): 'No continuing involvement' approach to derecognition

28. As noted above, both Approach 1 and Approach 2 permit, in some instances, the derecognition of financial assets, when an entity retains continuing involvement.

We understand that, for analysis purposes, users of financial statements would like information to be able to reconstruct an entity's financial statements on the basis of a 'no continuing involvement' approach to derecognition—i.e. financial assets being derecognised only when the transferor has no continuing involvement with the transferred assets. Therefore, we have proposed some disclosures specifically to meet this objective.

Disclosure objective (3): relationship between assets and associated liabilities

29. When financial assets are transferred but not derecognised, the information needs of users are reversed in that there has been a contractual event that may not be fully captured by the accounting treatment. Therefore, it is useful to understand the relationship between transferred financial assets and the associated liabilities that the entity recognises, so that users can identify both:

    a. economic benefits from assets that the entity cannot use in an unrestricted manner (eg cash flows that can only be used to settle specific obligations); and

    b. liabilities for which the counterparties do not have claims against the assets of the entity in general (non-recourse liabilities).

30. See paragraphs 17-20 and 28 in Agenda Paper 2C for detailed disclosure requirements.

Other details about Approach 2

Unilateral ability to transfer

31. The derecognition test of Approach 2 requires the transferee to be able to exercise its practical ability to transfer the asset it purchased from the transferor to a third party unilaterally. That is, the transferee should have the ability to dispose of the asset independently of the actions of others. This concept is based on the reasoning that an apparent ability to dispose of something is not a practical ability if another party can prevent the apparent ability from being used.

32. The transferee will not be able to exercise its ability unilaterally if, for example, the terms of the transfer require the transferee to obtain the consent of the transferor to the transfer of the asset, which consent can be withheld without reason, and that restriction is effective in practice.

33. On the other hand, if the transferor's consent is needed but it cannot reasonably be withheld, the transferee may still have the ability to transfer the asset unilaterally.

'Without additional restrictions'

34. The transferee needs also to be able to exercise its ability to transfer the asset to a third party without having to impose additional restrictions on that transfer. Restrictions that have no impact on the transferee's s practical ability to transfer should not be taken into account.

35. The concept of additional restrictions refers to any contract that the transferee would have to enter into with a third party on a subsequent transfer of the asset that is assessed for derecognition (ie the 'Asset'). Such a contract would be required if as part of the original transfer between the transferor and the transferee, the parties entered into an additional contract and that additional contract effectively prevented the transferee from transferring the Asset unless a similar additional contract were entered into by transferee and that third party.

36. Such an arrangement needs not be in a separate contract from the contract for the sale and purchase of the Asset. Both the 'sale and purchase agreement' and the additional contractual arrangement may be part of one contract. An additional restriction cannot be any feature inherent in the Asset (ie that feature would not have been part of the Asset before the transfer).

37. This point is well illustrated taking the case of a convertible bond. Although there may be a call option embedded in the convertible bond, that option is part of the Asset being assessed for derecognition and hence would not be considered an additional contract entered into as part of the transfer.

38. On the other hand, a call option (separate from the embedded option) attached to a convertible bond that is not readily obtainable is an additional contract and may

mean that the transferee would have to add a similar option to a subsequent transfer to avoid default under the call option contract between the transferor and the transferee. That is, the transferee may have to add restrictions (or additional restrictions) to the subsequent transfer of the Asset being assessed for derecognition and hence would be deemed not to have the practical ability to transfer the Asset in isolation.

39. The following are examples of circumstances where the transferee would be judged not be free and able to transfer to a third party the Asset purchased from the transferor as it risks being in default of its obligations to the transferor if it undertakes a transfer without attaching restrictions to protect its position:

   a. If the transferee has written a call option enabling the transferor to insist on the return of a transferred asset that is not readily obtainable, the transferee will risk defaulting on its obligation to the transferor if it transfers the asset to a third party without attaching a call option or forward purchase contract.

   b. A put option held by the transferee may also constrain the transferee's ability to dispose of the asset unless replacement assets are readily obtainable. In this case the transferee may 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.

   c. If the transferor has imposed obligations on the transferee concerning the servicing of the asset, which the transferee would have to impose on any entity to which it transferred the asset, the transferee would need to attach a similar provision to any transfer that it makes to a third party.

Factors to consider in the 'practical ability to transfer' test

40. ***Associated contracts -*** In assessing a particular transfer, it is necessary to consider any related arrangements, including any side agreements or sets of simultaneous agreements entered into contemporaneously with, or in contemplation of, the transfer of the financial asset or component thereof.

41. For example, if the transferee has written a call option whereby the transferor can insist on the return of a transferred asset that is non-readily obtainable, the transferee will risk defaulting on its obligation to the transferor if it transfers the asset to a third party. In such a situation the transferee will be judged to lack the practical ability to transfer the financial asset to a third party.

42. ***Nature of the asset (fungibility and availability)*** **-** In considering the practical effect of any restrictions relating to the transferee's ability to transfer the asset to a third party, the ease with which replacement assets can be obtained is an important factor. In essence, the issue is whether the transferee might find itself in default of any commitments or obligations to the transferor if it transfers the asset to a third party.

43. A contractual prohibition on disposing of an asset (or the absence of an explicit contractual right to dispose of it) may have no effect on the transferee's practical ability (and may therefore not prevent the transferee from having the practical ability to transfer the asset to a third party) if it is easy to obtain replacement assets, because the transferee may be able to transfer the asset and still satisfy the prohibition by obtaining a replacement asset.

44. For the practical ability to transfer analysis, replacement assets are deemed to be readily available only if the asset is actively traded on an accessible market (at the date of transfer).

45. ***The market for the Asset*** **-** A restriction or limitation that is effective on the number or identity of the parties to whom the transferee can transfer the asset also will have no practical effect if sufficient other potential buyers exist to create a market for the transfer of the asset.

46. Although the asset involved in a transfer may not be capable of being easily replaced, because of market convention, other established practice or an express or implied term of the transaction, it may be possible that an asset that is not identical to the asset transferred will be considered by the transferor to be an acceptable replacement for the transferred asset. If that is the case, the other arrangements entered into by the parties to the transfer (as part of the transfer) will not prevent the transferee from transferring the asset.

47. ***Transferee's ability to obtain full economic benefits -*** As the 'practical ability to transfer' test assesses the transferee's ability to obtain the full economic benefits of the asset transferred, any retained rights by the transferor that does not prevent the transferee from doing so will have no effect on the test of practical ability.

48. The retention by the transferor of a right to match a bona fide offer received by the transferee from a third party will not prevent the transferee from having the practical ability to transfer the asset to a third party. In such cases, when the repurchase occurs pursuant to the contract, the transferee's position is no better or worse than if it were to sell the financial asset in the market on that day.

49. The same analysis applies to transfers where the transferor retains a first right of refusal on the asset or a repurchase right at the prevailing market value of the asset.

50. ***Economic constraints to transfer -*** If a transferee stands to incur losses on the transfer to a third party, it may economically be impeded from, and therefore judged not to be practically free and able to, transfer the asset to a third party.

51. For example, a put option held by the transferee may constrain the transferee's ability to dispose of the asset unless replacement assets are readily obtainable. The transferee may be economically impeded from transferring the asset unencumbered by an option or right to reacquire because the transferee would not then be able to exercise its retained put option.

52. Although a transferee is, in theory, always free to choose not to exercise a put option, in reality a put option may convey benefits to the transferee that it is unlikely to be prepared to give up lightly, so its existence may constrain the transferee.

53. 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 underlying asset in isolation (i.e. without attaching the put option or a similar option).

54. In majority of cases where the put option is transferable, the asset that is assessed for derecognition would be readily obtainable and hence the transferee would be deemed to have the practical ability to transfer (as he would be able to acquire a replacement asset to fulfil its obligation or rights under the option contract)

Question for the Board

55. Should Approach 1 or Approach 2 form the basis for the forthcoming exposure draft?

(It is the intention of the staff that the approach not selected by the board will be included in the ED as a detailed ‘Alternative View’).

Appendix 1: Decisions made in respect of Approach 2 (extracts of IASB Updates)

October 2008

In June 2008 the Board added derecognition of financial instruments to its active agenda. At this meeting, the Board discussed two possible approaches to derecognition of financial assets. The IASB and the FASB discussed this topic further at their meeting on 20 and 21 October. No decisions were made.

November 2008

The Board continued its discussion of two possible approaches to making a derecognition principle for financial assets operational, and made the following tentative decisions:

- For transfers involving an entire asset, transferring the right to the cash flows of a financial asset is akin to transferring the asset itself.
- For transfers involving a part of a financial asset, the following item would be assessed for derecognition:
  - […]
  - within approach 2 - a part of a financial asset or group of financial asset as defined in paragraph 16 of IAS 39, subject to specific guidance about transfers of groups of similar financial assets, derivatives, embedded derivatives and equity instruments.
- ‘Continuing involvement’ in a transferred financial asset or component thereof (the Asset) represents retention of any contractual rights or contractual obligations inherent 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 circumstances). Continuing involvement 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. Continuing involvement would not include standard

representations and warranties, fiduciary/agency servicing, fair value forwards and fair value options

- For a transferee to have the practical ability to transfer a financial asset purchased from a transferor, it must be in a position immediately after the purchase to transfer the asset to a third party unilaterally without having to impose additional restrictions on that transfer. Determining whether a transferee has the practical ability to transfer a financial asset requires judgment considering all the relevant facts and circumstances.
- The transferor would not reassess 'practical' ability in subsequent periods, except in some cases (such as when an option is exercised or expires) when the transferee subsequently acquires the practical ability to transfer the asset to a third party.
- The derecognition tests would be applied from the perspective of the transferee, not the perspective of the transferor.

December 2008

The Board continued its discussion of the two approaches to derecognition that the staff presented at the joint meeting with the US Financial Accounting Standards Board (FASB) in October. The Board made the following tentative decisions:

- For Approach 2, to continue to include economic constraints (including some options allowing the transferee to put a transferred asset back to the transferor) in the assessment of whether a transferee has the practical ability to transfer to a third party for its own benefit the financial asset that it purchased from the transferor.
- The Board also tentatively adopted the following derecognition principle for financial liabilities:

  > "An entity should derecognise a financial liability or component thereof when it no longer qualifies as a liability of the entity (ie when the present obligation is eliminated and the entity is no longer required to transfer economic resources in respect of that obligation)."

- The Board also discussed secured borrowings with or without recourse, security lending arrangements and repurchase agreements (repos). For secured borrowings with recourse and security lending arrangements and repos, the Board made the following tentative decisions:
    - Secured borrowings with recourse and securing assets should be accounted for similarly to unsecured borrowings and unpledged assets.
    - Any restrictions on a debtor’s ability to benefit from the securing asset should be addressed by disclosure.
    - Security lending arrangements and repos involving readily obtainable financial assets should qualify for derecognition.
- The Board made no tentative decisions on the accounting for secured borrowings without recourse and the related securing assets.

January 2009

The Board resumed its discussion of the two approaches to derecognition originally presented at the Board’s joint meeting with the US Financial Accounting Standards Board in October 2008. The Board made the following tentative decisions for Approach 2:

- For a transfer of a part of a derivative, a hybrid instrument with an embedded derivative that requires bifurcation or an equity instrument, to assess the part (rather than the entire instrument) for derecognition only if it involves specifically identified and/or proportionate cash flows. As a result, if a transferred part of a financial instrument can be either an asset or a liability over its life (eg an interest rate swap) or involves future economic benefits other than cash flows (eg an equity investment), it will not qualify for derecognition.
- To allow transferred financial assets to be evaluated for derecognition as a group, but not allow any of those assets to be instruments that can be either assets or liabilities over their life (eg interest rate swaps) or that involve future economic benefits other than cash flows (eg equity investments).

- In a transfer that qualifies for derecognition, to treat the retained component of a financial asset or group of financial assets as a retained part of the financial asset recognised before the transfer (rather than as a new asset).
- To treat as a new asset an investment that a transferor purchases from a transferee securitisation vehicle.
- To disclose in the notes (rather than in the statement of financial position) the relationship between a transferred financial asset that does not qualify for derecognition and the associated liability, if the transferee's only recourse is to the transferred asset rather than to the transferor.

[Appendix 2 omitted from observer notes]

Appendix 3: Detailed application of Approaches 1 and 2 to transactions

This appendix applies Approach 1 and Approach 2 to some transactions (those which the staff discussed with the Board throughout this project). The transactions are the following:

1:	Transfer of financial asset with *physically*-settled forward purchase (or total return swap) at fixed price
2:	Transfer of financial asset with physically-settled purchased call at fixed price
3:	Transfer of financial asset with physically-settled written put at fixed price
4:	Transfer of financial asset with *net*-settled total return swap: • **Scenario 1:** Base swap • **Scenario 2:** Swap with interim return payments baked into settlement • **Scenario 3:** Fully prepaid swap • **Scenario 4:** Fully prepaid swap with asset 'ringfenced' (reverse pass-through)
5:	Transfer of *first* 80% interest in a portfolio of originated loans

Detailed analyses of transactions

See following pages

Transaction 1

Transfer of a financial asset with a *physically*-settled forward purchase (or total return swap) at a fixed price

Analysis

<table>
<tr><th></th><th>Readily obtainable financial asset
(eg publicly-traded bond)</th><th>Non-readily obtainable financial asset
(eg originated loan)</th></tr>
<tr><td>Approach 1</td><td colspan="2">Derecognition

The transfer qualifies for derecognition because the transferor does not presently have access to all of the cash flows of the bond (loan). The transferor may presently have access to some of the interim cash flows of the asset (ie those before the derivative settles), but it does not presently have access to the remaining cash flows of the asset that are scheduled to occur after the settlement date (the transferor will get access those cash flows when the derivative settles and it receives the asset from the transferee).</td></tr>
<tr><td>Approach 2</td><td>Derecognition

The transfer qualifies for derecognition because even though the transferor has continuing involvement in the bond (‘the Asset’) after the transfer as a result of the derivative (forward or total return swap), the transferee has the practical ability to transfer the bond for its own benefit. This is because the transferee can sell the bond to someone else unilaterally and without having to impose any additional restrictions. Because the bond is publicly traded, the transferee likely will not have to combine the bond with the derivative in order to sell it. Also, the transferee can easily obtain a replacement bond when it has to perform under the derivative.</td><td>No derecognition

The transfer fails derecognition because

• the transferor has continuing involvement in the loan (‘the Asset’) after the transfer as a result of the derivative (forward or total return swap), and

• the transferee does not have the practical ability to transfer the loan for its own benefit because if it were to do so it would have to default under the forward/swap. Alternatively, the transferee might be able to transfer the loan but only if it were to attach the forward/swap to the loan.</td></tr>
</table>

Transaction 2

Transfer of a financial asset with a physically-settled purchased call option at a fixed price (assume the call is neither deeply in the money nor deeply out of the money)

Analysis

<table>
<tr><th></th><th>Readily obtainable financial asset (eg publicly-traded bond)</th><th>Non-readily obtainable financial asset (eg originated loan)</th></tr>
<tr><td>Approach 1</td><td colspan="2">Derecognition

The transfer qualifies for derecognition because the transferor does not presently have access to the cash flows of the bond (loan). It is the transferee who presently has access to all of the bond’s (loan’s) cash flows given that it can hold onto the bond (loan) to maturity and receive, and keep for itself, all the bond’s (loan’s) cash flows. Through the purchased call option, the transferor has a right to get access to the bond’s (loan’s) cash flows, but until it exercises the option and pays the strike price, it does not presently have access to the bond’s (loan’s) cash flows.</td></tr>
<tr><td>Approach 2</td><td>Derecognition

The transfer qualifies for derecognition because even though the transferor has continuing involvement in the bond (‘the Asset’) after the transfer as a result of the derivative (call), the transferee has the practical ability to transfer the bond for its own benefit. This is because the transferee can sell the bond to someone else unilaterally and without having to impose any additional restrictions. Because the bond is publicly traded, the transferee likely will not have to combine the bond with the derivative in order to sell it. Also, the transferee can easily obtain a replacement bond when it has to perform under the derivative.</td><td>No derecognition

The transfer fails derecognition because
• the transferor has continuing involvement in the loan (‘the Asset’) after the transfer as a result of the derivative (call), and
• the transferee does not have the practical ability to transfer the loan for its own benefit because if it were to do so it would have to default if the transferor exercised the call. Alternatively, the transferee might be able to transfer the loan but only if it were to attach the call to the loan.</td></tr>
</table>

Transaction 3

Transfer of a financial asset with a physically-settled written put option at a fixed price (assume the put is neither deeply in the money nor deeply out of the money)

Analysis

<table>
<tr><th></th><th>Readily obtainable financial asset
(eg publicly-traded bond)</th><th>Non-readily obtainable financial asset
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<tr><td>Approach 1</td><td colspan="2">Derecognition

The transfer qualifies for derecognition because the transferor does not presently have access to the cash flows of the bond (loan). It is the transferee who presently has access to all of the bond’s (loan’s) cash flows given that it can hold onto the bond (loan) to maturity and receive, and keep for itself, all the bond’s (loan’s) cash flows. Until the transferee exercises the put, the transferor does not have access to the bond’s (loan’s) cash flows.</td></tr>
<tr><td>Approach 2</td><td>Derecognition

The transfer qualifies for derecognition because even though the transferor has continuing involvement in the bond (‘the Asset’) after the transfer as a result of the derivative (put), the transferee has the practical ability to transfer the bond for its own benefit. This is because the transferee can sell the bond to someone else unilaterally and without having to impose any additional restrictions. Because the bond is publicly traded, the transferee likely will not have to combine the bond with the derivative in order to sell it. Also, the transferee can easily obtain a replacement bond when it wants to exercise the put.</td><td>No derecognition

The transfer fails derecognition because
the transferor has continuing involvement in the loan (‘the Asset’) after the transfer as a result of the derivative (put), and
the transferee does not have the practical ability to transfer the loan for its own benefit because arguably it would only transfer the loan if it attached the put to it or if it attached a provision to the loan requiring the buyer to return the loan to the transferee if the transferee exercised the put.</td></tr>
</table>

Transaction 4

An entity transfers for CU100 a financial asset that has a 5-year maturity and pays interest of CU10 at t0, t1…t5 and principal of CU100 at t5 (that is, after the transfer the transferee has physical custody of the asset). In connection with the transfer, the entity enters into a *net*-settled total return swap with the transferee. Four scenarios for the swap:

1. ***Scenario 1 (base swap)*:** On t1 and t2, the transferor pays to the transferee a return (say, LIBOR plus a credit spread) on the initial CU100 it received from the transferee. The transferee pays to the transferor the CU10 that the financial asset generates. Also on t2 (in addition to the cash flows relating to the transferee's CU10 payment and the transferor's LIBOR-based payment), the parties exchange cash on the basis of the difference of the fair value of the financial asset and CU100. That is, if the fair value of the financial asset exceeds CU100, the transferee pays to the transferor that excess. Alternatively, if the fair value of the financial asset is less than CU100, the transferor will pay to the transferee that difference.

2. ***Scenario 2 (swap with interim return payments baked into settlement):*** Same scenario as scenario 1 except that the interim return payments on the transferee's initial CU100 investment are baked into the settlement price of the swap. On t1 and t2, the transferee pays to the transferor the CU10 that the financial asset generates. Also on t2, the parties exchange cash on the basis of the difference of the fair value of the financial asset and CU130 (different from the CU100 in the previous example – the CU130 includes the interim return payments that the transferor made in scenario 1 at t1 and t2). That is, if the fair value of the financial asset exceeds CU130, the transferee pays to the transferor that excess. Alternatively, if the fair value of the financial asset is less than CU130, the transferor will pay to the transferee that difference.

3. ***Scenario 3 (fully prepaid swap):*** On t0, the transferor pays to the transferee CU100 (so on a net-basis, the parties do not exchange cash on t0). On t1 and t2, the transferee pays to the transferor the CU10 that the financial asset generates. Also, on t2, the transferee pays to the transferor the fair value of the asset. The transferor does not have a security interest in the asset that the transferee has in its custody. Also, the transferee is not restricted from selling the asset to a third party.

4. ***Scenario 4 (fully prepaid swap with asset 'ringfenced' – reverse pass-through):*** Same as 3 but the transferor has a security interest in the asset transferred to transferee on t0 (as a result, assume the transferee cannot sell the asset to a third party). The transferor cannot go after transferee's other assets if the asset does not generate any cash flows. Also, in theory the transferee could decide to 'walk away' from its obligation to pass on any cash flows from the assets on t1 and t2 and/or pay the fair value of asset at t2 by giving the asset to the transferor.

Transaction 4 (continued)

Analysis

<table>
<tr><th></th><th>Readily obtainable financial asset (eg publicly-traded bond)</th><th>Non-readily obtainable financial asset (eg originated loan)</th></tr>
<tr><td>Approach 1</td><td colspan="2">Scenarios 1-3: Derecognition

The transfer qualifies for derecognition because in all three scenarios the transferor does not presently have access to all cash flows of the bond (loan).

• In scenarios 1-2, the transferor must pay the transferee to get access to the bond’s (loan’s) cash flows (in scenario 1, this is in form of the LIBOR-based payments at t1 and t2 and the CU100 payment embedded in the settlement of the swap at t2; in scenario 2, this is in form of the CU130 payment embedded in the settlement of the swap at t2).

• In scenario 3 even though the transferor receives from the transferee cash flows at t1 and t2 that are equal in value to those that the bond (loan) generates and also receives the fair value of the bond (loan) at t2, those cash flows are not necessarily those generated by the bond (loan) (eg the transferee may have sold the bond (loan) to a third party which would be entitled to all the bond’s (loan’s) cash flows; in that case the transferee would pay cash flows to the transferor in reference to the cash flows of an asset that neither of them owns).

Scenario 4: No derecognition

The transferor fails derecognition because the transferor presently has access to all of the cash flows of the bond (loan) (through the security interest, the bond (loan) is ‘ringfenced’ so that the transferee cannot sell it; in that case although the transferee has access to all of the cash flows of the bond (loan), it does so not for its own benefit because it has an obligation to pass them onto the transferor – after the transfer the role of the transferee is that of a servicer)</td></tr>
<tr><td>Approach 2</td><td colspan="2">Scenarios 1-3: Derecognition

The transfer qualifies for derecognition because even though the transferor has continuing involvement in the bond (loan) (‘the Asset’) after the transfer as a result of the derivative (total return swap), the transferee has the practical ability to transfer the bond (loan) for its own benefit. This is because the transferee can sell the asset to someone else unilaterally and without having to impose any additional restrictions. Because the swap is net settled, the transferee does not have an obligation to deliver the asset to the transferor upon settlement.

Scenario 4: No derecognition

The transfer fails derecognition because

• through the swap, the transferor has continuing involvement in the bond (loan) and

• the transferee is precluded from transferring the bond (loan) for its own benefit.</td></tr>
</table>

Transaction 5

Transfer of *first* 80% interest in a portfolio of financial assets

Analysis

<table>
<tr><th></th><th>Readily obtainable financial assets (eg publicly-traded bonds)</th><th>Non-readily obtainable financial assets (eg originated loans)</th></tr>
<tr><td>Approach 1</td><td colspan="2">Derecognition

The transfer qualifies for derecognition because the transferor does not presently have access to all cash flows of the portfolio (it has access to only the last 20%).</td></tr>
<tr><td>Approach 2</td><td colspan="2">No derecognition

The transfer does not qualify for derecognition because
the transferor has continuing involvement in the portfolio (‘the Asset’) after the transfer as a result of (i) its retention of a 20% interest in the portfolio and (ii) the subordination of that interest; and
the transferee does not have the practical ability to transfer the portfolio for its own benefit because the transferor retains a 20% interest in the loan portfolio.</td></tr>
</table>