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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: February 2009, London

**Project: IAS 39 Financial Instruments: Recognition and
Measurement – Derecognition of Financial Assets and
Liabilities**

Subject: Complex Cases – Observations (Agenda paper 2D)

PURPOSE

1. Agenda Paper 2E illustrates the application of Approaches 1 and 2 to a number of examples and the accounting outcomes.
2. This paper summarises some of the issues the staff identified in developing Agenda Paper 2E. Some of those issues have been discussed previously by the Board whilst others have been implicit in previous Board discussions. This paper also considers the effect of the order of application of the proposed derecognition and consolidation guidance.
3. The detailed fact pattern for the examples, the consolidation and derecognition analysis and conclusions thereof are not replicated in this paper. Not all the

examples raise issues that the staff considers to be significant and hence this paper does not include commentary on all of the examples. The numbering of the cases follows the numbers given to the detailed example in Agenda Paper 2E.

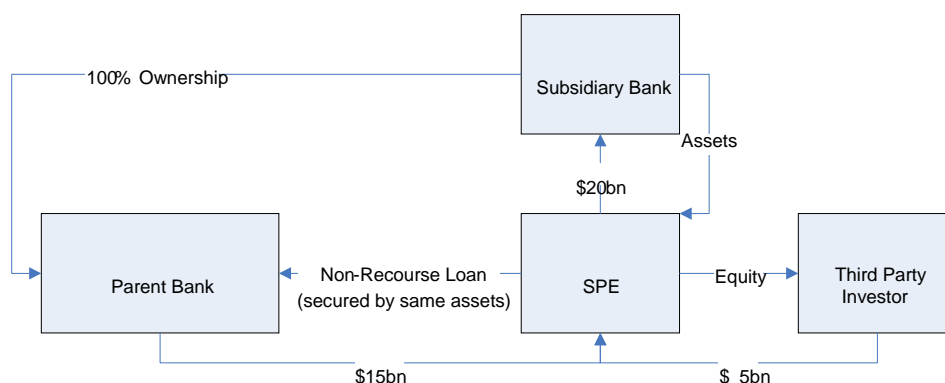
4. The staff's analysis of the cases follows the steps (questions) in the flowcharts. The flowcharts reflect the tentative decisions made so far by the Board in respect of the two approaches (see Agenda Papers 2A and 2B).
5. The staff does not propose to discuss this paper and Agenda paper 2E at this meeting. **If Board members do not understand or have questions on this paper or Paper 2E, please ensure you contact the staff before the meeting.** If the Board wants the staff to further research any of the issues raised, we run the risk of not meeting the ED deadline.
6. The appendix to this paper contains the Flowcharts for Approach 1 and 2. They are attached to this paper to provide Board members easy access to the Flowcharts as they work through the examples in paper 2E.

OBSERVATIONS

Example 2: Distressed Debt and Reassessment

Example 2A (Consolidation first and then derecognition)

Example 2B (Derecognition first and then consolidation)



Issue 1: Scope of the entities included in the continuing involvement test under Flowchart 2

7. The staff notes that the derecognition outcome under Flowchart 1 is not dependent on the order in which the derecognition and consolidation guidance are applied. Under that approach it does not matter whether consolidation between Parent and Subsidiary is done first.
8. However it does matter under Approach 2 whether the derecognition decision is made before or after the consolidation decision. The outcome under Flowchart 2 will depend on:
 - a. the order of applying derecognition and consolidation¹; and/or
 - b. if derecognition is applied first, whether the parent's involvement in the SPE through the nonrecourse loan is 'counted' as continuing involvement at the subsidiary level.

¹ This case is about the items that are recognised in the Parent Bank group and should be distinguished from a general discussion about whether the SPE should be consolidated with the Parent Bank group. As noted in the example, the third party investor, not the transferor (S bank), is assumed to consolidate the SPE (transferee) in this case.

9. As one of the beneficial interest holders of the SPE is the transferor's parent company, the accounting outcome would vary under Flowchart 2, depending on whether the parent company's beneficial interest (non-recourse loan secured by the asset) is taken into account in assessing whether the transferor has continuing involvement in the asset transferred.
10. If the subsidiary Bank is considered to have a continuing involvement in the asset transferred (by virtue of the parent's contracts with the SPE), as the SPE does not have practical ability to transfer the asset, under flowchart 2, the transfer will fail the derecognition criteria and would be accounted for as secured borrowing.
11. Similarly, if the derecognition test (continuing involvement test) is done *after* consolidation analysis and decision (Example 2A), P bank's beneficial interest would qualify as continuing involvement of the transferor (P+S in this case) and the transfer would not qualify for derecognition.
12. On the other hand, if the derecognition test for S bank is done *before* consolidation between P and S bank (Example 2B), since the transferor (S bank) has no continuing involvement in the assets, the transaction would qualify as a sale.
13. Hence the ED needs to clarify the order in which the derecognition and consolidation guidance ought to be applied and whether in assessing continuing involvement in the transferred asset, contracts between entities in the same group as the transferor and the transferee ought to be taken into account. To date, the Board has decided that the derecognition assessment should precede the consolidation analysis – that is the 2B example.

Issue 2: Practical ability to transfer under Flowchart 2 in the context of securitisation

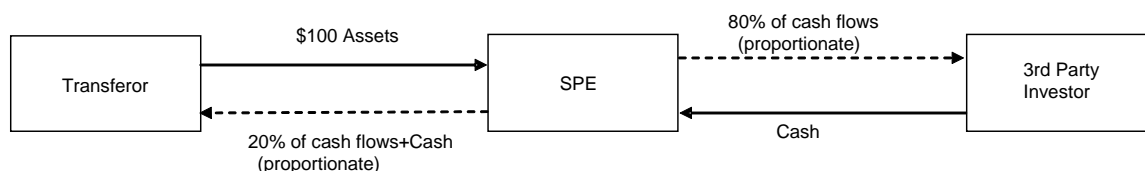
14. As noted at the January Board meeting, in many securitisation structures the transferor would not derecognise the assets under Flowchart 2 unless the transferor has no continuing involvement in the assets transferred to the SPE. This is because the transferee (SPE) does not usually pass the "practical ability to transfer for its own benefit" test as such SPEs cannot sell assets unilaterally or are prohibited from doing so. (The staff, however, notes that the lack of practical ability to transfer in a securitisation scenario could be overcome by a simple structure. For example, the practical ability to transfer test could be circumvented by executing the transaction in two-steps. ie. one SPE (the first SPE)

may transfer the asset to another (second) SPE simply to demonstrate its ability to sell the asset even though the second SPE might be restricted from transferring the asset it received from the first SPE).

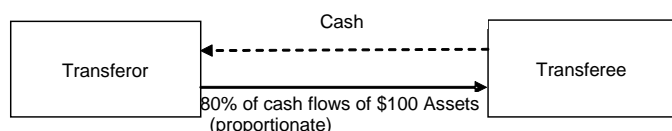
15. In examples 2A and 2B, the SPE (transferee) does not have the practical ability to transfer the assets. The SPE manager does not have the right to sell assets and distinguish proceeds unless the manager explicitly receives approval from the third party investor, according to guidelines agreed to by Subsidiary Bank and the third party investor on creation of the SPE. Hence the SPE cannot sell the assets unilaterally.
16. However, some may wonder if the inability of the SPE to sell the asset unilaterally is persuasive enough to conclude that the transfer does not qualify for derecognition.
17. Furthermore, others may argue that it does not matter who benefits from the selling restriction at the SPE level, as long as the beneficial interest holders (not the SPE) have the “practical ability to transfer” for their own benefit in the context of securitisations.
18. The staff notes that the FASB decided at its January Board meeting (as part of its redeliberation of the amendment to SFAS140) that, for securitisation transactions, the ability of an investor to pledge or exchange its interests in a securitisation vehicle is a determinative factor when assessing whether the transferor has relinquished control.
19. This argument comes down to the question if one can conclude that the transferor has really maintained control over the asset when the transferee (SPE) lacks the practical ability to transfer the asset for its own benefit, which is the rationale behind Flowchart 2.

Issue 3: Identical transactions but non identical accounting outcome

Example 6A: Transfers with acquisition of proportionate cash flows (through beneficial interest in SPE)²



Example 6B: Transfers with retention of proportionate cash flows of the assets (No SPE involved)



20. Two economically equivalent transactions (transfer of a “part” of the assets) may be accounted for differently under Flowchart 2 (Example 6A and 6B) due to the definition of “the Asset” and the “practical ability to transfer” test.
21. Examples 6A and 6B illustrate how economically equivalent transactions (transfer of a “part” of the assets) may be accounted for differently under Flowchart 2.
22. The transfer does not pass the “practical ability to transfer” test in Example 6A, as is often the case with many securitisations.
23. The transferor however does not need to apply that test in Example 6B because “the Asset” is proportionate 80% of the asset of the asset previously recognised and the transferor would be deemed not to have a continuing involvement in the part of the asset transferred.

Issue 4: Interaction of the proposed derecognition principle for financial assets and liabilities

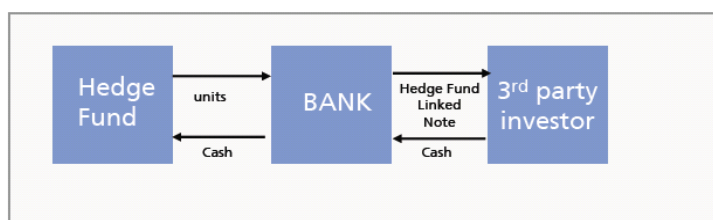
24. At the December meeting the Board discussed the accounting for nonrecourse loans but the Board did not decide on how to account for some of the non recourse loan transactions. Although the Board did not reach a consensus on this issue, the staff continues to believe such transactions are so common and significant that they merit further attention by the Board.

² It is assumed that the SPE is consolidated by the third party investor.

25. The staff recommended that the debtor in a self liquidating nonrecourse loan should recognise a call option and should derecognise the related securing asset. Thus the 'liability' should not be recognised by the debtor. Under the recommended treatment, the creditor would recognise an asset, the securing asset net of the effective call option written.
26. The staff view will avoid potential inconsistencies in the application of the existing guidance on derecognition of financial liabilities and conflicts between the derecognition models for financial assets and financial liabilities.
27. Typically, self liquidating nonrecourse loans have the following features:
- a. the finance will be repaid only from proceeds generated by the specific asset it finances (or by transfer of the item itself);
 - b. there is no possibility whatsoever of a claim on the transferor ("borrower") entity being established other than against funds generated by that asset (or the asset itself);
 - c. the transferor ("borrower") entity is not obliged to support any losses from the financial asset;
 - d. the provider of the finance ("transferee") has agreed in writing (in the finance documentation or otherwise) that it will seek repayment of the finance, as to both principal and interest, only to the extent that sufficient funds are generated by the specific asset it has financed and that it will not seek recourse in any other form; and
 - e. if the funds generated by the asset are insufficient to pay off the provider of the finance, this does not constitute an event of default for the entity.
28. The staff continues to be of the view that a self liquidating nonrecourse obligation is not a liability of the debtor. The rationale is that the security arrangement with the nonrecourse provision substantively transferred the securing assets to the "creditor." (And the creditor is not a creditor, but recognises the asset).

29. Although a nonrecourse debtor may plan to pay the debt in cash (transferring what are unquestionably its assets), the debtor does not have to do that: it need only let the creditor have the securing asset.
30. Thus, it can be said that the debtor in a nonrecourse borrowing no longer owns the securing asset. By undertaking the nonrecourse borrowing, the debtor in effect exchanged the securing asset for a call option. By extension then, since someone owns every asset, the lender in a nonrecourse borrowing must own the securing asset.
31. Example 5 (summarised below) illustrates the mechanics of a self liquidating nonrecourse loan, the effect of the derecognition principle for financial assets and liabilities on such transactions and the similarity between nonrecourse loans and pass through arrangements.

Example 5: Bank invests in Hedge Fund



5A: Summary (Fund linked notes not contractually linked to Fund Units)

32. Bank invests in hedge fund (10% of the total fund units). Bank then issues a note referencing 10% of the fund units in hedge fund (same payout profile as the fund units). The note pays the investor all interim and terminal distributions by the hedge fund. Bank is not obliged to buy into Hedge Fund under Fund Linked Note Agreement.

5B: Summary (Fund linked notes contractually linked to Fund Units)

33. Bank invests in hedge fund (10% of the total fund units). Bank then issues a note agreeing to payout all the cash flows of the fund units held by the Bank to the investor in exchange for cash. The Fund Linked Note is secured against the fund units held by the Bank. The Fund Linked Note Agreement specifies that the investor would look only to the cash flows of the Fund Units that the Bank actually owns for payment. The Bank is obligated to pass through to the investor all cash flows received from the fund units and the Bank is obliged to pay the investor if and to the extent that the hedge fund pays out cash or other economic

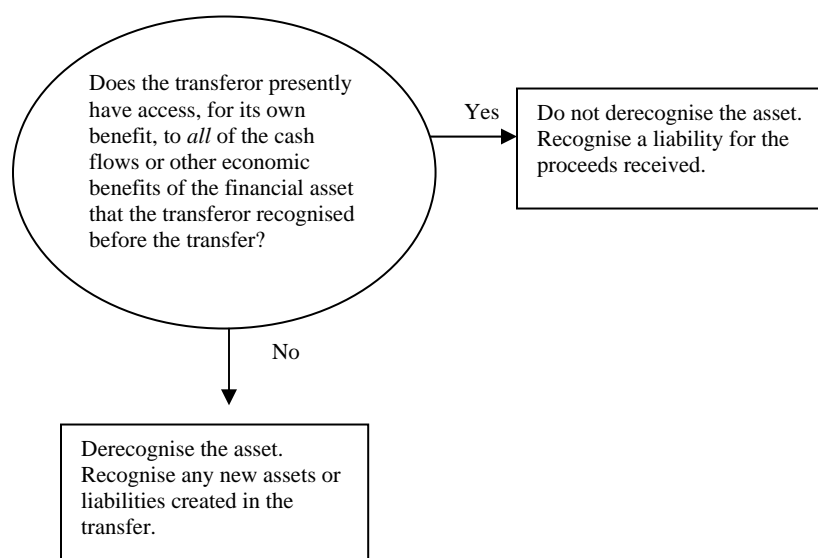
benefits. The Bank is prohibited from selling or redeeming the fund units but can do so with the express instruction of the investor.

5C: Summary (Fund linked notes is initially not contractually linked to Fund Units but subsequently amended to be so)

34. Initial Agreement: As under Example 5A. Agreement is subsequently amended to the terms under Example 5B.
35. Example 5A-C show how the derecognition approaches for financial assets and liabilities would interact.
36. Under Example 5A, Bank initially recognises the fund units as financial assets. The Fund Linked Note Agreement is not contractually linked to the fund units (they just serve as the referenced asset for any payout under the Notes agreement). That is the agreement does not specify the source of the payment from the Bank and the Bank may or may not transfer the cash flows from the fund as it receives those cash flows. Neither are the Notes secured on the fund units held by the Bank. Hence, the issuance of the Note does not represent a transfer of the fund units. Bank will recognise a financial liability for the Notes issued.
37. In Example 5B, the Notes are secured on the fund units and the note holders have no recourse to Bank. The Board decided, tentatively in November 2008, that transferring the right to the entire cash flows of a financial asset is akin to transferring the asset itself. Hence by agreeing to transfer all the cash flows of the fund units to the investors, the Bank has transferred the fund units. The transaction therefore qualifies for sale accounting and the proceeds of the transfer does not represent a liability of the Bank.
38. The accounting under Example 5C will initially (prior to the amendment) be the same as in Example 5A. However, following the amendment, Bank will derecognise the asset (fund units) and treat the liability as the proceeds received on sale of the fund units. One way of looking at this is that the assets have been used to pay off the liability. Alternatively, it could be described as a sale of the asset for a consideration, which is the debt forgiven. This amended agreement is no different from transactions that are derecognised under the pass-through provisions in IAS 39 today.

Appendix 1: Flowcharts reflecting the Board's tentative decisions to date

FLOWCHART 1



FLOWCHART 2

