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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: **Application of Flowcharts to more complex cases**

(Agenda paper 2E)

Purposes of this paper

1. This paper:

   a. illustrates the application of Approaches 1 and 2 to a number of examples and the accounting outcomes; and

   b. provides an indication of how the proposed derecognition and consolidation models would interact.

2. The staff's analysis of the cases reflects decisions made by the Board in respect of Approach 1 and Approach 2 and their associated flowcharts.

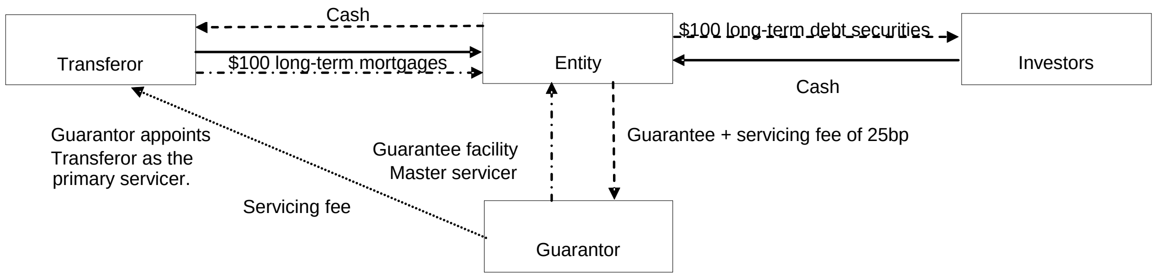
3. The purpose of the paper is not to re-examine consolidation issues. Therefore, facts and circumstances described in this appendix have been modified (basically shortened) from the original texts in FIN46R and consolidation team's examples to the extent that the basis for conclusion on consolidation for each case does not change.

4. Paper 2D summarises some of the issues the staff identified in developing this paper. Some of those issues have been discussed previously by the Board whilst others have been implicit in previous Board discussions.

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.

COMPLEX CASES

Example 1: Transfers with retention of servicing rights



<u>Facts and Circumstances</u>

6. An entity is created and financed with $100 of a single class of investment grade 30-year fixed-rate debt securities. The entity uses the proceeds to purchase $100 of 30- year fixed-rate residential mortgage loans from the Transferor. The entity enters into a guarantee facility with a guarantor that absorbs 100 percent of the credit losses incurred on the entity's assets. Additionally, all activities of the entity are pre-specified by the trust agreement and servicing guide, which are both established by the Guarantor. No critical decisions are generally required for the entity unless default of an underlying asset is reasonably foreseeable or occurs.

7. The Guarantor also serves as the Master Servicer for the entity. The Master Servicer can only be removed for a material breach in its obligations. As compensation for the guarantee and services provided, the Guarantor receives a fee of 25 basis points calculated as a percentage of the asset value. As Master Servicer, the Guarantor also is responsible for supervising and monitoring the servicing of the residential mortgage loans (primary servicing). However, the Guarantor is allowed to, and does, hire the Transferor to perform primary servicing activities that are conducted under the supervision of the Guarantor. The Guarantor monitors the primary servicer's performance and has the right to remove the primary servicer at any time.

8. The primary servicing activities are performed under the servicing guide established by the Guarantor. As compensation for servicing the underlying loans, the Transferor receives a fee that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

Derecognition analysis (Flowchart 1 and 2) and accounting outcomes

Example 1: Transfers with retention of servicing rights

Flowchart 1

Step 1 Does the transferor presently have access, for its own benefit, to *all* of the cash flows?	No. The transferor does not have access to all of the cash flows of the transferred assets (mortgage loans).
Derecognition	The transferor derecognises the entire assets and may recognise a servicing asset or liability[1].
Consolidation	The guarantor consolidates the entity. Therefore, the assets are derecognised both from the consolidated and stand-alone financial statements of the transferor.

Flowchart 2

Step 1: Determine the "Asset"	'The Asset' is the entire assets transferred (mortgage loans).
Step 2: Does the transferor have any continuing involvement in the Asset?	No. Transferor only acts as a servicer and the servicing does not qualify as continuing involvement because it is assumed to meet the definition of fiduciary/agency servicing[2].

[1] Servicing assets or liability would not be recognised if the fee is at market rates. This applies to all examples hereafter.

[2] Servicing constitutes continuing involvement if the "transferee" does not have the right to terminate the transferor as a servicer. It is the Guarantor, not the transferee (the entity), who has the right to terminate the transferor as a primary servicer in this example. However, the staff assumes that it meets the definition of fiduciary/agency servicing because the Guarantor controls and thus consolidates the entity (transferee).

	Hence the transferor would derecognise the assets
Step 3: Does the transferee have the practical ability to transfer?	N/A
Derecognition	The guarantor consolidates the entity. Therefore, the assets are derecognised both from the consolidated and stand-alone financial statements of the transferor.
Consolidation	The guarantor consolidates the entity.

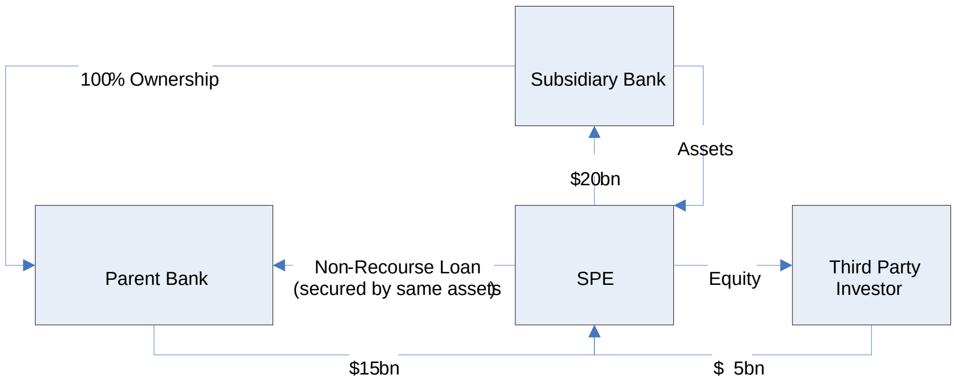
Basis for conclusion on the consolidation treatment

Example 1: Transfers with retention of servicing rights

9. The Guarantor established the trust agreement and the servicing guide of the entity and actively manages the activities of the entity as Master Servicer. Although the primary servicing activities have been delegated to the Transferor, the Transferor acts as an agent for the Guarantor, performing primary servicing tasks according to the Guarantor's instructions. The Guarantor has the power to direct all of the activities of the trust. Through its fee and guarantee arrangements, the Guarantor is exposed to variability of returns from its involvement with the entity.

10. Therefore, the Guarantor has the power to direct the activities of the entity to generate returns for the Guarantor. The Guarantor controls and should consolidate the entity.

Example 2: Distressed Debt and Reassessment



Facts and circumstances

11. An SPE is established to facilitate the acquisition of a portfolio of liquid and illiquid assets (receivables) from Subsidiary Bank. The SPE obtains a non-recourse loan from Parent Bank of $15bn (recourse only to the assets sold to the SPE) and an equity investment from a third party investor of $5bn. The SPE uses the financing to purchase $20bn of assets from Subsidiary Bank. The Subsidiary Bank has no obligation to make payments on any non-performance of the assets.

12. An SPE manager is appointed by the third party investor and is paid a market fee. The SPE manager does not have the ability to sell assets and distinguish proceeds unless the manager explicitly receives approval from the third party investor. The third party investor can remove the SPE manager without cause.

13. The equity investor benefits from all asset value increases and is at first risk of loss if the cash flows collected from the assets are less than $20bn. However should the cash flows collected from the assets be less than $15bn, the loan is non-recourse to SPE and therefore Parent Bank is exposed to losses incurred of more than $5bn. Parent Bank has first right of refusal to purchase the asset portfolio at fair value if the SPE decides to sell the portfolio.

Note: In this example we consider the effects of the order of consolidation/derecognition on the assets/liabilities recognised in the consolidated books of the Parent Bank group. This case should be distinguished from a general discussion about whether the SPE should be consolidated with the Parent Bank group. As noted below, the third party investor, not the transferor (S bank), is assumed to consolidate the SPE (transferee) in this case.

<u>Basis for conclusion on the consolidation treatment</u>

Example 2: Distressed Debt and Reassessment

14. The SPE was established to facilitate the sale of a portfolio of liquid and illiquid receivables by the Subsidiary bank and to provide investment opportunities for the third party investor. Managing and servicing the assets is the only activity of the entity that cause the returns of the SPE to vary. Therefore, having power to direct the management of the assets equates to having power to direct the activities of the SPE.

15. The SPE manager actively manages the assets, however it does so within the boundaries established by the Subsidiary bank and third party investor. The third party investor must also approve all sales of assets. In addition, because the manager can be removed without cause by the third party investor, the manager acts as an agent on behalf of the third party investor. The third party investor is also exposed to variability of returns of the SPE. It benefits from any increase in asset valuation and is exposed to the first $5bn losses.

16. Therefore, the third party investor has the power to direct the activities to generate returns for itself. The third party investor consolidates the SPE.

17. Parent Bank is exposed to variability of returns because it is exposed to losses on the assets of greater than $5bn. However, neither Parent Bank nor Subsidiary Bank has the power to direct the activities of the SPE to generate returns for themselves. Parent Bank has retained the ability to manage its exposure to losses by having first right of refusal to purchase the assets at fair value if the SPE decides to sell. However until that event happens, Parent Bank does not have any power to direct the activities of SPE.

Derecognition Analysis

Example 2A: Distressed Debt and Reassessment (Consolidation before Derecognition)

Flowchart 1

Consolidation	P bank consolidates S bank. Third party investor consolidates SPE.
Step 1 Does the transferor presently have access, for its own benefit, to *all* of the cash flows?	No. The transferor (P+S bank) does not have access to all of the cash flows of the assets.
Derecognition	The transferor (P+S bank) derecognises the entire $20bn assets (i.e., the SPE recognises the entire assets). Therefore, • For consolidated F/S of P bank, P+S (the Group) derecognises the entire $20bn assets and recognises $5bn Cash and $15bn non-recourse loan to SPE. • For stand-alone F/S of S bank, the transferor (S bank) derecognises the entire $20bn assets. • There is an issue with how the non recourse loans ought to be treated but that issue is addressed in Example 5.

Flowchart 2

Consolidation	P bank consolidates S bank. Third party investor consolidates SPE.
Step 1: Determine the "Asset"	'The Asset' is the entire assets because the transferor (P+S) bank transferred the entire assets to the SPE

Step 2: Does the transferor have any continuing involvement in the Asset?	Yes. The transferor (P+S bank) has an interest in the performance of the assets through P bank's non-recourse loan to the transferee (SPE).
Step 3: Does the transferee have the practical ability to transfer?	No. From the perspective of the transferee (the entity) does not have the practical ability to transfer the assets because any asset transfers have to be approved, by the third party. Therefore the transferee does not have the practical ability to transfer. (However, from the perspective of the investor group (third party + SPE), there is arguably practical ability to transfer.)
Derecognition	The transferor (P+S bank) continues to recognise the entire assets (no derecognition). Therefore, • For consolidated F/S of P bank, the transferor (P+S) continues to recognise the entire \$20bn assets. In addition, the transferor (P+S bank) recognises \$5bn cash and \$5bn liability to the SPE[3].

Example 2B: Distressed Debt and Reassessment (Derecognition before Consolidation)

Flowchart 1

Step 1 Does the transferor presently have access, for its own benefit, to *all* of	No. The transferor (S bank) does not have access to any of the cash flows of the assets.

[3] On a consolidated basis: The Group receives \$20bn cash from the SPE but the Group in turn lends \$15bn cash to the SPE. Hence the Group receives net cash of \$5bn and assumes a liability to repay those funds.

the cash flows?	
Derecognition	The transferor (S bank) derecognises the entire assets and SPE recognises the assets.
Consolidation	P bank consolidates only S bank because third party investor consolidates SPE. Therefore, • For consolidated F/S of P bank, P+S derecognises the entire \$20bn assets and recognises \$5bn Cash and \$15bn non-recourse loan to SPE. • For stand-alone F/S of S bank, the transferor (S bank) derecognises the entire assets. ***(The derecognition outcomes are consistent if Flowchart 1 is applied, no matter whether consolidation between Parent and Subsidiary is done first.)***

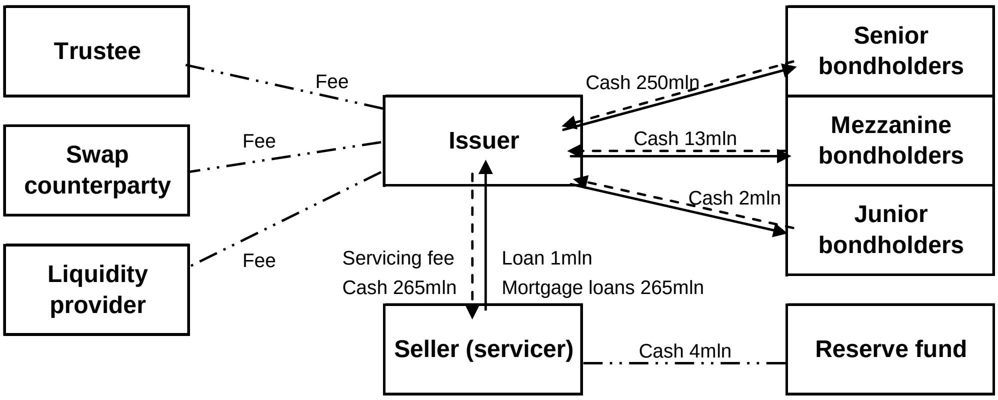
Flowchart 2

Step 1: Determine the "Asset"	'The Asset' is the entire assets because S bank transferred the entire assets to the SPE.
Step 2: Does the transferor have any continuing involvement in the Asset?	No. The transferor (S bank) has no continuing involvement in the asset.[4]
Step 3: Does the transferee have the practical ability to transfer?	N/A
Derecognition	The transferor (S bank) derecognises the entire assets (i.e., the SPE recognises the entire assets).

[4] If P bank's non recourse loan to the SPE should be treated as continuing involvement in the Asset (even before the consolidation between P and S banks) for the purpose of continuing involvement test here, the answer is "Yes" and the answers to the following steps would be the same as ones for 2A.

Consolidation	P bank consolidates only S bank because third party investor consolidates SPE. Therefore, • For consolidated F/S of P bank, P+S derecognises the entire $20bn assets and recognises $5bn Cash and $15bn non-recourse loan to SPE. For stand-alone F/S of S bank, the transferor (S bank) derecognises the entire assets. ***(For Flowchart 2 the outcomes depend on the order of applying derecognition and consolidation, and/or 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.)***

Example 3: Residential Mortgage Backed Securitisation



<u>Facts and circumstances</u>

Issuer

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

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

Bondholders

20. Issuer funds the purchase of the mortgage assets through the issue of three categories of bonds with different ratings and level of subordination: senior (CU250 million), mezzanine (CU13 million) and junior (CU2 million). Bonds are issued to various investors, all of which are unrelated to Seller. All tranches of bonds mature after the longest maturity of securitised assets (i.e. bonds will not be rolled over in the market).

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

Credit enhancement

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

23. Seller may lose up to CU5 million (the loan and the reserve fund) if the excess spread is not enough to replenish the amount drawn from the reserve fund. However, Seller has no obligation to make any payments to bondholders on non-performance of loans beyond that.

Servicer

24. Seller services the pool of mortgage loans on behalf of bondholders. In return, it receives a servicing fee at market rates. The servicer is obliged to act in accordance with servicing standards and transaction agreements.

Trustee

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

<u>Example 3: Residential Mortgage Backed Securitisation</u>

Flowchart 1

Step 1 Does the transferor presently have access, for its own benefit, to *all* of the cash flows?	No. After the transfer, the transferor (Seller) does not have access to all of the cash flows of the assets (mortgage loans).
Derecognition	The transferor (Seller) derecognises all the transferred assets (mortgage loans) and recognises a loan to Issuer and investment in the reserve fund. (Note: It is debatable whether the Issuer should continue to recognise the asset transferred on issuance of the beneficial interests. Some argue that Issuer has effectively transferred the asset by the issuance of the beneficial interests in the assets. The SPE will potentially be an empty shell under this view. See Example 5 for staff analysis on nonrecourse transactions.).
Consolidation	The transferor (Seller) consolidates Issuer. Therefore, the assets are not derecognised from transferor's consolidated financial statements (derecognised only from the stand-alone financial statements of the transferor).

Flowchart 2

Step 1: Determine the "Asset"	The 'Asset' is the entire transferred assets (mortgage loans) because the transferor (Seller) transferred the entire assets to the Issuer.
Step 2: Does the transferor have any continuing involvement in the Asset?	Yes. The transferor provides credit enhancement thorough the reserve fund (residual interest in the performance of the assets).

Step 3: Does the transferee have the practical ability to transfer?	No. All loans must remain in the portfolio to service the beneficial interests.
Derecognition	The transferor (Seller) continues to recognise the assets and recognises the proceeds received as a liability (No derecognition).
Consolidation	The transferor (Seller) continues to recognise the assets both in the consolidated and stand alone F/S of the transferor.

Basis for conclusion on the consolidation treatment

Example 3: **Residential Mortgage Backed Securitisation**

Flowchart 1

26. Issuer was established to facilitate the sale of mortgage loans by Seller and to provide investment opportunities for investors.

27. Seller retains servicing of defaulted loans, the only activity of Issuer that requires decision making and causes the returns of Issuer to vary. Even though Seller services the assets according to servicing standards and transaction agreements, Seller has discretion in managing the assets when in default and, therefore, has the ability to manage the assets to affect the returns of Issuer. The ability of the bondholders and other parties to change the established policies of Issuer is limited and would be considered to be protective rights. The removal rights held by the trustee is also a protective right because Seller can be removed only if Seller breaches its contractual arrangement.

28. Seller is exposed to variability of returns of Issuer because it receives any excess spread (or any upside) from the activities of Issuer and can lose up to CU5 million (the loan plus the reserve fund).

29. Seller has the power to direct the activities of Issuer to generate returns for Seller. Seller controls and should consolidate Issuer.

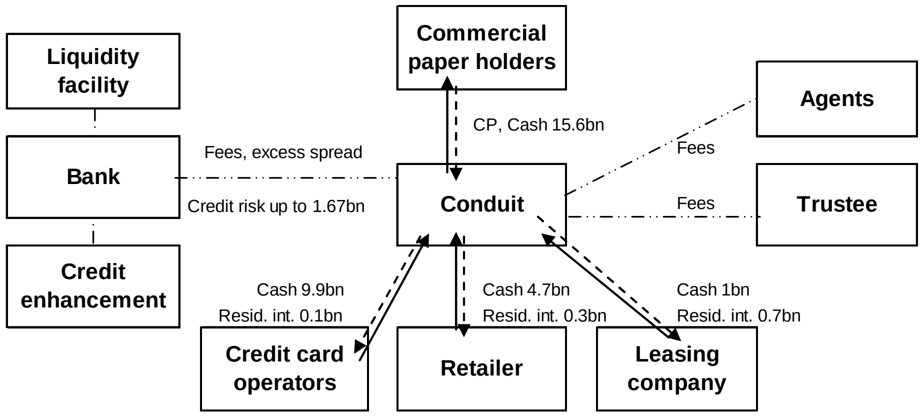
Flowchart 2

30. The mortgage loans are not derecognised by Seller (Transferor). The arguments for consolidation in this situation are not as straight forward because Transferor is not managing the assets of Issuer—Seller (Transferor) manages its

own assets that provide security for amounts owed by it to Issuer. Issuer has an asset of CU265m (a receivable from the Transferor), cash of CU5m, and three liabilities (debt securities held by third parties of CU265m, a loan payable to Issuer of CU1m and the reserve fund of CU4m). Seller (Transferor) holds no direct beneficial interest in Issuer however the reserve fund of CU4m is similar to a subordinated beneficial interest in Issuer which exposes Transferor to variability of returns from its involvement with Issuer.

31. Seller (Transferor) has the ability to manage its exposure to variability of returns of Issuer by managing the securitised receivables, which act as security for the receivable of CU265m held by Issuer. Because management of the securitised receivables is the only activity that affects the returns of Issuer, we think that it can be argued that Seller's (Transferor's) ability to manage those receivables means that it has the power to direct the activities of Issuer to generate returns for itself. Therefore Seller (Transferor) would control Issuer and consolidate it.

Example 4: Multi-Seller Conduit



<u>Facts and circumstances</u>

Conduit

32. Bank structured a multi-seller conduit as a separate legal entity. The conduit's activity is to invest in loans originated by third parties on an ongoing basis from funds obtained by issuing commercial paper. The aim of the conduit is to provide alternative financing to the transferors of the assets and generate benefits from the term structure of credit spreads.

33. The conduit issued commercial paper (CP) at par value of CU15.6 billion to fund the transfer of the receivables to the conduit. The CP has a short-term maturity date after which it is rolled over. None of CP is linked to specific assets of the conduit.

Transactions

34. Twelve parties transferred receivables to the conduit: Ten credit card operators, a retailer and a leasing company (more about the specifics of the transfers below).

35. The assets transferred to the conduit are not cross-collateralised with other assets of the conduit. Therefore, no transferor bears any liability for loss on other transferor's assets.

Credit card operators (CU10 billion)

36. Ten credit card operators transferred credit card receivables of CU1 billion each to the conduit (i.e. CU10 billion in total). Due to the high excess spread between the rate of interest on each credit card account and the rate paid on CP, only one per cent cash reserve (over-collateral) is required to secure losses on the receivables. The total retained interest of these ten credit card operators is CU100 million (CU10 million for each operator).

Retailer (CU5 billion)

37. A retailer transferred CU5 billion of prime consumer receivables to the conduit. The retailer's total retained interest that serves as over-collateral equals six per cent (i.e. CU300 million).

Leasing company (CU1.7 billion)

38. A leasing company transferred lease cash flows of CU1.7 billion of retail operating leases to the conduit. The leasing company's total retained interest that serves as over-collateral equals CU700 million.

Bank

39. Bank provides administration, liquidity and credit enhancement services for which it receives fees comparable to market fees in other similar arrangements and senior to principal payments on CP. Bank does not own any equity or debt interest in the conduit.

40. Bank in the role of an administrator has the following responsibilities related to the management of the conduit's operations:

    a. Manage daily operations of the conduit;
    b. Issue, manage and repay the CP; and

c. Evaluates and enters into asset purchases and hedging arrangements

41. As the liquidity facility provider, Bank stands ready to provide funds to the conduit to fund the purchase of all CP in the event the conduit is unable to reissue them to other third party purchasers (for reasons other than credit deterioration of the portfolio assets).

42. Bank also provides credit enhancement in form of a guarantee on 10 per cent of the transferred assets that should absorb all expected losses of the conduit. Bank absorbs the conduit's losses up to the guaranteed amount after the losses exceed the over-collateral provided by the transferees. Any losses in excess of the guarantee would be absorbed by all CP holders proportionally to their interest.

43. The excess spread, that represents net interest payments on the conduit's receivables after paying all expenses and payables, is deposited to a reserve account. The account is used to cover credit default on the portfolio receivables. The amounts accumulated on the reserve account above specified level are regularly distributed to Bank. Upon liquidation of the conduit, any residual amounts are paid to Bank.

Policies

44. The conduit's activities are governed by formal credit and investment policies established at the inception of the structure. Under specified circumstances, Bank may amend the provisions of the policies subject to the approval of a rating agency.

Example 4: Multi-Seller Conduit

Flowchart 1

Step 1 Does the transferor presently have access, for its own benefit, to *all* of the cash flows?	No. The transferors (credit card operators, retailer, leasing company) do not have access to all of the cash flows of the assets transferred into the conduit.
Derecognition	The transferors (originators of the assets) derecognise all the assets and recognise the residual interest as a new asset.
Consolidation	The bank consolidates the conduit. Therefore, the assets are derecognised both from the consolidated and stand-alone F/S of the transferors.

Flowchart 2

Step 1: Determine the "Asset"	'The Asset' is the entire assets because the rights to residual (subordinate) cash flows of the transferred assets retained by the transferors (originators of the assets) do not qualify as a fully proportionate share of the assets.
Step 2: Does the transferor have any continuing involvement in the Asset?	Yes. Transferor's residual interest meets the definition of continuing involvement because it represents an interest in the future performance of the transferred assets.
Step 3: Does the transferee have the practical ability to transfer?	No. The transferee (the conduit) will not to be able to sell the assets transferred and therefore the transferee does not have the practical ability to transfer.
Derecognition	The transferors continue to recognise the asset and recognise the proceeds received as a liability (No derecognition).
Consolidation	The transferor continues to recognise the assets both in the consolidated and stand alone F/S of the transferor.

Basis for conclusion on the consolidation treatment

Example 4: Multi-Seller Conduit

Flowchart 1

45. The Conduit was established to facilitate the sale of receivables by 12 different parties and to provide investment opportunities for investors.

46. The Bank provides administration, liquidity and credit enhancement services which allow it to manage the liabilities of the Conduit (issue, manage and repay CP) and manage the assets of the Conduit (evaluates and enters into asset purchases and hedging arrangements). Even though each of the transferors retains servicing of the receivables transferred to the Conduit, the Bank has discretion to decide on new transferors, approve assets transferred, and under specified circumstances, amend the provisions of the policies that cover asset eligibility and structural elements in asset transfer transactions. Other parties, including the trustee, have some rights that are protective in nature. Consequently, the Bank has the power to direct the activities of the Conduit.

47. The Bank also is exposed to variability of returns of the Conduit—it receives the excess spread (or any upside) from the activities of the Conduit and is exposed to losses from the provision of credit enhancement and liquidity support.

48. The Bank has the power to direct the activities of the Conduit to generate returns for the Bank. The Bank controls and should consolidate the Conduit. Hence assets would be consolidated by Bank.

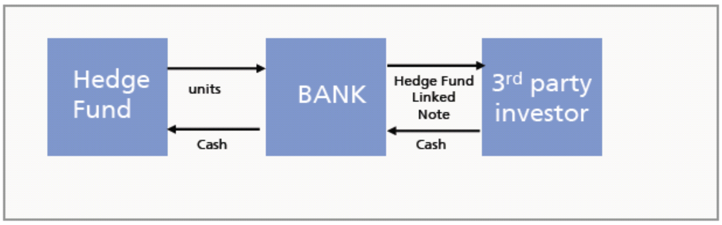
Flowchart 2

49. The credit card operators, retailer and leasing company do not derecognise their respective receivables. Therefore, the Conduit has 12 receivables, one from each of the transferors secured by the actual credit card, trade and lease receivables of the Transferors.

50. Our conclusions regarding consolidation in this situation would be the same as for Flowchart 1—i.e. the Bank controls the Conduit. The fact that the credit card, trade and lease receivables are recognised by the transferors rather than by the Conduit does not change the analysis of control of the Conduit. The

analysis for Flowchart 1 is also applicable to Flowchart 2. Hence the assets (the 12 receivables) and liabilities would be consolidated by Bank.

Example 5: Bank invests in Hedge Fund



Facts and circumstances

51. A third party investor wishes to invest in Hedge Fund. For tax and other reasons, it is beneficial to obtain the risks and rewards associated with a direct holding in Hedge Fund without directly purchasing units in the fund. Bank facilitates the wishes of the third party investor for a market fee by issuing a note whose returns are linked to the performance of the hedge fund to the third party investor.

52. Bank has no right to make any decisions or kick out the fund manager of Hedge Fund. It can redeem its units on any day at the NAV of the Hedge fund.

53. The strategy of Hedge Fund is controlled by the fund manager of the Hedge Fund.

54. The Hedge Fund manager has no stake in the Hedge Fund.

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

55. 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: Modified Facts and circumstances (Fund linked notes contractually linked to Fund Units)

56. 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 without the express instruction of the investor.

5C: *:Modified Facts and circumstances* (Fund linked notes are initially not contractually linked to Fund Units but sebsequently amended to be so)

57. Same as 5B except that the Initial Agreement is as under Example 5A. The Agreement is subsequently amended to the terms under Example 5B.

<u>Example 5:</u> Bank invests in Hedge Fund

<u>Example 5A *(Fund linked notes not contractually linked to Fund Units)*</u>

Flowchart 1

Step 1 Does the transferor presently have access, for its own benefit, to *all* of the cash flows?	Yes. The transferor (Bank) still has access to all of the cash flows of the assets (units of the fund) for its own benefit.
Derecognition	The transferor continues to recognise the assets.

Flowchart 2

Step 1: Determine the "Asset"	The Asset is the entire assets (units of the fund).
Step 2: Does the transferor have any continuing involvement in the Asset?	Yes. The bank is exposed to both the upside and the downside of the asset.
Step 3: Does the transferee have the practical ability to transfer?	No.
Derecognition	The transferor continues to recognise the assets.

<u>5B: Modified fact pattern *(Fund linked notes contractually linked to Fund Units)*</u>

Flowchart 1

Step 1 Does the transferor presently have access, for its own benefit, to *all* of the cash flows?	No. The transferor (Bank) has access to all of the cash flows of the assets (10% units of the fund), but not for its own benefit. The Bank is obliged to pass through the cash flows of the fund units on receipt.
Derecognition	The transferor derecognises the assets and recognises the cash received as proceeds.

Flowchart 2

Step 1: Determine the “Asset”	The Asset is the entire assets (units). Transferring the right to the cash flows of the assets is akin to transferring the assets themselves (this is what the Board decided for transfers involving entire assets).
Step 2: Does the transferor have any continuing involvement in the Asset?	No. The Bank will not benefit nor suffer from the fund units under any circumstance.
Step 3: Does the transferee have the practical ability to transfer?	N/A
Derecognition	The transferor derecognises the assets.

<u>5C: Modified fact pattern (Fund linked notes are initially not contractually linked to Fund Units but sebsequently amended to be so)</u>

Flowchart 1

Step 1 Does the transferor presently have access, for its own benefit, to *all* of the cash flows?	No. Subsequent to the amendment, the transferor (Bank) no longer has access to all of the cash flows of the assets (units of the fund) for its own benefit. The transferor is obliged to pass through all the economic benefits in all cases.
Derecognition	The transferor derecognises the assets.

Flowchart 2

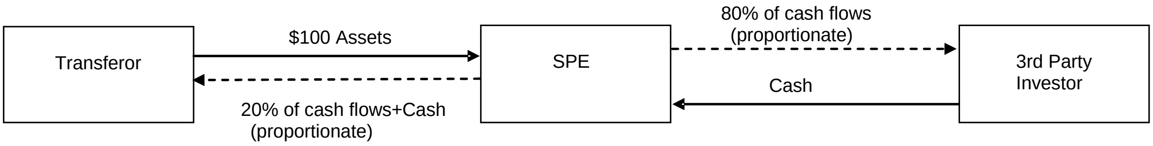
Step 1: Determine the “Asset”	The Asset is the entire assets (units). Transferring the right to the cash flows of the assets is akin to transferring the assets themselves (this is what the Board decided for transfers involving entire assets or a proportionate share of cash flows thereof).
Step 2: Does the transferor have any continuing involvement in the Asset?	No. Subsequent to the transfer, the Bank will not benefit nor suffer from the fund units under any circumstance.

Step 3: Does the transferee have the practical ability to transfer?	N/A
Derecognition	The transferor derecognises the assets.

Basis for conclusion on the consolidation treatment

Example 5A + 5B: No consolidation analysis for these examples.

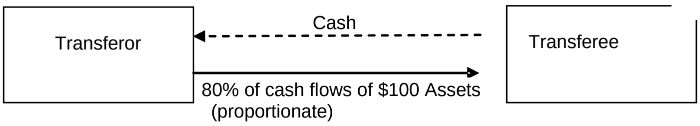
Example 6A: Transfers with acquisition of proportionate cash flows (through beneficial interest in SPE)



Facts and circumstances

58. The SPE is created by the 3rd party investor to facilitate the purchase of the assets.
59. The Transferor transfers $100 assets to the SPE (non-recourse). The SPE is not allowed to sell the assets.
60. The SPE funds the purchase of the assets through issuance of two categories of beneficial interests (proportionate 20% and 80%) in the assets.
61. The Transferor purchases the 20% interest, while the 3rd party investor purchases the 80% interest.

Example 6B: Transfers of proportionate cash flows



Facts and circumstances

62. The Transferor transfers 80% of cash flows (proportionate) of $100 asset to the Transferee (non-recourse).
63. The Transferor has no continuing involvement in the transferred part (80%) of the assets.

<u>Example 6A: Transfers with retention of proportionate cash flows (through beneficial interest in SPE)</u>

Flowchart 1

Step 1 Does the transferor presently have access, for its own benefit, to *all* of the cash flows?	No. The transferor does not have access to all of the cash flows of the assets.
Derecognition	The transferor derecognises all the assets and recognises the 20% beneficial interest in the SPE as a new asset.
Consolidation	The third party investor consolidates the SPE. Therefore, the assets are derecognised both from the consolidated and stand-alone F/S of the transferor.

Flowchart 2

Step 1 Determine the "Asset"	'The Asset' is the entire assets because the transferor transferred the entire assets to the SPE.
Step 2 Does the transferor have any continuing involvement in the Asset?	Yes. The transferor has continuing involvement because the transferor's beneficial interest meets the definition of continuing involvement. The beneficial interest represents an interest in the future performance of the transferred assets.
Step 3 Does the transferee have the practical ability to transfer the Asset for its own benefit?	No. The transferee (the SPE) is not allowed to sell the assets transferred and therefore the transferee does not have the practical ability to transfer.
Derecognition	The transferor continues to recognise 'the Asset' and recognises the proceeds received as a liability (No derecognition).
Consolidation	The third party investor consolidates the SPE.

<u>Example 6B: Transfers with retention of proportionate cash flows (No SPE involved)</u>

Flowchart 1

Step 1 Does the transferor presently have access, for its own benefit, to *all* of the cash flows or other future economic benefits?	Same as 6A
Derecognition	Same as 6A

Flowchart 2

Step 1 Determine the "Asset"	"The Asset" is a part (80%) of the assets because it meets the definition (fully proportionate) of a component of the assets.
Step 2 Does the transferor have any continuing involvement in the Asset?	No. The transferor does not have continuing involvement in "the Asset".
Step 3 Does the transferee have the practical ability to transfer the Asset for its own benefit?	N/A
Derecognition	The transferor derecognises a part (80%) of the assets.

Basis for conclusion on the consolidation treatment

Example 6A: Transfers proportionate cash flows (through beneficial interest in SPE)

64. It is simply assumed that the third party investor consolidates the SPE.

Example 6B: Transfers proportionate cash flows

65. No SPE is involved in this example (i.e., no consolidation issue).