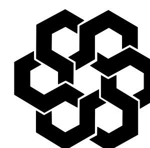

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International
Accounting Standards
Board

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:	**January 2009, London**
Project:	**Derecognition of Financial Assets and Liabilities**
Subject:	**'The Asset' in Flowchart 2: Transfers of Groups of *Similar* Assets (Agenda Paper 2D)**

Background

1. At the IASB meeting in November 2008, the Board tentatively decided that the determination of 'the Asset' that is to be assessed for derecognition in Flowchart 2 should be done on the basis of paragraph 16 of International Accounting Standard (IAS) 39 *Financial Instruments: Recognition and Measurement*, subject to consideration of specific guidance about transfers of groups of *similar* financial assets.

   (See Appendix 1 for Flowchart 2)

2. The Board's intention with paragraph 16 of IAS 39 (reproduced in Appendix 2 to this paper) appears to have been to specify the circumstances in which a

component of a financial asset or a component of a group of financial assets qualifies for derecognition rather than to prescribe the groups of assets to which the derecognition tests in IAS 39 should be applied. This becomes evident in the basis for conclusions on IAS 39. BC39 states:

> The original IAS 39 also did not contain guidance on when a part of a financial asset could be considered for derecognition. The Board decided to include such guidance in the Standard to clarify the issue. It decided that an entity should apply the derecognition principles to a part of a financial asset only if that part contains no risks and rewards relating to the part not being considered for derecognition. Accordingly, a part of a financial asset is considered for derecognition only if it comprises:
>
> (a) only specifically identified cash flows from a financial asset (or a group of similar financial assets);
>
> (b) only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets); or
>
> (c) only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).
>
> In all other cases the derecognition principles are applied to the financial asset in its entirety.

3. Despite this interpretation of the Board's intention with the guidance in paragraph 16 of IAS 39, the fact is that the paragraph 16 is worded so that it applies not only to transfers of *parts* of financial assets or groups of financial assets but also to transfers of *whole* financial assets or groups of financial assets. In addition, it is worded so that it narrows the types of financial assets that can be evaluated for derecognition as a group (ie those assets would have to be 'similar').

4. In 2006 IFRIC received a number of inquiries about when financial assets (mainly whole derivative assets transferred together with whole non-derivative financial assets) are considered to be 'similar' for the purposes of the pass-through and risks and rewards derecognition tests in IAS 39. After consultation with the Board, IFRIC initially decided not to take on the issue to its agenda. In its rejection notice, IFRIC cited the Board's views on this issue, which were as follows:

> Derivative and non-derivative instruments are not 'similar'. For example, if an entity enters into an arrangement to pass the cash flows from both a mortgage and a mortgage guarantee to a third party, the mortgage and the guarantee cannot be similar.
>
> If two assets are not similar, the pass-through tests in IAS 39 when relevant must be applied to the two assets separately. Therefore, in the previous example, the pass-through tests should be applied separately to the mortgage and mortgage guarantee. One of the pass-through tests required by IAS 39 is to consider whether the transferor has any obligation to pay amounts to the eventual recipients if it does not collect equivalent amounts from the asset being considered for derecognition. When assessing whether any such obligation exists for the mortgage, the entity must consider the possible effects of a default on the mortgage. The fact that, in the event of a default on the *mortgage*, the transferor is required to pay over the receipts from the guarantee to the eventual recipients does not cause the mortgages to fail the pass-through tests as the obligation to pay over receipts from the guarantee arises from the transfer of the guarantee not from a default on the mortgages. However, if the transferor is required to pay over amounts to eventual recipients in the event of default on the *guarantee*, such an obligation is considered to be the result of a default on the mortgage, and would therefore result in the mortgage failing the pass-through tests.
>
> Derivative instruments can be either assets or liabilities. Consequently, a derivative such as an interest rate swap that is transferred as part of a derecognition transaction must pass both the asset and the liability derecognition tests.

5. After it published its rejection notice, IFRIC received comments letters criticising its decision not to take on the issue to its agenda because despite the Board's view expressed in the rejection notice there continued to be ambiguity of how the pass-through and risks and rewards derecognition tests in IAS 39 should be applied to transfers of groups of financial assets. Also some questioned the usefulness of the accounting outcomes that would result from applying the Board's view. For example, one of the 'Big 4' accounting firms stated, in part, in their letter:

> The IFRIC rejection provided an example of mortgages that are transferred along with mortgage indemnity guarantees (MIG). As IFRIC has concluded you apply the derecognition tests separately to the loan and MIG, if no cash flows are

payable to the transferee unless they are received under the loan or MIG, then both assets could pass the pass-through tests. IFRIC also concluded in its rejection wording that if the transferor is required to pay over amounts to the transferee in the event of default on the MIG, such an obligation is considered to be the result of a default on the loan, and would therefore result in the loan failing the pass-through tests. This conclusion illustrates the leap in thinking that is required when you apply the derecognition tests separately. If there has been a default under the MIG (ie the insurer has failed to pay the transferor), but the transferor is obligated to pay the transferee, why should this payment always be associated with the loan rather than the MIG itself? If the arrangement is structured so that if there is a default of the MIG, the transferor still has to pay under the MIG then surely the MIG has failed pass-through and not the loan. We presume IFRIC included these words to avoid arbitrage between the two derecognition tests [pass-though and risks and rewards tests] to stop entities claiming that any cash payable to the transferee was in respect of the MIG and not the loan, and thereby getting derecognition for the loan. This illustrates that applying the derecognition tests separately is artificial as the transferor pays cash to the transferee based on the performance of *both* transferred assets and does not separate out the cash paid to the transferee and attribute this to specific transferred assets.

6. Responding to the comment letters, IFRIC reversed its decision and decided to add the issue to its agenda (note: in light of the Board's decision to add a project on derecognition to its active agenda in 2008, IFRIC has since removed the issue from its agenda).

   (The staff is happy to make any IASB and IFRIC papers, as well as any comment letters, related to this issue available to the Board upon request.)

7. This paper

   a. analyses the issue in terms of its impact on Flowchart 2

   b. provides some alternatives, and

   c. provides a staff recommendation.

Staff analysis and proposed alternatives

*Transfers of a group of **whole** financial assets*

8. The staff notes that the issue that was raised to the IFRIC was in the context of transfers of *whole* financial assets as a group. For those types of transfers, the staff acknowledges that at times it might be difficult to apply the pass-through and/or risks and rewards tests in IAS 39 to the assets individually rather than as a group and (arguably more so) that the resulting accounting outcomes might not be intuitive – for an example, see the transaction put forth in the comment letter cited in the background section.

9. However, the staff believes that unlike the pass-through and risks and rewards tests in IAS 39, which might require the transferor to consider the impact of one type of financial asset transferred on the other type of financial asset transferred, the 'practical ability to transfer' test of Flowchart 2 is a control test that can be applied to transferred assets individually or as a group in a more straightforward manner. The staff also believes that applying the 'practical ability to transfer' test in Flowchart 2 generally should result in the same accounting outcomes irrespective of whether the test is applied to assets individually or as a group (unless for example the transferor has continuing involvement that somehow restricts the transferee's ability to transfer the assets individually).

10. Take a transfer of a mortgage loan along with a mortgage indemnity guarantee (MIG) as an example. Whether Flowchart 2 were applied to the mortgage loan and MIG separately (Flowchart 2 would have to be applied twice – once to the mortgage loan and once to the MIG) or as a portfolio (Flowchart 2 would be applied only once – to the portfolio), in either case the transfer would qualify for derecognition because the transferor would not have any continuing involvement beyond fiduciary/agency servicing into the assets individually or as a group.

11. In light of the foregoing, the staff thus could see an argument that for purposes of determining 'the Asset' in Flowchart 2, financial assets that are transferred as a group do not have to be similar.

*Transfers of a **component** of a group of whole financial assets*

12. To the extent the Board decides to prohibit or restrict transfers of *components* of derivatives, hybrid instruments with embedded derivatives that require bifurcation

or equity instruments (see Agenda Paper 2B), the Board might want to consider making a similar prohibition or restriction for transfers of components of groups of financial assets. This would be to preclude entities from circumventing any such prohibition or restriction by including derivative assets in a group of non-derivative financial assets and then transferring a proportionate interest in those assets as a group.

13. The alternatives proposed in Agenda Paper 2B to modify the component definition in paragraph 16 of IAS 39 for purposes of determining 'the Asset' to be pushed through Flowchart 2 and the corresponding staff recommendation if the Board chose a given alternative are as follows (see next page):

<table>
<tr><th>Proposed alternatives in Agenda Paper 2B to modify components for purposes of determining ‘the Asset’ in Flowchart 2</th><th>If the Board decides on this alternative in Agenda Paper 2B, then the staff proposes the Board further modify components as follows…</th></tr>
<tr><td>Alternative 1 (FAS 140R ED approach - most restrictive): Modify the component definition in paragraph 16 of IAS 39 to explicitly prohibit derivatives, hybrid instruments with embedded derivatives that require bifurcation or equity instruments from qualifying as components.</td><td>Strike ‘similar’ out of the component definition of paragraph 16 of IAS 39 but make it explicit that for a transferred component of a group of financial assets, none of those assets can be derivatives or hybrid instruments with embedded derivatives that require bifurcation or equity instruments</td></tr>
<tr><td>Alternative 2: Don’t modify the component definition in paragraph 16 of IAS 39</td><td rowspan="2">Strike ‘similar’ out of the component definition of paragraph 16 of IAS 39 but make it explicit that for a transferred component of a group of financial assets, none of those assets can be
• instruments that can be either assets or liabilities over their life[1], or
• equity instruments that involve future economic benefits other than cash flows (eg shares)</td></tr>
<tr><td>Alternative 3: Modify the component definition in paragraph 16 of IAS 39 to indicate that components of a financial asset include specifically identified and/or proportionate cash flows from a financial instrument that can be either an asset or a liability over its life.</td></tr>
<tr><td>Alternative 4 (least restrictive): Same as Alternative 3 but add ‘other future economic benefits’ to allow for transferred portions of equity instruments that do not involve cash flows to qualify as components. In that case, components of a financial asset would be defined as to include specifically identified and/or proportionate cash flows or other future economic benefits from a financial instrument that can be either an asset or a liability over its life.</td><td>Strike ‘similar’ out of the component definition of paragraph 16 of IAS 39 but make it explicit that for a transferred component of a group of financial assets, none of those assets can be instruments that can be either assets or liabilities over their life[2]</td></tr>
</table>

[1] The staff highlights that Alternative 3 and Alternative 4 in Agenda Paper 2B permit a transfer of a component of a financial instrument that can be either an asset or a liability over its life (eg, a transfer of the receive leg of an interest rate swap). However, the staff recommends that the Board not extend that permission to a transfer of a component of a group of financial assets if that group includes a financial instrument that can be either an asset or a liability because it is concerned that potentially the principle for derecognition of financial liabilities could be circumvented (see discussion in footnote 3 in Agenda Paper 2B).

[2] See comment in footnote 1 which also applies to this alternative.

Staff recommendation

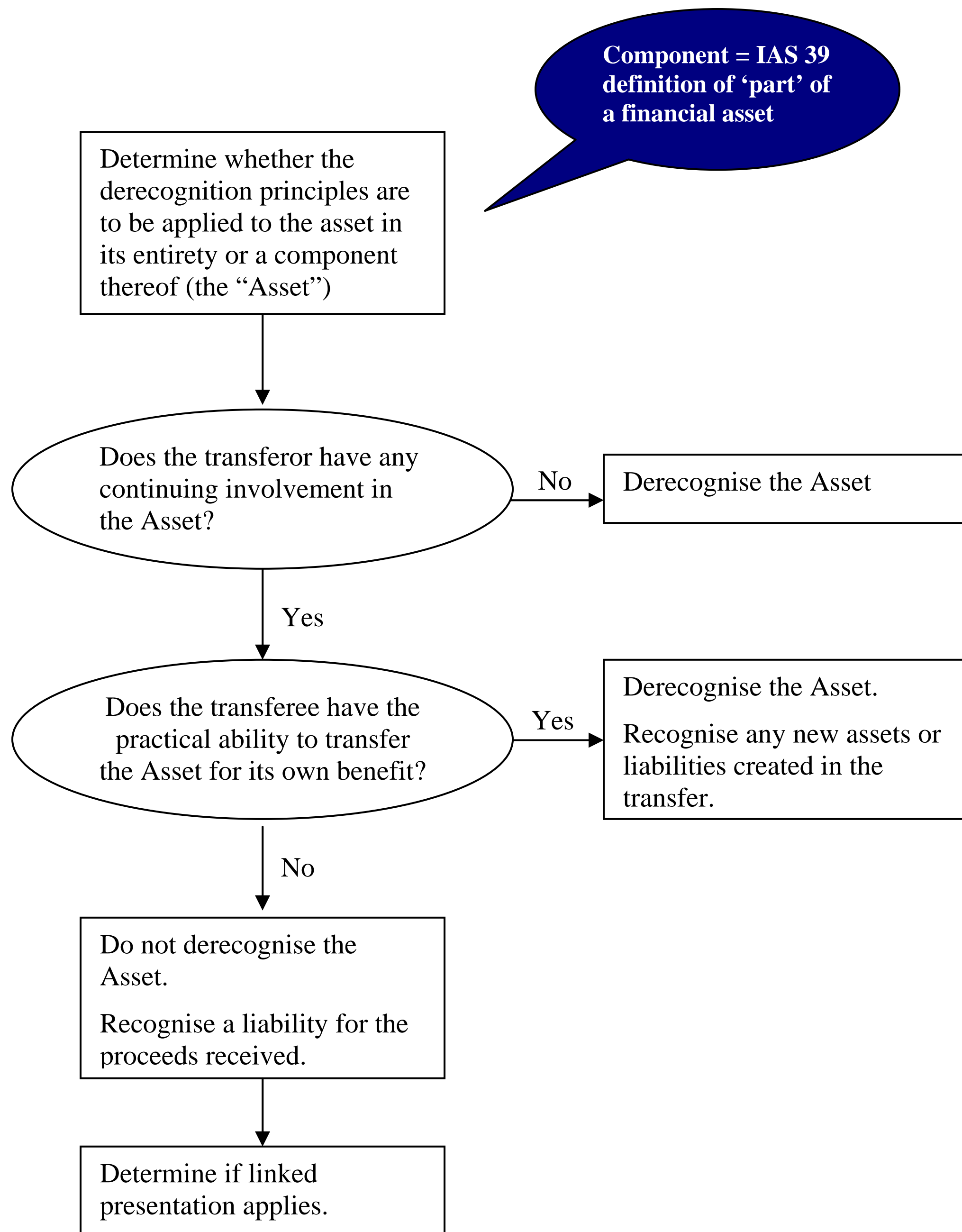
14. The staff recommends that for transfers of *whole* financial assets as a group, the Board eliminate 'similar' from the component definition of paragraph 16 of IAS 39. The consequence would be that the 'continuing involvement' step and 'practical ability to transfer' test in Flowchart 2 would be applied to the assets as a group.

15. The staff recommends that for transfers of a *component* of a group of financial assets, the Board extend the decisions it made in Agenda Paper 2B on transfers of a component of (a) a derivative, (b) a hybrid instrument with an embedded derivative that requires bifurcation or (c) an equity instrument to those transfers, preferably along the lines of the staff's recommendations in the table in paragraph 13.

Question for the Board

16. Do you agree with the staff's recommendations in paragraphs 14-15? If not, why not?

Appendix 1: Flowchart 2



Appendix 2: Definition of a Part a Financial Asset in IAS 39 Paragraph 16

Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17-23, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

(a) Paragraphs 17-23 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.

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

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

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

(b) In all other cases, paragraphs 17-23 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8

per cent of the principal amount of the receivables, paragraphs 17-23 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 17-26, the term ‘financial asset’ refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.