IASB Meeting Agenda reference **11B**

Staff Paper Date **October 2009**

Project **Derecognition – Financial Instruments**

Topic **Accounting for Repurchase agreements and similar transactions**

Contents and purpose of this paper

1. Many respondents to the Derecognition Exposure (‘ED’) disagreed with the proposed treatment for sale and repurchase (‘repo’) and similar transactions. Under both approaches described in the ED, such transactions would generally be treated as sales as opposed to collateralised lending as required under IAS 39 *Financial Instruments: Recognition and Measurement* and FAS 166 *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*[1].

2. This paper analyses this issue, and asks how the Board would like such transactions to be addressed in the next stage of the project.

The Issue

3. The staff believes that there are no substantive differences between standard repos and securities lending arrangements (although documented differently); hence the staff’s analysis in this paper focuses on repos, which is the more common form of such transactions. The analysis in this paper applies equally to ‘collateral’ posted in respect of derivative transactions, where the transferee has the right to transfer the asset for its own benefit[2].

[1] FAS 166 has not yet been codified. It is anticipated that this standard will primarily be incorporated into ASC 860 Transfers and Servicing

[2] “Any reasonable man ought to know that a broker’s office is no place to leave money or securities for safe keeping” – Kenneth C Kettering in Repledge Deconstructed.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

4. Both collateralised lending and repos involve a transfer of a financial asset from one party (transferor) in exchange for a consideration given by another party (transferee) plus a required future transfer of an asset from the transferee to the transferor. Under both standard repos[3] and collateralised lending, the consideration given by the transferee is usually a payment of cash, and the contractual obligation of the transferor is usually a payment of an amount equal to the cash received, plus a premium.

5. Similar to a collateralised loan arrangement, under a standard repo agreement, the two counterparties (transferor and transferee) retain particular rights and obligations to each other with respect to a particular class of assets. At the end of the repo term, the transferee is obligated to sell, and the transferee is obligated to buy, an asset equivalent to the original asset transferred.

6. The question that arises is whether these continuing rights and obligations of the transferee and transferor make a repo transaction substantively the same as a collateralised lending, or whether there is a meaningful difference.

Standard repo agreement - description

7. A repo is a single transaction combining a spot market sale with a simultaneous forward agreement to repurchase the underlying instrument or a similar financial instrument at a later date. Repos are typically short term but longer term repos are increasingly common. An overnight repo is for next-day delivery and any repo that is not overnight is considered a term repo. The financial assets sold in repos tend to be readily obtainable financial instruments but any type of asset could be used.

8. A standard repo agreement has the following important features:

   (a) Repos can be structured in many different ways but a standard repo is structured as a sale of a financial asset from the transferor to the transferee

[3] ISMA Global Master Repurchase Agreement

for cash and a forward contract requiring the transferee to sell, and the transferor to purchase, an equivalent financial asset at some future date or dates.

(b) The financial asset is delivered to the transferee upon the transfer, and the transferee obtains title to the asset and has the right to collect any payments relating to the asset transferred.

(c) During the term of the repo, the transferor is entitled to receive from the transferee an amount equal (equivalent) to all interest or dividends paid on the underlying asset.

(d) The transferee has complete control over the transferred asset and it is permitted to sell or deal in the asset transferred immediately or at any time following initial transfer.

(e) The agreement does not impose any obligation on the transferee to maintain either the asset transferred or any substitute 'collateral' for the benefit of the transferor prior to exercise of the forward.

(f) If upon a subsequent sale of the asset by the transferee, proceeds are in excess of the price paid by the transferee on the original transfer, the transferee is not required to account to the transferor for the excess. Similarly, if the transferee realises less than the original purchase price, the transferor would not be required to make up any difference.

(g) The price at which the transferor is required to repurchase the asset (an equivalent asset) equals the initial sale price plus a 'price differential'. This 'price differential' is negotiated at the inception of the arrangement and repo rates are typically quoted in the financial markets for various types of financial assets along with principal amount, maturity, and underlying asset type.

(h) During the term of a repo, the assets delivered to the transferee may be 'marked-to-market' and the transferor or transferee can call for the return or delivery of assets or cash to maintain the agreed margin ratio.

Suggested motives of the parties to a repo agreement

9. It is usually claimed that repos and stock lending activities are undertaken for financing reasons but the staff notes the following additional motives which are also frequently cited:

    (a) Repos provide investors a means of increasing overall portfolio returns. Repos and stock lending provides a way for an entity to 'lend' financial assets to financial intermediaries for a fee. This 'lending fee' is an additional return to the institutional investor on top of returns from the assets themselves.

    (b) Repos enable financial intermediaries to generate additional brokerage income by transacting in assets subject to repos.

    (c) They assist financial intermediaries to complete delivery when they have a shortfall of specific assets (to deliver against a short sale).

    (d) Repos sometimes provide a means of acquiring an asset to access a cheaper means of fulfilling margin requirements (than by depositing cash)

    (e) They allow financial intermediaries to address the needs of longer term lenders and shorter term borrowers.

    (f) Repos are used by central banks as a policy tool to ease liquidity in the financial system or drain liquidity from the financial system in the short-term.

Arguments for treating repos and similar transactions as collateralised lending arrangements

10. Many respondents to the ED argued that repos are commercially viewed as financing transactions in nature and that a sale treatment does not reflect that commonly held view.

11. Some also argued that repos and similar arrangements are financing devices because one party provides the other with funds against the promise that the funds will be paid back in the future, and that promise is assured through the transfer of an interest in a financial asset. The initial sale value of the financial

asset (in the immediate cash sale portion of the repo) is the amount of the loan under this analogy and the forward price used in the repo is the payback on the loan, including a margin to reflect the time value of money. The argument is that since the financial asset is held during the repo agreement by the effective lender, it is effectively collateral against default on the loan. Those respondents also argue that because a repo is effectively a loan, it is settled on the basis of an interest rate (the repo rate) rather than directly in terms of a forward price of the underlying asset.

> *...as regard repo transactions the transferor has full access to primary cash flows of the transferred asset and therefore in our opinion is in full control of it...The transferee receives only the cash flows connected with the loan which it provided and which is collateralised by the transferred securities. (CL#4)*

12. Some also argue that repos are in economic substance collateralised lending arrangements for the following reasons: First, repurchase agreements have specific maturity dates, settlement dates for repayment of funds, and specific rates of interest to be paid at the time of settlement. Second, the initial sale price of the assets in a repo transaction may not reflect the full market value of the asset. Third, principal and interest payments on the assets underlying these transactions continued to be paid to the transferor (although indirectly, via the transferee) during the term of the transaction. Fourth, the transferee is entitled to request additional margin any time during the life of the agreement. Lastly, the transferor may be entitled to substitute other specified assets for the assets transferred.

> *The difference between a repo and a pledged borrowing (where the asset is pledged to the counterparty in guarantee of a loan) is more a question of legal form than of economic substance: repos give the lender an easier legal access to the benefits of the guarantee in the event of bankruptcy (no need to go to court to obtain ownership of the collateral). There would be some inconsistency and a real lack of comparability if those two comparable types of financing arrangements were accounted for differently, leading to a derecognition of the transferred asset in one case and not in the other.*
>
> *In substance, repos are secured borrowings. We note that the money lender bears a risk on the transferred asset which is purely equivalent to the risk borne by any lender in the value of a pledge, and has control of a loan granted to the transferor, of which credit risk reflects the value of the assets "transferred". As used to secure borrowings, repos transactions create significant liabilities that need to be reported in banks' statements of financial position and to be measured as financing liabilities which is amortised cost. […]*

> *Consequently, we strongly disagree with the derecognition of financials assets subject to repo transactions […] as it would be inconsistent with the economic substance of the transaction. (CL88)*

13. Many respondents also commented that the transferor ('borrower') retains substantially all risks and rewards of the underlying asset in a repo agreement and thus the economic substance of such transactions is that they are collateralised lending arrangements.

> *[R]epo transactions are widely used by banks in some Europe in order to secure borrowings, among which borrowings from central banks. Under such financing arrangements, the transferor retain substantially all the risks and rewards of the transferred assets, but those financing arrangements often include other features (transferor's right to proceed to exchange of assets at any time during the arrangement, transferor's right to receive any coupon…) that further demonstrate the transferor's control of the transferred assets.*

14. Some respondents also reject the argument that in a repo transaction, the rights and obligations of the parties are no different from parties to a forward transaction (after the initial transfer). Those respondents argued that a repo transaction can be distinguished from a sale of an asset with a separate forward contract to buy back the asset in the future.

> *Although one could argue that the economics of these arrangements are similar to a sale of the financial asset with a forward repurchase commitment, these transactions differ from a typical forward purchase agreement in that the transferor is (i) paid the interest and dividends from the transferred asset and (ii) assured that the transferred asset will be returned via the provision of collateral that is valued daily and adjusted frequently for changes in the market value of the transferred asset. The transferor is entitled to the collateral should the transferee default. However, the transferee is exposed to the transferor's credit risk on the return of cash (ie the repurchase price), similar to a secured lender in a financing. These provisions are not typical of forward contracts where collateral arrangements generally protect only the fair value of the forward for both counterparties. (CL#61)*
>
> *Some view the repo as to be equivalent to a sale combined with a standalone forward and explain that after the transfer entities that are obliged to a repurchase agreement should account for the transaction as a standalone forward. However, in practice and in substance, repurchase agreements after transfer of assets are generally not equivalent to standalone forwards: the initial price of a standalone forward would be generally zero, whereas the implicit price of the forward of a repo is - approximately – equal to the haircut (excess of value of the collateral over the loan) less the difference between the return on the assets and the transferor's cost of funding. Consequently, it is not adequate to separate the transfer from the repurchase agreement when assessing the accounting treatment to apply to repo transactions.*

15. Some respondents also argued that treating repos as sales for accounting purposes will lead to a reduction in market liquidity and would affect the behaviour of financial institutions adversely, which may have unintended consequences on the financial markets in light of the importance of repos and similar transactions as a main source of funding.

> *If profit and loss are to be recognized at the time of each transaction, practically nobody would engage in these transactions and market liquidity would dry up. (CL#55)*
>
> *...if derecognition standards with the proposed treatment were effective before the new financial instrument standard regulating the classification becomes effective or if [the] HtM category with its tainting rules was not cancelled many banks would face [a] significant problem. (CL#4)*

Repos – a conceptual analysis

16. As noted previously, some of respondents argue that any change to the accounting of repos will lead to a reduction in market liquidity and may adversely affect the banking industry. Those assertions may or may not be correct. However, accounting is about faithfully representing the financial position and performance of an entity.

17. Many of the respondents cited intent of the parties or referenced the pricing of transaction to support their argument that repos should be accounted for as collateralised lending.

18. The staff believes that whether a particular transaction (including a repo transaction) is a sale or a collateralised lending depends on the contractual rights and obligations created by that transaction. The staff believes that the accounting should not be determined by a label applied by the parties but should be determined based on the contractual rights and obligations created by the transaction.

19. The staff agrees that there are some similarities between repos and collateralised lending. However, in a repo transaction the transferee has (and the transferor has surrendered) substantive rights beyond those of a borrower in a collateralised lending arrangement.

A. Is there a security interest?

20. Both collateralised lending and repos begin with an immediate transfer of property interest from one party to another party.

21. In a collateralised loan transaction, the secured party only obtains a limited property interest in the transferred asset, known as a security interest. The security interest is subject to a property interest retained by the debtor, sometimes known as debtor’s equity (of redemption). Whereas, in a sale, the transferor transfers its entire property interest to the transferee.

22. A specific security interest possesses the following characteristics:

    (a) it is a right given by a debtor to a creditor in an asset

    (b) the right is by way of an interest in the debtor’s asset not by way of reservation of title to the creditor

    (c) the right is given for the purposes of securing an obligation

    (d) the asset is given in security only, not by way of outright transfer

    (e) the agreement restricts the debtor’s right to dispose of the asset free from the security interest.[4]

> *By definition, a property interest is a legal right of one person enforceable against another person or class of persons with respect to the possession, enjoyment and or alienation of a thing.*
>
> *In a secured transaction the rights to the thing are divided between two persons. The secured party’s interest is called a security interest. This includes the right upon the debtor’s default to alienate, or collect or otherwise to realise the value of the thing for the purpose of satisfying a secured obligation.*
>
> *In security interest, the debtor retains an interest in the thing colloquially called ownership (known as debtor’s equity). This*

[4] Leg

23. Because a debtor retains property rights in the collateral subject to a security interest, a secured party does not traditionally have unfettered right to deal in the collateral. The lender's right to possess the collateral is conditioned on the debtor's breach of the secured obligation. In the event of failure in the fulfilment of the underlying obligation for which the security has been taken, the creditor may have recourse to the asset, usually by selling it, so that the proceeds of the sale or other method of enforcement can be applied towards satisfying the unfulfilled obligation.

24. "By definition, a security agreement requires that there be a collateral that is the subject of the security interest. It would therefore be inconsistent with this principle to give the secured party the unbridled right and power to dispose of

the collateral, thereby destroying the debtor's property interest (its debtor equity) in the collateral".[5]

25. In a standard repo agreement, the transferee has complete control over and right of possession of the transferred asset and it is permitted to sell the asset transferred at any time following initial transfer. The agreement does not impose any obligation on the transferee to resell and redeliver the original financial asset transferred to the transferee. Rather, it provides that the transferee must sell and deliver an equivalent financial asset to the transferor. Moreover the agreement does not impose any obligation on the transferee to maintain either the asset transferred or any substitute 'collateral' for the benefit of the transferor prior to exercise of the forward.

26. If upon a subsequent sale of the asset by the transferee, proceeds are in excess of the price paid by the transferee on the original transfer, the transferee is not required to account to the transferor the excess. Similarly, if the transferee realises less than the original sale price, the transferor would not be required to make up any difference.

27. Because by definition a security interest requires that there be existing collateral securing a secured transaction, if the transferee were in fact to sell the repo security to a third party in a transaction that would cut off transferor and transferee's rights in the security, at that point the transferor would cease to have a security interest in that asset.

28. Therefore the staff believes that a transaction structured in the form of a repo that gives the transferee such substantive rights should not be deemed to be a collateralised lending arrangement as such a provision is fundamentally inconsistent with the minimum elements of a secured arrangement. The transferee's unrestricted right to deal in the transferred asset during the term of the agreement represents an incident of ownership which does not pass to a secured lender in a collateralised transaction. Outside the capital markets arena,

[5] Repledge Deconstructed – Kenneth C. Kettering

it is not easy to think of settings in which a secured party is given the right to sell collateral before default.

29. The standard repo agreement's provision that the transferee has right to deal in the repo securities gives objective economic substance to the formal characterisation of the transaction as a sale. The transferor in such a repo transaction has given the transferee more rights in the collateral than is consistent with the transferor's continued ownership, and the transaction should be treated as a sale (whether the transferee sells the asset to a third party or not). The staff believes this interpretation would be supported by the insolvency and bankruptcy provisions governing repurchase transactions in many jurisdictions.

B. Existence of a loan obligation (is it a loan?)

30. The definition of a secured lending and the accounting thereof requires that the collateral secures a loan. In a standard collateralised loan, a debtor would have an obligation to pay cash, to the lender (secured party). If the debtor grants the creditor collateral to secure this obligation, the debtor nevertheless retains its obligation under the loan.

31. In a repo, however, the transferor does not have an obligation (a loan liability) to pay money to the transferee prior to the repurchase date and hence the transferee is not yet a creditor in that sense. Rather, the repo parties are only parties to a forward contract (an executory sales contract). The transferor's obligation to make payment under the repo agreement is conditioned on the transferee's tender of delivery of the specified assets.

32. Under a standard collateralised loan transaction, the debtor's obligation to pay continues whether or not the collateral securing the obligation continues to exist to secure the transaction and despite the fact that the secured party cannot return any collateral to the debtor upon payment of the secured obligation. In contrast, if there is no repo asset for the transferee to return to the transferor, and if the transferee does not tender delivery of such an asset, then not only does the transferor have no obligation whatsoever, secured or not, to pay money to the transferee. The transferee may owe damages to the transferor in this case.

33. **The terms of the repo agreement is also inconsistent with a loan treatment as both parties are exposed to each others credit risk which is not a feature of a typical loan arrangement.**

34. In a secured transaction, the debtor owes a secured obligation. If, upon default the secured party realises proceeds in excess of the secured obligation it must account to the debtor for the excess. Alternatively, if the secured party realises less than the secured obligation, then the debtor must make up the deficit. In contrast, if a transferee disposes of the repo asset, the transferee has no obligation to account for any excess proceeds, and the transferor has no obligation to make up for any deficit.

C. Contingent liability

35. A standard repo is also substantively different from a collateral under a contingent obligation. A debtor could, for example, grant a security interest to a secured party to secure the debtor's obligation to pay damages if the debtor breached its contractual obligation under a separate contract or arrangement. But the nature of the contingency in the secured contingent obligation and the repo are opposite to each other. Under the contingent arrangement, the debtor's obligation arises if the debtor fails to fulfil its obligations under the underlying contract. Under a repo, the debtor's obligation arises when the transferee does fulfil its obligation under the repo to sell back an equivalent financial asset.

D. Economic exposure

36. A repo transaction also exposes the transferee to the risks associated with the transferred asset. If the transferee does not sell the asset then the transferee will not have any exposure to the performance of the underlying asset. However in practice the transferee will inevitably sell the asset as in many cases the sole reason for entering the transaction is to be able to sell the underlying asset. Once the security that has been acquired under a repo is subsequently transferred to a third party, the original transferee does become exposed to the market risks associated with the asset (in an opposite manner to the transferor)

as it will need to repurchase an equivalent asset to fulfil its obligation under the repo. If prices rise, the transferee will suffer a holding loss and vice versa.

E. Right to equivalent payments (income stream)

37. Under a standard repo, the transferor is entitled to an amount equal to such income payable on the underlying asset, as opposed to a direct right to the income itself. This is particularly on point where the transferee sells the asset to a third party (as typically will be the case) – and then the transferee will have to 'manufacture' the payments to be made to the transferee rather than simply 'passing through' any cash flows received on the reference asset. This provision does not support the treatment of repos as collateralised lending.

38. It is not unusual for market participants to componentise financial assets into separate parts to be sold separately. For example fixed income assets are commonly unbundled into principal and interest only strips. The interest only strip is sold as a separate financial instrument. The fact that, in a standard repo transaction, the parties might have separated the underlying asset into two parts-the right to the income stream for a limited period and all other rights with respect to the asset transferred-need not necessarily prevent accounting for the transaction as a sale.

F. Essential conceptual considerations

a. Should history matter?

39. Treating standard repo and similar transactions as collateralised lending arrangements result in very different accounting by two entities with identical contractual rights and obligations only because one of those entities once owned the transferred financial asset. Under IAS 39, a forward (a derivative) that entitles and obligates the holder to acquire an asset it has never owned would be accounted for simply as a forward. Yet under a collateralised accounting treatment, if that forward pertains to an asset previously recognised by the transferor, the transferor and transferee would be required to recognise a

liability and asset respectively (effectively grossing up the statement of financial position). As a result, ownership history affects the accounting.

40. This inevitably leads to two or more entities recognising the same item as their assets. Under the IASB *Framework* and many of the standards under IFRS, only one party can recognise an asset as its asset unless the parties are joint owners of the asset. Having two parties recognise the same securities as their assets is not satisfactory and can result in an overstatement of the individual statement of financial positions.

b. Recognition of rights and obligations

41. The staff notes that IAS 39 (and indeed the IASB *Framework*) is founded primarily on a control model. The recognition criteria in IAS 39 focuses on control and look to each of the rights and obligations of the parties to a financial contract to determine whether an asset or liability should be recognised and at what amount. On the contrary, treating repos and similar transactions as collateralised lending arrangements does not reflect fully the contractual rights and obligations of the parties involved in the transaction. Hence a collateralised lending treatment would be contrary to the principles in the *Framework* and will introduce inconsistency into IAS 39.

c. Recognition of non existent assets and liabilities

42. The staff notes that treating repos and similar transactions as collateralised lending arrangements results in recognising assets and liabilities that do not meet the definitions of those elements in the *Framework*. Under the *Framework*, an asset qualifies as an asset of a particular entity if the entity controls the economic benefits underlying that asset. Following the transfer of the asset to the transferee, the transferor in a repo transaction, ceases to have present access to the economic benefits underlying the asset transferred. As such the asset transferred no longer qualifies as an asset of the transferor. Hence the collateralised lending treatment necessitates the recognition of 'non-existent' liabilities and assets because it treats the transfer as a failed sale.

d. Risks and rewards notion

43. The argument that the transferor continues to be exposed to the risks and rewards of the asset transferred confuses the purpose of the statement of financial position and how risk is to be reflected in financial statements.

44. The Board's definition of asset and liability limits the population of assets and liabilities to the underlying economic resources and obligations of an entity and not the item to which the entity is exposed to the risks thereof. The definition of assets, liabilities and equity therefore imposes a limit or restraint on what can be included in the balance sheet.

45. The staff notes that the Board's definition of assets does not incorporate the concept of risks and rewards. The staff also notes that the *Framework*'s recognition criteria does not include the concept of risk and rewards and it is logically not part of the recognition and derecognition process (i.e. that concept is not relevant in determining when to recognise an 'asset' in a financial statement and thus when that item ought to be derecognised).

46. The staff notes that derecognising the asset transferred and recognising a forward instead does not in anyway hides the risk exposure of the transferor. The valuation of the forward incorporates all the risks and rewards of the underlying asset. As outlined in the *Derecognition* ED, the transferor would have to prominently disclose the obligation to repurchase the asset and the timing thereof.

Conclusion and staff recommendation

47. The staff also notes that **investors that the staff spoke with were, generally, in support of the proposed treatment of repo transactions**. In addition, the staff notes that a few banks also support, or are indifferent to, the proposed treatment for repo transactions.

48. Based on the above analysis, the staff believes that conceptually, repos should be treated as sales with a forward (derivative) to repurchase the underlying.

49. The staff, however, notes that most respondents to the ED disagreed with this position, with some arguing that such accounting treatment would not provide useful information.

Question for the Board:

a) Which of the following approaches, does the Board believe should be adopted for accounting for repos and similar transactions:

(i) account for repos and similar transactions as collateralised lending arrangements

(ii) account for repos and similar arrangements as sales of the underlying assets and a forward to repurchase those assets

b) What is the basis for your preference in (a) and why?