Project **Derecognition**

Topic **Proposed derecognition approach for financial assets and liabilities**

Introduction

1. This paper provides further analysis of the derecognition approach as it applies to pass through arrangements, sale with option contracts, non recourse loans and SPE's that issue beneficial interests in the 'assets' of the SPE or the SPE.

2. This is in response to requests for additional explanation of the above issues by FASB members at the April education session -

   (a) **Call and put options** – Further analysis of, and the basis for, the proposed treatment of sale of an asset with an option to repurchase the asset (or similar asset) in the future

   (b) **Contracts that replicate the performance of an asset (a 'synthetic' contract)** – Do derivatives that replicate the performance of a recognised asset result in derecognition of the asset (eg total return swaps or interest rate swaps that are physically or net settled, and/or prepaid)?

   (c) **Pass through arrangements** – Comparison of the accounting treatment and outcomes of applying the proposed model to pass through arrangements and sale of an asset with acquisition of an interest in the transferee vehicle

   (d) **Nonrecourse loans** - Should a nonrecourse provision result in special accounting treatment?

   (e) **'Empty' SPE issue** – Does the application of the proposed derecognition approach result in special-purpose entities (SPEs) that, through the issuance of beneficial interest distribute all the cash flows from their assets, becoming 'empty shells'?

3. The paper is also accompanied by the following appendices:

(a) Appendix 1 – Examples: an illustration of how the proposed approach is applied in cases involving the issues raised in the paper

(b) Appendix 2 – Proposed approach: an early staff draft of the proposed requirements based on IASB decisions to date, and associated application guidance and disclosure requirements [Not included in Observer Notes]

4. The paper asks generally how the boards would like to move forward, and specifically whether the staff should move towards the balloting process for a due process document. The staff has no plans for further papers to the board (other than any possible sweep or transition issues) on the proposed approach, unless the boards ask for further analysis of specific issues.

A. Call and put options

Transfer of a financial asset with a right (a call option) to repurchase.

5. Under the proposed approach if an entity sells an asset and as part of the transaction obtains a call option on the asset, the asset is derecognised.

6. This is because the transferor no longer controls the economic benefits underlying the asset and hence that asset ceases to qualify as an asset of the entity. During the period before exercise of the option, the transferor (the call holder) no longer has the present ability to obtain and restrict others access to the economic benefits of that asset. Instead, the transferor has a right to obtain and restrict others access to those economic benefits *in the future* (that is, on exercise of the call option).

7. The transferor is in the same position as an entity that has purchased a call option without having ever owned the underlying financial asset. The transferor would recognise a call option and derecognise the asset transferred. The transferee would recognise the asset and a written call option.

8. Today, when an entity enters into an agreement giving it a right to purchase a financial asset at a future date, it does not have present access to the economic benefits of the asset that is the subject of the contract. Instead, it has a contractual right to obtain those economic benefits but conditional upon exercise

of the call. Similarly, until exercise of the call option, it does not have a contractual obligation to pay the strike price, merely an obligation that is again conditional upon electing to exercise the option.

Transfer of a financial asset subject to a put option

9. If an entity transfers a financial asset and writes a put option which obligates it to buy back the asset, the transferor would derecognise the asset. This is because the transferor has not retained control of the economic benefits of the asset and hence the asset ceases to qualify as an asset of the entity.

10. During the period before exercise of the option, the transferor cannot obtain, for its own benefit, the cash flows or other economic benefits underlying the asset transferred. Instead, the transferor has an obligation, contingent upon the transferee's discretionary exercise of the option, to obtain access to the economic benefits in the future.

11. The transferor is in the same position as an entity that has written a put option or a financial guarantee without having ever owned the underlying financial asset. The transferor would derecognise the asset and recognise a written put option. The transferee, on the other hand, would recognise the asset and a put option.

12. It does not matter that the asset in question is not readily obtainable. The future economic benefits embodied in an asset may flow to an entity in a number of ways. Although the main and most common means tend to be by exchange for other assets or in settlement of a liability or distribution to the owners of the entity (collectively transfer), a transferee can obtain (access) the economic benefits of a financial asset in ways other than through a transfer of the asset to a third party.

13. For example, an entity that purchased a portfolio of loans may be restricted (as part of the arrangement with the seller) from selling the portfolio to a third party. However, that restriction does not preclude the entity from holding the portfolio and receiving (and keeping for itself) all of the cash flows that the underlying loans generate. Thus the proposed approach does not view the absence of an ability by the transferee to sell or exchange the asset as a conclusive evidence that it cannot obtain or access the economic benefits of the asset.

B. Contracts that replicate the performance of an asset (a 'synthetic' contract)

14. Some board members requested an explanation of the accounting for the sale of an asset with a derivative that replicates the performance of the asset (eg a total return swap) under the proposed approach.

15. Under the proposed approach, an asset would only be derecognised only if there is a link between (a) a financial asset that an entity has recognised and (b) the arrangement the entity has entered into. There is a link between the two if the entity has agreed to pass on cash flows from that asset to the other entity such that the transferor no longer has present access to the economic benefits of the asset or no longer can restrict others' access to those benefits.

16. Under the proposed approach, the key issue is not whether the transferor would receive a payment similar to the returns or economic benefits of the asset. Rather whether the transferor has passed, or promises to pass, the economic benefits of the asset to the other party. That is, the transferor should have granted the transferee a right to the economic benefits of a specific asset or portfolio of assets. That right binds the economic benefits of the specific asset or portfolio of assets to the transferee and it is able, by virtue of that right to benefit from the economic benefits itself and to restrict others (including the transferor's) access to the economic benefits.

17. Consequently, under the proposed approach synthetic contracts do not result in a derecognition of any specific asset or group of assets.

18. In contrast to a synthetic contract, in a pass through arrangement an entity which holds the contractual right to receive cash flows from a financial asset (the original asset) assumes a contractual obligation to pay those cash flows to a transferee (the eventual recipient). Although the transferor may or may not provide a guarantee to the transferee, that is not relevant for this particular analysis. We typically refer to an arrangement that promises the cash flows of an asset to another party as creating a one to one mapping between the transferor's right to receive the cash flows (the asset) and the right of the transferee.

19. Example 1 of Appendix 1 illustrates the application of the above analysis to a synthetic transaction and a pass through arrangement.

C. Pass through arrangement vs. sale and acquisition of beneficial interest in transferee

20. Transfer of a partial interest in a financial asset may be structured as:

    (a) a sale of the entire asset coupled with an acquisition of a beneficial interest in the transferee (or the asset); or

    (b) a transfer of an interest in the asset.

21. If beneficial interests acquired in a transfer and a retained interest in a transferred asset are not treated similarly, it would lead to an asymmetrical treatment for economically identical transactions and creation of structuring opportunities.

22. The following is a summary of the accounting outcomes under the proposed approach for these types of arrangements:

    (a) **Issuance of equity instrument or an interest in the net assets of an 'operating entity'**. No derecognition of any of the entity's assets as there is no direct link between (a) the entity's assets and (b) the equity claim (or claim on the net assets). The entity has not agreed to pass on cash flows from a specific asset or portfolio of assets to the equity holder or the beneficial interest holder. Hence the entity continues to have present access to the economic benefits of the asset and can restrict others' access to those benefits.

    (b) **Transfer of a right to cash flows of a recognised asset:** The transferor derecognises all of the asset previously recognised and recognises the rights and obligations resulting from the transaction. This is the case whether the right transferred represents a proportionate or disproportionate interest in the asset previously recognised by the transferor.

(c) **Transfer of an asset by a transferor into an SPE and acquisition of a beneficial interest in the assets of the SPE.** The transferor derecognises the asset previously recognised and recognises the rights and obligations resulting from the transaction. The transferor would recognise its interest in the assets of the SPE. Other beneficial interest holders in the SPE's assets will also recognise their respective interests.

(d) **Transfer of an asset by a transferor into an SPE and acquisition of a beneficial interest in the SPE – accounting by the SPE.** No derecognition by the SPE of any of the assets transferred into the SPE as there is no direct link between (a) the SPE's assets and (b) the claims (beneficial interests) issued by the entity. The SPE has not agreed to pass on cash flows from a specific asset or portfolio of assets to the equity holder or the beneficial interest holder. Hence the SPE has present access to the economic benefits of the asset and can restrict others' access to those benefits.

23. Hence, under the proposed approach, if an entity transfers an entire asset (or group of financial assets) or an interest in a previously recognised financial asset (or group of financial assets), and the transaction meets the derecognition criteria, the entity derecognises the entire asset or group of financial assets.

24. The transferor recognises the interest in the asset (or of the group of financial assets) retained or the beneficial interest in the transferee's assets acquired as part of the transfer arrangement.

25. That is, the accounting for a retained interest in a financial asset or a beneficial interest acquired in a transferee vehicle's assets are similar.

D. 'Empty' SPEs

26. Some Board members were concerned that the proposed derecognition approach would lead to all SPEs being 'empty'.

27. The proposed approach may result in more 'empty' SPEs than currently possible under IAS 39 *Financial Instruments: Recognition and Measurement* and US GAAP. However, the proposed approach will also lead to more items being recognised by parties involved in transfer activity.

28. The staff believes that the Boards, in issuing IAS 39 and FAS 166 derecognition guidance, contemplated that there are legitimate scenarios where an SPE would have no assets or liabilities.

29. Hence we do not believe this is a new issue. We recognise however that the proposed approach could expand somewhat the set of SPEs that could have no assets or liabilities (ie be empty). We believe this change is appropriate and we do not recommend a reintroduction of any concept of prorateness or proportionately nor ‘obligation to pay only and if only the asset generates returns’ requirement.

30. Under the proposed approach whether an SPE will be empty or not depends on the nature of the beneficial interests issued (ie whether the beneficial interests entitles the holders of such instrument to the cash flows of an asset or a portfolio of assets, or to an interest in the entity).

Nature of beneficial interests issued by the SPE

31. The accounting for issuance of beneficial interests by an SPE will depend on the terms of those instruments.

32. If the beneficial interests entitles the holders of such instruments directly to some or all of the cash flows of specific assets or portfolio of assets (beneficial interests in those assets), those arrangements would have to be assessed for derecognition. In that assessment, if the beneficial interests give the holders the ability to obtain and restrict others access to the economic benefits of specific assets or portfolio of assets, those assets will be derecognised under the proposed approach.

33. However, if beneficial interests issued by an SPE entitle the holders thereof to some or all of the net assets (net cash flows) of the SPE or represent an interest in the SPE, then the arrangement will not lead to derecognition of the assets of the entity under the proposed approach as there is no direct link between (a) the entity’s assets and (b) the claims (beneficial interests) issued by the entity. The SPE has not agreed to pass on cash flows from a specific asset or portfolio of assets to the equity holder or the beneficial interest holder. Hence the SPE

continues to have present access to the economic benefits of the asset and can restrict others' access to those benefits.

34. Some might argue that an interest in an entity (or net assets) is economically equivalent to an interest in the assets of the entity (particularly in the case of SPEs, as they are conduits).

35. It is worth noting that in overwhelming majority of the complex transaction structures, the SPE will have other assets and liabilities (such as guarantees, interest rate swaps and loans) in addition to the assets transferred into it by transferor.

36. The proposed derecognition approach does not permit an entity to apply the financial asset derecognition principle to a transfer of a financial instrument that can either be an asset or a liability over its life (e.g. an interest rate swap) or a portfolio including such an instrument, unless the counterparty to that financial instrument has expressly consented to the novation.

37. Similarly, the proposed approach cannot be applied to a financial liability or a portfolio of assets and liabilities (as one item), unless the counterparty to the financial liability included in such a portfolio has expressly consented to the novation of the liabilities. If such a consent is given, the derecognition principle for financial liabilities would be applied to the liabilities and the financial asset derecognition principle would be applied to the assets in the portfolio.

38. However, under the proposed approach, an SPE is not be prevented from treating a transaction as a sale of the entity's assets and the beneficial interest holders to recognise those assets solely because SPE has entered into contracts with another party for collection services or portfolio management services and has an obligation to pay for those services. Such arrangements are no different from where a party gives his assets to be managed by an agent for a fee.

39. Hence if a beneficial interest in the SPE is deemed to be an interest in the assets and liabilities of the entity, the beneficial interests will not lead to derecognition of the assets and liabilities of the SPE under the proposed approach.

40. Some might argue that that economic equivalence holds true in cases where there are no liabilities in the SPE. That might well be the case but we believe

an interest in an entity is fundamentally different from an interest in the assets of an entity. For example, a 100% shareholding in a shell company with cash holding of CU100 is not the same as a contract giving right to the CU100 asset held by the entity.

41. In summary, the accounting for beneficial interests in an SPE will always depend on the specific terms (the rights given to the holders of such instruments). If the terms of the instruments issued by the SPE results in the SPE not having control of the economic benefits of the assets then derecognition of those assets occurs, and vice versa.

E. Nonrecourse 'loans'

42. Assets and liabilities may be related, contractually or otherwise, by security arrangements. A security arrangement gives a creditor particular legal rights pertaining to one or more specific assets of a debtor entity. By granting or agreeing to those rights, the debtor accepts restrictions on the securing asset(s).

43. Commonly, the restrictions may:

    (a) preclude sale of the asset unless the debt is satisfied;

    (b) allow the creditor to take possession of the securing asset if the entity does not meet its obligations under the related secured liability; and/or

    (c) give the creditor a preferred claim to the securing asset or the proceeds from sale of it in the event of the entity's insolvency or liquidation.

44. A security arrangement may be supplemented by another type of contractual relationship - a nonrecourse provision. That is an agreement that, should the debtor default on a secured obligation, the creditor can look only to the securing asset (or assets) to recover its claim. Should the debtor fail to pay and the specific asset(s) fail to satisfy the full claim, the creditor has no legal recourse other assets of the debtor.

45. The instruments related by a nonrecourse provision can be grouped into two classes -

(a) ***Non pass-through arrangements:*** In these nonrecourse loans, the primary source from which the debtor is expected to obtain cash to pay the principal and interest on the loan is independent of or only indirectly related to the securing asset. The purpose of those security arrangements is to give the debtor a greater incentive to honor its obligation for fear of losing the securing asset. The securing asset is only a potential secondary source of cash to settle the obligation if the primary source proves insufficient, and the nonrecourse feature does no more than limit the debtor's potential loss to the securing asset in that event. In essence, the non-recourse features act like collateral.

(b) **Pass-through arrangements:** In other nonrecourse arrangements, the primary source from which the debtor is expected to obtain cash to pay the principal and interest on the loan is the securing asset. The debtor effectively promises or agrees to pass the cash flows of the asset to the 'creditor'. In those arrangements, the securing asset is the source of cash to settle the obligation, and the nonrecourse feature sets the upper bound for the cash the 'creditor' will receive. These arrangements are effectively pass –through agreements.

46. Under the proposed approach, for the set of nonrecourse loans described in paragraph 45(a), despite the nonrecourse feature and security arrangement, the collateral (the asset) qualifies as the asset of the debtor because the debtor can obtain the benefit embodied in the asset and control others' access to it.

47. An essential characteristic of a liability is that the entity has a present obligation. As the entity continues to have a present obligation to the lender, under the proposed approach the debtor should recognise a liability for the funds received.

48. Hence nonrecourse loans of such nature should be accounted for in the same way as liabilities with recourse, and the related securing assets in the same way as unpledged assets. The security arrangement could be disclosed either by the descriptions used in the statement of financial position or in the notes.

49. On the other hand, under the proposed approach for the set of nonrecourse loans described in paragraph 45(b), the 'debtor' will derecognise (or not recognise) the related secured assets. The nonrecourse obligation is not a liability of the debtor

because the arrangement of that kind substantively surrenders control of the asset (or a part thereof) as the 'debtor' passes or promises to pass the economic benefits to the 'creditor'. (Consequently the 'creditor' is not a creditor, but should recognise the asset or an interest in the asset).

50. This class of nonrecourse loans is no different from pass-through arrangements. Thus the conceptual basis for not recognising the original asset and the related obligation to pass on cash flows in a pass-through arrangement applies to such arrangements (ie the asset and liability do not meet the definitions of assets and liabilities from the perspective of the 'borrower').

51. The definition in the Framework of an asset refers to the control of a resource from which future economic benefits are expected to flow to the entity. A right to receive a cash flow in a nonrecourse arrangement does not represent a future economic benefit to the holder of that right when the holder of that right also has an obligation to pay the amount it will receive to a third party and cannot otherwise use the cash flow (or part thereof) for its benefit. Instead, the effect of assuming the obligation to pass the cash flows to the 'lender' is that the 'borrower' has relinguished control over the future economic benefits (or part thereof) from the asset, leaving the 'borrower' with neither an asset nor a liability (for the part represented by the nonrecourse 'loan').

52. Therefore, under the proposed approach, the nonrecourse loans described in paragraph 45(b) (ie the pass-through nonrecourse 'loans'), a liability is should not be recognised and the related securing asset should also not be recognised by the 'debtor'. The accounting is symmetrical for the 'lender' and the 'debtor'. The parties recognise their interests in the underlying asset.

53. This treatment avoids possible inconsistencies in the application of the proposed derecognition guidance and conflicts between the derecognition models for financial assets and financial liabilities..

Question for the Boards:

(a) Generally, how would the boards like to move forward? Do you require additional information and/or analysis? If so, what do you require and why?

(b) Specifically, do the IASB and/or FASB wish the staff to move towards the balloting process?

APPENDIX 1: Examples

1. The following examples illustrate the application of the requirements of the proposed approach for derecognition of financial assets.

Example 1. Issue of equity-linked note

(a) *Scenario A—Note not contractually linked to shares*. Entity A issues to Entity C a note for which the returns are linked to the performance of 10 per cent of Entity B's outstanding ordinary shares (ie Entity A will pay to Entity C 10 per cent of all interim and final distributions made by Entity B on Entity B's outstanding shares). According to the terms of the note, Entity A is not obliged to hold a 10 per cent investment in Entity B. However, although it is not obliged, Entity A invests in 10 per cent of Entity B's outstanding shares.

The issue by Entity A of the equity-linked note to Entity C does not result in the derecognition of Entity A's 10 per cent investment in Entity B because Entity A is not obliged to remit to Entity C the economic benefits of its investment in Entity B. If Entity A were to sell its investment in Entity B to a third party, it would not be required to pass to Entity C the proceeds from the sale. Furthermore, the third party would receive all of the economic benefits of the investment in Entity B (ie distributions from Entity B would flow to the third party) and, as a result, there would be nothing for Entity A to remit to Entity C. In essence, Entity A has issued a note with an embedded derivative referenced to 10 per cent of the outstanding ordinary shares of Entity B. As a result, the issue of the note would not result in the derecognition of Entity A's investment in Entity C shares.

(b) *Scenario B—Note contractually linked to shares*. The facts are the same as in Scenario A except that:

(i) Entity C has a security interest in the shares that Entity A holds in Entity B;

(ii) Entity C agrees to look to only the cash flows from those shares for repayment of the note (ie Entity C has no recourse against Entity A);

(iii) Entity A is obliged to pass to Entity C all cash flows it receives from its 10 per cent investment in Entity B; and

(iv) Entity A is prohibited from selling the shares without the approval of Entity C.

In contrast to Scenario A, the issue by Entity A of the equity-linked note to Entity C would result in the derecognition of Entity A's 10 per cent investment

in Entity B because Entity A is obliged to pass to Entity C the economic benefits of its investment in Entity B. Entity A is prohibited from transferring the shares in Entity B and is required to forward to Entity C all distributions that it receives on those shares. Because it cannot transfer the shares, unlike Scenario A, those distributions could never flow to an entity other than Entity A (which then would have an obligation to pass them to Entity B). Entity C also has access to the economic benefits of the shares through its security interest.

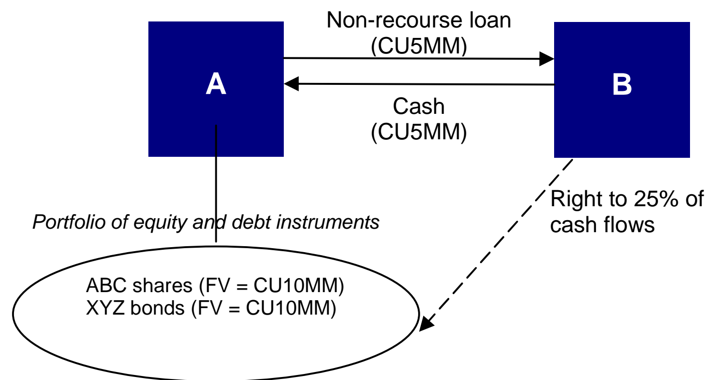
Example 2. John Smith Question

Description of transactions

Staff paper

1. The particular transactions raised at the April FASB education session, by Mr John Smith, are set out below:

Transaction 1



a. A holds a portfolio of readily obtainable equity instruments and debt instruments. The fair value of the equities is CU10 million, and the fair value of the debt instruments is CU10 million. A has legal custody of the shares and bonds.

b. B lends CU5 million to A for five years. B agrees to look to only 25% (pro rata) of the cash flows of the portfolio for repayment of principal and interest (ie the loan by B to A is nonrecourse to A).

c. A transfers any dividends from the ABC shares first, then interest and principal cash flows from the XYZ bonds.

d. A retains the right to transfer any or all of the shares or bonds, but must replace any items transferred with similar assets of similar value.

Transaction 2

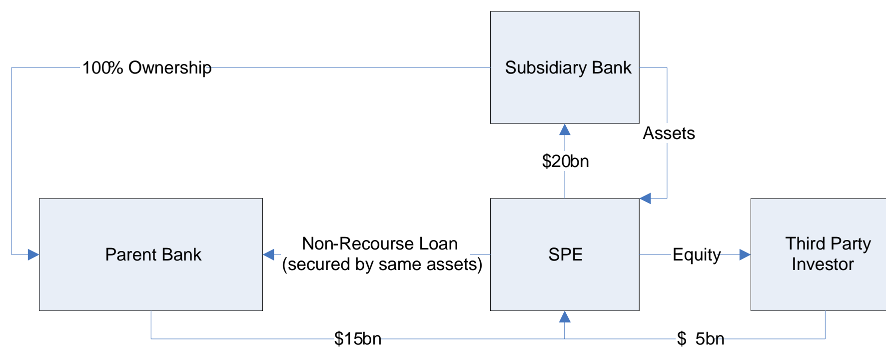
Same as Transaction 1, except that B agrees to look to only the *first* 25% (disproportionate) cash flows from the shares and bonds held by A for repayment of the principal and interest of the nonrecourse loan.

Analysis of transactions

2. The analysis of these two transactions under the proposed approach is set out in the following table.

Steps	Transaction 1	Transaction 2
The transfer	25% of cash flows from the portfolio of equity and debt instruments	*First* 25% of cash flows from the portfolio of equity and debt instruments
*Does the transferor presently have access, for its own benefit, to **all** of the cash flows of the financial asset that the transferor recognised before the transfer?*	**No**. After the issuance of the beneficial interest (ie issuance of nonrecourse loan), A has access to only 75% (not 100%) of the cash flows that the portfolio of equity and debt instruments generates.	Same as for Transaction 1
Accounting outcome under proposed approach	A has passed control over 25% of the portfolio of ABC shares and XYZ bonds to B. As a result, the transfer qualifies for derecognition. A would recognise a 75% interest in the portfolio and B will likewise recognise 25% interest in the portfolio.	Same as for Transaction 1 but the valuation of the subordinated 75% and the senior 25% will be different.

Example 3. Distressed debt



Facts

2. 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.

3. 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.

4. 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.

Analysis - Derecognition

5. In the Subsidiary Bank's stand-alone financial statements, the Subsidiary Bank derecognises the $20bn receivables because after the sale of these assets to the SPE, it no longer has the present ability to obtain all of the economic benefits of these assets for its own benefit (in fact, it has no present ability to obtain *any* benefits of the receivables).

6. The SPE ('debtor') should derecognise (or not recognise) the portfolio of receivables. The SPE has issued a beneficial interest in the portfolio and by virtue of that contract it no longer has access to all of the economic benefits of the portfolio. The SPE has surrendered control of the asset as the SPE promises to pass some of the economic benefits to the Parent Bank. Hence the SPE will derecognise the portfolio (or not recognise the portfolio) and recognise a subordinated interest in the portfolio.

7. In the group's (ie Parent Bank's and Subsidiary Bank's consolidated) financial statements, the group, through the Parent Bank's $15bn non-recourse loan, has a right to some of the cash flows of the receivable portfolio. The Parent has the present ability to obtain some of the economic benefits of the receivables, but not all. The group derecognises the $20bn receivable portfolio and recognises the $15bn investment in the receivable portfolio as a new asset.

Analysis - Consolidation

8. 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 SPE that significantly affect the returns. Therefore, having power to direct how the assets are managed equates to having power to direct the activities of the SPE.

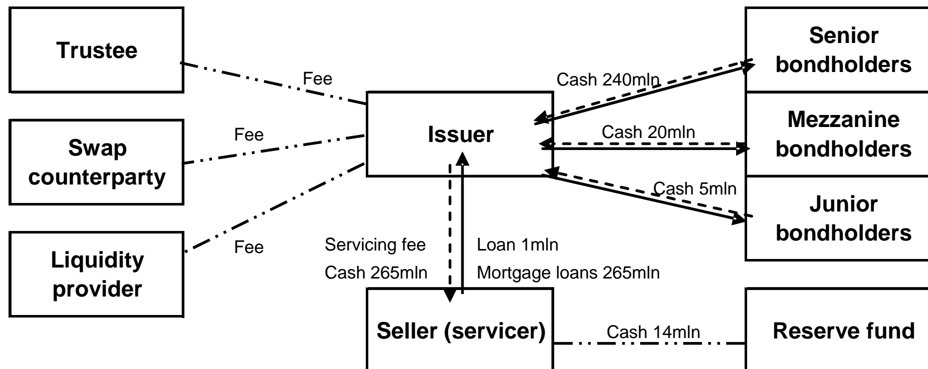
9. The SPE manager actively manages the assets, however it does so within the boundaries established by the Subsidiary bank and third party investor. The third party investor must also approve all sales of assets. In addition, because the manager can be removed without cause by the third party investor, 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.

10. Therefore, the third party investor has the power to direct the activities to generate returns for itself. The third party investor controls and should consolidate the SPE.

11. 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, that right is a protective right, designed to protect the interests of Parent Bank in the event that the third party investor decides to sell the assets. Until that event happens, Parent Bank does not have any power to direct the activities of SPE.

Example 4: Residential mortgage-backed securitisation



Facts

Issuer

12. 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.

13. 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

14. Issuer funds the purchase of the mortgage assets through the issue of three categories of bonds with different ratings and level of subordination: senior (CU240 million), mezzanine (CU20 million) and junior (CU5 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).

15. 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

16. Seller funded a reserve fund of CU14 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.

17. Seller may lose up to CU15 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.

Trustee

18. An independent party, a trustee, holds all Issuer's nominal equity that does not carry voting rights. It receives a senior fee at market rates and ensures that the counterparties to Issuer are in compliance with the transaction agreements and legal requirements.

19. 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.

Servicer

20. 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. The servicer's responsibilities are as follows:

    (a) To collect cash flows on loans from mortgage holders (ie interest and principal payments, tax and insurance liabilities) and distribute the payments to entitled parties in accordance with the priority of payments;

    (b) To monitor overdue payments (ie contact mortgage holders, negotiate collection of overdue amounts and modify the payment terms—timing, amount or substitution of collateral);

(c) On default, to decide what action to take based on the procedure that maximises the net present value of the proceeds to bondholders (ie foreclose on and sell the mortgage asset or renegotiate the terms of the loan with the mortgage holder);

(d) After default, if the loan was not restructured, execute foreclosure (ie deciding when to foreclose, and when and to whom sell the mortgage assets);

(e) Invest funds pending distribution in short term, risk-free investments with a maturity date before the distribution date to Investors (the investment returns are not retained by Servicer);

(f) Preparation of reports and other administrative functions.

Swap counterparty

21. To fund the floating rate interest due on the bonds with the fixed rate interest on the mortgage loans, Issuer enters into a fixed-for-floating interest rate swap with an unrelated counterparty at market rates.

Priority of payments

22. The amounts collected on mortgage loans are distributed according to the following waterfall of payments:

(a) fee to the trustee and payments due under the interest rate swap agreement;

(b) fee to the servicer;

(c) interest due on the senior and mezzanine bonds in order of seniority;

(d) principal due on the senior and mezzanine bonds in order of seniority;

(e) interest and principal due on the junior bonds;

(f) replenishment of the reserve fund to its required amount;

(g) principal and interest due under the loan to fund the initial costs;

(h) distribution of excess spread to Seller.

Analysis - Derecognition

23. In the Seller's stand-alone financial statements, after the sale of the loans to the Issuer, the Seller no longer has present access to all the economic benefits of the loans for its own benefit because under its servicing contract it is obliged to pass through all these benefits (net of its servicing fee, loan and excess above the required reserve fund level) to the bondholders and other stakeholders (eg trustee, swap counterparty). As a result, the Seller derecognises the loans and recognises as new assets its loan and interest in the reserve fund.

24. In the group's (ie Seller's and Issuer's consolidated) financial statements, the issuance of the senior, mezzanine and junior bonds by the group would not result in the group derecognising the loans and recognising the group's retained interest in the loans (ie the group's interest in the reserve fund[1]) as a new asset. The bondholders, by virtue of the waterfall structure have an interest in the net assets of the SPE (after payments to the interest rate swap provider). The group (ie the Issuer) holds a derivative that can be an asset or a liability over its term (interest rate swap) and for which it has to pay the periodic settlements before it can distribute cash to the holders of the bonds. The derecognition principle for financial assets cannot be applied to a financial liability or a portfolio of assets and liabilities (as one item), unless the counterparty to the financial liability included in such a portfolio has expressly consented to the novation of the liabilities.[2] Since the facts do not indicate that the swap counterparty has consented to the novation of the swap, the issuance of the bonds do not lead to the derecognition of the loans in the group's financial statements.

25. Thus, the accounting outcome is the same regardless of whether consolidation is applied before derecognition, or vice versa.[3]

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[1]Note that the Seller's loan to the Issuer to cover the initial set up costs would be eliminated in consolidation.

[3]If derecognition is applied first, the Seller derecognises the loans in its stand-alone financial statements, and the Issuer recognises the loans as its assets). The Seller then consolidates the Issuer), resulting in the loans remaining on the group's statement of financial position.

Analysis - Consolidation

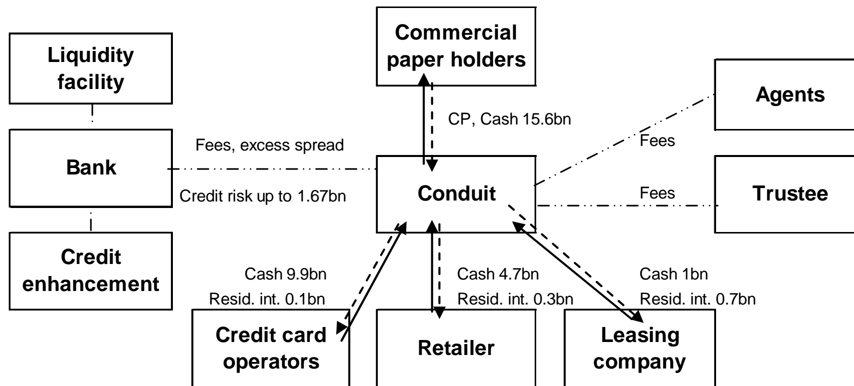
26. Issuer was established to facilitate the sale of mortgage loans by Seller and to provide investment opportunities for investors.

27. Seller retains servicing of defaulted loans, the only activity of Issuer that requires decision making and significantly affect the returns of Issuer. 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 CU15 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.

Example 5: Multi-seller conduit



Facts

Conduit

30. 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.

31. 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 the CP is linked to specific assets of the conduit.

Transactions

32. 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).

33. The conduit has a revolving assets structure, ie principal collections on the conduit's receivables are used to purchase new eligible receivables and replenish the conduit's portfolio rather than repay CP. The transferors (originators of the assets) continue to service the assets transferred to the conduit.

34. 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; no transferor has any right to any other transferor's excess collateral.

Credit card operators (CU10 billion)

35. 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)

36. 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)

37. 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

38. 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.

39. 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.

40. 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).

41. 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.

42. 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

43. 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.

Analysis - Derecognition

44. After the sale of the assets to the conduit, each of the transferors – the credit card operator, retailer and leasing company – does not have present access to all the economic benefits of these assets for its own benefit. That is, each has the present ability to obtain the benefits of these assets but is obliged to pass them through to the conduit under its servicing arrangement (net of its respective servicing fee and any cash flows allocated to its respective subordinated interest). Accordingly, each derecognises the assets sold to the conduit and recognises as a new asset its subordinated interest and the servicing contract to the extent that that contract qualifies as an asset or liability.

Analysis - Consolidation

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 – an activity that could affect the returns of 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 that *most* significantly affect the returns.

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.