International Financial Reporting Standards

Derecognition of Financial Assets and Liabilities

FASB Educational Session
Update on Derecognition Project
April 2010

The views expressed in this presentation are those of the presenter, not necessarily those of the IASC Foundation or the IASB

Agenda

- Derecognition approach for financial assets
  - Description
  - Comparison to US GAAP
  - Examples
- Derecognition approach for financial liabilities
- Disclosures
- Questions

Derecognition approach for financial assets – Description

Focus: Rights and obligations after transfer

Asset definition (*Framework*)

- Existence of future economic benefits
- **Control** of the future economic benefits

Control

Present ability to:

- Obtain (access) the future economic benefits
- Restrict others' access to those benefits

Criteria for assessing control

Does an entity cease to have **present access for its own benefit** to all economic benefits of the financial asset?

More about ‘economic benefits’…

Have economic benefits associated with nonfinancial component of contract been **separately** recognised **at initial recognition**?

Think of voting or subscription rights!

Yes

‘Economic benefits’ = Economic benefits associated with **only** financial component of contract

No

‘Economic benefits’ = Economic benefits associated with **both** financial and nonfinancial components of contract

Implication 1:

Transfer rights to some ECs = Derecognise entire asset + Recognise economic benefits retained:

Proportionate benefits (eg 10% CFs)

Recognise as part of old asset

- Allocate carrying amount of old asset to part retained on basis of relative FVs
- Subsequently measure part retained using measurement attribute applied to old asset

To address earnings manipulation concerns

Disproportionate benefits (eg first/last 10% CFs)

Recognise as new asset

- Initially measure at FV
- Subsequently measure according to IFRS 9

Implication 2:

Some non-recourse loans and SPEs are in effect pass-throughs

=

- Derecognise underlying assets
- Recognise any residual interest in the asset

Key question:

Do the non-recourse loan, or in the case of the SPE the beneficial interests in the SPE, represent an interest in the underlying financial assets?

Repos and securities lendings

EXCEPTION: Seller accounts for repos and securities lendings as secured borrowings…

…if:

…even though seller no longer controls all the economic benefits of the asset.

Entitled and obliged to repurchase same, or substantially same, asset on or before maturity of asset

+

Entered into in contemplation or contemporaneously

+

Applies to agreements between two parties only

Interaction with consolidation

Order of application does **not** affect outcome

Focus is on control. **But:** Control of asset **≠** Control of entity

Derecognition (Asset/Liability level)	Consolidation (Entity level)
- Ability to obtain the future economic benefits - Not a risk/rewards model	- Power to direct activities of another entity to generate returns - Must have some exposure to risk/rewards

Why is the Board pursuing this approach?

A) Benefits:

- Principle based (with only limited exceptions)
- Single concept (control)
- Risks appropriately reflected in measurement
- Resolves ‘stickiness’ issue (ie ‘history’ does not matter)
- Results in recognition of assets and liabilities that are consistent with IASB *Framework*
- Much simpler to apply in practice

B) Positive feedback on ED and from outreach

Derecognition approach for financial assets – Comparison to US GAAP

We are not that far apart!

Main difference:

Legal isolation

Without legal isolation, approach is similar to US GAAP

Smaller differences:

- I/O and P/O strips
- Some puts and calls
- Measurement of some retained interests

Some differences are not substantive (easy to structure around)!

Derecognition approach for financial assets – Examples

Example 1: Transfer with derivative

Facts

- Seller sells a financial asset to Buyer
- As part of the sale, Seller enters into **net**-settled derivative with Buyer
- Derivative could be forward purchase, total return swap, purchased call or written put

Example 1: Transfer with derivative

Analysis

After the sale, Seller no longer has present access to all the CFs of the financial asset.

(Under terms of derivative, Seller might receive CFs that are similar to, but not the same as, those of the asset.)

Accounting outcome

Seller derecognises the financial asset and recognises the derivative.

Example 1a: Transfer with derivative

Facts

- Seller sells a financial asset to Buyer
- As part of the sale, Seller enters into a **physically**-settled derivative with Buyer on the same (or substantially the same) asset
- Derivative could be forward purchase, total return swap, purchased call or written put

Example 1a: Transfer with derivative

	Derivative = Forward purchase or total return swap*	Derivative = Purchased call or written put*
Analysis	As part of the sale, Seller has entered into an agreement with Buyer that entitles and obligates it to repurchase the same (or substantially the same) asset. Transaction meets repo exception.	After the sale, Seller no longer has present access to all the CFs of the financial asset.
Accounting outcome	Seller continues to recognise the financial asset. Seller recognises a financial liability for the consideration received.	Seller derecognises the financial asset and recognises the derivative.

**physically settled*

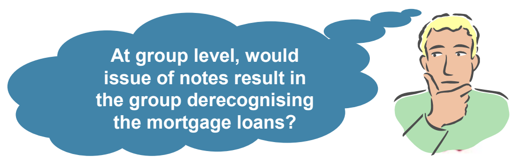
Example 2: Residential backed mortgage securitisation

Facts

- Originator sells fixed-rate mortgage loans to SPE
- SPE issues floating-rate senior, mezzanine and junior notes to third-party investors to finance purchase of loans
- SPE enters into fixed-for-floating interest rate swap with an unrelated counterparty
- SPE is restricted from selling the loans
- Originator services the loans for at-market fee
- Originator funds a reserve fund for liquidity/credit support

Example 2: Residential backed mortgage securitisation

	Derecognition	Consolidation
Analysis	Originator no longer has present access to all the cash flows of the mortgage loans.	Originator has the power to direct the SPE's activities to generate returns for itself: • Has discretion in managing loans when in default • Exposed to variability in returns through reserve fund
Accounting outcome	Originator derecognises the loans and recognises its residual interest in the SPE (ie the reserve fund).	Originator consolidates SPE, and with that all the SPE's assets (mortgage loans) and liabilities (eg notes).



Example 2: Residential backed mortgage securitisation

At group level, would issue of notes result in the group derecognising the mortgage loans?

No, because the SPE holds a derivative that can be an asset or a liability over its term (interest rate swap). Thus the notes represent **interests in the net assets** of the SPE, rather than interests in the mortgage loans.

Example 3: Distressed debt

Facts

- Subsidiary transfers £20bn distressed debt to SPE
- SPE finances purchase through
  - £15bn non-recourse loan by parent of subsidiary
  - £5bn equity from unrelated third-party investor (equity is at first risk of loss)
- Unrelated third party services debt for at-market fee (investor can remove the servicer without cause)
- Parent has protective rights (right of first refusal on sale of assets by SPE/investor)

Example 3: Distressed debt

	Derecognition*	Consolidation
Analysis	Subsidiary no longer has present access to all the cash flows of the distressed debt.	Third-party investor has the power to direct the SPE's activities to generate returns for itself: • Can remove servicer without cause • Exposed to variability in returns (first risk of loss)
Accounting outcome	Subsidiary derecognises the distressed debt and recognises its £15bn senior interest in the debt.	Investor consolidates SPE.

**Same analysis and accounting outcome for group (ie parent consolidates subsidiary).*

Derecognition approach for financial liabilities

Alignment with IASB *Framework*

Primary characteristics of a liability:

- Present obligation
- Outflow of resources embodying economic benefits

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Derecognition approach:

Derecognise financial liability if:

- Present obligation is eliminated **and**
- No longer required to transfer economic resources in respect of that obligation

Special guidance for debt modifications

Extinguish liability when existing contract is substantially modified (ie if either test if met):

Quantitative test:	Qualitative test:
Timing, amounts or uncertainty of CFs under new or modified contract are **substantially different** from those under the original contract	Modification changes **nature** of debtor's obligation or nature of investment that contract represents
Similar to IAS 39, but no threshold!	New!

Debt modifications (continued)

Examples of when qualitative test is met:

- Change in currency in which P+I are denominated
- Addition or removal of contingent interest rate or shared appreciation features
- Change in liquidation preference or ranking of instrument
- Change from variable interest rate to fixed rate or vice versa
- Addition of repayment provisions or prepayment premium clauses

Disclosures

Objectives

On-balance sheet disclosures

To help understand the relationship between financial assets that are not derecognised and associated liabilities

Off-balance sheet disclosures

To help evaluate the nature of and risks from continuing involvement in derecognised financial assets

Users' concern!

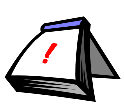
On-balance sheet disclosures

a) Nature of (non derecognised) assets
b) Nature of risks to which entity remains exposed
c) Carrying amounts of assets and associated liabilities
d) Description of nature of relationship between assets and associated liabilities (incl. restrictions on use of assets)
e) If recourse only to assets: FV of assets, associated liabilities and net position

Off-balance sheet disclosures

QUANTITATIVE disclosures – Part 1

a) Carrying amount and FV of continuing involvement
b) Maximum exposure to loss from continuing involvement
c) FV of derecognised assets in which entity has continuing involvement
d) Cash outflows to repurchase assets
e) Maturity analysis of future cash outflows
f) Sensitivity analysis



Aggregate disclosures when more than one category of continuing involvement with same derecognised assets

Off-balance sheet disclosures

QUANTITATIVE disclosures – Part 2

- Gain or loss at date of derecognition
- Income and expense recognised from continuing involvement
- If transfer activity not evenly distributed in reporting period:
  - Total amount of activity and related gain or loss in period and
  - When greatest activity within period took place

Off-balance sheet disclosures

QUALITATIVE disclosures

Terms of the transaction or modification that resulted in derecognition of financial assets:

- Description of the derecognised assets
- Nature and purpose of continuing involvement
- Risks to which entity remains exposed:
  - How entity manages risk from continuing involvement
  - Whether entity bears losses before other parties + ranking and loss amounts borne by each category of party involved
  - Events/circumstances that would trigger financial support or repurchase of derecognised asset

Questions

Questions for the FASB

1. Do you have enough information to express a preliminary view at the April 2010 joint meeting?
2. If not, what other information would you need?