IASB Meeting | Agenda reference **3B**

Staff Paper | Date **February 2010**

Project **Derecognition**

Topic **Derecognition Principle – Access to economic benefits**

Introduction

1. This paper discusses concerns raised by respondents to the ED on Derecognition of financial instruments in respect of the derecognition principle under the Alternative Approach.
2. The paper also explains further the key terms in the derecognition principle under the Alternative Approach.

Why a paper on the derecognition principle?

3. As indicated in Agenda Paper 3A, some respondents to the Derecognition ED, raised concerns about the meaning of and how the transfer definition should be applied in specific scenarios. The staff is of the view that those issues are already addressed under the derecognition principle for the Alternative Approach.
4. Some respondents also noted that some of the key words in the derecognition principle needed further clarification. The staff believes those concerns arose because no application guidance or detailed basis for conclusions were provided for the Alternative Approach in the ED.
5. The staff however notes that a complete analysis of the provisions of the Alternative Approach and the basis for that approach were provided as part of the papers the staff prepared for the Board prior to issuing the ED.
6. The staff does not believe that the concerns raised indicate a shortcoming of the approach itself but highlights the lack of 'detailed explanation' of the Alternative Approach in the ED. The staff therefore does not recommend that

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

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the Board revisits the derecognition principle but rather consider those comments in issuing the next public document on the project.

7. However, the staff sets out in paragraphs 16 – 32, the meaning of the key words in the derecognition principle under the Alternative Approach.

8. We also discuss in paragraphs 33 – 55 how the derecognition principle applies to the following issues:

   (a) **Unit linked insurance products** - Does the sale of units in an insurance fund in which the insurer has agreed to pass onto the policyholder the economic benefits of the underlying linked investments constitute a 'transfer'?

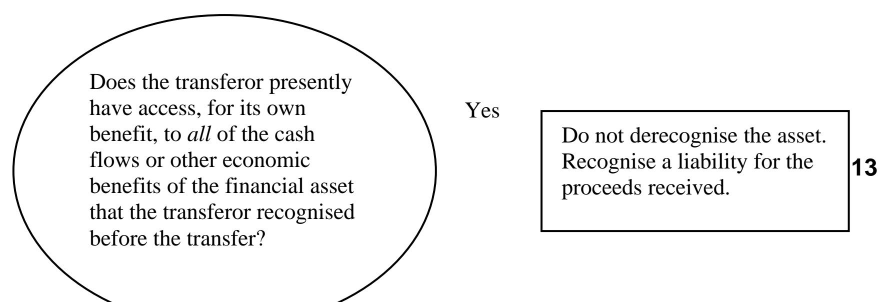
   (b) '**Empty' SPE issue** - Some respondents to the ED argued the proposed guidance would result in special-purpose entities (SPEs) that through the issuance of beneficial interest distribute all the cash flows from their assets becoming 'empty shells'.

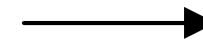
   (c) **Pass through arrangements and the detailed requirements under IAS 39 for such arrangements** - Are the 'pass through' criteria in IAS 39 paragraph 19, in particular the requirement for the transferor to remit cash received without material delay, still relevant for determining whether a transfer has taken place?

BACKGROUND

9. The Alternative Approach sets out criteria to be used to determine when a financial asset should be derecognised by a transferor. In particular, the Alternative Approach requires an assessment of whether the transferor presently has access, for its own benefit, to all of the cash flows or other economic benefits of the financial asset that the transferor recognised before the transaction.

10. The following flow chart illustrates the evaluation of whether a financial asset is derecognised under the Alternative Approach.





No

Derecognise the asset. Recognise any new assets or liabilities created in the transfer.

11. The Alternative Approach requires that if a financial asset or group of financial assets qualifies for derecognition, the transferor should recognise as a new financial asset or liability the contractual rights acquired and obligations assumed as part of the transaction.

12. Similarly, if a transaction results in derecognition, the transferee would recognise the contractual rights (financial assets) acquired and the contractual obligations (financial liabilities) assumed as part of the transaction.

13. Hence transferors and transferees would recognise and measure, after a transfer of financial assets, the financial statement elements (assets, liabilities, gains and losses) each has as a result of the transaction.

14. The associated disclosure requirements would require sufficient disclosures to enable evaluation of risk exposures and performance in respect of an entity's risks associated with a transferred asset (as a result of the continuing involvement in the transferred asset).

15. Thus a significant advantage of the Alternative Approach is that the expectations of future cash in-flows that are controlled by the transferor, and the risks that arise from those expectations, will be included in the financial statements and the note disclosures accompanying the financial statements.

DERECOGNITION PRINCIPLE (Access to economic benefits for its own benefit)

16. The fundamental basis for the Alternative Approach is that an entity should derecognise a financial asset when the financial asset ceases to qualify as an asset of the entity.

17. To make the derecognition principle for financial assets operational, the Alternative Approach proposes that an entity should derecognise an asset if the entity ceases to have **present** **access**, **for its own benefit**, to all the cash flow or other economic benefits of the asset.

18. The following paragraphs explains further the key terms highlighted in the derecognition principle.

ACCESS

19. Access is used here to mean ability to obtain the economic benefits underlying an asset.

20. The staff notes that for an asset to qualify as an asset of an entity, the future economic benefits underlying that asset should be controlled by the entity or should accrue to the entity.

21. 'Control', in terms of an asset, is the means by which the entity ensures that the economic benefits accrue to it and not to others. 'Control' of the economic benefits has two aspects: the ability to obtain (or access) the economic benefits and the ability to prevent or limit the access of others to those benefits. To have control, an entity must have both of these abilities.

22. Hence, if an entity does not have the ability to access (or obtain) the economic benefits underlying the asset, as a result of a transaction or an event, control over the future economic benefits has been surrendered and hence the asset should be derecognised and vice versa.

23. However being able to obtain or access the economic benefits is not a conclusive test of an entity's control over the economic benefits of the asset (as explained in paragraphs 29 – 32).

PRESENT ACCESS

24. Present here means that on the date of the financial statements the entity controls the economic benefits.

25. Under the definition of an asset, **only present ability** to obtain and restrict others access to future economic benefits is asset under that definition.

26. Thus both the control of the economic benefits and the economic benefits themselves must exist. If control has been relinquished, but the economic benefits still exist, then the entity no longer has an asset. Similarly, if control is present, but the economic benefits no longer exist, then the entity no longer has an asset.

27. In the same way, an entity has no asset for a particular future economic benefit if the entity would have access to and control of the benefit in the future. Also, an entity is considered still to have an asset if the entity's access to and control of the economic benefit would be removed, but the event that would remove its access or control of the economic benefits is in the future.

28. This also means that an ability to get access to a financial asset's cash flows that is conditioned on something else is not equivalent to having control over that asset. Accordingly, the right to get access is not the same as a right entitling the entity access now (to the cash flows or other economic benefits).

FOR ITS OWN BENEFIT

29. As noted in paragraph 23, being entitled to receive all of the cash flows or economic benefits of a financial asset is not sufficient to establish control over those cash flows. This is because the entity might be required by contract or otherwise to pass on the cash flows it receives to someone else.

30. The definition of an asset requires access to future economic benefits to be controlled by the entity. An entity will control the access if it has the ability to obtain the economic benefits for itself (i.e. have the ability to keep the economic benefits, to deploy and benefit from their deployment, or to prevent or limit others' access to those economic benefits).

31. For example, a trustee is required to act in a predetermined way and has the power to deploy the trust's benefits, but the beneficiaries benefit from their deployment, not the trustee.

32. Similarly, in a pass through or sub-participation loan arrangement, the bank that sells a pool of originated loans will continue to receive the interest and principal cash flows from the underlying debtors. However, it will not receive the cash flows for its own benefit because it must forward all the cash flows to the buyer (transferee) of the loans. Therefore, the bank's role in collecting the cash flows and distributing them to the buyer (transferee) is that of an agent. As a result, the buyer (transferee), not the bank, has control over all the cash flows of the loan portfolio.

SPECIFIC CONCERNS RAISED BY RESPONDENTS

A. Unit Linked Insurance

33. Unit linked insurance product is a contract between a policy holder and an insurance company whereby a portion of the premium paid by the policy holder is used to purchase life cover (the sum assured) with the balance invested in an authorised unit trust/trusts. Thus the contract can be viewed as a combination of insurance and an investment in a pooled fund.

34. <u>There are a wide range of these products with varying terms and conditions. The staff summarises below some of the common terms:</u>

    (a) **Units**: The number of units of the fund that a customer gets depends on the unit price when he pays his premium. The daily unit price is based on the market value of the underlying assets (equities, bonds, government securities, et cetera) and computed from the net asset value.

    (b) **Return**: The return arising from a unit linked policy is determined by reference to the value of a particular fund of investments. The performance of the contract is objectively linked to the investment performance of the fund investments rather than being at the discretion of the insurer and thus the investment risk is passed on to the policyholder.

(c) **Management**: All funds are managed to a specific investment objective and monitored accordingly.

(d) **Valuation of a fund's assets:** The value of a fund is the sum of the value of its underlying assets at the valuation point. This includes fund income received, and also accrued entitlements for dividends, interest receivable and other income up to the valuation point.

(e) **Guarantees**: The value of investments can fall as well as rise and may or may not be guaranteed – this means that an investor may get back less than they have invested.

(f) **Manager's fees**: There are various methods by which the management charge may be applied to the policies investing in unit linked funds, either by: a charge deducted from the fund, reducing the value of the units attributable to the policy, or by cancelling the appropriate number of units attaching to the policy; or by a combination of the above.

(g) **New funds:** Each fund needs to reach and maintain a minimum size in order to operate effectively. Hence the insurer/manager may put its own money into new funds at launch, and create units in the normal way, to ensure the fund reaches the minimum size. The seed money may be withdrawn, by liquidating units only as the fund exceeds the minimum sustainable size and the fund no longer needs this support.

(h) **Termination of funds:** The manager/insurer reserves the right to close funds or merge funds together at any time provided. For example, it may decide that a fund has insufficient assets to be managed efficiently or because investments to match the fund objectives are no longer available.

35. Some respondents (insurance companies) were concerned that the alternative approach might cause entities to derecognise the assets and liabilities related to unit-linked insurance and investment contracts -

- *[A]pplying the derecognition principles to assets backing insurance and investment products […] could result in many assets held by insurers in a fiduciary capacity being derecognised and much valuable information being lost from the balance sheet. This would not reflect the economic substance of our underlying business. Furthermore a key part of an insurer's business is to manage policyholders' funds; how well this is achieved is useful information in predicting future success as a business. It would not be helpful to users if this information was lost as a consequence of holding these assets off balance sheet. We also note that is it not clear from the ED whether the related liability*

would be derecognised if financial assets backing insurance and investment products were derecognised. (CL65)

- *Another major concern is that the new proposed rules (including the alternative approach) could be interpreted in a manner that may lead to the derecognition of a significant portion of many insurers' investment assets. Such a situation could occur, for example, when unit-linked insurance and investment contracts are entered into. The policy is issued by the insurer and is usually valued by reference to a pool of ring fenced assets. Based on both the proposed and alternative approaches, these assets could be regarded as a 'transfer' without any continuing involvement that would lead to a derecognition of these assets.*

  This would result in a situation that the unit-linked assets would be derecognised and the associated insurance liability would still be recognised. In order to avoid such mismatch, in our view it is required that the assets are kept on the books of the reporting entity when the obligation to transfer the rights of the asset's cash flows represents a liability out of the scope of the financial instruments standards (e.g. an insurance liability under IFRS 4). (CL87)

36. The staff does not believe this is a derecognition issue but rather a recognition issue.

37. Current practice, for such contracts, is that the insurer recognises the assets in the fund as its assets and a corresponding liability towards the policy holders.

38. To the extent that the insurer recognises such investments as its assets (under whatever basis), applying the derecognition principle to those arrangements, one would conclude, in some cases, that the insurer does not control the economic benefits (i.e. although it can obtain the economic benefits, it has to pass those benefits to the policy holders subject to any fee arrangement in place).

39. The staff believes the issue should be addressed as part of the project that is addressing the recognition of such arrangements. We however note that we believe the result obtained by applying the derecognition principle to such financial 'assets' and 'liabilities' is appropriate. Hence we do not recommend that the Board amends the derecognition principle or introduce an exception for unit linked contracts.

40. The staff notes that this issue is been addressed in a paper (on insurance) that will be discussed by the IASB and FASB in February 2010. The staff also notes

that the issue has consolidation implications and we understand the Board's project on Consolidations will be addressing the consolidation issues.

B. 'Empty' SPEs

41. Some respondents asked for clarification whether the alternative approach would cause special purpose entities (SPEs) that are set up to purchase financial assets and distribute to note holders and other interest holders (e.g. trustee, servicer, guarantor) all the cash flows that those assets generate not to recognise those assets and the corresponding liabilities (in which case the entities would be 'empty'). They believe that such an outcome would be inconsistent with the views of the stake holders of special purpose entities (after all, the assets in which they invested must be somewhere!) and would also render the consolidation standard (and proposals in ED 10) meaningless -

- *The example provided in paragraph AG52L(g)iii, of a note that is contractually linked to shares, indicates that if all the cash flows are passed through to the other entity, control of the asset has been lost. An extension of this example is when an SPE passes on all cash flows to its note holders, the transaction is a transfer as defined […] and as transferring the rights to cash flows is akin to transferring the asset itself, provided the AG49A provisions for an agency or fiduciary relationship are met, the SPE will not recognise the assets it manages or the related liability to the note holders. In this situation the SPE is in substance acting as an agent for the note holders. If this analysis is correct it would mean that many investment vehicles such as certain investment funds would report an 'empty' statement of financial position. Guidance on this matter would be helpful, to clarify if this is an appropriate analysis. (CL71)*
- *It is very common that SPEs are structured so that ultimately no cash flows are retained by the SPE and note holders receive all of the cash flows of the assets held by the entity. In this case the SPE has no continuing involvement in the assets transferred to it as all the cash flows are re-distributed to note holders through the waterfall structure. Application of paragraph BC81 to such SPEs will seem to result in the SPE reporting zero balance sheet. This is not only counter-intuitive, but will be confusing to the investors relying on financial statements submitted by such entities.*

  Further, such derecognition of the assets by the SPE will not necessarily result in the recognition of those assets by the investors in the notes as often investors

> *will be multiple, disparate parties. This may cause the assets transferred to such an SPE to "disappear" as they will not be recognized by the original transferor, the SPE or the note-holders. (CL106)*

42. The staff does not agree that the application of the derecognition principle will necessarily lead to 'empty' SPEs as alluded to by some respondents. The accounting for issuance of beneficial interests by an SPE will very much depend on the terms of those instruments. To the extent that the beneficial interests entitles the holders of such instruments to the cash flows of specific assets or portfolio of assets, those arrangements would have to be assessed for derecognition.

43. If the instruments (beneficial interests issued) give the holders the ability to obtain and restrict others access to the economic benefits of specific assets or portfolio of assets, we believe those assets should be derecognised.

44. Paragraph AV22 of the Derecognition ED (Alternative Approach) would not permit an entity to apply the financial asset derecognition principle (paragraph AV19 of the ED) 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.

45. Similarly, 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. 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.

46. Hence under the Alternative Approach, an entity is not allowed to apply the derecognition principle to net assets of an entity (or to derecognise an interest in its net assets), except where the transaction meets both the asset and the liability derecognition principle.

47. Consequently, if beneficial interests issued by an SPE entitle the holders thereof to some or all of the net assets of the vehicle, then the arrangement will not lead to derecognition of the assets of the entity (under the Alternative Approach) unless the creditors of the SPE have consented to the transaction (i.e. the novation of the liabilities of the SPE).

48. Thus the staff is of the view that most, if not all, of the instruments issued by an SPE would not lead to derecognition of the vehicle's assets as the creditors of the entity would most likely not have consented to the novation of the vehicle's liabilities.

49. The staff therefore believes that the concerns raised by respondents are not necessarily founded. The accounting for such instruments 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 its assets then derecognition of those assets would be appropriate, and vice versa.

B. Pass through arrangements

50. Some respondents questioned whether the Board intended the current pass through test in IAS 39 to be met for a transaction to qualify as a transfer or even for derecognition –

The application of the definition seems only to be meaningful and operational when the agreement to pass relates to "specified" assets of the transferor. Without this clarification, application of the transfer definition in a circumstance in which the transferor has not yet transferred legal title or will retain legal title to the asset is potentially unclear.

Relatedly, given the different formulations of the above paragraphs, the Board should clarify whether, in order for a transaction to qualify as a transfer when legal title has not yet passed or will not pass, the would-be transferor should contractually grant to the transferee a security interest in the asset or otherwise be prohibited from selling or pledging the asset during the period that the transferor retains legal title.

It is not clear to what extent the existing "pass through" requirements are retained by the ED. The bullet point above deals with the prohibition on the transferor selling or pledging the asset. The existing test in IAS39.19(a) requiring the transferor to pass cash flows to the extent that they have been received seems to be retained but the test in IAS39.19(c) dealing with timeliness of passing cash flows does not appear to be

retained. The Board should clarify the extent to which the "pass through" requirements are retained. CL37

51. IAS 39 paragraph 19 ('the pass through' test) requires that a transaction that meets the following criteria should be treated as a transfer of the asset or a part thereof -

    (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.

    (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows

    (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay,

52. The staff notes that transactions that meet criterion (a), implies the entity does not have control of the economic benefits of the asset since it cannot restrict others access to those economic benefits. As and when the entity obtains the economic benefits of the asset, it would have to pass on those benefits to the counterparty. Hence, a transaction that meets that criterion would (in the absence of any other factors) lead to derecognition of the asset. On the other hand if that condition is not met, we believe the entity has a liability for the obligation to pass economic benefits to the counterparty and should continue to recognise the asset.

53. Failing criterion (b) (i.e. the entity is not prohibited from dealing in the asset concerned) does not necessarily mean that the entity has maintained control of the economic benefits of the asset. Where the transaction fails criterion (b), it only suggests that the entity has the ability to obtain the economic benefits of the asset. The entity would should also have the ability to restrict others access to the economic benefits for the asset to qualify as its assets.

54. Failing criterion (c) suggests that the entity is not acting as a servicer or an agent of the counterparty. It means the entity has ability to obtain the economic benefits for itself to the extent that the returns resulting from the delay in remitting the proceeds to the counterparty does not accrue to the counterparty. If the returns from the delay or reinvestment of the proceeds accrue to the

benefit of the counterparty, it would indicate that the entity cannot restrict others access to the economic benefits and it is acting as an agent of the counterparty.

55. The staff therefore concludes that the pass through test in IAS 39 does not need to be included in the derecognition guidance, as the derecognition principle under the Alternative Approach addresses all the issues intended to be addressed by the pass through test.

Question for the Board:

Does the Board agree with the staff analysis on the preceding issues? If not, why not?