Project	**Derecognition**
Topic	**Accounting for repurchase agreements (repos) and similar transactions**

Introduction

1. At the October 2009 meeting, the Board tentatively decided to develop a model for derecognition based on the 'alternative approach' in the Exposure Draft (ED/2009/3) *Derecognition*.

2. Under the alternative approach (as set out in the ED), sale and repurchase agreements (repos) and similar transactions are treated as sales. However, many respondents to the ED were of the view that repos and similar transactions, in light of the nature and the terms of those transactions, should be treated as financing arrangements rather than as sales, even under the alternative approach.

3. At the October meeting, some Board members expressed the view that not all repos are sale arrangements, but that not all are financing arrangements. As a result, the Board directed the staff to research further whether there are appropriate criteria that can be used to distinguish repos that are sales arrangements from those that should be treated as financing arrangements.

4. A summary of the structure of a standard repo is attached as appendix 1.

Purpose of this paper

5. In response to the request from the Board, the staff conducted an extensive outreach program and met with a wide range of constituents, including investors, regulators and active participants in repo markets (e.g. banks and securities firms).

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

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.

Decisions made by the Board are reported in IASB *Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

6. Based on discussions with constituents and further analysis of the nature of repos and similar transactions, the staff has set out in this paper three alternatives for accounting for these transactions under the alternative approach. The staff is asking the Board at this meeting to determine which approach most appropriately addresses those Board members' concerns, which are also shared by many other respondents to the ED. The three alternative approaches are as follows:

   (a) Effective control (SFAS 140/166) approach

   (b) Gross forward presentation approach

   (c) Original alternative approach

Alternative accounting approaches for repurchase transactions

A. Effective control (SFAS 140/166) approach

7. This approach treats repos and similar transactions that meet particular conditions as financings. The proposed conditions in this paper for this approach (paragraph 27) are similar to those in US GAAP (SFAS 140/166[1]). See appendix 2 for detail on SFAS 166 guidance.

Conditions under US GAAP

8. Under US GAAP, the transferor is deemed to have maintained *effective control* over the transferred assets and hence the transaction would be treated as secured financing, if the agreement both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee and all of the following conditions are met[2]:

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[1] FASB Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125* (SFAS 140), is codified in FASB ASC 860 'Transfers and Servicing' but the ASC has not been updated for SFAS 166, *Accounting for Transfers of Financial Assets - an amendment of FASB Statement No. 140.* However, no significant amendments to the treatments of repos and similar transactions are expected as a result of the update. (See *Accounting Standards Update 2009-16* for how the ASC is being amended).

[2] Paragraph 9c(1) and 47 of SFAS 166 or FASB ASC 860-10-40-5(c)(1) and 860-10-40-24

(a) The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred.

(b) The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee.

(c) The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

(d) The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

Both a right and an obligation

9. Under US GAAP, the transferor is considered to maintain effective control over the transferred asset and thus does not derecognise the asset if there is an agreement that both entitles and obligates the transferor to repurchase it before its maturity.

10. This is based on the premise that the existence of the contract that *binds* the transferor to repurchase the asset is the unique feature of repo transactions which most distinguishes them from other normal sales transactions and justifies the non-sale (financing) accounting for them.

11. Therefore, arrangements where the transferor has only a right (an option, which may not be exercised) to repurchase the transferred asset and/or the transferor is allowed to net settle the transaction, rather than through a physical delivery of the asset, do not meet this condition for being treated as financing under this approach.

At a fixed or determinable price

12. Another important factor to characterise repos as financing transactions under this approach is that the repurchase price is fixed or determinable. Under repo transactions, the repurchase price is normally pre-determined at a fixed price in such a way that the difference from the sale price could be viewed as interest on

the cash transferred, according to the term of the contract[3]. Thus, the contract meets this condition.

13. On the other hand, if the transferor agrees, at the time of entering into the contract, to repurchase the transferred asset at fair value at a future date (e.g. at fair value when the transferor repurchases the asset in three months), the transaction does not meet the condition 'at a fixed or determinable price' and thus would be treated as a sale. In this case, the transferor is in the same economic position as a third party that purchases the asset from the transferee. As a result, the transferor is not considered to have maintained effective control over the asset.

Collateral maintenance provisions

14. Under the effective control approach, for the transfer to be treated as financing, US GAAP requires the transferor to have the ability to repurchase the asset on substantially the agreed terms, even in the event of default of the transferee as described in paragraph 8(b).

15. To be able to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets from others[4].

16. For example, the implementation guidance[5] under US GAAP requires the fair value of the collateral to be in a particular range for this requirement to have been met. The guidance further requires agreements to stipulate daily valuations and frequent adjustments for changes in the market price of the collateral in order to meet this additional condition.

17. The staff agrees that the maintenance of collateral is an important factor of repo transactions to assure the transferor's right to repurchase the asset will be

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[3] The 'interest' could include the pricing effects of the availability of, and demand for, the asset.
[4] Paragraph 49 of SFAS 166 or FASB ASC 860-10-40-24(b)
[5] Paragraph 218 of SFAS 166 or FASB ASC 860-10-55-37

satisfied. However, we have some concerns about the US GAAP conditions and related guidance in the context of IFRS.

18. First, the Board had previously decided that 'what happens in the event of the default of the related parties to the transfer' should not form part of the derecognition model when it discussed the 'legal isolation (bankruptcy remoteness)' concept under US GAAP and concluded that that should not be used as a criterion to distinguish between sales and financing. To be consistent with that principle, a condition that refers to a specific legal situation, such as 'in the event of default of the transferee', would also be incompatible with the proposed model.

19. Secondly, prescribing detailed guidance (such as requiring a particular level of collateralisation) would be contrary to the Board's aim of developing high quality principle based standards.

20. Market rules and practices around repo transactions, especially collateral maintenance provisions, vary significantly depending on the market and the country. Many constituents the staff met as part of the outreach effort argued that detailed guidance would not properly address significantly diversified market practices around the world.

21. In addition, respondents suggested that the guidance could even be a cause of an arbitrary accounting choice between sales and financing, for example, by adjusting the level of collateralisation for a particular asset even during the contract term.

22. Therefore, **the staff does not recommend that the Board incorporate the condition and related guidance on transferee's ability to repurchase the asset even in the event of default of the transferee (collateral maintenance) should the Board adopt this approach for accounting for repos and similar transactions.**

Guidance on 'substantially the same'

23. Under US GAAP, the repurchased asset has to share specified characteristics (e.g. the same primary obligor, identical form and type, the same maturity and so

on) with the transferred asset to qualify as 'substantially the same' [6]. US GAAP also provides even more guidance on each of the above characteristics[7].

24. The staff agrees that the condition 'substantially the same' should be required for the transaction to be treated as a collateralised financing arrangement, rather than a sale of the transferred asset.

25. However, in light of the global diversity of market rules and practices for repos and similar transactions and the degree of tolerance allowed for the difference between the originally transferred asset and the asset actually delivered to the transferor at the end of the term, **the staff does not recommend that the Board provide further detailed guidance on the definition of 'substantially the same' should the Board decide to adopt this approach to account for repos and similar transactions.**

Proposed conditions in this paper

26. Based on the analysis in the previous paragraphs, the effective control approach for the derecognition model in the context of IFRS that the staff would recommend would be as follows, if the Board were to adopt this approach.

27. The transferor is deemed to have maintained effective control over the transferred assets and hence the transaction would be treated as secured financing, **if the agreement both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee and all of the following conditions are met:**

   (a) The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred.

   (b) The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

   (c) The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

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[6] Paragraph 48 of SFAS 166 or FASB ASC 860-10-40-24

[7] FASB ASC 860-10-55-35

B. Gross forward presentation approach

28. **This approach treats repos and similar transactions as sales**, as originally proposed under the alternative approach in the ED. Therefore, under this approach, the transferor derecognises the transferred asset and recognises a forward contract to repurchase the asset while the transferee recognises the asset and a forward contract to return the asset.

29. However, this approach is different from the alternative approach in that **this approach requires *a gross-up presentation of the forward contract* resulting from those transactions on the statement of financial position as follows:**

    (a) **For the transferor: it presents the forward contract gross as an asset (the right to receive the asset in the future) and a liability (the obligation to pay cash in the future), and**

    (b) **For the transferee: it presents the forward contract gross as a liability (the obligation to return the asset in the future) and an asset (the right to receive the cash in the future).**

30. This approach reflects the lending aspect of the transaction by presenting both the rights and obligations of the related parties separately on the statement of financial position, rather than presenting the net position of the forward as a single unit.

31. Under this approach, users of the financial statements can recognise *on the face of the statement of financial position* some of the information which would not be shown there if sale accounting was adopted and the forward contract (a derivative) was presented net[8].

32. The transferor under this approach presents an obligation to pay cash (the liability leg of the forward contract) which is more or less the same amount as the liability that would have been recognised had the transaction been treated as a secured lending. On the asset side, the transferred asset is replaced with

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[8] Some would argue that the forward contract presented net at fair value on the statement of financial position and related disclosures in the notes are sufficient.

another asset, the right to receive the transferred asset in the future (the asset leg of the forward contract). The net effect on the statement of financial position of the transferor would be similar to that under IAS 39 (financing treatment). See appendix 3.

33. On the contrary, the effect on the statement of the financial position of the *transferee* could be different (from the results achieved under IAS 39) in two ways:

    (a) Under IAS 39, the transferee is not required to recognise the obligation to return the asset unless it sells on the transferred asset to a third party[9]. But under this approach, the transferee would present the obligation to return the asset to the transferor whether or not the transferee sells on the asset to a third party.

    (b) If the transferee 'repos-out' the transferred asset, under this approach the transferee would gross up the resulting forward. Thus the transferee would present on a gross basis two forwards. However, under IAS 39, the transferee would recognise only a liability to repay the proceeds received on the repo transaction.

34. Hence, this approach would lead to substantial grossing up of the statement of financial position compared to the results under the current requirements in IAS 39.

35. Although this approach is consistent with the derecognition principle under the alternative approach in that it treats repo transactions as sales, the 'gross forward presentation approach' would contradict how most other derivatives are presented.

Subsequent measurement

36. The disaggregation of a single forward contract into two parts under this approach is only for presentation purposes. Therefore, **the staff recommends that each of the disaggregated parts should be measured initially and subsequently at fair value should the Board adopt this approach**, as with

[9] IAS 39 AG15 (b)

other derivative instruments under IFRS 9 and IAS 39, in order for the net position of the forward to be appropriately measured following the guidance.

37. An alternative way would be to ***recognise*** and measure each of the disaggregated parts based on the guidance under IFRS 9 and IAS 39 (as if they were acquired/assumed separately as an independent asset and liability). However, in this case, if either of them qualifies for amortised cost for subsequent measurement purposes, the net position no longer represents the fair value of the forward contract.

C. Original alternative approach (Sales)

38. As originally proposed under the alternative approach in the ED, this approach treats repos and similar transactions as sales on the basis that the transferor does not have present access to *all* of the economic benefits of the asset transferred.

39. This is consistent with the proposed derecognition principle and existing guidance in other IFRSs for similar transactions. The ‘effective control approach’ inevitably makes an exception in some way to the overarching principle under the alternative approach. The ‘gross forward presentation approach’ would contradict the presentation guidance on derivatives in general.

Staff analysis and recommendation

40. Conceptually, the staff believes that repos should be treated as sales transactions with a forward contract under the alternative approach in the ED. However, if the Board decides to agree with the views of many respondents to the ED that such treatment does not provide useful information, **the staff would recommend the ‘effective control approach’ (as proposed in paragraph 27)** for the following reasons.

Advantages of the effective control approach

41. The ‘effective control’ notion and related guidance under US GAAP to treat repos and similar transactions as borrowings has been working well in practice

in the US and have stood the test of time during the crisis period[10]. Although the 'control' model proposed in the ED (as the alternative approach) is different from the derecognition model adopted under US GAAP, many constituents supported the effective control (SFAS 140/166) approach. This treatment would address respondents' concerns about repos and similar transactions without impacting adversely current practice and market for such transactions assuming that the 'collateral maintenance' condition under US GAAP is not incorporated into an IFRS.

42. One possible concern about this approach is that the transferor could relatively easily accomplish a preferred accounting treatment (sales/financing) for repo transactions. For example, the transferor may add a net-settlement option to the contract (ie is no longer *obliged* to repurchase the asset) in order to obtain sale accounting, even in cases where both parties to the contract implicitly agreed such option would not be exercised or the exercise of the option is not practical.

Disadvantages of the gross forward presentation approach

43. While the 'gross forward presentation approach' would mitigate respondents' concerns to some extent by reflecting the lending flavour of the transaction, it still requires an entity to recognise a gain or loss on the transfer and the changes in the fair value of the forward contract (with a grossed up presentation) subsequently, as the approach basically treats repos as sales arrangements. In addition, it grosses up the statement of financial position of the transferee even if the transferee does not sell on the related asset. Therefore, many respondents (mainly preparers) would argue the approach still adversely affects repo markets.

Views of other staff

44. Some of the staff prefer the 'gross forward presentation approach' because it is the only approach that would be consistent with the derecognition principle that underlies the alternative approach and also address the concerns about leverage. Thus, under the 'gross forward presentation approach' history would not to matter and the financial asset would continue to be recognised by only one entity

[10] SFAS 166 did not alter the guidance in its predecessor SFAS 140 on repo transactions in response to the crisis.

(either by the transferee or the entity to which the transferee, or any subsequent buyer, sells the asset).

45. The staff supporting the 'gross forward presentation approach' acknowledge that that approach would result in the forward contract being presented on a gross basis, which is different from the net presentation of most derivatives (including derivatives acquired as part of a transfer that qualifies for derecognition under IAS 39).

46. However, the staff note that the gross presentation of the forward is responsive to the concerns of many respondents to the ED that depicting a repo as a sale does not provide useful information because it does not show the inherent financing element (ie the transferor's obligation to pay cash to repurchase the same, or substantially the same, asset upon settlement of the forward).

47. The staff in favour of the 'gross forward presentation approach' also point out the primary reason why some respondents argued that repo transactions should be accounted for as financings is because these types of transactions are commercially viewed as financings. However, the staff note that contracts for repo transactions are documented as sales and also include provisions that explicitly stated that the intention of the parties to the contracts was for the contracts to be a sale. Making an exception for repo transactions along the lines of the SFAS 166 repo guidance would thus treat all repo transactions as financings, irrespective of whether contractually and intentionally they are sales. A similar argument can be made for securities lendings where the intention of the parties to the contract is often to trade or lock in a spread but not to finance.

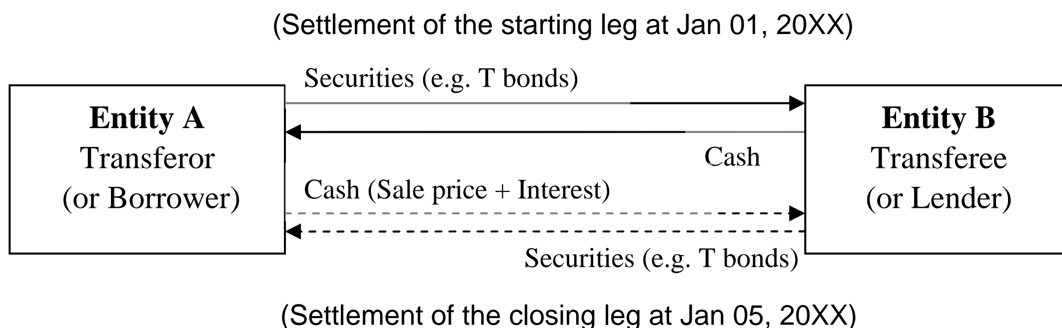
Question for the Board
As described in paragraph 40, the staff would recommend that the Board adopt the 'effective control approach' (as proposed in paragraph 27), if the Board decides that not all repos and similar transactions should be treated as sales. Does the Board agree with this staff recommendation? If not, which alternative treatment does the Board prefer, and why?

Appendix 1

Basic structure of repo transactions[11]

1. 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.
2. Repos are typically short term (many are overnight, but may roll forward). Longer term repos are increasingly common.
3. The financial assets transferred in repos tend to be readily obtainable financial instruments (e.g. Treasury bonds) but any type of asset could be used.

Example



4. 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 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.

[11] See AP11B of the October 2009 Meeting for detailed description of repo transactions.

(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) 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.

(f) 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.

(g) 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.

Appendix 2

Effective Control over the transferred asset on repurchase agreements under US GAAP (SFAS 166)

1. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor's effective control over those assets when all of the following conditions are met:
    (a) The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred.
    (b) The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee.
    (c) The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
    (d) The agreement is entered into contemporaneously with, or in contemplation of, the transfer.
2. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:
    (a) The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same).
    (b) Identical form and type so as to provide the same risks and rights.
    (c) The same maturity (or in the case of mortgage backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield).
    (d) Identical contractual interest rates.
    (e) Similar assets as collateral.
    (f) The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

3. To be able to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets from others.

Appendix 3

Illustration: Gross forward presentation approach

Examples[12]

- Entity A (transferor) transfers assets held at CU95 and with a fair value of CU 100 to Entity B (transferee) for net cash of CU 98. Simultaneously, Entity A agrees to repurchase the same assets from Entity B in one year for CU102.
- The journal entries under sales treatment, the gross forward presentation approach and financing treatment are as follows:

Sales treatment (Sales + Net forward presentation): Original alternative approach

(For transferor)				(For transferee)			
Dr.	Cash	98		Dr.	Asset	100	
	Forward	2					
Cr.	Asset		95	Cr.	Cash		98
	Gain		5		Forward		2

Gross forward presentation approach (Sales + Gross forward presentation):

(For transferor)				(For transferee)			
Dr.	Cash	98		Dr.	Asset	100	
	Right to receive Asset	100			Right to receive Cash	98	
Cr.	Asset		95	Cr.	Cash		98
	Obligation to pay Cash		98		Obligation to return Asset		100
	Gain		5				

Financing treatment (IAS 39):

(For transferor)				(For transferee)			
Dr.	Cash	98		Dr.	Receivables	98	
Cr.	Liability		98	Cr.	Cash		98

[12] It should be noted that examples in this paper are provided *solely for illustrative purposes of the gross up effect* of the forward contract. For example, if the forward contract simply reflects the market rate for the term, the net fair value at inception would be zero.