Project **Derecognition**

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

Introduction

1. At the February meeting, the Board tentatively decided to make an exception to the derecognition principle as it applies to sale and repurchase agreements (repos) and similar transactions. If the agreement both entitles and obligates the transferor to repurchase or redeem the asset, those transactions should be accounted for as secured borrowings (financing), rather than sales of the asset. This is similar to the accounting for such transactions under 'effective control' notion under US GAAP (SFAS 140/166[1]).

2. The Board also agreed that all the following additional conditions should be met for those transactions to be treated as secured borrowings.

   (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.

[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).

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.

3. However, some of the Board expressed views that the exception should be strictly defined more closely in line with the conditions and guidance adopted under US GAAP, especially on the following two points:

   (a) **Substantially the same**: Guidance should be provided on to what extent the repurchased asset should be the same as the transferred asset.

   (b) **Collateral maintenance**: Collateral should be maintained by the transferor as one of the conditions to be met for the transaction to be treated as a borrowing, as required under US GAAP.

4. The staff analyses these points and makes recommendations in this paper. The staff is asking the Board at this meeting whether the Board agrees with the staff recommendations.

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

A. Substantially the same

Issue

6. It is important that the asset to be repurchased is similar to the asset originally transferred in concluding that the repo transaction should be treated as a secured borrowing. For example, if the repurchased asset is totally different from the transferred asset (e.g. fixed coupon vs. variable interest rate), there should be no grounds for treating such transaction as a secured borrowing even as an exception to the proposed derecognition model.

7. In this regard, the staff proposed at the February meeting that the repurchased asset should be '*the same or substantially the same*' as that transferred, as required under US GAAP. However, the staff proposed that there should be no further guidance on what constitutes *substantially the same*. In other words, IFRS should not adopt the US GAAP guidance regarding which characteristics (e.g. the same obligor, maturity and so on) the repurchased asset should share with the transferred asset.

8. However, some of the Board argued that the scope of the exception should be more clearly and strictly defined in line with the guidance under US GAAP to the extent feasible.

Conditions and implementation guidance under US GAAP

9. Under US GAAP, 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[2]:

   (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.

10. Implementation guidance (examples) related to the above characteristics is also provided as follows under US GAAP.[3]

   (a) The same primary obligor:

   > The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.

   (b) Identical form and type:

   > The following exchanges would not meet this criterion:

---

[2] SFAS 166 paragraph 48 or FASB ASC 860-10-40-24 (a)

[3] FASB ASC 860-10-55-35 and 860-10-40-24 (a), or AICPA Statement of Position (SOP) 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*.

(i) GNMA I securities for GNMA II securities

(ii) Loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary in form and type)

(iii)Commercial paper for redeemable preferred stock

(c) The same maturity:

The exchange of a fast-pay GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a slow-pay GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

(d) Similar assets as collateral:

Mortgage-backed pass-through and pay-through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages, to meet this characteristic.

(e) The same aggregate unpaid principal amount or principal amounts within accepted ‘good delivery’ standards for the type of security involved:

Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Bond Market Association and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by the Bond Market Association.

Staff analysis and recommendation

Is ‘substantially the same’ needed?

11. In general, in the context of financial instruments, as long as two instruments represent the same rights or obligations to the same cash flows, they should be considered to be the same for accounting purposes, even if they have a different serial/identifying number attached to a specific certificate (if any).

12. In addition, the staff believes that the condition should include the phrase ‘substantially the same’ in any case to properly address the divergence in market

practices around the world, regardless of whether 'the same' requires the repurchased asset to have the same serial/identifying number or not[4].

13. For example, market participants in practice may accept the difference in the primary (or nominal) obligor of a bond in some repo markets in the case of government-guaranteed bonds (which sounds economically reasonable). In fact, repo transactions involving those bonds would qualify as secured borrowings even under US GAAP as indicated in paragraph 9(a) above, provided that those bonds have other characteristics (e.g. interest rates) in common.

Guidance to be adopted from US GAAP

14. The characteristics described above in paragraph 9 would be applicable to any markets including outside the US as general guidance on 'substantially the same'. Providing those characteristics as part of the definition of 'substantially the same' is consistent with the Board's direction to make the scope of the exception clearer to the extent possible.

15. However, the additional implementation guidance (examples) described in paragraphs 10(b) and 10(c) on 'identical form and type' and 'the same maturity' respectively, which refer to GNMA securities or the US tax system, would not be necessarily relevant to the markets outside the US, and hence would not serve as appropriate or helpful guidance in the context of IFRS. In addition, the guidance in paragraph 10(e) on what constitutes accepted 'good delivery' in practice should not be limited to the one specified under US GAAP because there would be other well-established market practices accepted by market participants.

16. On the other hand, the guidance in the above paragraphs 10(a) and 10(d) would be useful in further clarifying the meaning of 'the same primary obligor' and 'similar assets as collateral' respectively.

17. Therefore, the staff recommends that the Board:

[4] A CUSIP (Committee on Uniform Securities Identification Procedures) number identifies most securities including stocks of all registered US and Canadian companies, and US government and municipal bonds. While the number uniquely identifies a company or issuer and the type of security, it does not distinguish one specific (physical) certificate from others that belong to the same type. For example, there is one CUSIP number for IBM common stocks, regardless of when they are issued.

(a) adopt all characteristics set out above in paragraph 9 in the main text of the next due process document as those required to be considered 'substantially the same', and

(b) provide examples (a) and (d) from paragraph 10 as part of application guidance for those characteristics.

Question for the Board
Does the Board agree with the staff recommendation? If not, what conditions does the Board prefer for 'substantially the same', and why?

B. Collateral maintenance

Issue

18. Under the US GAAP 'effective control' approach, for a transfer to be treated as a financing, the *transferor* has to be able to repurchase the asset on substantially the agreed terms even in the event of default of the transferee. To meet this condition, the *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[5].

19. Furthermore, implementation guidance below is provided under US GAAP which requires the level of collateralisation to be in a particular range. The guidance further requires agreements to stipulate daily valuations and frequent adjustments for changes in the market price of the transferred security in order to meet this condition.

> Arrangements to repurchase or lend readily obtainable securities, typically with as much as 98 percent collateralization (for entities agreeing to repurchase) or as little as 102 percent overcollateralization (for securities lenders), valued daily and adjusted up or down frequently for changes in the market price of the security transferred and with clear powers to use that

[5] FASB ASC 860-10-40-24(b) or Paragraph 49 of SFAS 166

collateral quickly in the event of default, typically fall clearly within that guideline. Other collateral arrangements typically fall well outside that guideline (FASB ASC 860-10-55-37).

20. At the February meeting, the staff recommended that the Board not incorporate this condition and related guidance (ie collateral maintenance) into IFRS for the following reasons:

    (a) 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.

    (b) 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.

    (c) 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.

21. However, some of the Board were in favour of the maintenance of collateral as one of the conditions for repo transactions to be treated as financing arrangements rather than sales of the transferred asset. Those Board members mainly raised the following concerns.

    (a) If this condition were not required an asset could be recognised by more than one entity on the statement of financial position in cases where Entity A first transfers a bond to Entity B under a repo contract and then Entity B repos-out the bond to Entity C and so on.

    (b) Collateral seems to be essential to the accounting for repo transactions as borrowings.

22. As a result, the Board asked the staff for further input to decide if collateral maintenance should be retained as required under US GAAP, and if so, how much detailed guidance should be provided.

Staff analysis

Concerns raised by the Board

(a) One asset on many statements of financial position

23. First of all, it should be noted that this condition requires the *transferor* of a financial asset (e.g. a bond) to maintain sufficient collateral (e.g. cash). It does *not* prohibit the *transferee* from transferring the bond to a third party (either through an outright sale or a repo). Therefore, requiring the condition does not mitigate the concern that one asset may be recognised by more than one entity.

24. Secondly, as long as repos are treated as financing arrangements in accordance with the proposed exception, only the original transferor recognises the bond and no subsequent transferees recognise the bond as their assets even if several consecutive *repo* transactions are entered into using the same bond. Subsequent transferees all recognise receivables against their own transferee (and liabilities to their own transferor)[6].

(b) Collateral to qualify as financing

25. It would be true that if the transferor of a financial asset maintains sufficient cash as collateral under repo transactions the repurchase of the transferred asset (or some other replacement assets) in the future is more ensured other things being equal.

26. However, the staff does not agree that collateral maintenance should be required as a condition for transactions to qualify as borrowings (even as an exception to the derecognition model, which the Board believes should be strictly defined). Rather, it is an issue of risk management.

---

[6] It is true that if the transferee (Entity B) *sells on* (rather than *repos-out*) the asset to Entity C, both the original transferor (Entity A) and Entity C would recognise the asset. However, as described in paragraph 23, this would happen even if the condition is required.

27. For example, when a bank makes a loan to its customer the bank may or may not require the customer to provide some collateral to the bank. The existence/non-existence of the collateral is generally reflected in the interest rate applied to the loan in accordance with the difference in the credit risk. However, it does not affect the nature of the transaction as lending. Similarly, suppose an outright sale of a financial instrument with (a) an immediate payment, (b) a payment due in three months or (c) the same payment terms as (b) but accompanied by some collateral. The seller is exposed to a different level of credit risk but the difference would not affect the nature of the transaction as a sale of the asset for accounting purposes.

Relevance of the condition in the context of the derecognition model under US GAAP

28. Legal isolation of the transferred asset from the transferor even in bankruptcy is required under US GAAP to decide that the transferor has surrendered control over the asset. Therefore, as a mirror image of the principle, it seems consistent to assure that the asset will be returned to the transferor as promised even in the event of default (of the transferee in this case) in order to conclude that the transferor still has (effective) control over the asset within such a model. Both requirements are to make sure that the accounting decision on which party controls the asset should not be denied even in the event of default of related parties.

29. However, as stated in paragraph 20(a), the Board has already decided that legal isolation concept should not be adopted for the assessment of control in IFRS.

Staff recommendation

30. Based on the analysis in previous paragraphs, **the staff recommends that the Board <u>not</u> incorporate the condition and related guidance under US GAAP on collateral maintenance.**

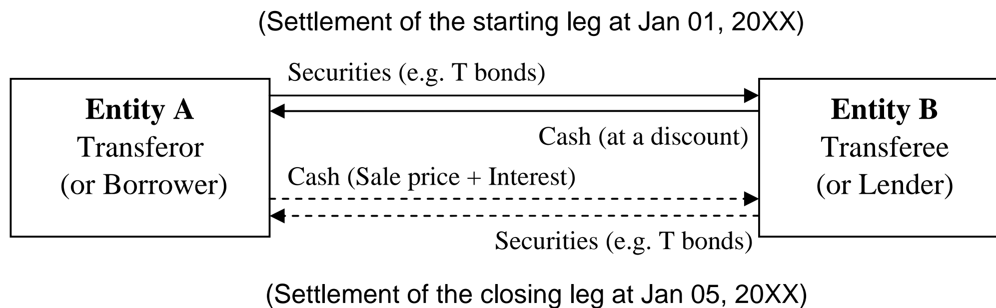
Question for the Board
Does the Board agree with the staff recommendation? If not, what alternative does the Board prefer, and why?

Appendix 1

Basic structure of repo transactions[7]

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.

[7] 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.