IASB Meeting | Agenda reference **5B**

Staff Paper | Date **Week beginning 15 March 2010**

Project **Derecognition**

Topic **Pass-through arrangements, nonrecourse loans and accounting for assets and liabilities of SPEs**

Introduction

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

2. This is in response to requests for additional explanation of the above issues by some board members at the February meeting -

   (a) **Pass through arrangements and the detailed requirements under IAS 39 for such arrangements** - Are the 'pass through' criteria in IAS 39 paragraph 19, still relevant for determining whether an asset should be derecognised?

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

   (c) **'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'?.

A. Pass through arrangements

3. At the February meeting the staff discussed some respondents concerns as to whether the Board intended the current pass through test in IAS 39 to be met for

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.

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a transaction to qualify as a transfer or even for derecognition. The staff's conclusion was that the derecognition criteria does address the requirements of the pass-through test in IAS 39.

4. 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,

5. The staff noted that 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. Hence, a transaction that meets that criterion would (in the absence of any other factors) lead to derecognition of the asset.

6. On the other hand, the staff asserted that if that condition is not met (i.e. an obligation to pay exists, even if equivalent cash flows are not collected from the original asset), we believe the entity has a liability for the obligation to pass economic benefits to the counterparty and should continue to recognise the asset. On reflection, we believe our conclusion on this paragraph is not entirely correct and could create an inconsistency in the model.

7. The staff believes that the key issue is not whether the transferor would have to make payments regardless of whether it collects equivalent amounts from the original asset. Rather whether it has passed or promises to pass the cash flows of the asset to the other party. We believe that if the transferor agrees to pass some or all of the economic benefits of the asset to the transferee, irrespective of any implicit or explicit guarantee, the asset should be derecognised.

8. We also believe the presence of a guarantee should not matter for the derecognition analysis. Under the proposed approach, if a transferor sells an asset to a transferee and as part of the transaction provides a guarantee, the

conclusion is that the entity no longer controls the economic benefits of the asset and hence should derecognise the asset and recognise a guarantee (similar to current derecognition treatment for financial liabilities).

9. We believe that where the transferor would have to make payments regardless of whether it collects equivalent amounts from the original asset, to the extent that it has agreed to pass some or all of the economic benefits of the asset to the transferee, the transferor should derecognise the asset.

10. This is a change to the staff's conclusion on this issue but we believe it is the appropriate interpretation of the model and the asset and liability definitions in the *Framework*.

11. The staff however maintains it's conclusions in respect of criterion (b) and (c) as we believe they are correct and consistent with the proposed derecognition approach -

    - **Criterion (b):** Failing criterion (b) (i.e. the entity can deal 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. It does not provide a definitive answer as to whether derecognition should occur, or not. The entity should also have the ability to restrict others access to the economic benefits for the asset to qualify as its assets.

    - **Criterion (c):** 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.

12. The staff therefore concludes that the pass through test in IAS 39 does not need to be included in the derecognition requirements, as the derecognition principle

under the proposed approach addresses the issues intended to be addressed by the pass through test. However, the staff proposes that the Board should provide an illustration of how the derecognition criteria addresses the pass-through requirements in application guidance.

B. 'Empty' SPEs

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

14. The staff does not agree that the application of the derecognition principle will necessarily lead to 'empty' SPEs. The staff believes this is not the case because (1) it 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) and (2) some of the SPEs that would be empty would be treated similarly under current requirements in IAS 39.

Nature of beneficial interests issued by the SPE

15. 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 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.

16. 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.

17. 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.

18. 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.

19. Hence under the proposed 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.

20. Consequently, 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, then the arrangement will not lead to derecognition of the assets of the entity (under the proposed approach) unless the creditors of the SPE have consented to the transaction (i.e. the novation of the liabilities of the SPE).

21. 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 net assets as the creditors of the entity would most likely not have consented to the novation of the vehicle's liabilities.

22. The staff therefore believes that the concerns raised by respondents are not 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 the assets then derecognition of those assets would be appropriate, and vice versa.

23. The staff however notes that the SPE should 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. The staff sees such arrangements as no different from where a party gives his assets to be managed by an agent for a fee. In this case we cannot argue that by virtue of the management contract, the

transferor should be deemed not to own the asset the agent manages (on behalf of the transferor).

Accounting for assets and liabilities of SPEs under IAS 39

24. The staff believes that the Board, in issuing IAS 39 derecognition guidance, contemplated that there are legitimate scenarios where an SPE would have no assets or liabilities (ie if the pass-through requirements and the derecognition test are met).

25. IAS 39, paragraph AG37, states –

    "The situation described in paragraph 18(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a special purpose entity or trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 19 and 20 are met."

26. IAS 39, paragraph AG38, also states that –

    "In applying paragraph 19 (*ie the pass-through criteria*), the entity could be, for example, the originator of the financial asset, or it could be a group that includes a consolidated special purpose entity that has acquired the financial asset and passes on cash flows to unrelated third party investors." emphasis added

27. The Board explained in paragraph BC 56 that -

    "To address these issues (*ie questions about appropriate accounting treatment and divergent interpretations*); the Exposure Draft of proposed amendments to IAS 39 included guidance to clarify under which conditions pass-through arrangements can be treated as a transfer of the underlying financial asset. The Board concluded that an entity does not have an asset and a liability, as defined in the Framework, when it enters into an arrangement to pass through cash flows from an asset and that arrangement meets specified conditions [the pass-through criteria]. In these cases, the entity acts more as an agent of the eventual recipients of the cash flows than as an owner of the asset. Accordingly, to the extent that those conditions are met the arrangement is treated as a transfer

and considered for derecognition even though the entity may continue to collect cash flows from the asset. Conversely, to the extent the conditions are not met, the entity acts more as an owner of the asset with the result that the asset should continue to be recognised." emphasis and explanation added

28. The Board therefore concluded in paragraph BC60 that

"These conditions (*ie the pass-through criteria*) follow from the definitions of assets and liabilities in the *Framework*. Condition (a) indicates that the transferor has no liability (because there is no present obligation to pay cash), and conditions (b) and (c) indicate that the transferor has no asset (because the transferor does not control the future economic benefits associated with the transferred asset)." emphasis added

29. Consequently the Board concluded in paragraph BC 64 that

"Whether a transfer of a financial asset qualifies for derecognition does not differ depending on whether the transfer is direct to investors or through a consolidated SPE or trust that obtains the financial assets and, in turn, transfers a portion of those financial assets to third party investors."

30. 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 the 'remittance without material delay' requirement nor 'obligation to pay only and if only the asset generates returns' requirement.

C. Nonrecourse 'loans'

31. 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).

32. 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

(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.

33. 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.

34. 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.

35. The staff believes that for the set of nonrecourse loans described in paragraph 35(a), despite the nonrecourse feature and security arrangement, the collateral (the asset) still qualifies as the asset of the debtor because the debtor can obtain the benefit embodied in the asset and control others' access to it.

36. 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, the staff believes that the debtor should recognise a liability for the funds received.

37. 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.

38. On the other hand, the staff believes that for the set of nonrecourse loans described in paragraph 35(b), the 'debtor' should derecognise (or not recognise) the related secured assets. The staff view is that 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).

39. 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').

40. 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. The staff notes that 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').

41. The staff therefore recommends that for the kind of nonrecourse loans described in paragraph 35(b) (ie the pass-through nonrecourse 'loans'), a liability should not be recognised and the related securing asset should also not be recognised by the 'debtor'. The accounting should be symmetrical for the 'lender' and the 'debtor'. The parties should recognise their interest in the underlying asset.

42. This treatment will avoid potential inconsistencies in the application of the proposed derecognition guidance and conflicts between the derecognition models for financial assets and financial liabilities. These potential problems are illustrated with some cases in appendix 3.

Question for the Board:

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

APPENDIX

Case 1

Entity A lends CU90 to Entity B on a recourse basis. Entity B then purchases distressed receivables (with a fair value of CU100) with the funds advanced.

Entity B later grants Entity A a right to some of the cash flows of the receivables (95%, pro rata cash flows) in satisfaction of its obligations under the loan agreement. Entity B will collect and pass through the cash flows to Entity A. Entity B does not provide any guarantees or other support in relation to the receivables. Hence Entity A will look solely to the receivables for repayment.

Accounting:

Under existing liability derecognition requirements, the conclusion will be that Entity B's liability has been extinguished as Entity B has transferred part of the financial asset in satisfaction of its obligation. Entity B would also derecognise a part of the portfolio of receivables.

Also under the proposed derecognition guidance for financial assets, the conclusion will be that entity B does not have present access to all of the cash flows of the asset (for its benefit) and hence it will derecognise the portfolio of receivables and recognise the economic benefits it controls (ie a partial interest in the portfolio). Entity A would also recognise its interest in the portfolio of receivables.

Case 2

Entity A 'lends' CU90 to Entity B on non-recourse basis. Entity A agrees to look to a portfolio of distressed receivables (with a fair value of CU100) purchased with the funds advanced for both interest and capital repayment (up to 95% of the cash flows, pro rata).

Accounting:

The conclusion under existing liability derecognition requirements would be that Entity B has a loan of CU90.

However, under the proposed derecognition approaches for financial assets, Entity B does not have control of all of the economic benefits of the asset and hence Entity B will not recognise the portfolio of receivables. Entity B will recognise the economic benefits it controls (ie its right to some of the cash flows of the portfolio of assets), likewise Entity A. This case is not dissimilar to a pass through arrangement. Moreover, the position of both Entity A and B, under this scenario, are economically identical to that in Case 1.

CURRENT GUIDANCE – ACCOUNTING TREATMENT

	B liability	Receivables
Case 1 – A lends CU90 (recourse). B settles liability with 95% pass-through	Derecognised	Recognised by A
Case 2 – A lends CU90 (non-recourse). A only looks to 95% of receivables.	B recognises liability.	Recognised by B

PROPOSED TREATMENT

	B liability	Receivables
Case 1 – A lends CU90 (recourse). B settles liability with 95% pass-through	Derecognised	Recognised by A
Case 2 – A lends CU90 (non-recourse). A only looks to 95% of receivables.	Derecognised	Recognised by A