IASB Meeting | Agenda reference **5E**

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

Project **Derecognition**

Topic **Interaction with consolidation**

Introduction

1. This paper:
   (a) illustrates the application of the derecognition approach for financial assets that was described as the alternative approach in Exposure Draft ED/2009/3 *Derecognition* to a number of securitisation transactions and the associated accounting outcomes, and
   (b) provides an indication of how that approach would interact with the consolidation model that the Board is currently developing.
2. **The staff does not intend to discuss this paper at this meeting, unless the Board have questions about it.**
3. The securitisation transactions are the following:
   (a) Example 1: Distressed debt
   (b) Example 2: Residential mortgage-backed securitisation
   (c) Example 3: Multi-seller conduit
4. These transactions are the same as those discussed with the Board at the February 2009 meeting (see Agenda Paper 2E).

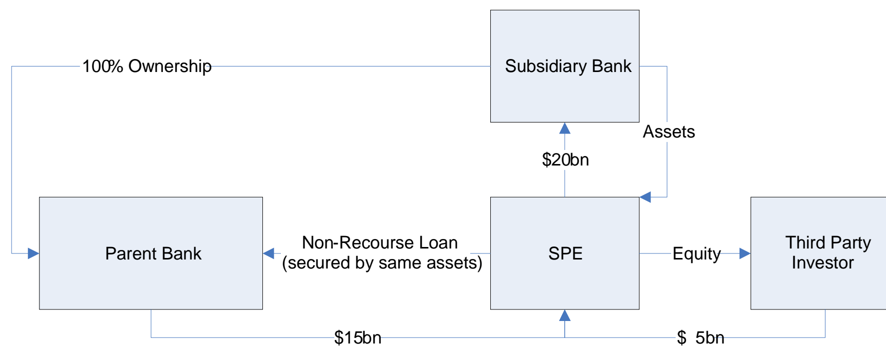
This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

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.

Example 1: Distressed debt



Facts

5. An SPE is established to facilitate the acquisition of a portfolio of liquid and illiquid assets (receivables) from Subsidiary Bank. The SPE obtains a non-recourse loan from Parent Bank of $15bn (recourse only to the assets sold to the SPE) and an equity investment from a third party investor of $5bn. The SPE uses the financing to purchase $20bn of assets from Subsidiary Bank. The Subsidiary Bank has no obligation to make payments on any non-performance of the assets.

6. An SPE manager is appointed by the third party investor and is paid a market fee. The SPE manager does not have the ability to sell assets and distinguish proceeds unless the manager explicitly receives approval from the third party investor. The third party investor can remove the SPE manager without cause.

7. The equity investor benefits from all asset value increases and is at first risk of loss if the cash flows collected from the assets are less than $20bn. However should the cash flows collected from the assets be less than $15bn, the loan is non-recourse to SPE and therefore Parent Bank is exposed to losses incurred of more than $5bn. Parent Bank has first right of refusal to purchase the asset portfolio at fair value if the SPE decides to sell the portfolio.

Analysis - Derecognition

8. In the Subsidiary Bank's stand-alone financial statements, the Subsidiary Bank derecognises the $20bn receivables because after the sale of these assets to the SPE, it no longer has the present ability to obtain all of the economic benefits of

these assets for its own benefit (in fact, it has no present ability to obtain *any* benefits of the receivables).

9. In the group's (ie Parent Bank's and Subsidiary Bank's consolidated) financial statements, the group, through the Parent Bank's $15bn non-recourse loan, has the present ability to obtain some of the economic benefits of the receivables, but not all. As a result, the group derecognises the $20bn receivables and recognises the $15bn nonrecourse loan as a new asset.

Analysis - Consolidation

10. The SPE was established to facilitate the sale of a portfolio of liquid and illiquid receivables by the Subsidiary bank and to provide investment opportunities for the third party investor. Managing and servicing the assets is the only activity of the SPE that significantly affect the returns. Therefore, having power to direct how the assets are managed equates to having power to direct the activities of the SPE.

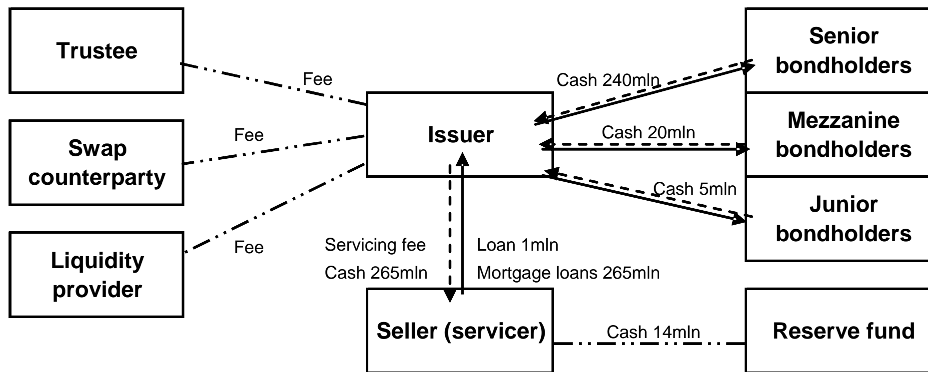
11. The SPE manager actively manages the assets, however it does so within the boundaries established by the Subsidiary bank and third party investor. The third party investor must also approve all sales of assets. In addition, because the manager can be removed without cause by the third party investor, the manager acts as an agent on behalf of the third party investor. The third party investor is also exposed to variability of returns of the SPE. It benefits from any increase in asset valuation and is exposed to the first $5bn losses.

12. Therefore, the third party investor has the power to direct the activities to generate returns for itself. The third party investor controls and should consolidate the SPE.

13. Parent Bank is exposed to variability of returns because it is exposed to losses on the assets of greater than $5bn. However, neither Parent Bank nor Subsidiary Bank has the power to direct the activities of the SPE to generate returns for themselves. Parent Bank has retained the ability to manage its exposure to losses by having first right of refusal to purchase the assets at fair value if the SPE decides to sell. However, that right is a protective right, designed to protect the interests of Parent Bank in the event that the third party investor decides to sell

the assets. Until that event happens, Parent Bank does not have any power to direct the activities of SPE.

Example 2: Residential mortgage-backed securitisation



Facts

Issuer

14. A retail bank (Seller) sets up a limited liability company (Issuer) for the purpose of carrying out restricted activities as described below. The initial set up costs of Issuer were funded by Seller in form of a loan of CU1 million to Issuer.

15. Seller sells a portfolio of mortgage loans to Issuer at par value of CU265 million, which mature in 20-25 years. All loans were originated by Seller and must remain in the portfolio until maturity.

Bondholders

16. Issuer funds the purchase of the mortgage assets through the issue of three categories of bonds with different ratings and level of subordination: senior (CU240 million), mezzanine (CU20 million) and junior (CU5 million). Bonds are issued to various investors, all of which are unrelated to Seller. All tranches of bonds mature after the longest maturity of securitised assets (i.e. bonds will not be rolled over in the market).

17. Significant changes to structural features of the transaction can be made only by the agreement of a majority of bondholders. Bondholders do not have rights to exchange, pledge or sell the loans held by the Issuer.

Credit enhancement

18. Seller funded a reserve fund of CU14 million. The reserve fund was established to ensure distribution of the principal and interest payments to bondholders in accordance with the priority of payments and provides a source of credit and

liquidity support. The reserve fund, when drawn, is replenished from any available excess spread. The excess spread represents the difference between cash inflows from mortgage holders and cash outflows to bondholders and other Issuer's expenses. Amounts collected above the required level on the reserve fund are distributed to Seller. Upon liquidation of Issuer, the residual amounts are paid to Seller.

19. Seller may lose up to CU15 million (the loan and the reserve fund) if the excess spread is not enough to replenish the amount drawn from the reserve fund. However, Seller has no obligation to make any payments to bondholders on non-performance of loans beyond that.

Trustee

20. An independent party, a trustee, holds all Issuer's nominal equity that does not carry voting rights. It receives a senior fee at market rates and ensures that the counterparties to Issuer are in compliance with the transaction agreements and legal requirements.

21. On behalf of Issuer, the trustee, an independent third party, can terminate the servicer's appointment on the occurrence of certain events of default of the servicer or a breach of servicing obligations. In such events the trustee appoints a designated stand-by servicer.

Servicer

22. Seller services the pool of mortgage loans on behalf of bondholders. In return, it receives a servicing fee at market rates. The servicer is obliged to act in accordance with servicing standards and transaction agreements. The servicer's responsibilities are as follows:

    (a) To collect cash flows on loans from mortgage holders (ie interest and principal payments, tax and insurance liabilities) and distribute the payments to entitled parties in accordance with the priority of payments;

    (b) To monitor overdue payments (ie contact mortgage holders, negotiate collection of overdue amounts and modify the payment terms—timing, amount or substitution of collateral);

(c) On default, to decide what action to take based on the procedure that maximises the net present value of the proceeds to bondholders (ie foreclose on and sell the mortgage asset or renegotiate the terms of the loan with the mortgage holder);

(d) After default, if the loan was not restructured, execute foreclosure (ie deciding when to foreclose, and when and to whom sell the mortgage assets);

(e) Invest funds pending distribution in short term, risk-free investments with a maturity date before the distribution date to Investors (the investment returns are not retained by Servicer);

(f) Preparation of reports and other administrative functions.

Swap counterparty

23. To fund the floating rate interest due on the bonds with the fixed rate interest on the mortgage loans, Issuer enters into a fixed-for-floating interest rate swap with an unrelated counterparty at market rates.

Priority of payments

24. The amounts collected on mortgage loans are distributed according to the following waterfall of payments:

(a) fee to the trustee and payments due under the interest rate swap agreement;

(b) fee to the servicer;

(c) interest due on the senior and mezzanine bonds in order of seniority;

(d) principal due on the senior and mezzanine bonds in order of seniority;

(e) interest and principal due on the junior bonds;

(f) replenishment of the reserve fund to its required amount;

(g) principal and interest due under the loan to fund the initial costs;

(h) distribution of excess spread to Seller.

Analysis - Derecognition

25. In the Seller's stand-alone financial statements, after the sale of the loans to the Issuer, the Seller no longer has present access to all the economic benefits of the loans for its own benefit because under its servicing contract it is obliged to pass through all these benefits (net of its servicing fee, loan and excess above the required reserve fund level) to the bondholders and other stakeholders (eg trustee, swap counterparty). As a result, the Seller derecognises the loans and recognises as new assets its loan and interest in the reserve fund.

26. In the group's (ie Seller's and Issuer's consolidated) financial statements, the issuance of the senior, mezzanine and junior bonds by the group would not result in the group derecognising the loans and recognising the group's retained interest in the loans (ie the group's interest in the reserve fund[1]) as a new asset. In addition to the loans, the group (ie the Issuer) holds a derivative that can be an asset or a liability over its term (interest rate swap) and for which it has to pay the periodic settlements before it can distribute cash to the holders of the bonds. As discussed in Agenda Paper 3B at the February 2010 meeting, 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.[2] Since the facts do not indicate that the swap counterparty has consented to the novation of the swap, the issuance of the bonds do not lead to the derecognition of the loans in the group's financial statements.

27. Thus, the accounting outcome is the same regardless of whether consolidation is applied before derecognition, or vice versa.[3]

---

[1]Note that the Seller's loan to the Issuer to cover the initial set up costs would be eliminated in consolidation.
[2]See paragraphs 41-49 of that agenda paper.
[3]If derecognition is applied first, the Seller derecognises the loans in its stand-alone financial statements, and the Issuer recognises the loans as its assets (see analysis in paragraph 25). The Seller then consolidates the Issuer (see analysis in paragraphs 28-31), resulting in the loans remaining on the group's statement of financial position.

Analysis - Consolidation

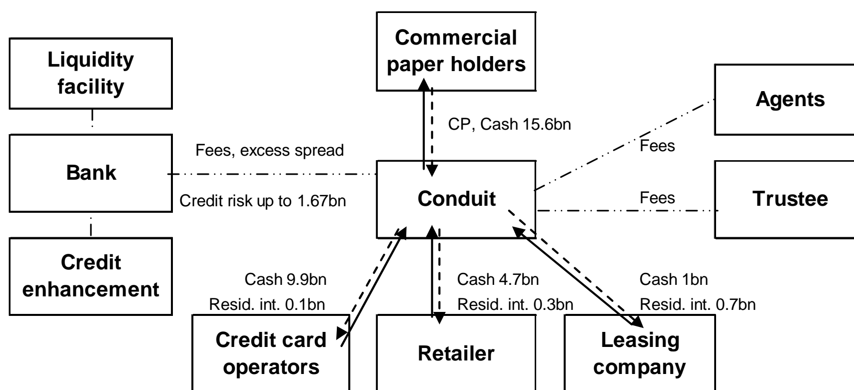
28. Issuer was established to facilitate the sale of mortgage loans by Seller and to provide investment opportunities for investors.

29. Seller retains servicing of defaulted loans, the only activity of Issuer that requires decision making and significantly affect the returns of Issuer. Even though Seller services the assets according to servicing standards and transaction agreements, Seller has discretion in managing the assets when in default and, therefore, has the ability to manage the assets to affect the returns of Issuer. The ability of the bondholders and other parties to change the established policies of Issuer is limited and would be considered to be protective rights. The removal rights held by the trustee is also a protective right because Seller can be removed only if Seller breaches its contractual arrangement.

30. Seller is exposed to variability of returns of Issuer because it receives any excess spread (or any upside) from the activities of Issuer and can lose up to CU15 million (the loan plus the reserve fund).

31. Seller has the power to direct the activities of Issuer to generate returns for Seller. Seller controls and should consolidate Issuer.

Example 3: Multi-seller conduit



Facts

Conduit

32. Bank structured a multi-seller conduit as a separate legal entity. The conduit's activity is to invest in loans originated by third parties on an ongoing basis from funds obtained by issuing commercial paper. The aim of the conduit is to provide alternative financing to the transferors of the assets and generate benefits from the term structure of credit spreads.

33. The conduit issued commercial paper (CP) at par value of CU15.6 billion to fund the transfer of the receivables to the conduit. The CP has a short-term maturity date after which it is rolled over. None of the CP is linked to specific assets of the conduit.

Transactions

34. Twelve parties transferred receivables to the conduit: Ten credit card operators, a retailer and a leasing company (more about the specifics of the transfers below).

35. The conduit has a revolving assets structure, ie principal collections on the conduit's receivables are used to purchase new eligible receivables and replenish the conduit's portfolio rather than repay CP. The transferors (originators of the assets) continue to service the assets transferred to the conduit.

36. The assets transferred to the conduit are not cross-collateralised with other assets of the conduit. Therefore, no transferor bears any liability for loss on other transferor's assets; no transferor has any right to any other transferor's excess collateral.

Credit card operators (CU10 billion)

37. Ten credit card operators transferred credit card receivables of CU1 billion each to the conduit (i.e. CU10 billion in total). Due to the high excess spread between the rate of interest on each credit card account and the rate paid on CP, only one per cent cash reserve (over-collateral) is required to secure losses on the receivables. The total retained interest of these ten credit card operators is CU100 million (CU10 million for each operator).

Retailer (CU5 billion)

38. A retailer transferred CU5 billion of prime consumer receivables to the conduit. The retailer's total retained interest that serves as over-collateral equals six per cent (i.e. CU300 million).

Leasing company (CU1.7 billion)

39. A leasing company transferred lease cash flows of CU1.7 billion of retail operating leases to the conduit. The leasing company's total retained interest that serves as over-collateral equals CU700 million.

Bank

40. Bank provides administration, liquidity and credit enhancement services for which it receives fees comparable to market fees in other similar arrangements and senior to principal payments on CP. Bank does not own any equity or debt interest in the conduit.

41. Bank, in the role of an administrator, has the following responsibilities related to the management of the conduit's operations:

    (a) Manage daily operations of the conduit;

    (b) Issue, manage and repay the CP; and

    (c) Evaluates and enters into asset purchases and hedging arrangements.

42. As the liquidity facility provider, Bank stands ready to provide funds to the conduit to fund the purchase of all CP in the event the conduit is unable to reissue them to other third party purchasers (for reasons other than credit deterioration of the portfolio assets).

43. Bank also provides credit enhancement in form of a guarantee on 10 per cent of the transferred assets that should absorb all expected losses of the conduit. Bank absorbs the conduit's losses up to the guaranteed amount after the losses exceed the over-collateral provided by the transferees. Any losses in excess of the guarantee would be absorbed by all CP holders proportionally to their interest.

44. The excess spread, that represents net interest payments on the conduit's receivables after paying all expenses and payables, is deposited to a reserve account. The account is used to cover credit default on the portfolio receivables. The amounts accumulated on the reserve account above specified level are regularly distributed to Bank. Upon liquidation of the conduit, any residual amounts are paid to Bank.

Policies

45. The conduit's activities are governed by formal credit and investment policies established at the inception of the structure. Under specified circumstances, Bank may amend the provisions of the policies subject to the approval of a rating agency.

Analysis - Derecognition

46. After the sale of the assets to the conduit, each of the transferors – the credit card operator, retailer and leasing company – does not have present access to all the economic benefits of these assets for its own benefit. That is, each has the present ability to obtain the benefits of these assets but is obliged to pass them through to the conduit under its servicing arrangement (net of its respective servicing fee and any cash flows allocated to its respective subordinated interest). Accordingly, each derecognises the assets sold to the conduit and recognises as a new asset its subordinated interest and the servicing contract to the extent that that contract qualifies as an asset or liability.

Analysis - Consolidation

47. The conduit was established to facilitate the sale of receivables by 12 different parties and to provide investment opportunities for investors.

48. The Bank provides administration, liquidity and credit enhancement services, which allow it to manage the liabilities of the conduit (issue, manage and repay

CP) and manage the assets of the conduit (evaluates and enters into asset purchases and hedging arrangements). Even though each of the transferors retains servicing of the receivables transferred to the conduit – an activity that could affect the returns of the conduit, the Bank has discretion to decide on new transferors, approve assets transferred, and under specified circumstances, amend the provisions of the policies that cover asset eligibility and structural elements in asset transfer transactions. Other parties, including the trustee, have some rights that are protective in nature. Consequently, the Bank has the power to direct the activities of the conduit that *most* significantly affect the returns.

49. The Bank also is exposed to variability of returns of the conduit—it receives the excess spread (or any upside) from the activities of the conduit and is exposed to losses from the provision of credit enhancement and liquidity support.

50. The Bank has the power to direct the activities of the conduit to generate returns for the Bank. The Bank controls and should consolidate the conduit.