STAFF PAPER

28 October – 1 November 2013

IASB Meeting

Project	**Annual Improvements (2012-2014 cycle)**
Paper topic	IFRS 7 *Financial Instruments: Disclosures*—Servicing Contracts

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Introduction

1. In September 2013, the IFRS Interpretations Committee ('the Interpretations Committee') recommended to the IASB that it should propose an amendment to IFRS 7 *Financial Instruments: Disclosures* through the Annual Improvements project. The proposed amendment would clarify how the entity should decide whether servicing rights and obligations are continuing involvement for the purposes of the disclosure requirements in paragraphs 42A-42H of IFRS 7.

2. The objective of this Agenda Paper is to ask the IASB whether it agrees with the proposed amendment to IFRS 7. This Agenda Paper will therefore:

   (a) provide a summary of the issue;

   (b) provide a summary of the discussions in the previous meetings;

   (c) explain the proposed amendment to IFRS 7;

   (d) provide an assessment against the annual improvement criteria; and

   (e) ask the IASB whether it agrees with the Interpretation Committee's recommendation.

Summary of the issue

3. The IASB issued *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7) —herein called 'the transfer disclosures'—in October 2010. The transfer

disclosures included the addition of paragraphs 42A-42H to IFRS 7 and are effective for annual periods beginning on or after 1 July 2011.

4. According to paragraph 42B of IFRS 7, the objective of the transfer disclosures is to enable users of financial statements:

   (a) to understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and

   (b) to evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets.

5. Paragraph 42C of IFRS 7 sets out a description of the term 'continuing involvement' in transferred financial assets for the purposes of applying the transfer disclosures:

> For the purposes of applying the disclosure requirements in paragraphs 42E–42H, an entity has continuing involvement in a transferred financial asset if, as part of the transfer, the entity retains any of the contractual rights or obligations inherent in the transferred financial asset or obtains any new contractual rights or obligations relating to the transferred financial asset. For the purposes of applying the disclosure requirements in paragraphs 42E–42H, the following do not constitute continuing involvement:
>
> (a) normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action;
>
> (b) forward, option and other contracts to reacquire the transferred financial asset for which the contract price (or exercise price) is the fair value of the transferred financial asset; or
>
> (c) an arrangement whereby an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash

> flows to one or more entities and the conditions in paragraph 3.2.5(a)–(c) of IFRS 9 are met.

6. Paragraph B30 of IFRS 7 provides additional guidance on the meaning of ‘continuing involvement’ for the purposes of applying the transfer disclosures:

> An entity does not have a continuing involvement in a transferred financial asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the transferred financial asset nor acquires any new contractual rights or obligations relating to the transferred financial asset. An entity does not have continuing involvement in a transferred financial asset if it has neither an interest in the future performance of the transferred financial asset nor a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future.

7. In October 2012, the Interpretations Committee received a submission that requested clarification through an Annual Improvement about whether servicing rights and obligations are continuing involvement for the purposes of the transfer disclosures. That submission contained two views:

   (a) View 1: servicing rights and servicing obligations do not constitute continuing involvement for the purposes of the transfer disclosures.

   (b) View 2: servicing rights and servicing obligation do constitute continuing involvement for the purposes of the transfer disclosures.

Summary of the discussions in the previous meetings

8. The IASB discussed this issue in the February 2013 meeting. In that meeting, the IASB indicated that their intention was that servicing contracts would generally meet the definition of continuing involvement for the purposes of the transfer disclosure requirements and that paragraph 42C includes servicing contracts in the transfer disclosures. Furthermore, assessing whether a servicing contract represents continuing involvement in the financial assets being serviced requires assessment against the description of continuing involvement in paragraph 42C of

IFRS 7 and the guidance in paragraph B30 of IFRS 7. In this regard, the IASB members acknowledged that there may be rare circumstances in which a servicing contract does not constitute continuing involvement for the purposes of the transfer disclosures.

9. Also at that meeting, the IASB acknowledged that some interested parties are particularly concerned about the clarity of paragraph 42C(c); specifically, whether that guidance explicitly excludes servicing contracts from the scope of the transfer disclosures. The IASB members noted that paragraph 42C(c) discusses so-called ‘pass-through arrangements’. Specifically, that paragraph confirms that the cash flows collected to be passed through are not themselves continuing involvement for the purposes of the transfer disclosures. However, the IASB observed that a servicing contract itself is not a pass-through arrangement, because the servicer does not pass through any of the cash flows that it receives as a fee for servicing the transferred financial asset. Consequently, the servicing contract could qualify as continuing involvement.

10. The Interpretations Committee discussed this issue in January 2013, May 2013, and September 2013. The Interpretations Committee noted that the intention of the IASB is not necessarily clear on the basis of the wording of paragraph 42C of IFRS 7. Accordingly, in September 2013, the Interpretations Committee decided to recommend to the IASB that it should amend IFRS 7 through an Annual Improvement to provide guidance for deciding how the principle in paragraph 42C of IFRS 7 should be applied to a servicing contract for the purposes of the transfer disclosure requirements. The details of the amendments agreed by the Interpretations Committee are set out in the following paragraphs.

The proposed amendments agreed by the Interpretations Committee

Guidance for application of paragraph 42C to servicing contracts

11. As indicated in the previous meetings of the IASB, we think that a servicing contract is generally continuing involvement for the purposes of the transfer disclosure requirements. In most cases, the servicer has an interest in the future performance of the transferred financial assets as a result of that contract, because

the amount and/or timing of the servicing fee depends on the amount and/or timing of the cash flows collected from the transferred financial asset. This would be true irrespective of how the servicer receives its servicing fee; that is, whether the servicer retains a portion of the cash flows collected from the transferred financial asset as its fee or it passes through all of the cash flows collected and receives its fee separately from the transferee or another entity.

12. On this matter, we are of the view that contractual rights and obligations in a servicing contract should be assessed by applying paragraphs 42C and B30 of IFRS 7 to decide whether the servicing contract constitutes continuing involvement for the purposes of the disclosure requirements.

13. In the September 2013 meeting of the Interpretations Committee, a question was raised as to whether a servicer's obligation to pay cash flows collected from the transferred financial assets should be viewed as "a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future" as described in paragraph B30 of IFRS 7. If so, a typical servicing contract would always be viewed as continuing involvement for the purposes of the transfer disclosure requirements.

14. However, we are of the view that the servicer's obligation to pass through to one or more entities the cash flows that it collects from the transferred financial asset is not in itself continuing involvement for the purposes of the disclosure requirements. This is because the activity of passing through cash flows does not in itself constitute an interest in the future performance of the transferred financial asset. We note that paragraph 42C(c) of IFRS 7 confirms that the cash flows collected to be passed through are not themselves continuing involvement for the purposes of the transfer disclosure requirements. Hence, we think that our view is consistent with the guidance in paragraph 42C(c) of IFRS 7. Accordingly, we think that paragraph B30 of IFRS 7 should be amended to clarify that an obligation in a contract, including a servicing contract, to pass through an amount collected is not 'payment' for the purpose of applying paragraph B30 of IFRS 7.

15. We think that it is appropriate to clarify the points discussed above by adding guidance to, or amending the guidance in, the Application Guidance of IFRS 7 rather than by amending the requirements in paragraph 42C of IFRS 7. This is

because a servicing contract is only one example of an arrangement in which an entity would need to assess whether the resulting contractual rights or obligations meet the description of continuing involvement for the purposes of applying the transfer disclosure requirements.

16. The Interpretations Committee agreed with the staff analysis and recommended to the IASB that it should provide the clarifications described in the preceding paragraphs.

Effective date

17. With respect to the effective date of the amendment, the Interpretations Committee tentatively decided that an entity should apply the amendments for annual periods beginning on or after 1 January 2016. This effective date is subject to change depending on the progress of the entire Annual Improvements project. We will provide the Interpretations Committee and the IASB with any updates on the effective date of this amendment.

Transition

18. We note that paragraph 42E (b) of IFRS 7 requires disclosure of fair value of the assets and liabilities that represent the entity's continuing involvement in the derecognised financial assets. Retrospective application of this proposed amendment to financial statements for any preceding periods might therefore require an entity to determine fair value for a servicing asset or servicing liability as of the end of a preceding period, which the entity might not have previously determined. We are concerned that it might be impracticable for an entity to determine the fair value of such a servicing asset or liability at a specific earlier date without using hindsight.

19. A majority of the members of the Interpretations Committee had the same concern and therefore decided to propose to provide a specific exemption in the transition requirements for the proposed amendments in respect of comparative periods. This exemption would be that an entity does not need to apply the amendments to any period presented that begins before the date of initial application of the amendment, which is the date of beginning of the annual period for which the

entity first applies the amendments. This is consistent with the transition requirements in paragraph 44M of IFRS 7 in *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7), which added the transfer disclosure requirements.

Short-term exemptions for first-time adopters

20. For the same reason, the Interpretations Committee observed that the IASB should provide a first-time adopter with the same transition relief for the initial application of the amendment, as a short-term relief. If this relief were not provided, a first-time adopter would be disadvantaged as compared with the current IFRS preparers. This is also consistent with the amendments to IFRS 1 *First-Time Adoption of International Financial Reporting Standards* in *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7). In that amendment, paragraph E4 was added to Appendix E— Short-term exemption in IFRS 1. Accordingly, the Interpretations Committee recommended to the IASB that it should amend IFRS 1 by adding a paragraph to Appendix E of IFRS 1 to provide first-time adopters with a short-term exemption from applying the amendments to comparative periods that begin before the initial application date of the amendment.

21. Because of the short-term nature of the exemption, we will present our analysis on when the short-term exemption should be withdrawn in a future meeting of the IASB. That analysis would also include the analysis on whether, and if so when, the other short-term exemptions that currently exist in Appendix E of IFRS 1 should be withdrawn.

Assessment against the annual improvement criteria

22. The amendments proposed in this Agenda Paper would not change the requirements or guidance that address the assessment of continuing involvement for the purposes of the transfer disclosure requirements. Those amendments are to add guidance on application of the transfer disclosure requirements to a servicing contract.

23. Accordingly, the Interpretations Committee agreed that the potential amendments meet the criteria for inclusion in an annual improvement project of the IASB.

24. For the details of the criteria and our assessment against them, refer to **Appendix B** to this Agenda Paper.

The Interpretations Committee's recommendation to the IASB

25. The Interpretations Committee recommends that the IASB should propose to amend paragraph B30 of IFRS 7 and add paragraph B30A to IFRS 7. The Interpretations Committee also recommends that IFRS 1 should be amended as a consequential amendment arising from the amendment to IFRS 7.

26. If the IASB agrees with the Interpretations Committee's recommendation, we propose the draft amendment to IFRS 7 as set out in Appendix A to this Agenda Paper.

Questions for the IASB

1. Does the IASB agree with the Interpretations Committee's recommendation to amend IFRS 7?

2. If the IASB agrees with the Interpretations Committee's recommendation to amend IFRS 7, does the IASB agree with providing the transition relief for both current IFRS preparers and first-time adopters?

3. If the IASB agrees with the Interpretations Committee's recommendation, does the IASB agree with the proposed wording for the Annual Improvement in Appendix A?

Appendix A—Proposed wording for the amendment

A1. The proposed amendment to IFRS 7 is presented below.

Amendment to IFRS 7 *Financial Instruments: Disclosures*

Paragraphs 44Y and B30A are added. Paragraph B30 is amended. New text is underlined.

Paragraphs B29 and B31 are presented only for the sake of reference in this meeting.

Effective date and transition

…

<u>44Y</u> <u>*Annual Improvements to IFRSs 2012-2014 Cycle* issued in [date] amended paragraph B30 and added paragraph B30A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact. An entity need not apply the amendments for any period presented that begins before the annual period for which the entity first applies those amendments.</u>

Derecognition (paragraphs 42C–42H)

Continuing involvement (paragraph 42C)

B29 The assessment of continuing involvement in a transferred financial asset for the purposes of the disclosure requirements in paragraphs 42E–42H is made at the level of the reporting entity. For example, if a subsidiary transfers to an unrelated third party a financial asset in which the parent of the subsidiary has continuing involvement, the subsidiary does not include the parent's involvement in the assessment of whether it has continuing involvement in the transferred asset in its separate or individual financial statements (ie when the subsidiary is the reporting entity). However, a parent would include its continuing involvement (or that of another member of the group) in a financial asset transferred by its subsidiary in determining whether it has continuing involvement in the transferred asset in its consolidated financial statements (ie when the reporting entity is the group).

B30 An entity does not have a continuing involvement in a transferred financial asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the transferred financial asset nor acquires any new contractual rights or obligations relating to the transferred financial asset. An entity does not have continuing involvement in a transferred financial asset if it has neither an interest in the future performance of the transferred financial asset nor a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future. <u>The term 'payment' in this context does not include amounts that an entity collects from the transferred financial asset and is required to remit to the transferee.</u>

<u>B30A When an entity transfers a financial asset, the entity may retain the right to service the financial asset for a fee such as under a servicing contract. Such an arrangement is generally continuing involvement for the purposes of applying the disclosure requirements. The entity must assess the servicing contract in accordance with the guidance in paragraphs 42C and</u>

B30 to make that determination. For example, a servicer will have continuing involvement in the transferred financial asset for the purposes of the disclosure requirements if the servicing fee is dependent on the amount or timing of the cash flows collected from the transferred financial asset. Similarly, a fixed fee that is not paid in full because of non-performance of the transferred financial asset will also lead to the conclusion that the servicer has continuing involvement for the purposes of the disclosure requirements. In these examples, the servicer has an interest in the future performance of the transferred financial asset. This assessment is independent of whether the fee to be received is expected to compensate the entity adequately for performing the servicing.

B31 Continuing involvement in a transferred financial asset may result from contractual provisions in the transfer agreement or in a separate agreement with the transferee or a third party entered into in connection with the transfer.

Consequential amendment to IFRS 1 *First-Time Adoption of International Financial Reporting Standards*

Paragraph 39U is added.

Effective date

39U *Annual Improvements to IFRSs 2012-2014 Cycle* issued in [date] added paragraph E4A. An entity shall apply that amendment for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

Appendix E
Short-term exemptions from IFRSs

Paragraph E4A and a footnote are added.

E4 …

E4A A first-time adopter may apply the transition provisions in paragraph 44Y of IFRS 7*.

* Paragraph E4A was added as a consequence of *Annual Improvements to IFRSs 2012-2014 Cycle* issued in [date]. To avoid the potential use of hindsight and to ensure that first-time adopters are not disadvantaged as compared with current IFRS preparers, the IASB decided that first-time adopters should be permitted to use the same transition provisions permitted for existing preparers of financial statements prepared in accordance with IFRSs that are included in *Annual Improvements to IFRSs 2012-2014 Cycle*.

Basis for Conclusions on the proposed amendment to IFRS 7 *Financial Instruments: Disclosures*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment

Servicing contracts

BC1 In October 2010, the Board issued *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7). The amendment included the addition of paragraphs 42A-42H to IFRS 7 *Financial Instruments: Disclosures.* Those paragraphs require an entity to provide disclosures for all transferred financial assets that are not derecognised and for any continuing involvement in a transferred asset, existing at the reporting date, irrespective of when the related transfer transaction occurred.

BC2 The Board received a request to clarify whether servicing contracts constitute continuing involvement for the purposes of applying the disclosure requirements in paragraphs 42E-42H of IFRS 7. More specifically, the question was raised as to whether paragraph 42C(c) excludes servicing contracts from the scope of those disclosure requirements.

BC3 The Board observed that paragraph 42C(c) discusses arrangements whereby an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more entities; ie a 'pass through arrangement'. Paragraph 42C(c) confirms that the cash flows collected to be passed through are not themselves continuing involvement for the purposes of the transfer disclosure requirements. Therefore, the Board observed that the servicer's obligation to pass through to one or more entities the cash flows that it collects from the transferred financial asset is not in itself continuing involvement for the purposes of the disclosure requirements, because the activity of passing through cash flows does not in itself constitute an interest in the future performance of the transferred financial asset. The Board observed however that a servicing contract is generally continuing involvement for the purposes of the transfer disclosure requirements because, in most cases, the servicer has an interest in the future performance of the transferred financial assets as a result of that contract. That would be the case if the amount and/or timing of the servicing fee depends on the amount and/or timing of the cash flows collected from the transferred financial asset. This would be true irrespective of how the servicer receives its servicing fee; that is, whether the servicer retains a portion of the cash flows collected from the transferred financial asset as its fee or it passes through all of the cash flows collected and separately receives its fee from the transferee or another entity.

BC4 On the basis of these observations, the Board noted that paragraphs 42C and B30 need to be considered to determine whether a servicing contract is continuing involvement for the purposes of the transfer disclosure requirements. The Board proposes to add additional guidance to the Application Guidance of IFRS 7 to make clear how the guidance in paragraph 42C is applied to servicing contracts.

BC5 The Board also considered whether the amendment should apply to any period presented that begins before the annual period for which the entity first applies the amendment. The Board noted that paragraph 42E (b) of IFRS 7 requires disclosure of the fair value of the assets and liabilities that represent the entity's continuing involvement in the derecognised financial assets. Application of the amendment to such a period might therefore require an entity to determine the fair value as of the end of the period for a servicing asset or servicing liability, which the entity might not have previously determined. It might be impracticable for an entity to determine the fair value of such a servicing asset or servicing liability without using hindsight. The Board also noted that paragraph 44M provides similar transition provisions for the transfer disclosure requirements. Consequently, to avoid the risk of hindsight being applied, the Board proposes to require the application of the amendment only to annual periods beginning on or after the beginning of the annual period for which the amendment is applied for the first time. Furthermore, for the same reason, the Board observed that those transition provisions should be available to first-time adopters. Accordingly, the Board proposes to amend IFRS 1 *First-Time Adoption of International Financial Reporting Standards* to ensure that first-time adopters are not disadvantaged as compared with current IFRS preparers.

Appendix B—Assessment against the Interpretations Committee's agenda criteria and annual improvement criteria

B1. In the table below, we have assessed the issue against the annual improvement criteria described in the *Due Process Handbook*.

Agenda criteria of the Interpretations Committee	
We should address issues(5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected;	**Met** The results of our outreach indicate that this issue is significantly widespread.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**Met** The results of our outreach indicate that there is significant diversity in practice.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**Met** This issue can be resolved by amending guidance in and adding guidance to IFRS 7 on the basis of the existing principles rather than by amending or adding a principle.
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs (5.17)?	**Met** This amendment is sufficiently narrow and well-defined because the scope of the issue is limited to a servicing contract that an entity retains in a transfer of financial assets that qualifies for derecognition of the financial asset in its entirety.
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	**Met** We are not aware of any existing or forthcoming project of the IASB that would affect the issue discussed in this Agenda Paper.

Additional criteria for annual improvement	
Replace unclear wording Provide missing guidance Correct minor unintended consequences, oversights or conflict	**Met** The potential amendment is intended to provide additional guidance on how an entity should apply the requirements in paragraph 42C of IFRS 7 and guidance in paragraph B30 of IFRS 7 to a servicing contract. The amendment would not change the existing requirements or guidance for the assessment of continuing involvement. Accordingly, we are of the view that it would be a clarification of the existing principle in IFRS 7.
Not change an existing principle or propose a new principle	**Met** See above.
Not be so fundamental that the IASB will have to meet several times to conclude	**Met** We think that the IASB will be able to reach a consensus on the potential amendment on a timely basis because the amendment is to clarify the IASB's original intention when it added the transfer disclosure requirements.