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Derecognition: IASB's Proposed Amendments to IAS 39

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Introduction

The G20 and the Financial Stability Forum have expressed concerns about a number of accounting issues that have emerged from the current financial crisis and market turmoil, and have urged sound reform of the international accounting principles.

In response, the International Accounting Standards Board ("IASB") has undertaken a wide range of activities, including a significant acceleration of the revision process on the derecognition requirements[1] and the related derecognition disclosure requirements.

In March 2009 the IASB's efforts resulted in the publication on its website[2] of an exposure draft on derecognition[3] (the "Exposure Draft" or "ED"), with an invitation to comment addressed to the public (auditors, trade associations, regulators, other users of financial statements, etc.). The comment deadline expired on 31 July 2009. An IASB meeting is scheduled to be held this month to discuss possible ways forward.

The purpose of this Client Alert is to (i) briefly summarize the amendments proposed in the Exposure Draft[4] regarding the IAS 39 and (ii) conduct a preliminary analysis on the impact that they may have, if implemented, on strategies and techniques available to banks to derecognize their portfolios of loans through their disposal in the context of securitization transactions.

Existing Derecognition Requirements

By way of background, under the current derecognition requirements of IAS 39, following the transfer of a financial asset from an entity (transferor) to another entity (transferee), the transferor will derecognize the asset if:

(a) it has transferred to the transferee substantially all the risks and rewards of the asset (the "substantially all the risks and rewards" test); or

(b) failing the "substantially all the risk and rewards" test, it has ceased to control the asset, *i.e.* it has lost the "practical ability to sell the asset", which is now with the transferee (the test of control).

Under IAS 39 the notion of "practical ability to sell the asset" encompasses the ability to sell the asset:

- in its entirety to an unrelated third party; and
- unilaterally and without having to impose additional restrictions.

In the event the transferor retains such control, the test of control fails and the transferor recognizes the asset to the extent of its "continuing involvement" in the asset.

Exposure Draft

The current derecognition requirements have been largely criticized by users for combining elements of several derecognition concepts (risks and rewards, control, continuing involvement) which result in complexities and internal inconsistencies. From an operational viewpoint, this makes them (and in particular the "substantially all the risks and rewards" test) difficult to understand and to apply in practice, especially when dealing with complex structures such as, for instance, those used in securitization transactions.

The amendments to the IAS 39 proposed in the Exposure Draft are intended to reduce the complexity of the derecognition requirements[5] and improve uniformity in their application.

To achieve this, the Exposure Draft proposes a shift in the focus of derecognition assessment from the "substantially all the risks and rewards" test, to the "test of control", by excluding the former and reforming the latter.

Before analyzing in greater detail the proposed amendments to the derecognition requirements, it is worth mentioning that, despite a general consensus in the IASB on the principle that an entity surrendering control of a financial asset derecognizes the asset, divergent views have emerged between members of the board regarding the asset that is the subject of the transfer, *i.e.* the notion of unit of account.

According to the view supported by the majority of the IASB (the "prevailing approach"), a unit of account for the purpose of assessing derecognition is:

(i) a financial asset in its entirety; or

(ii) a group of financial assets, "*to the extent that none of the assets in the group is an instrument that can be an asset or a liability over its life*"[6]; or

(iii) part of a financial asset (or of a group of financial assets) "*only if that part comprises specifically cash flows or a proportionate share of the cash flows from that financial asset (or that group of financial assets)*"; this is the case when "*the performance of the part retained does not depend on the performance of the part transferred and* vice versa".[7]

Conversely, the minority of the IASB (the "alternative approach") believe that a unit of account may also be identified in any economic benefit retained in the financial asset (*i.e.* the transferor's right to part of the cash flows of the asset). On this basis, this minority view ultimately proposes that if an entity transfers an asset and, following the transfer, no longer controls *all* the economic benefits of the asset, the entity would derecognize the transferred asset and recognize, as new assets, any rights and obligations either retained or obtained in the transfer.[8]

In this Client Alert we are not analyzing in details the alternative approach. Therefore, any references below to the amendments to the IAS 39 proposed in the Exposure Draft are to be read as references to the amendments proposed by the prevailing approach.

Proposed New Derecognition Requirements

Pursuant to the proposed new paragraph 17A of IAS 39, an entity shall derecognize a financial asset if:

(a) "*the contractual rights to the cash flow of that asset have expired*"[9] (*e.g.* as a consequence of a payment of cash, conversion of the obligation to equity, etc.);

or following a transfer of the asset (*i.e.* a transaction that, irrespective of the relevant legal form, causes some or all of the cash flows or other economic benefits underlying the asset to pass from a transferor to a transferee;[10]

(b) the entity has no continuing involvement (*i.e.* it does not retain contractual rights or obligations relating to the asset nor does it acquire new contractual rights or obligations in respect of the asset); this is, for instance, the case when the transferor "*has neither an interest in the future performance of the asset or responsibility in any circumstance to make payments in respect of the asset in the future*";[11]

(c) the entity "*retains a continuing involvement*[12] *in [the asset] but the transferee has obtained the "practical ability to transfer the asset* for the transferee's own benefit[13]".[14]

If the transfer fails to pass the reformed version of the test of control mentioned in *sub* (c) above, the transferor would continue to recognize the asset in its entirety and would recognize a financial liability for the consideration received.[15] In the alternative scenario, the transferor would derecognize the asset and recognize (initially at fair value) any new assets obtained or liabilities assumed in the transfer.[16]

Proposed New Test of Control

Under the new test of control (as reformed by the proposed new paragraph 17A(c) of IAS 39) the notion of the "practical ability to transfer the asset for its own benefit" encompasses the ability to transfer the asset to an unrelated third party:

- "unilaterally": independently of the actions of others and in particular the consent of the transferor;
- "without additional restrictions":[17] "*in isolation,* i.e. *without having to add restrictive conditions to the transfer of the asset* to a third party[18]"[19] such as, for instance, the maintenance of the servicing with the original transferor or a call option in favor of the transferor (unless, in this latter case, the underlying asset is readily obtainable in the market); it has been clarified by the IASB that a "*feature inherent in the asset*" does not constitute an additional restriction (*e.g.* the conversion option embedded in a convertible bond); and
- "for its own benefit": by keeping for itself the consideration that would be paid by a third party for the asset, with no need to pass any such consideration on to the transferor.[20]

By way of comparison with the current test of control in IAS 39,[21] the reformed version of the test proposed in the Exposure Draft presents one major innovation, the additional requirement that all proceeds a transferee may receive from a subsequent transfer of the relevant financial asset to an unrelated party must remain with the transferee.

This is the prevailing view emerging from the Board's debate of the notion of "asset" and the concept of "control". On the basis of an analysis of the essential characteristics of an asset for accounting purposes, the majority of the IASB members have reached the following consensus:

- as general notion of "control" in the context of a financial asset, control is "*the ability to obtain (access) the future cash inflows of the asset, and to restrict others' access to those future cash inflows*";[22]

- for the purposes of assessing control, the main way by which an entity may access cash inflows of a financial asset is "via *transfer of that asset [...] to another entity in exchange for other assets, in settlement of a liability or as a distribution to the entity's owners*".[23]

Control Assessment

In performing the proposed new test of control, it should be borne in mind that:

(a) derecognition is assessed *from the transferee's perspective*: if the transferee has obtained the control over the asset, then the transferor has relinquished such control and, as a consequence, the asset shall be recognized by the transferee and derecognized by the transferor (symmetry of accounting);[24]

(b) no reassessment of the test of control is allowed: once the derecognition test has been applied, no subsequent re-assessments are allowed following external events which reduce or increase the ability of the transferee to transfer the asset to a third party for its own benefit;[25] and

(c) in assessing the transferee's "practical ability to transfer the asset for its own benefit", consideration should be given to;[26]

- *the terms of the transfer contractual arrangements*, whether contained in the transfer agreement, side letters or other arrangements "*entered into contemporaneously with, or in contemplation of, the transfer of the asset*"; [27]

- *the nature of the asset (fungibility and obtainability)*: a contractual provision preventing the transferee from disposing of the asset is not necessarily inconsistent with the transferee's ability to transfer the asset if the asset is readily obtainable (*i.e.* actively traded on an accessible market);

- *the market for the asset*; *e.g.* a clause restricting the identity of potential buyers has no impact on the transferee's ability to transfer the asset if enough persons satisfy the relevant identification criteria;

- *the transferee's ability to obtain the full economic benefits of the asset*; in principle this ability is not impaired by the transferor's right to match (a third party's bona fide offer)/first right of refusal/repurchase right at the prevailing market value of the asset; and

- *the existence of economic constraints*; for example, "*a put option or a guarantee [given by the transferor to the transferee] may constrain the transferee's ability to dispose of a [non-readily obtainable] asset [...] because the transferee may be unlikely to forfeit the benefit of the option or the guarantee without attaching a similar option, guarantee or other restrictive conditions on the transfer of that asset to a third party*"[28]; however, in the Authors' view, there are grounds to maintain that a put option or a guarantee embedded in the financial asset (*e.g.* an asset-backed security issued in a securitization) would not entail an economic constraint on the transferee since the benefit of the put option or the guarantee would be presumably reflected in the asset price offered by a third party to the transferee for the transfer of the asset.

Final Remarks on the "Test of Control"

In the interest of simplicity, the amendments to IAS 39 proposed in the Exposure Draft do away with the obscure "substantially all the risks and rewards" test and tighten the test of control by adding the "for its own benefit" requirement.

The IASB believes that, from an accounting perspective, the derecognition outcomes of this single approach based on control will be similar, in most cases, to those of IAS 39. However, "*unlike the current IAS 39, the proposed approach does not have:*

- *a test to evaluate the extent of risks and rewards retained;*
- *specific pass-through requirements; or*
- *a requirement for the transferor (in a transfer that fails derecognition) to recognize and measure a financial asset to the extent of its continuing involvement*".[29]

Impact of Proposed New Derecognition Requirements on Securitizations

In this section of the Client Alert, the Authors carry out a preliminary analysis of the application of the new (and, to a certain extent, stricter) derecognition approach presented in the Exposure Draft to the transfer of a specific type of a non-readily obtainable financial asset (a portfolio of loans) through its disposal in the context of a securitization transaction:

- *Transfer of a portfolio of loans with a deferred purchase price payable to the originator*. As part of the arrangements regarding the transfer of a portfolio, the originator is entitled to receive an additional deferred component of the purchase price (the "deferred purchase price"), equal to (a percentage of) the residual cash inflows of the portfolio once all senior costs of the securitization (including, *inter alia*, the principal of the relevant asset-backed notes and the interest accrued thereon) have been paid in full. The right to the deferred purchase price may be seen as a subordinated interest of the originator in the portfolio. Therefore, the "asset" to be assessed for derecognition is the entire portfolio (the performance of the originator's interest in the portfolio depends on the performance of the interest transferred). Because of its right to the deferred purchase price, the originator is interested in the future performance of the portfolio and, therefore, has continuing involvement in the asset. From a legal point of view, assuming that the originator has not the right, under the relevant contractual documentation, to prevent the securitization vehicle from subsequently transferring the portfolio to a third party, if the securitization vehicle subsequently transfers the portfolio, in theory the originator may be entitled (depending on the peculiarities of the relevant jurisdiction) (a) to a claim for damages or (b) to a part of the proceeds of the transfer in substitution of the deferred purchase price. Therefore, in any case, it is likely that the securitization vehicle would be deemed not to be in control of the portfolio because (i) the damages liability to which it is exposed poses an economic constraint (the originator will not transfer the portfolio without requesting an indemnity covenant from the third party), or (ii) because of its inability to keep for itself the asset price received from the third party.

- *Transfer of a portfolio of loans with a put option granted by the originator*. In the context of a securitization, the originator grants (directly or through a back-to-back transaction) to the holders of the asset-baked notes issued by the relevant securitization vehicle a put option as a form of credit enhancement. The originator has a continuing involvement in the underlying portfolio of loans since it is clearly interested in the performance of the portfolio (a low performance of the portfolio is likely to trigger the exercise of the put option by the noteholder and, as a consequence, the originator would be responsible for the payment of the relevant strike price). In principle, the put option should not affect the ability of the securitization vehicle to transfer the portfolio to a third party as the put option has been granted to the noteholders and, therefore, is not an “economic constraint” for the securitization vehicle. As a result, (i) control over the portfolio has passed to the securitization vehicle that recognizes the asset, and (ii) the originator derecognizes the portfolio and recognizes the put option.

- *Transfer of a portfolio of loans with a credit derivative between the originator and the securitization vehicle*. As part of the transfer of a portfolio of loans, the securitization vehicle and the originator enter into a credit derivative pursuant to which the originator retains the downside risk (first loss) and some upside potential of the portfolio (residual interest). This credit derivative being, to some extent, a combination between a credit default swap and a total return swap. The credit derivative contemplates: (a) no physical delivery, (b) no up-front payments on any sides, (c) no security over the portfolio in favour of the originator, (d) no right for the originator to prevent the securitization vehicle from subsequently transferring the portfolio to a third party, and (e) that the payment obligations of both parties are not affected by the subsequent transfer of the portfolio to a third party. Because of the credit derivative, the originator is interested in the future performance of the portfolio and, therefore, has continuing involvement in the asset. The credit derivative does not entail for the securitization vehicle an additional restriction (no need for the securitization vehicle to add restrictive conditions to the transfer of the portfolio to a third party because of the credit derivative) or economic constraint (the transferee would benefit from the payments due to it under the credit derivative irrespective of whether it holds the portfolio). As a result, on the basis of the rationale behind the derecognition requirements proposed in the Exposure Draft, one could argue that (i) the securitization vehicle has obtained the ability to transfer the portfolio to a third party for its own benefit, and, therefore, the control over the portfolio, (ii) the securitization vehicle recognizes the asset, (iii) the originator derecognizes the portfolio, and (iv) both recognize the credit derivative. This example is based on the (perhaps unrealistic) assumptions that: (1) the parties are able to determine the terms of the credit derivative (in practice this could prove to be particularly difficult due to the type of financial asset involved. *i.e.* a portfolio of loans), and (2) it is commercially sensible for the originator to enter into the credit derivative with a securitization vehicle (which, in the event of a subsequent transfer of the portfolio to a third party, after application of the relevant proceeds towards redemption of the notes issued by it and payment of the other costs, could end up having no financial resources to perform its obligations under the credit derivative). Nevertheless, the current example clarifies that the originator’s participation in the upside potential of the transferred portfolio, in principle, does not necessarily result in the originator recognizing the financial asset, to the extent that the cash inflows generated by the performance of the portfolio (and, therefore, the transferor’s right to such cash inflows) are capable of being isolated from the cash inflows generated by the sale of the portfolio (and the transferee’s right to keep such cash inflows for its own benefit).

- *Transfer of a portfolio of loans with an interest in the junior notes*. In the context of the securitization, the originator (a) transfers a portfolio of loans to the securitization vehicle in a transfer that qualifies for derecognition and (b) acquires a participation in the entity subscribing the junior notes issued by the securitization vehicle. Irrespective of certain formal differences, this is the same example described in letter (d) of the proposed new paragraph AG52L of the Application Guidance and, therefore, the same conclusions apply.[30] Through its interest in the entity holding the junior notes, the originator has the right to some of the cash flows of the portfolio. In particular, as the junior notes represent the residual interest of the portfolio, the originator may be deemed to have retained a subordinated interest in the portfolio itself (the performance of the originator’s interest in the portfolio depends on the performance of the interest transferred). Then the “asset” to be assessed for derecognition is the entire portfolio. Because of the retained subordinated interest in the portfolio, the originator is clearly interested in the performance of the portfolio and, therefore, has continuing involvement in the asset. If the securitization vehicle subsequently transfers the portfolio, a part of the price asset may pass on (*via* the junior notes and the junior noteholder) to the originator. As a result the securitization vehicle has not obtained the “ability to transfer the portfolio to a third party for its own benefit” and, therefore, is not in control of the portfolio. The originator continues to recognize the portfolio and recognizes a liability for the consideration paid to it by the securitization vehicle.

Conclusions

In the meeting held in September 2009 the Board discussed and analyzed the numerous comments received on the Exposure Draft. The next IASB meeting dealing with derecognition requirements has been scheduled for October 23 and is expected to be of pivotal importance as the Board will presumably discuss, also taking into account the feedback received on the Exposure Draft, possible ways forward, including other feasible derecognition approaches for financial assets. An update of this Client Alert is expected to be issued in the next weeks if significant decisions on derecognition requirements are taken by the Board at that meeting.

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If you have any questions concerning this developing issue, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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[1] *I.e.* the requirements for the removal of a previously recognized financial asset or liability from an entity's statement of financial position.

[2] http://www.iasb.org/NR/rdonlyres/74354283-FBBE-4B0D-9D45-FFB88BFE313B/0/EDDerecognition.pdf

[3] Exposure Draft ED/2009/3 Derecognition (Proposed amendments to IAS 39 and IFRS 7).

[4] In this Client Alert reference will be made to the following sections of the Exposure Draft: "Introduction" (pages 4 to 8), "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" (pages 11 to 39), and "Basis for Conclusions" (pages 55 to 81).

[5] See paragraph IN9 of the "Introduction" Section of ED. In addition, the Exposure Draft aims also at improving convergence between derecognition requirements under the IFRSs and the US standards.

[6] Proposed new paragraph AG42A of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED.

[7] Proposed new paragraph 16A of IAS 39. See also proposed new paragraph AG39A of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED, and paragraph BC72 of the "Basis for Conclusions" Section of ED. As a consequence, in a transfer of a financial asset where the transferor retained a subordinated interest in the asset, the unit of account is the entire asset and not the part transferred.

[8] See paragraph BC67 of the "Basis for Conclusions" Section of ED.

[9] Proposed new paragraph 17A of IAS 39.

[10] See proposed new paragraph 9 of IAS 39, and proposed new paragraph AG44A of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED. Under certain circumstances, the issue of debt or equity instruments by a securitization vehicle may qualify as a transfer of all the cash flows of the assets in the vehicle (see paragraph BC39 of the "Basis for Conclusions" Section of ED).

[11] Proposed new paragraph AG48A of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED.

[12] Pursuant to proposed new paragraph 18A of IAS 39 (see the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED), "*a transferor shall not be deemed to have retained any continuing involvement in the asset on the basis of the sole fact that:*

(i) it has given normal representations and warranties which, if breached, could invalidate the transfer as a result of a legal action

(ii) it has retained the servicing of the asset in a fiduciary or agency relationship (provided however that (a) the servicing fees are reasonable remuneration for the servicing activity performed and are senior to any payment to the transferee from the serviced assets, and (b) the transferee has the right to terminate the servicing agreement); or

(iii) it has been granted with a forward, option or other rights concerning the reacquisition of the asset for a price equal to the fair value of the asset."

On this subject see also paragraphs BC40 to BC45 of the "Basis for Conclusions" Section of ED.

[13] Emphasis added.

[14] Proposed new paragraph 17A of IAS 39.

[15] See proposed new paragraph 23A of IAS 39, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED.

[16] See proposed new paragraph 19A of IAS 39, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED.

[17] To assess the transferee's ability to transfer the asset "without additional restrictions" consideration must be given to "*what the transferee is able to do in practice, rather than what contractual rights or contractual prohibitions the transferee has regarding the asset*" (see paragraphs BC50 to BC56 of the "Basis for Conclusions" Section of ED).

[18] Emphasis added. In this "additional restrictions" seem to diverge from the "economic constraints" referred to in the last bullet point of letter (c) of the "*Control Assessment*" section of this Client Alert.

[19] Proposed new paragraph AG52B of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED.

[20] See proposed new paragraphs AG51A, AG52A, AG52B, AG52C, and AG52D of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of the ED.

[21] See *supra* the "*Existing Derecognition Requirements*" section of this Client Alert.

[22] Paragraph BC11 of the "Basis for Conclusions" Section of ED.

[23] Paragraph BC19 of the "Basis for Conclusions" Section of ED. This conclusion is opposed by the minority of the Board which believes that there are other ways a transferee may access cash inflows of an asset and through which the transferee may exercise control over the asset. This view, however, has been rejected by other members of the IASB on the grounds that, in transfers of non-readily obtainable financial assets in which (as it happens frequently in practice) the transferor has continuing involvement after the transfer, it would be difficult to assess which entity controls the financial asset and any attempt to define a prevalence test "*would import issues encountered currently in practice with the "substantially risks and rewards" test in IAS 39*" (in this respect see paragraphs BC20 to BC22 of the "Basis for Conclusions" Section of ED)

[24] See paragraphs BC15 to BC17 of the "Basis for Conclusions" Section of ED. A minority view in the IASB has objected that this approach to derecognition makes a financial asset - once recognized - "sticky" as "*two entities with identical rights and obligations may report different assets and liabilities depending on the order in which they acquired or incurred those rights and obligations*". However, according to the prevailing approach, this issue will have in practice little impact given that (i) "*the concern relates primarily to assets that are readily obtainable in the market*", and (ii) in respect of those assets, "*the proposed approach [to derecognition] will lead to accounting outcomes that are consistent with an approach for which the order of transactions does not matter*" (see paragraph BC74 of the "Basis for Conclusions" Section of ED).

[25] See proposed new paragraphs AG52F and AG52G of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Sectio n of ED.

[26] See proposed new paragraph AG52E of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED.

[27] Letter (a) of proposed new paragraph AG52E of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED.

[28] Letter (e) of proposed new paragraph AG52E of the Application Guidance, in the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measurement" Section of ED.

[29] Paragraph IN10 of the "Introduction" Section of ED.

[30] See the "Proposed Amendments to IAS 39 Financial Instruments: recognition and measure ment" Section of ED.