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SPEAKING OF SECURITIZATION

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Affecting Transfers and Servicing of Financial Assets

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INTERNATIONAL ACCOUNTING RULES PROPOSED FOR SECURITISATIONS

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Immediately after the Barcelona ABS conference, the International Accounting Standards Board (IASB)* released an Exposure Draft of Proposed Amendments to their existing documents, IAS 39 and IAS 32: *Financial Instruments: Recognition and Measurement and Disclosure and Presentation*.

Comments are due by October 14, 2002

This summary deals only with the accounting for securitisations aspect of the 336 page Exposure Draft. Copies of the full document can be obtained from IASCF Publications Department; publications@iasb.org.uk or www.iasb.org.uk

On page 9, we present a comparison of the Exposure Draft to FASB 140.

Executive Summary

The IASB proposes as the guiding principle *a continuing involvement approach* that **disallows** taking a transferred financial asset off-balance-sheet to the extent the transferor has **any** continuing involvement in the asset or a portion of the asset it has transferred. A transferor is regarded as having continuing involvement when (a) it could elect to or be required to reacquire control of the transferred asset (for example, if the financial asset can be called back by or put to the transferor, the transfer does not qualify for derecognition to the extent of the asset that is subject to the call or put option) or (b) it has a right or obligation to receive or pay subsequent changes in the value of the transferred asset (for example, if the transferor provides a credit guarantee -either directly or through a subordinated interest- or a total return swap, derecognition is precluded up to the amount that may be paid out under the arrangement).

S.O.S. contains general information only; it is not a substitute for consultation with a professional. To receive copies or other information dealing with matters herein, contact the Securitization Strategies Team hotline at (213) 688-6555 or e-mail us at securitization@deloitte.com.

* The International Accounting Standards Board (IASB), based in London, began operations in 2001. It is funded by contributions from the major accounting firms, private financial institutions and industrial companies throughout the world, central and development banks, and other international and professional organisations. The 14 Board members reside in nine countries and have a variety of functional backgrounds. The Board is committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this objective, the Board cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world. On June 7, 2002, the Council of the European Union (EU) adopted a regulation to require EU companies with listed securities to follow standards issued by the IASB in preparing their financial statements, beginning no later than 2005, or 2007 for companies currently following US GAAP or listing only debt offerings.

The proposed approach does not include any requirement that the transferred assets be put presumptively beyond the reach of the transferor and its creditors ("legally isolated") for the transfer to qualify for derecognition. On the other hand, the relative degree of continuing involvement is not a basis for determining whether the asset can be derecognised. Any continuing involvement requires the maximum amount of exposure to be recognized as a borrowing under the ED.

The Exposure Draft neatly dismisses the need to develop separate consolidation rules for many securitisation special-purpose entities. It proposes a 'look through' procedure whereby the evaluation of whether a transfer meets the derecognition criteria generally does not differ if the transfer is direct to investors or through an SPE that obtains the financial assets and, in turn, transfers a portion of those financial assets to third party investors. If a transfer by an SPE to a third party investor meets the conditions specified for derecognition, the transfer would be accounted for as a sale by the SPE and those derecognised assets or portions thereof would not be brought back on the balance sheet in the entity's consolidated financial statements.

One aspect of the proposal that we find quite confusing (and is sure to be quite controversial) is the accounting for retained subordinated interests. The retained subordinated interests stay on balance sheet, as would be expected. However, since the subordination effectively provides a credit guarantee for a portion of the interest sold to investors, that is considered a form of continuing involvement. This means that a portion of the investors' interest does not qualify for derecognition. Instead, an additional amount equal to the subordinated retained interest stays on balance sheet as loans and the associated amount received as sales proceeds is booked as a borrowing. This has been described by some as "double-counting." See example below on "*Sale of a Portion of a Financial Asset with Subordination.*"

The proposal does not allow for the recognition of the positive arbitrage that might result from a securitisation execution vs. a whole loan sale, whenever there are illiquid securities or other non-traded instruments retained by the transferor. When there are no price quotes or recent market transactions to support the fair value of a residual interest, the best estimate of fair value of the retained residual interest is the difference between the fair value of the underlying financial asset as a whole and the consideration received from the transferee for the portion transferred.

Effective Date and Transition (No grandfathering)

The Standard becomes operative for annual financial statements covering financial years beginning on or after [date to be inserted, after exposure] 2003. The Standard shall be applied retrospectively except in certain specified circumstances. The opening balance of retained earnings for the earliest prior period presented and the other comparative amounts shall be adjusted as if the Standard had always been in use unless restating the information would require undue cost or effort.

OTHER AREAS ADDRESSED IN THE EXPOSURE DRAFT

The Exposure Draft is intended to provide accounting and disclosure guidance for all financial instruments, not just those arising in securitisation transactions. Other areas specifically included are:

- Derivatives and embedded derivatives
- Financial assets and financial liabilities held for trading
- Loans and receivables originated by the entity
- Regular way purchase or sale of a financial asset
- Securities lending
- Repurchase agreements
- Held-to-maturity investments
- Reclassifications
- Fair market value measurement considerations
- Impairment and uncollectability of financial assets
- Hedging

SELECTED TEXT OF PROPOSED AMENDMENTS

35. An entity shall derecognise a financial asset when, and only when:

- (a) the entity's contractual rights to the cash flows that constitute the financial asset (or a portion of a financial asset) expire or are forfeited; or
- (b) the entity transfers the contractual rights to the cash flows that constitute the financial asset and the entity has no continuing involvement in all or a portion of those rights (see paragraph 37).

If one of these conditions is met for the asset in its entirety, all of the financial asset is derecognised. If one of these conditions is met for only a portion of the asset, that portion is derecognised and the other portion continues to be recognised.

37. A transferor has no continuing involvement in the contractual rights to cash flows that constitute a transferred asset or a portion thereof to the extent that both of the following conditions are met for all or a portion of the transfer:

- (a) the transferor either:
 - (i) relinquishes its contractual rights to the cash flows; or
 - (ii) enters into a 'pass-through' arrangement that meets the conditions in paragraph 41; and
- (b) there are no contractual provisions related to the transfer that either:
 - (i) may result in the transferor (including a consolidated entity) reacquiring control of its previous contractual rights (for example, through a repurchase agreement, a call option held by the transferor, or a put option written by the transferor); or
 - (ii) gives the transferor (including a consolidated entity) an obligation to pay subsequent decreases, or a right to receive subsequent increases, in the value of its previous contractual rights (for example, through a credit guarantee, a total return swap, or a cash-settled put or call option).

A continuing involvement in a transferred financial asset may result from contractual provisions incorporated in the transfer agreement itself or a separate agreement with the transferee or a third party entered into in connection with the transfer. 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 do not constitute a continuing involvement in a transferred financial asset. The retention of the right to service a transferred financial asset does not in itself constitute continuing involvement in that asset.

39. A transfer does not qualify for derecognition to the extent that there are contractual provisions related to the transfer that require payments to be made by or to the transferor based on subsequent changes in the value of the transferred asset. For example, a transferor may provide a credit guarantee on the transferred asset and the transferee may agree to pay increases in value of the transferred asset back to the transferor. In those cases, the transfer does not qualify for derecognition to the extent of the transferor's continuing involvement in the gains or losses of the transferred asset (the maximum amount of the consideration received that could be required to be repaid or the amount of the asset on which increases in value are returned to the transferor, whichever is greater).

41. If an entity transfers its contractual rights to all or a portion of the cash flows that constitute a financial asset and continues to collect cash flows from the transferred asset (a 'pass-through arrangement'), the transfer qualifies for derecognition to the extent that the transfer of all or a portion of the asset meets all of the following conditions and the transferor does not otherwise have a continuing involvement (see paragraph 37(b)):

- (a) The transferor does not have an obligation to pay amounts to the transferee unless it collects equivalent amounts from the transferred asset or portion thereof that qualifies for derecognition (ie the transferee is entitled only to the cash flows of the underlying financial asset or the portion thereof that qualifies for derecognition). {D&T Query: does this preclude servicer advances?}
- (b) The transferor is prohibited by the terms of the transfer contract or documents from selling or pledging the transferred asset or otherwise using that asset for its benefit.
- (c) The transferor has an obligation to remit any cash flows it collects on behalf of the transferee without material delay. The transferor is not entitled to reinvest such cash flows for its own benefit. (Emphasis added.)

Servicing Assets and Servicing Liabilities

43. If an entity transfers all or a portion of a financial asset and retains the right to service the financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognised for the servicing right at an amount determined on the basis of an allocation of the consideration received in accordance with paragraph 47.

Derecognition of a Portion of a Financial Asset

47. If an entity, as a result of a transfer, derecognises a portion of a financial asset while it continues to recognise the other portion, the previous carrying amount of the financial asset shall be allocated between the portion that continues to be recognised and the portion that is derecognised based on the relative fair values of those portions on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a portion that continues to be recognised. The difference between (a) the carrying amount allocated to the portion derecognised and (b) the sum of (i) the consideration received for the portion derecognised and (ii) any cumulative gain or loss allocated to it that had been recognised directly in equity shall be included in profit or loss for the period.

48. Examples of the circumstances described in paragraph 47 are:

- (a) separating the principal and interest cash flows of a bond and selling some of them to another party while retaining the rest; and
- (b) selling or securitising a portfolio of receivables while retaining the right to service the receivables profitably for a fee that is expected to be more than adequate compensation for the servicing, resulting in an asset for the servicing right (see paragraph 50). Although a servicing asset is not a financial asset, it is treated as if it were in allocating the previous carrying amount based on relative fair values.

49. A transferor may retain the right to a portion of the interest payments on transferred financial assets as compensation for servicing those assets. The portion of the interest payments that the transferor would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The portion of the interest payments that the transferor would not lose is an interest- only strip receivable. For example, if the transferor would not lose any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. The fair values of the servicing asset and interest- only strip receivable are used to allocate the carrying amount of the receivables between the portion of the assets that is derecognised and the portion that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the transferor adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

Fair Value of Residual Interests

51. If an entity retains a residual interest in a transferred financial asset and has a history of selling similar residual interests or other market transactions exist for similar residual interests, recent prices of actual transactions provide the best estimate of the fair value of the retained residual interest. When there are no price quotes or recent market transactions to support the fair value of a retained residual interest, the best estimate of the fair value of the retained residual interest is the difference between the fair value of the underlying financial asset as a whole and the consideration received from the transferee for the portion transferred.

Accounting for Transfers that Do Not Qualify for Derecognition

52. If all or a portion of a financial asset is transferred to another entity but the transfer does not satisfy the conditions for derecognition or only a portion qualifies for derecognition, the transferor shall account for the transaction as a collateralised borrowing by recognising a financial liability for the portion of the transferred asset that does not qualify for derecognition.

53. The transferor shall account for the transferred asset and the associated borrowing that arises when a transfer does not qualify for derecognition on a basis that is consistent with, and reflects, the transferor's rights and obligations related to the transfer. When the transferor has only a limited exposure to changes in the fair value of the asset, changes in the fair value of the asset to which the transferor is not exposed shall not be recognised. The transferred asset and the associated borrowing shall not be offset.

54. The transferor accounts for the transferred asset and the related borrowing on a basis that ensures that the net carrying amount of the transferred asset and the related borrowing reflects the transferor's rights and obligations related to the transfer. Accordingly, when the transferred asset is measured at fair value and the transferor has only a one- sided exposure to changes in the fair value of the transferred asset because of a retained call option or written put option, the recognition of changes in the fair value of the asset is limited by the option exercise price.

A8.(d) If a guarantee to pay for default losses on the transferred asset provided by the transferor prevents a transferred asset from being derecognised, the borrowing is measured at the maximum amount of the consideration received in the transfer that the transferor could be required to repay ("the guarantee amount"). At the date of the transfer, the asset is measured at the guarantee amount less any consideration received for the guarantee. Subsequently, the asset is measured at the guarantee amount less impairment losses or, if the asset is measured at fair value, the guarantee amount less the fair value of the guarantee to ensure that the net carrying amount of the asset and the related liability reflect the fair value of the transferor's obligation under the credit guarantee.

FORMS OF CONTINUING INVOLVEMENT

Put options and call options. If the financial asset can be called back by the transferor, the transfer does not qualify for derecognition to the extent of the amount of the transferred asset that is subject to repurchase upon exercise of the call option. If the financial asset can be put back by the transferee, it has not been transferred to the extent of the amount of the transferred asset that is subject to repurchase upon exercise of the put option. Although a put option held by the transferee provides the transferee with control over the right to put the asset back to the transferor and thus not defeating sale accounting under US Standard FASB 140, the transferee's contractual ability to require the transferor to repurchase the asset may result in the transferor regaining control of the asset and, therefore, the transferred asset does not qualify for derecognition under the IAS 39 Exposure Draft to the extent of the amount of the asset that is subject to the put. Normal reps and warranties are OK.

Put options and call options that are deeply out of the money. No exception to the derecognition principles is made for a deep out-of-the-money put option held by the transferee or, unlike in the U.S., a deep out-of-the-money call option or a fair value call option held by the transferor on transferred financial assets. Derecognition is precluded to the extent of the amounts subject to being reacquired because the transferor may regain control of the rights to the benefits of the cash flows of the transferred financial assets. The probability of the transferor exercising its option is not considered.

Cash settled call or put options. No exception to the derecognition principle is made for a transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash. Derecognition is precluded to the extent of the amount of the asset that is subject to the put or call option or forward repurchase agreement because the transferor has continuing involvement in changes in the value of the transferred asset.

Removal of accounts provision. A removal of accounts provision is an unconditional repurchase (call) option that gives the transferor a right to reclaim assets transferred subject to certain restrictions. Such an option precludes derecognition to the extent of the amount subject to repurchase. For example, if the carrying amount and proceeds from the transfer of loan assets are 100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed 10,000, then 90,000 of the loans would qualify for derecognition. In the US, believe it or not, under the FASB staff's interpretation of the control concept, if any one individual loan could be selected by the transferor to be called back, the entire transaction is accounted for as a financing.

Clean-up calls. A clean-up call is a call option held by a servicer, which may be the transferor, to purchase remaining transferred financial assets when the amount of outstanding

assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Although this is the same definition as in FASB 140, a clean-up call held by a transferor precludes derecognition under the IASB proposal to the extent of the amount of the assets that is subject to the call.

Conditional put options on defaulted assets. A transferee may have the right to put defaulted assets back to the transferor. For a special purpose entity, the exercise of the put option may be automatic whereby, if and when a loan defaults, the special purpose entity is required to put the defaulted loan back to the transferor. Although the exercise of the put options is conditional upon the occurrence of default and is for the protection of the transferee, the options nonetheless provide a means by which the transferor regains control of the rights to the cash flows of the transferred asset and thereby preclude derecognition to the extent of the amount of the assets that is subject to the put. Normal reps and warranties are OK.

Subordinated retained interests and credit guarantees. A transferor may agree to provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. Such agreements could result in the transferor in effect repurchasing the transferred asset if the debtor fails to make payments or the asset is impaired. Derecognition is precluded to the extent of the amount that the transferor could be required to pay. Alternatively, when a portion of a financial asset is transferred, the transferor may provide credit enhancement to the transferee by subordinating the residual interest retained to make good any credit losses in the portion of the underlying asset that was the subject of the transfer. The credit enhancement is similar to a written option because the retained beneficial interest is subject to downside risk from credit exposure and has limited upside potential. Derecognition is precluded to the extent of an amount that the transferor could lose related to the transferred assets.

Total return swaps. A transferor may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the transferor in exchange for a fixed payment or variable rate payment and any increases or declines in the market value of the underlying asset are absorbed by the transferor. Although a total return swap is a cash settled derivative, the transferor could potentially be required to compensate the transferee for a loss of the entire amount of the underlying principal in the event, no matter how remote, of a loss. Accordingly, derecognition is prohibited.

Amortising interest rate swaps are OK. A transferor may transfer a fixed rate financial asset that is paid off over time to a transferee and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount outstanding of the transferred financial asset at any point in time. The amortising interest rate swap

does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset.

EXAMPLE FROM THE ED OF A SALE OF A PORTION OF A FINANCIAL ASSET WITH SUBORDINATION

The following example from the ED illustrates the application of the derecognition principles of the Standard when a portion of a financial asset is derecognised and the other portion continues to be recognised. In that case, the carrying amount of the asset is allocated between the portion that is derecognised and the portion that does not qualify for derecognition.

Company A originates 10,000 of loan assets. The loans have an effective yield and coupon of 11 per cent. Company A later transfers the loans to a special purpose entity (SPE) that it controls and consolidates. The SPE sells a portion of the total principal amount of the loans to investors in the form of beneficial interests that meet the conditions for accounting as a 'pass-through' arrangement under IAS 39 (paragraph 41). Under the terms of the sales agreement, the investors purchase 90 per cent of the principal with interest at 6 per cent for net proceeds of 9,000. The SPE retains the remaining 10 per cent of the principal and the excess interest of 5 per cent due on the underlying loans that were sold to the investors. The SPE continues to have responsibility for servicing activities related to the loan assets. The excess interest consists of a servicing fee of 1.75 per cent and an interest-only strip of 3.25 per cent. The SPE subordinates its residual interests in the loans and the interest-only strip on a first-loss basis to the 90 per cent portion sold to the investors and pledges these residual interests as collateral to the investors.

The fair value of the portion of the loans sold is the net proceeds obtained of 9,000. There is no quoted market price for the interest-only strip and residual interests in the loans that are held by the SPE and for the servicing asset, and there is no sales transaction history of similar assets to serve as a basis for estimating their fair values. Dealer quotations are available, however, for loans that are similar to the underlying loans that are the subject of the sale. Based on such quotations, Company A determines that the fair value of the underlying loans is 10,100 at the transfer date.

The SPE therefore estimates the fair value of its residual interests in the loans as 1,100, representing the difference between the estimated fair value of the underlying loans of 10,100 and the net proceeds it receives of 9,000.

The SPE allocates the carrying value of its loans between the portion transferred and the portion retained as follows:

Table 1	Estimated Fair Value	Percentage of Total	Allocated Carrying Value
Underlying loans	10,100	100%	10,000

Now Company A must determine the relative value of each of the components of its total retained interest of 1,089. Although the SPE has estimated the fair value of its residual interest of 1,100 based on the fair value of the underlying loans less proceeds, it also estimates the 'stand-alone' fair values of the components that constitute its retained interest (a total of 1,304), as a means of allocating its remaining basis to those components.

The SPE estimates the fair value of the servicing, subordinated interest-only strip, and subordinated residual interest and allocates the retained interest of 1,089 to these assets based on their relative fair values as follows:

Table 2	Estimated "Stand-Alone" Fair Value	Percentage of Total	Allocated Carrying Value
Total retained interests	1,304	100.00 %	1,089

Because of its continuing involvement, the SPE essentially now must reverse a portion of the sale and recognise a related portion of the proceeds as a borrowing.

The SPE reduces the amount transferred by the allocated carrying value of the retained interests of 879 from table 2 above: (406 for the interest-only strip and 473 residual) that are subordinated to the portion of the loans that were transferred. The SPE allocates the proceeds of 9,000 to the portion derecognised and the portion that continues to be recognised based on the allocated carrying amounts of the subordinated interests that do not qualify for derecognition and the remaining portion that is derecognised. The portion that is derecognised is the amount that is not subject to being reacquired by the SPE. The allocation is as follows:

Table 3	Allocated Carrying Amount	Percentage of Portion Transferred	Allocation of Proceeds	Gain on Sale
Portion derecognised	8,032	90.14%	8,112	80

COMPARISON OF IAS EXPOSURE DRAFT AND FASB 140

	IASB Exposure Draft	US FASB 140