Article

Accounting for Structured Covered Bonds

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Accounting treatment of Structured Covered Bonds

What is a covered bond?

Covered bond is a security that provides on-balance sheet funding of assets. Covered bonds provide recourse to both the issuer's credit and a "cover pool" of high quality assets that are insulated or "ring-fenced" from the issuer's insolvency. The other creditors have access to cover-pool assets only if and when the covered bonds have been paid in full.

Here we will be discussing the accounting treatment of structured covered bonds. The structure for the covered bonds, the accounting of which we would be discussing here, has been described in the following paragraphs.

The entity issuing the covered bonds is regarded as the issuer/originator. The issue of covered bonds will be collateralized against a portfolio of assets of the issuer and the same will be ring fenced for the purposes of repayment of the covered bond. The issuer will assign the cover pool assets by way of a full recourse assignment to the SPV. The assignment will be by way of conditional sale assignment agreement. The agreement to assign has specific Trigger Events. On the happening of any of the Trigger Events, the agreement to assign will automatically and mandatorily convert itself into a complete assignment. The risks in the Cover pool including but not limited to default, prepayment or partial prepayment risk are retained by the Issuer. The consideration for assignment shall be the sum total of all Receivables, that is, Principal Outstanding and Interest of the Cover Pool. The SPV shall discharge the consideration by allowing the Issuer to retain all collections from the Receivables. That is to say, when the last receivable in the Cover Pool is collected, the entire deferred sale consideration will stand discharged. The payment of sale consideration by the SPV is subordinated, that is to say, in case of any Trigger Events, the cashflows from the Cover Pool assets will first be used to make payment of Coupon and Principal to the Covered Bonds, and the residual, if any, will be paid to the Issuer. As and when the receivables forming part of the Cover Pool are recovered they shall be retained by the Issuer and will go to pay the deferred sale consideration. On happening of the Issuer's Event of Default or Early Redemption Events, the Issuer shall immediately cease to have any right to retain the collections from Cover Pool assets. The receivables will be diverted to the SPV. The collections from the Cover Pool will be used to pay off the Bondholders in the Waterfall mechanism. Once the Issuer's Event of Default or Early Redemption Events has occurred, the transaction will become a conditional pass-through. The covered bonds will be collateralized against cash flows derived from the underlying mortgages or loans (the cover assets pool) as well as the general-business cash flows of the originator. Hence, covered bonds provide a dual recourse, both against the issuer and against the underlying collateral pool.

In case of a structured covered bond transaction, the credit risk of the underlying assets pool is optimally absorbed by overcollateralization (i.e. the book value of the underlying

pooled assets, after credit provisions, exceeds the notional value of the covered bonds). Th issuer needs to ensure that the outstanding covered bonds are being over collateralized by the required minimum amount of over-collateralization ratio. The issuer is required to maintain the cover pool of collateral dynamically throughout the term of the issuance and the same must be replenished with new assets to maintain a specified credit quality. The criteria of over-collateralization principle must be satisfied not only at the time of issuance but also during the entire covered bonds program lifespan. The over-collateralization ratio must be maintained at all times at the required minimum degree during the lifetime of covered bonds program.

Accounting treatment for covered bonds could be studied from three perspectives –

- From the point of view of issuers
- From the point of view of the Special Purpose Vehicle (i.e. bankruptcy remote entities)
- From point of view of the issuer

The accounting treatment of the covered bond will be governed by the provisions of IFRS 9. IFRS 9 is effective for annual periods beginning on or after 1st January 2018. However one may voluntary adopt IFRS 9 before the said effective date. IFRS 9 replaces IAS 39.

In regard to accounting for liabilities, major changes have not been introduced by IFRS 9. The accounting treatment as required by IAS 39 in respect of the financial liabilities, has been in essence retained by IFRS 9.

The accounting has been discussed under the following paragraphs –

Accounting treatment of covered bonds by the issuer

Initial recognition, classification and measurement

As per para 3.1.1 of IFRS – 9, a financial liability is recognized by an entity when it becomes a party to the contractual provisions of the instrument. (For eg. Unconditional payables are recognized as liabilities when the entity becomes a party to the contract and as a consequence has a legal obligation to pay cash).

At the first time recognition of a financial liability, the classification of the same is to be done as per para 4.2.1 and 4.2.2 and the measurement is to be done as per para 5.1.1 of IFRS 9.

By virtue of para 4.2.1 and 4.2.2, the following two options are available to an entity for the purpose of accounting the covered bonds issued by it –

1. The financial liability towards the covered bond issue can be measured at **amortised cost** by the entity; or

2. The entity may irrevocably designate a financial liability as measured **through profit or loss**. [Para 4.2.2]

Since in case of issue of covered bonds, the issuer will hold the liability for the entire period of it, the accounting for covered bonds issue will be done as per the amortised cost method As per para 5.1.1 of IFRS 9, the financial liability shall be initially measured at its fair value plus or minus the transaction costs that are directly attributable to the acquisition or issue of the financial liability.

However, if there is a substantial difference between the fair value of the financial liability and its transaction price, an entity shall apply para B5.1.2A of IFRS – 9.

As per para B5.1.2A, if as per the entity the fair value of the financial liability at the time of initial recognition differs from the transaction price, the accounting for the instrument at that date will be as under –

- If the fair value, as required by para 5.1.1, is evidenced by a quoted price in an active market for an identical liability or based on a valuation technique that uses only data from observable markets, the difference between fair value at initial recognition and the transaction price should be recognized as a gain or loss.

- In other cases, the measurement as required by para 5.1.1 should be adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognize that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the liability.

Subsequent measurement

The subsequent measurement of the covered bonds will be done as per the amortised cost method (Para 4.2.1).

Interest expense shall be calculated by using the effective interest method. The same is calculated by applying the effective interest rate to the gross carrying amount of the financial liability.

The covered bond issued by an entity is recognized as a liability and is classified under debt.

Derecognition

The issue of covered bonds is secured by a portfolio of the financial assets of the issuer. The said portfolio of the financial assets is not derognised from the financials of the issuer, because all the risk and rewards of the financial assets is retained by the issuer himself.

This can be further understood in reference to the criteria for derecognition set out in IFRS – 9.

Para 3.2 of IFRS 9 deals with derecognition of financial assets. As per para 3.2.3, an entity shall derecognize a financial asset only if any of the following conditions are satisfied –

a. the contractual rights to the cash flows from the financial asset expire, or
b. it transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6.

Para 3.2.4 and 3.2.5 lay down the criteria as to when a financial asset will be regarded as transferred.

As per para 3.2.4, an entity shall be said to have transferred a financial asset, if the said transfer fulfills any of the following criteria –

a. If the contractual right to receive the cash flows of the financial asset is transferred; or
b. The contractual rights to receive the cash flows of the financial asset is retained by the entity, but it assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 3.2.5.

For the purposes of para 3.2.4.b Para 3.2.5 sets out the conditions as to when it can be said that a transfer of financial asset has happened in an arrangement where, the contractual rights to receive the cash flows of the financial asset is retained by the entity, but it assumes a contractual obligation to pay the cash flows to one or more recipients in the arrangement. In such an arrangement, a transfer of a financial asset happens on the fulfillment of all of the following conditions –

a. The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.
b. The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
c. The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IAS 7Statement of Cash Flows) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

Para 3.2.6 lays down the situations when a financial asset should continue to be recognized or when should it be derecognized from the balance sheet of the transferor of the financial asset. Para 3.2.6 has been reproduced below –

"When an entity transfers a financial asset (as per para 3.2.4), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

a. *if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.*
b. *if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.*
c. *if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:*
   i. *if the entity has not retained control, it shall derecognize the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.*
   ii. *if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset."*

The portfolio of assets secured towards the covered bond issue by the issuer would fall under the category of transfer, where substantially all the risks and rewards of ownership of the financial asset is retained by the entity. As per para 3.2.4.b, such a transfer of financial asset will not qualify for derecogniton from the books of the transferor.

Journal entries in the books of the issuer where there is no trigger event or default occurring

1. *At the time of issuance of covered bonds*

   Bank A/C…………………………………………………….Dr
   To, Covered Bonds A/C

   The initial recognition of the financial liability towards covered bonds is to be done at transaction price or the fair value plus the eligible transaction costs as the case may be.

2. For the purposes of accounting of subsequent measurement of the financial liability towards the covered bonds, the following entries need to be passed as per the amortised cost using the effective interest rate –

   Transfer of interest amount to the financial liability

   Interest on Covered Bond A/C………………………Dr
   To, Covered Bonds A/C
   At the time of payment of interest amount

Covered Bonds A/C……………………………..Dr
To Bank A/C

Transfer of the interest expense to profit and loss account

Profit and loss A/C………………………………….....Dr
To, Interest on Covered Bonds A/C

At the time of final repayment of the financial liability towards covered bond

Covered Bonds A/C…………………………………..Dr
To, Bank A/C

Balance sheet presentation of the issue of covered bonds by the issuer

Liabilities	$	Assets	$
Debt securities in issue Covered Bonds	[******]	**Loans and advances** Receivables (Cover Pool)	[******]

Included within the loans and advances are [Rs ***] (2014: Rs [***]) of mortgages assigned to a bankruptcy remote structured entity, [Name of the entity] LLP (note [*]). These loans provide security for issues of covered bonds made by the entity. These transactions do not qualify for derecognition from the balance sheet. At [date] there were [Rs **] (2014: Rs [*]) of covered bonds in issue under the covered bond programme, of the entity.

Journal entries in the books of the issuer where trigger event or default is occurring

1. At the time of issuance of covered bonds

   Bank A/C…………………………………………………….Dr
   To, Covered Bonds A/C

   The initial recognition of the financial liability towards covered bonds is to be done at transaction price or the fair value plus the eligible transaction costs as the case may be.

2. For the purposes of accounting of subsequent measurement of the financial liability towards the covered bonds, the following entries need to be passed as per the amortised cost using the effective interest rate –

   Transfer of interest amount to the financial liability

   Interest on Covered Bond A/C……………………….Dr
   To, Covered Bonds A/C

   At the time of payment of interest amount

   Covered Bonds A/C……………………………...Dr
   To Bank A/C

   Transfer of the interest expense to profit and loss account

   Profit and loss A/C……………………………………...Dr
   To, Interest on Covered Bonds A/C

   At the time of trigger event/default

   The ring fenced assets will be transferred to the SPV

   SPV A/C……………………………………………………...Dr
   To, Loans and advances A/C

   On discharge of the liability towards covered bond by the SPV from the cash flows of the cover pool assets

   Covered Bonds A/C……………………………………..Dr
   To, SPV A/C

   Receipt of the overcollateralization amount from the SPV

   Bank A/C…………………………………………………...Dr
   To, SPV A/C

Balance sheet presentation of the issue of covered bonds by the issuer in case of trigger event/default

Liabilities	$	Assets	$

Debt securities in issue Covered Bonds	[******]	**Non-current Assets** SPV	[******]

Disclosures in the financials of the issuer

IFRS 7 deals with the disclosures to be made in the financial statements in respect of financial instruments. Users of financial statements should be provided with information as regards the risks to which an entity is exposed and how the same is managed. IFRS 7 applies to all the risks arising from financial instruments.

As per para 8 of IFRS 7, the carrying amount of the financial assets and liabilities need to be disclosed either in the statement of financial position or in the notes.
As per para 14, an entity shall disclose the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities and the terms and conditions relating to its pledge.

As per para 20, an entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:

- net gains or net losses on financial liabilities measured at amortised cost.
- fee income and expense (other than amounts included in determining the effective interest rate) arising from financial liabilities that are not at fair value through profit or loss.

As per para 21, an entity shall disclose in accordance with para 117 of IAS 1 *Presentation of Financial Statements,* its significant accounting policies comprising the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

As per para 39, in respect of *liquidity risk,* an entity shall disclose a maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities a description of how it manages the liquidity risk inherent in it.

As per para 42B, the entity shall disclose information that enables users of its financial statements to understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities.

Para 42D of IFRS – 7 lay down the disclosure requirements in respect of transferred financial assets that are not derecognized in their entirety. As per the said para, an entity is required to make the following disclosures at each reporting date for each class of transferred financial assets that are not derecognized in their entirety: -

a. *the nature of the transferred assets.*
b. *the nature of the risks and rewards of ownership to which the entity is exposed.*
c. *a description of the nature of the relationship between the transferred assets and the associated liabilities, including restrictions arising from the transfer on the reporting entity's use of the transferred assets.*
d. *when the counterparty (counterparties) to the associated liabilities has (have) recourse only to the transferred assets, a schedule that sets out the fair value of the transferred assets, the fair value of the associated liabilities and the net position (the difference between the fair value of the transferred assets and the associated liabilities).*
e. *when the entity continues to recognise all of the transferred assets, the carrying amounts of the transferred assets and the associated liabilities.*
f. *when the entity continues to recognise the assets to the extent of its continuing involvement the total carrying amount of the original assets before the transfer, the carrying amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.*

Accounting treatment by the Special Purpose Vehicle (i.e. the bankruptcy remote entity)

In order to secure the covered bonds, ring fenced assets or cover pool are transferred to the special purpose vehicle (SPV), which is a bankruptcy remote entity. The sale of the assets is done such that it qualifies to be a legal sale but not a sale in terms of accounting standards. The special purpose vehicle (SPV) holds the title to the assets or the cover pool. The SPV typically acts as a guarantor.

In the present structure, the SPV buys the cover pool assets but the price for the same is kept unpaid – by way of a deferred purchase price.

Backed by the cover pool, the SPV provides a guarantee to covered bondholders for the payment of interest and principal on the covered bonds, which becomes enforceable if the issuer defaults. The guarantee represents an irrevocable, direct and unconditional obligation of the SPV and is secured by the cover pool.

If issuer bankruptcy event takes place, the SPV's guarantee to the bondholders kicks-in. At this stage, the SPV attaches the collateral lying with the issuer. The claims of the bondholders are paid from the cover assets. In case of a deficiency, the bondholders will have an unsecured receivable from the issuer.

The issuer continues to collect and service the cash flows from the cover pool (i.e.mortgage loans). As there is a mismatch between the payments from the mortgage pool and the payments on the bonds, the issuer is allowed to (a) retain the collections from the pool; and (b) make payments towards the bonds in excess of collections from the pool.

The transfer of the beneficial interest in the cover pool assets from the issuer to the special purpose vehicle does not meet the dercognition criteria as laid down under IFRS 9. The issuer does not transfers all the risks and rewards associated with the cover pool assets and therefore continues to recognize the same in its financial statements. As no transfer occurs for accounting purposes, the transfer of beneficial interest is not recognized in the financial statements of the SPV.

The financials of the SPV gives a brief description of the structure of the covered bond issue in its financials. In the description, the SPV states that the securities are issued by the originator and the SPV is acting as a guarantor.
The SPV gives a disclosure for the financial guarantee it provides to the issuer as to payments of interest and principal under the covered bonds where the amounts would otherwise be paid by the originator.

Accounting by the investor

The investment made in the covered bond by the investor will be accounted for as per the provisions of IFRS 9. The investment in covered bonds will be recgnised as a financial asset by the covered bond investor (hereinafter referred to as "investor").

As per para 4.1.1 of IFRS 9, the entity may classify the financial asset either as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

a. the entity's business model for managing the financial assets and
b. the contractual cash flow characteristics of the financial asset.

Taking the assumption that the investor will hold the covered bonds for the entire life of the instrument, the same will be accounted for at amortised cost. Para 4.1.2 of IFRS 9 lays down the condition as to when a financial asset will be accounted for at amortised cost. The same has been reproduced as under –

> *"A financial asset shall be measured at amortised cost if both of the following conditions are met:*
> *a. the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and*
> *b. the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding."*

As per para 5.4.1, interest revenue shall be calculated by using the effective interest method. The same is calculated by applying the effective interest rate to the gross carrying amount of the financial asset.

Journal entries in the books of the investor

1. *At the time of investment*

   Investment in covered bonds A/C……………………………………………Dr
   To Bank A/C

2. *At the time of recognition of interest income*

   Investment in covered bond A/C………………………………………………Dr
   To, Interest on covered bond A/C

3. At the time of recognition of interest income to profit and loss account

   Interest on covered bond A/C………………………………………………..Dr
   To, Profit and loss A/C

4. *At the time of receipt of interest income and principal repayment from the issuer/SPV*

   Bank A/C………………………………………………………………………………Dr
   To Investment in covered bonds A/C

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