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14. October 2002

<u>Proposed Amendments to the IAS 39, Financial Instruments: Recognition and Measurement</u>

1.1 The European Securitisation Forum ("ESF") welcomes this opportunity to comment on the International Accounting Standards Board's ("IASB") proposed amendments to the IAS 39, Financial Instruments: Recognition and Measurement, published in the recent Exposure Draft. Our response is part of our continuing dialogue with the IASB and we very much appreciate the time that members of the Board and IASB-staff have given the ESF, both before and during the course of the comment period to discuss some of the specific proposals of the IAS 39 Exposure Draft, and, more importantly, clarify their intended interpretation and application. We hope that we can continue this constructive dialogue and that we can be of assistance to the IASB going forward.

1.2 The ESF is an organisation which brings together securitisation market participants throughout Europe in order to promote the efficient growth and continued development of securitisation, and to advocate the positions, represent the interests, and serve the needs of its members. Membership of the ESF comprises over 80 firms from across Europe who are active participants in the growing European securitisation market, including securities firms and banks (arrangers), issuers and asset originators, investors and asset managers, trustees, servicers, rating agencies, law firms, accounting firms, financial guarantors, stock exchanges and industry utilities, information vendors, suppliers and financial consultants, and other financial and professional service organisations. The securitisation market has an important role in Europe, as a funding source and as a liquidity and credit risk management tool for banks. It has grown considerably in recent years, with issuance volume of approximately €153.6 billion in 2001[1].

1.3 In the ESF's recently published Whitepaper, entitled "*A Framework for European Securitisation*", three underlying accounting objectives were identified:

- To have accounting standards that recognise the economic impact of a securitisation transaction on a clear and consistent basis without significant divergence between different standard setters.

- To have accounting standards that provide a clear and consistent conceptual framework that ensures clarity of treatment, but also provides the ability to deal with non-standard transactions that may not be suitably covered by a more detailed approach.

- To have accounting standards that require disclosure of sufficient specific information in the financial statements of an originator/transferor to facilitate the users' understanding of the economic impact of a securitisation transaction.

Our comments below are written with these objectives in mind.

1.4 The key points we wish to emphasise and draw to your attention are set out in paragraphs 2.1 to 7.2 below. The matters that we raise in the letter below take into account the clarifications that were provided by members of the IASB and senior staff during our meeting of 12. September 2002.

1.5 Our detailed responses to the questions set out in the Exposure Draft are given in Appendix I to this letter. We have also provided in Appendix II, four examples of common securitisation transactions, which include some of the issues that are presented by the current wording of the IAS 39 Exposure Draft. Throughout the body of this letter and in Appendix I references to these examples are made.

2. The Interaction of IAS 39 with SIC 12

2.1 We recognise that the question of derecognition and the question of which entities should be consolidated are separate accounting issues. However, from a securitisation perspective, it is their interaction that is crucial. Thus, we wish to emphasise that for the securitisation industry both IAS 39 (derecognition) and SIC 12 (consolidation) are vital in determining the ultimate treatment of a transaction. The position taken in SIC 12 gives rise to many instances in which derecognition may be achieved at the originator level but, the assets and liabilities of the SPE are consolidated at the group level. We want to ensure that financial statements accurately reflect the economic impact of securitisation transactions for the entities involved. Thus, we believe that SIC 12 needs to be reconsidered as a matter of urgency, as highlighted in our letter to the IASB on 17. May 2002.

3. The Principle of Continuing Involvement – and the Resulting Measurement

[1] Figure taken from the ESF Securitisation Data Report issue, Spring 2002, which is available on ESF's website www.europeansecuritisation.com

3.1 Continuing involvement is a relatively new conceptual approach. We believe it is helpful in moving the debate on from some fairly entrenched views and, if modified, could have advantages over the existing IAS 39 regime. We support the approach taken of setting out principles rather than detailed rules. Nevertheless, we have significant concerns as to how continuing involvement is measured under the proposals. Equally, we have some reservations about the principle itself, as we have yet to see it in practical application.

We therefore believe that a great deal more work needs to be done and we are yet to be convinced that continuing involvement is a long-term solution. At the same time we recognize the time constraints that the IASB has been placed under and would urge a number of changes to ensure that IAS 39 is practical and workable until a more permanent solution is adopted.

We would be happy to work with the IASB in developing a more permanent solution that reflects the underlying accounting objectives set out in paragraph 1.3.

3.2 We believe that the measurement of the continued involvement in an asset needs to be based on the economics of a transaction and those elements that are likely to occur in practice rather than the maximum possible exposure of an entity to the transferred assets.

3.3 We do not agree with the measurement of residual interests as set out in the example commencing at paragraph B4 of the IAS 39 Exposure Draft. This suggests that the transferor has two assets, the original assets that have failed derecognition and the subordinated interest in the assets. We understand from our meeting with the IASB members that this was intentional.

The economic substance of the transaction is that the entity is exposed to the assets only to the extent of the subordinated interest. Accordingly, to recognise two assets in this instance misleads the user as to the exposure of the entity.

In addition, we do not understand what would be the subsequent accounting entries in the transferor's books when the transferor either receives cash or there is a default on the underlying asset. Is the cash write-down applied to the assets that failed derecognition or to the subordinated interests, or indeed, both with a corresponding reduction in the liability?

3.4 We are also concerned with the treatment of guarantees. The recording of a guarantee at its maximum amount may bear no relation to the commercial likelihood of the guarantee being required. Recording the continuing involvement at the fair value of the guarantee (with disclosure of the potential maximum amount), would provide a clearer indication of the exposure of the entity to the user and is consistent with the move toward fair value. This would provide a balance sheet that is based on commercial reality while providing the reader with the potential worst case scenario by way of the notes.

3.5 In addition, the treatment of those assets which continue to be recognised as a result of call- or put-options, leads to some anomalous valuations of assets and liabilities in particular, where the options are deep out-of-the money. It further causes potentially significant balance sheet volatility. We additionally feel that a "right of first refusal" which does not preclude derecognition is economically identical to assets subject to fair value options, the accounting treatment should reflect this.

3.6 As a general point, throughout the Exposure Draft, illustrative accounting at the date of a transaction is given, but there is rarely any guidance in relation to subsequent accounting entries. We feel that examples of the accounting entries subsequent to the transaction date and also guidance on the appropriate accounting for the transferee would be useful to practitioners as this is not necessarily intuitive.

4. Deferred Consideration

4.1 Many securitisations lead to the originator retaining some upside in the asset pool, often in the form of an excess spread or deferred consideration. As it cannot be certain which assets will give rise to this excess spread or deferred consideration, arguably the transferor has a continuing involvement in all assets and, under the current proposals, should therefore continue to recognise all assets.

4.2 We do not support such treatment. It does not represent the economic benefit or exposure of the originator to those transferred assets. We favour continued recognition of the asset only to the extent of the substance of the originator's continuing involvement. We would regard this as the fair value of any deferred consideration that may arise rather than the full value of the assets transferred.

5. Pledging of Assets Back to the Transferor

5.1 The pledge of collateral against a derivative is a normal market practice. In a number of securitisation transactions the transferee will pledge some or all of the transferred assets back to the originator as collateral in connection with, for example an interest rate swap. In the case where the asset was previously owned by the transferor, the IAS 39 Exposure Draft, as we understand it, precludes derecognition.

5.2 We disagree with this treatment on the basis that the transferor's continuing involvement in the asset is dependent on the default of the transferee. Accordingly, the transferor's exposure to the asset only occurs in the instance of default. We believe that a clearer indication of the economic exposure of the transferor would result from derecognition of the asset and recognition of the separate derivative transaction. Indeed, the value of the derivative transaction will incorporate the existence of the pledged collateral when there is a likelihood of default by the transferee.

5.3 A similar situation arises in a credit linked note transaction (see Appendix II example 4) in which the originator sells bonds to an SPE but accepts these bonds back as security against the credit default swap that has simultaneously been entered into by the parties. The originator has no right to receive the movements in value on those assets and has no right or obligation to repurchase them. The only way that the assets will return is via a default, and hence any continuing involvement is contingent on that event.

6. Pass-Through Arrangements

6.1 The ESF has reservations regarding the concept of pass-through arrangements and the different results that may arise from their application to securitisation transactions.

6.2 The current wording of the IAS 39 Exposure Draft is likely to lead to many instances where the originator records only its continued involvement in an asset, but the SPE records all the transferred assets. Consequently, on consolidation, there is very little impact of the securitisation transaction. Our objective is to ensure that the accounting reflects the economic substance of the transaction at the group, originator and SPE level.

6.3 During our meeting of 12. September 2002, some of the members of the IASB suggested that it was their intention to allow many securitisation transactions to meet the pass-through tests. Whilst we support the consolidated position that would arise on consolidating an SPE that has no assets or liabilities, we do have conceptual concerns that an SPE that has, for example, issued public notes, has a balance sheet that is virtually empty. At a minimum, we believe it is essential that the financial statements provide sufficient disclosure of the nature of the transaction that has taken place. We also reiterate that this highlights the need for an immediate revision of SIC 12 as we, in principle, do not think that the pass-through arrangements should serve as a substitute for dealing with what is a consolidation problem under SIC 12.

6.4 However, the current wording of paragraph 41 will result in most SPE's failing the derecognition criteria and lead to all assets and liabilities remaining on their balance sheet. For example, those transactions that make use of a liquidity facility or swap to make payments to investors or where there is a delay in passing on cash-flows from the underlying assets to the investors.

6.5 Accordingly, the wording of the pass-through paragraphs needs to be amended. We would suggest that there needs to be a clear distinction depending on whether the "transferor" is the originator or an SPE. Where it is the latter, we suggest that the SPE is permitted to use all its available cash flows to make payments, to sell or pledge the assets and hold any cash flows for a period of time and invest in risk-free assets provided that:

- Such actions are primarily for the benefit of the investors and not the transferor; and
- The actions of the SPE are predetermined and set out in the transaction documentation; and
- Such actions do not utilize any additional assets or cash flows of the transferor.

7. Retrospective Application

7.1 We request that the IAS 39 derecognition criteria is not applied retrospectively if this requires "*undue cost and effort*" or, if it is practically impossible for the reporting entity to retrospectively apply due to a lack of available information. We note that the previous version of the IAS 39 did not require retrospective application and would request that the same approach be applied going forward.

7.2 We recognise that where securitisation structures are revolving and an exception on the basis of undue cost or practical impossibility has been taken, this should not allow the reporting entity to apply the current IAS 39 to future additions to these structures.

The ESF is currently working on a "Green Paper" which discusses the various accounting treatments in key jurisdictions. This Paper will hopefully serve as a basis for determining a preferred accounting approach and drive the harmonisation process forward.

We appreciate the IASB's attention to the matters which we have raised. We would like an opportunity to discuss these issues further with the IASB and to work with you in drafting any proposed amendments. In the meantime, should you have any questions or, if we can be of any assistance please contact Scott Rankin, Executive Director European Office, on +44.20.77 43 93 00.

Yours faithfully,

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Appendices

Appendix I : Detailed answers to questions posed in the IAS 39 Exposure Draft

Appendix II : Detailed examples showing application of the IAS 39 Exposure Draft to typical structures and the problems arising building on our 4 securitisations of:

- Residential Mortgages
- Collateralised Debt Obligations
- Trade Receivables
- Credit Linked Notes

Appendix I

In this Appendix we have addressed those questions on which comments have been invited by the IASB. Throughout, we have referred to practical examples of securitisation where possible and for reference, have provided a detailed analysis of four examples in Appendix II.

1. Question 1 – Scope: Loan Commitments (paragraph 1(i))

1.1 The ESF has no comments on this question.

2. Question 2 – Derecognition: Continuing Involvement Approach (paragraph 35-57)

Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

2.1 Across the European securitisation market, there are a range of views as to the preferred approach for derecognition of securitised financial assets under the IAS 39, including proponents of the risks and rewards, control and financial components approaches.

Continuing involvement is a relatively new conceptual approach. It is helpful in moving the debate on from some fairly entrenched views and, if modified, could have advantages over the existing IAS 39 regime. We support the approach taken of setting out principles rather than detailed rules. Nevertheless, we have significant concerns as to how a continuing involvement is measured under the proposals. Equally, we have some reservations about the principle itself, as we have yet to see it in practical application.

We are yet to be convinced that continuing involvement is a long-term solution. At the same time we recognise the time constraints that the IASB has been placed under and would urge a number of changes to ensure that IAS 39 is practical and workable. We would be happy to work with the IASB in developing a more permanent solution that reflects the three underlying accounting objectives as set out in paragraph 1.3 of the main letter.

2.2 We believe that the measurement of the continued involvement in an asset, needs to be based on the economics of a transaction and those elements that are likely to occur in practice rather than the maximum possible exposure.

There appears to be a contradiction in requiring an entity to record an asset based on its maximum possible exposure and the propensity of "fair value" set out in the remainder of the IAS 39 Exposure Draft.

2.3 The following examples demonstrate our concern with the proposed measurement approach:

a. In the securitisation of trade receivables, it is not unusual for the originator to guarantee the first loss of the portfolio as a result of credit default. In this instance the guarantee can often be greatly in excess of the expected and likely potential default on the assets in order to provide comfort to the note holder investors.

Whilst we do not object to the principle of continuing to recognise those assets in which the originator has a genuine continuing involvement, it may, under the proposed guidance, lead to continued recognition of assets that economically present no exposure to the entity.

b. In many securitisations such as a residential mortgage transaction, the originator retains some upside in the asset pool often in the form of an excess spread or deferred consideration. As it cannot be certain which assets will give rise to this excess spread or deferred consideration, under the current wording in paragraph 39 of the IAS 39 Exposure Draft, the transferor has arguably a continuing involvement in all assets and should continue to recognise all assets.

We do not support such treatment. It does not represent the economic benefit or exposure of the originator to those transferred assets. We favour continued recognition only to the extent of the substance of the continuing involvement which we regard as the fair value of any deferred consideration that may arise (see Example 1 in Appendix II).

c. The example commencing at paragraph B4 of the IAS 39 Exposure Draft, suggests that where an originator retains an economic interest in a portion of assets through for example, the purchase of a subordinated interest, then the originator has two assets; i) the original assets that have failed derecognition, and ii) the subordinated interest in the assets. Such features are common in, amongst others, trade receivables and residential mortgage securitisations (see examples 1 and 3 in Appendix II).

The economic substance of the transaction is that the entity is exposed to the assets only to the extent of the subordinated interest. Accordingly, to recognise two assets in this instance, misleads the user as to the exposure of the entity.

In addition, we do not understand what would be the subsequent accounting entries in the transferor's books, when the transferor either receives cash or there is a default on the underlying asset. Is the cash write-down applied to the assets that failed derecognition or to the subordinated interests or indeed both with a corresponding reduction in the liability?

For example, if the transferor has a subordinated interest asset of 879 (as in the example) and the original asset retained at 879, if a 50% write-down of the value of the receivables occurs, is this applied to only one of these "assets" (and if so, which one) or is it applied to both with an offsetting reduction in the value of the liability arising out of the "failed sale"?

Furthermore, the liability that results from the above does not in fact represent an obligation of the entity to transfer economic benefit.

2.4 Following on from our comments above we believe that throughout the Exposure Draft illustrative accounting at the date of a transaction is given, but there is rarely any illustration of subsequent accounting entries. We feel that examples of the accounting entries subsequent to the transaction date would be useful to practitioners as this is not necessarily intuitive as illustrated in 2.3 above.

2.5 Some securitisation transactions involve the originator granting an option over some or all of the assets. The proposed treatment of assets that continue to be recognised as a result of options leads in our view, to anomalous and misleading results. For example, a deep out-of-the-money call would lead to a significant grossing up of the balance sheet, despite the fact that it is highly unlikely that the option will ever be in the money. Subsequently, the significant grossing up of the balance sheet will be followed by an immediate deflation of the balance sheet when the option expires unexercised.

In addition to our concerns in respect of the grossing up and volatility of the balance sheet arising out of such "failed sales", we believe that the grossed up asset value less the liability does not truly reflect the economic risk to which the entity is exposed. Although it may be an approximation of the value of the derivative instrument, such instruments are firstly measured on a net basis and we do not expect users to understand the results arising from this treatment, and secondly, the net position of the asset and liability fails to include the credit risk on the derivative to which the entity is exposed.

This treatment will also give rise to the situation where the collateralized liability shown by the transferor bears no relation to the loan asset recorded by the transferee in relation to the cash paid for the asset. This is because the cash payment will be lower, for example, than the option strike price on an asset sold with a retained call option. This is inconsistent with what we perceive to be the attempt in paragraphs 28 and 56 of the Exposure Draft to ensure that the accounting of the transferor and transferee mirror each other. As a general point we believe it would be useful to provide more guidance on the appropriate accounting for the transferee.

We are also of the opinion that to continue to recognise an asset that is subject to a fair value option is not appropriate. The entity has no contract or right that meets the definition of an asset or a liability. A "right of first refusal" does not preclude derecognition and is economically identical to assets subject to fair value options. We therefore believe that assets sold with fair value options should achieve derecognition.

2.6 There are a number of securitisations where the transferee pledges some or all of the transferred assets back to the originator as collateral in connection with for example an interest rate swap.

Another example is the credit linked note transaction (see Example 4 in Appendix II) in which the originator sells bonds to an SPE but accepts those bonds back as collateral against the credit default swap that has simultaneously been entered into by the parties. The originator cannot control those assets nor receive the movements in value on those assets. The only way that the assets will return is via a default by the SPE and hence, any continuing involvement is contingent on that event.

Under the current IAS 39 Exposure Draft, it appears that the transferor would be considered as having a continuing involvement in the entirety of the asset. We disagree with this treatment on the basis that the transferor's continuing involvement in the asset is incidental to the initial transfer of the asset and is dependent on the default of the transferee in a separate transaction. We believe that a clearer indication of the economic exposure of the transferor would result from derecognition of the original asset and recognition of a new asset, if appropriate at fair value of the derivative instrument, which will reflect the value of the pledged collateral when there is a likelihood of default by the transferee.

2.7 Paragraph A9(p) requires that "payments on the swap are not conditional on payments being made on the transferred asset". There are many securitisations where an SPE relies on the cash-flows from the transferred assets to make the swap payments. Where the transferor is also the swap counterparty this would seem to require continued recognition of the asset. We do not believe this is appropriate.

2.8 Under the proposed approach, many securitisation transactions could lead to a "*gain on sale*" for the originator. As noted in paragraph 51 of the ED the "*gain on sale*" will potentially be subject to significant judgment in instances where the assets are not easily valued. We do not suggest that this argues against gain on sale treatment, but highlights the need for judgment in presenting the economic substance of transactions and supports our views for the fair value of interalia guarantees and options discussed above.

3. Question 3 – Derecognition: Pass-Through Arrangements (paragraph 41)

Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

3.1 The ESF has reservations about the concept of pass-through arrangements and the results that may arise from their application to securitisations.

3.2 We believe that based on the current wording of the IAS 39 Exposure Draft there will be many securitisation transactions where the originator records only its continued involvement in an asset but the SPE records all of the transferred assets. Consequently there is very little impact of the securitisation transaction at a consolidated level. Our objective is to ensure that the accounting reflects the economic substance of the transaction at the group, originator and SPE level.

3.3 We understand from our meeting on 12 September 2002 that there was a view that SPE's preparing accounts under IAS, may be able to derecognise assets and liabilities under the pass-through tests. Hence on consolidation, the group will record only its remaining economic interest in the assets. Whilst we support the overall impact we have concerns that the SPE has virtually no assets or liabilities. At a minimum we believe it is essential that the financial statements provide sufficient and adequate disclosure of the nature of the transaction that has taken place. We would be pleased to assist the Board in determining some example disclosures. Preferably, however, this requires an immediate revision of SIC 12. We reiterate the need to reconsider SIC 12 and stress the fact that the "*pass-through*" rules should not be regarded as a substitute for dealing with this interpretation.

3.4 The current wording of paragraph 41 will result in most SPE's retaining all assets and liabilities on the balance sheet and hence the assets and liabilities being included at the consolidated level. This is demonstrated by the following examples:

Paragraph 41(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 (i.e. the transferee is entitled only to the cash flows of the underlying financial asset or the portion thereof that qualifies for derecognition).

For most asset repackagings in SPEs, the cash flows passed onto the beneficial interest holders will generally come from a combination of the underlying transferred asset and other financial instruments held by the SPE. Using the "*Collateral Debt Obligation*" transaction in Appendix II as an example, the cash-flows in this SPE arise from both the underlying portfolio of bonds and/or loans and the interest rate swap agreement that is entered into to provide the appropriate interest rate profile for the structure. Presuming that the concept of a pass-through was not intended to be restricted to only those SPEs that contain just the transferred assets and we would therefore recommend that the wording in 41(a) is amended to also include reference to other financial instruments entered into by the 'transferor' in relation to the overall structure.

Similarly, in the "*Trade Receivables*" transaction example (see Example 3 in Appendix II), the SPE may use cash-flows from the liquidity provider rather than the underlying asset pool.

Paragraph 41(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.

In the "*Credit Linked Note*" transaction example (see Example 4 in Appendix II), the SPE is required to pledge its assets. This example is discussed above in paragraph 2.6 of our response to question 2. We draw your attention to the fact that the credit linked note transaction will immediately fail the requirements of paragraph 41(b).

Similarly in the "*Collateralised Debt Obligation*" transaction example (see Example 2 in Appendix II), an asset manager would actively sell the underlying assets. This would immediately mean that the SPE failed paragraph 41(b) of the pass-through tests. We assume, based on our meeting of 12. September 2002 that it was not the intention of the Board to preclude an asset manager from actively managing the underlying assets provided that it was done so for the benefit of the transferee and not for the transferor. We would suggest that the wording of 41(b) is redrafted to reflect this.

Paragraph 41(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.

This test will presumably preclude pass-through treatment for any securitisation in which cash flows are received in a sporadic manner, such as credit card receivables, whereby payments on credit cards are generally received continuously throughout the year but payments to note holders are generally made on only 4 fixed dates (i.e. 3 monthly).

Often cash may be realised on receivables in advance of the obligation to make a payment on the debt issued, but the transferor (in this instance, probably an SPE) is restricted from taking any benefit from holding those funds. This seems to be in contradiction of the Implementation Guidance Committee ("IGC") Question 35-2 that requires the transferor to remit cash flows on a "*timely basis*" but permits the reinvestment of "*such cash flows for its benefit….to provide a return from short-term* *high quality investments made from the collection date to the date of remittance to the investors*" when a transferor is effectively servicing assets. In this instance, the SPE is simply benefiting from the timing of payments and by investing in "*short-term high quality investments*", for example UK Gilts, does not expose itself to significant credit risk.

3.5 We understand that it was the intention that paragraph 41 would enable many securitisation SPE's to derecognise assets and liabilities, and in light of the fact that SIC 12 is yet to be amended, we suggest that the wording of the pass-through paragraphs is redrafted. We would suggest that there needs to be a clear distinction depending on whether the "transferor" is the originator or an SPE. Where it is the latter, the wording needs to be amended to permit the SPE to use all its available cash flows to make payments, to sell or pledge the assets, to hold any cash flows for a period of time, and invest in risk-free assets provided that:

- such actions are primarily for the benefit of the investors and not the transferor; and
- the principles behind such actions of the SPE are predetermined and set out in the transaction documentation; and
- such actions do not utilize any additional assets or cash flows of the transferor.

4. Question 4 – Measurement: Fair Value Designation (paragraph 10), Question 5 – Fair Value Measurement Considerations (paragraphs 95-100D), Question 6 – Collective Evaluation of Impairment (paragraphs 112 and 113A-113D), Question 7 – Impairment of Investments in Available-for-Sale Financial Assets (paragraphs 117-119), Question 8 – Hedges of Firm Commitments (paragraphs 137 and 140) and Question 9 – 'Basis Adjustments' (paragraph 160)

4.1 The ESF has no comments on questions 4 to 9.

5. Question 10 – Prior Derecognition Transactions (paragraph 171B)

Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognized as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grand-fathered)? Alternatively, should prior derecognition transactions be grand-fathered and disclosure be required of the balances that would have been recognized had the new requirements been applied?

5.1 The ESF understands the IASB's rationale for requiring the recognition of assets previously derecognised under the provisions of IAS 39 as they currently stand. We note, however, that the previous version of IAS 39 did not require retrospective application and would request that the same approach be applied going forward. Our request is based on the fact that, in some instances, this may require entities to perform extensive analysis of previously enacted transactions at potentially significant cost and it may still not be possible for a number of companies to fully reconstruct all transactions that might be effected by these changes which would materially impact their opening balance sheet position. The IASB has permitted entities in paragraph 96 of the Exposure Draft of the IAS 32 not to apply that revised standard retrospectively if "*restating the information would require undue cost or effort*". The ESF recommends that the IASB consider giving the same exemption to entities in respect of derecognition under the IAS 39 and extending it to provide an exemption should an entity be unable to capture all previous transactions that might require restatement.

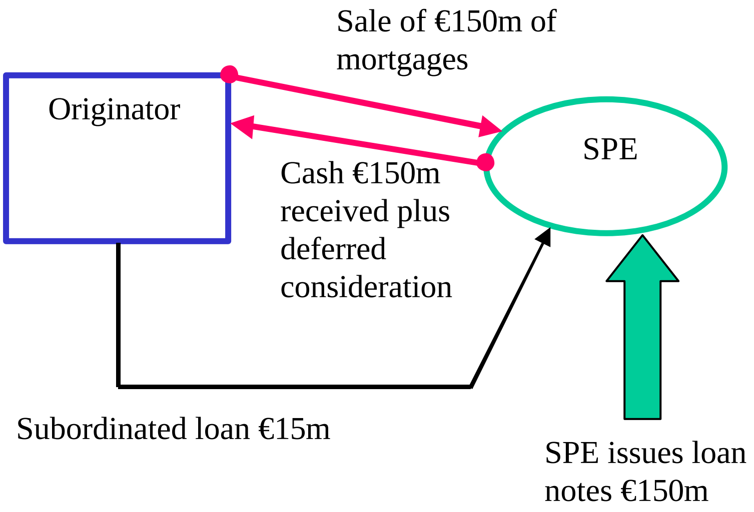
5.2 We recognise that where securitisation structures are revolving and an exception on the basis of undue cost or practical impossibility has been taken, that it should not allow the reporting entity to apply the current IAS 39 to future additions to these structures.

5.3 We have interpreted paragraph 171 as requiring retrospective derecognition of financial assets that do not meet the recognition criteria under the revised standard. We would appreciate clarification of this point.

Transaction Example 1

Residential Mortgage Backed Securitisation

Structure Diagram



Description of Transaction

An originator of residential mortgages sells by equitable assignment a portfolio of mortgages to an SPE. The originator sells the mortgages at par plus deferred consideration. This deferred consideration is designed to transfer any excess profit from the SPE. The originator also makes a subordinated loan to the SPE. The purpose of the subordinated loan is to provide credit enhancement to the scheme. The deferred consideration works by specifying that further payments will be made for the sale of the loans which amount to the residual profit in the SPE. The SPE then issues securitised loan notes. The Originator continues to administer the loans for an arms length fee in accordance with agreed standards.

Economic Rationale

The loan note holders receive a market interest rate and have their loan secured on the mortgage portfolio and the subordinated loan. They are at risk if loses exceed the subordinated loan. The originator has the potential for further income, being the excess profit in the SPE. This is a function of interest margin and loan performance. It also receives servicing income. It is at risk of losing its subordinated loan.

Originators undertake such transactions for one or more of the following primary purposes:

- Funding / liquidity management
- Risk transfer
- Capital relief

Accounting Analysis

IAS 39 Exposure Draft – Proposed Improvements

There are two contractual provisions with respect to the transaction that could be considered a continuing involvement in the transferred asset:

- Firstly, the transferor has a subordinated loan interest in the SPE of €15m;
- Secondly, the transferor has the right to a profit share in the SPE if there is any residual following the payment of the loan finance.

Initially we considered that partial derecognition of €85m could be achieved as this represents the amount that transferor is no longer exposed to (bar the potential servicing asset as described below). However, the existence of a profit share complicates this assessment as the profit share is over the residual balance of all the transferred assets following repayment of the loan finance. Paragraph 39 states that derecognition is not achieved to the extent that the transferor is exposed to gains or losses on the transferred asset. As the amount of deferred consideration is uncapped, and derives from any of the transferred assets, does this preclude derecognition for all the transferred assets?

Further, derecognition will be limited to the extent that the transferor has a servicing asset to the extent that the fee received is expected to be more than adequate compensation for the servicing of the transferred assets in accordance with paragraph 43. In accordance with paragraph 37 this is not considered to be continuing involvement.

SIC 12 – Current Guidelines

If the transferor continues to recognise all the transferred assets, consolidation of the SPE is largely irrelevant. However, even if partial derecognition was achieved, the application of SIC 12 would result in the consolidation of the SPE by the originator as the originator has the right to the majority of the residual interests of the SPE. Thus the application of SIC 12 results in the accounts of the originator reflecting all the mortgages and the external securitisation loans.

Issues

1. The fact that the profit share is over an unspecified number of transferred assets could potentially lead to the continued recognition of all the transferred assets. Continued recognition of all the assets is inconsistent with the net exposure to the assets that is limited €15m.

2. The existence of a potential payment under the deferred consideration agreement will result in continued recognition of all transferred assets, even though the likelihood of payment by the SPE may be remote. Under the proposed rules, the introduction of a cap on the potential payment under the deferred consideration agreement also may not result in derecognition because at the outset, it is not clear which of the transferred assets the potential deferred consideration up to the level of the cap will derive.

3. By fully recognising the mortgage portfolio on the originators balance sheet no account is taken or reflected of the securitisation transaction.

4. The originator cannot freely use the SPE's assets; it may therefore be misleading to include them on the consolidated balance sheet when it has received the full fair value of the transferred asset (less subordinated loan to the SPE).

5. Any exposure to these mortgages is restricted to the amount of the subordinated loan, a small percentage of the total. The subordinated loan will always be recognised on the balance sheet, so the risk asset is on the balance sheet.

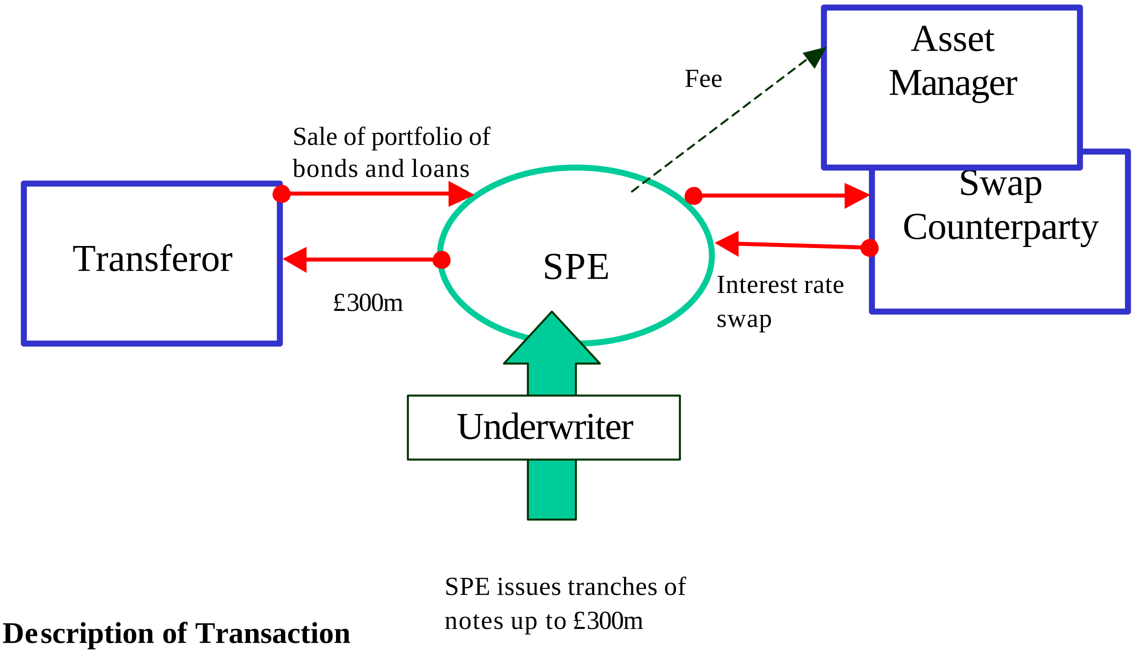
6. Consolidation of all or part of the assets of a SPE that the originator/sponsoring company does not control may mislead investors into thinking that the company has more assets at its disposal than it actually does. This would be problematic in the event of a bankruptcy, where any assets transferred into a bankruptcy-remote SPE could not be accessed by the creditors of the company that created it, even if the SPE has been consolidated in (or appears on) that company's financial statements. This issue is even more prevalent in the case of a multi-seller conduit if, as shown above, the same assets appear on several balance sheets and thus give inaccurate information to a larger number of creditors.

7. Other common issues occur around, swaps between the SPE and originator, buy back provisions in respect of customers seeking to switch products and clean up calls.

Transaction Example 2

Collateralised Debt Obligation Securitisation

Structure Diagram



Description of Transaction

A Collateralised Debt Obligation (CDO) is typically a packaging of bond and/or loan assets within an SPE structure financed by a range of rated and unrated notes. The assets could be transferred directly to the SPE by the arranger, or by other parties. These assets will be actively managed within predetermined guidelines, including to minimise early redemptions during an initial period. For both rating agency and investor purposes, the SPE may also enter into some form of swap transaction to modify the cash flows. Generally, this will be a vanilla interest rate swap, but it could also be a cap, floor or collar, or a cross currency swap.

Economic Rationale

CDO structures are created primarily to provide investors with a particular type or class of risk that they may not otherwise be able to obtain.

A bank's role in these transactions is primarily one of structurer and it will receive a structuring fee for this on the closing of the deal. In addition, the bank may source the underlying assets, may underwrite the notes issued and may be the counterparty to any derivative instrument required by the SPE. Sourcing of the assets is done as near to the closing date as possible and the purchase of the assets is typically done concurrently with a forward sale contract with the SPE. Underwriting fees are standard asset backed securitisation market rates dependent on the rating of each relevant tranche and all derivative instruments are transacted at market.

The investment manager will receive an annual fee from the SPE, some of which will be performance related. In Europe particularly, there is a publicity attraction for investment managers to take on this role, which can sometimes be the initial driver for the CDO. CDOs can also provide clients with a new line of asset management business.

The note holders receive a market interest rate and have their note secured on the underlying portfolio of loans and/or bonds. Due to the tier-based structure of CDOs, the note holders' levels of risk vary, depending on their prioritisation level. Most structures will include a significant AAA or AA rated senior note tranche, which carries the lowest level of risk. At the other end of the scale, there will usually be an unrated subordinated debt piece, which would take the 'first loss' on the underlying assets. This piece is similar to equity, but for both legal and marketing reasons cannot be structured as such in most European markets. The subordinated debt could be held by a few or many investors and could include any of the original counterparties to the transaction, most commonly the investment manager.

The counterparties to any derivative contract and any ongoing management related fees (e.g. trustee fees) usually rank senior to all note holders.

Accounting Analysis

IAS 39 Exposure Draft – Proposed Improvements

The various different roles that an entity may have in a CDO transaction are critical in considering the accounting analysis of a CDO under the IAS 39 Exposure Draft. For IAS 39 Exposure Draft to be relevant, the entity will be the transferor of the underlying collateral. In addition, the entity may be the swap counterparty; the holder of a subordinated and/or other tranche issued by the SPE and/or the asset manager. The analysis also needs to consider the impact of SIC 12.

If the entity's only role is as transferor of the collateral, the asset transfer should meet the derecognition requirements of paragraphs 35b and 37a(i) – i.e. no continuing involvement in the cash flows of the assets. In this situation, it is also highly unlikely that the SPE would also be considered at risk of consolidation under SIC 12.

If the transferor is also the swap counterparty, again the requirements of paragraphs 35b and 37a(i) should be met, as it would be unusual for the swap contract, whether an interest rate, currency or amortising swap, to have payments conditional on the receipt of amounts from the underlying assets (A9p & A9q).

If the transferor is also the asset manager, any continuing involvement in the assets will depend on the asset management fee arrangements. Such fee arrangements are established at appropriate market rates and these rates are often partly linked in some way to the performance of the assets, in order to act as an incentive for the manager to ensure the best performance of the portfolio. It is not clear whether these fee arrangements constitute a servicing fee, as described in paragraph 43 and, if so, whether these arrangements would be considered 'adequate compensation' for the servicing. Presuming the fee was 'adequate compensation', it appears that full derecognition of the assets should be possible. However, if the fee arrangement was considered otherwise, this would impact the accounting for the transfer, as described in paragraph 48b.

Finally, the transferor may hold various tranches of the notes issued by the SPE, including the subordinated tranche, or first loss piece. Paragraph 40 makes it clear that the holding of even the subordinated tranche does not preclude derecognition of at least some of the asset.

However, this paragraph would appear to then be overruled, in its current form, by SIC 12. This would result in derecognition to the extent of the subordinated tranche retained, but then result in consolidation of the SPE through SIC 12.

It would then be necessary to consider the accounting requirements of the SPE itself - in particular, whether the SPE itself would meet the requirements of the ‘pass-through’ arrangements described in paragraph 41. Given that a CDO requires a limited amount of rebalancing of the underlying portfolio by the asset manager, this could preclude CDOs from these pass-through arrangements. Also, the coupon requirements on the notes issued compared to the receipt of cash on the underlying assets, may not meet the requirements of paragraph 41(c). If the SPE does not meet the requirements of a pass-through arrangement and requires consolidation through SIC 12, no assets will be derecognised and no gain on sale calculation will be required at the consolidated reporting level.

If a subordinated tranche is retained, the transferor would need to consider the complex guidance from B4 onwards to determine its accounting for standalone reporting purposes. This guidance would, we believe, result in any retained interests being carried initially at amounts different to their actual fair values and also results in double counting, due to the related reduction in the amount of underlying assets to be derecognised.

Issues

1. These transactions are structured for client facilitation purposes. To the extent that the accounting analysis through IAS 39 ED and/or SIC 12 results in assets not being derecognised, this will mean that assets purchased for the benefit of third parties will be reflected as own assets, rather than assets provided to clients.

2. In the event that full recognition of the asset portfolio is required, no account is taken or reflected of the CDO transaction. These are not assets that any entity can freely use and any exposure to these assets is restricted to the amounts related to the tranches of notes held. Similarly, the CDO notes can only be repaid from the SPE’s resources, so presenting these notes on a balance sheet with other assets will be confusing for users of financial statements.

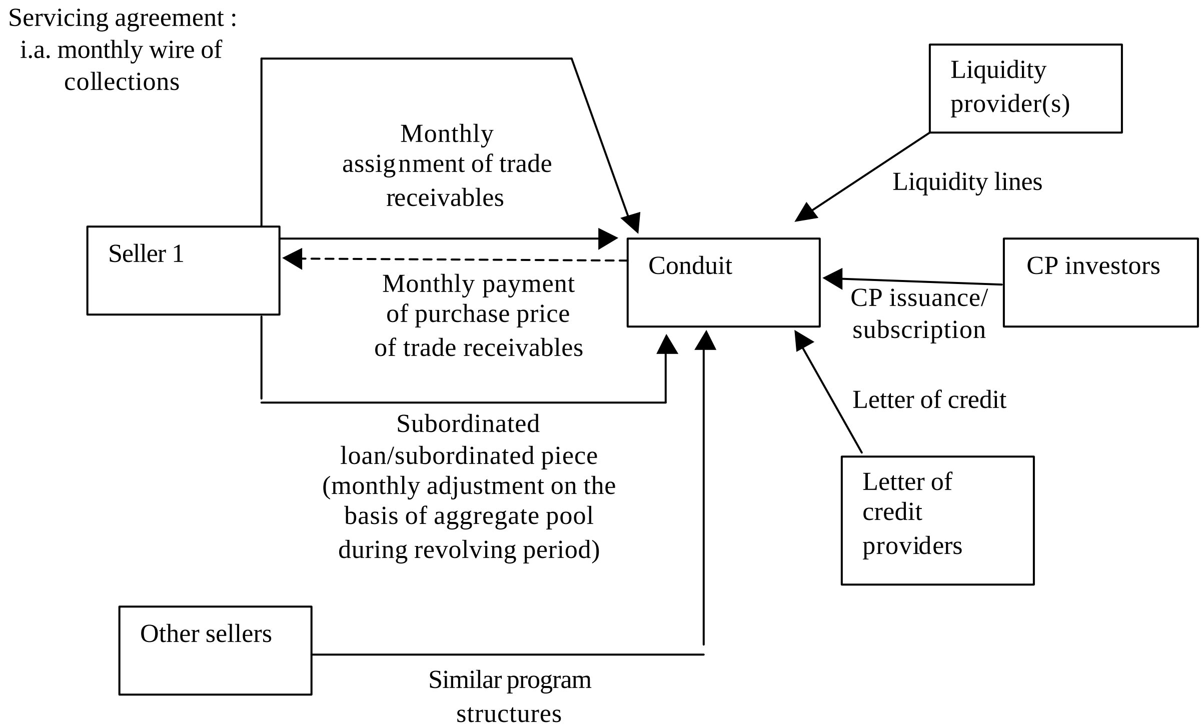
3. Given that all investors in CDO structures should be recognising their own interests in the notes issued on their own balance sheets, requiring the transferor to also recognise the related assets results in duplication, which again is not helpful to users of financial statements.

4. The activities of a CDO SPE are primarily for the benefit of the noteholders. These activities might include limited sales and purchases of the underlying assets and/or reinvestment of cash flows pending transfer to noteholders in accordance with predetermined payment schedules. Such activities seem consistent with the implied spirit of a pass-through arrangement, but the correct interpretation of the requirements is unclear.

Transaction Example 3

Trade Receivables Backed Securitisation

Structure Diagram



Description of Transaction

A corporate sells to a multi-seller conduit a portfolio of short-term non-interest bearing trade receivables, at par. This sale is non-recourse on the seller and enforceable in case of bankruptcy. The originator also subscribes a subordinated piece/makes a subordinated loan to the conduit, covering reserves for losses (based on expected and inherent losses of the portfolio), dilutions, as well as an interest reserve (necessary as the assets don't bear interest). Given the short-term nature of the assets, collections are primarily used to purchase new receivables on a monthly basis during the revolving period. The amount of the reserves is recalculated on a dynamic basis at each new assignment, by applying the rating agency's methodology to the historical performance of the pool, and applying the new reserve percentage to the aggregate pool resulting from the successive assignments.

At any time, the seller may decide to stop selling new receivables to the conduit, in which case the program amortises and the subordinated piece remains at its latest calculated level which represents the maximum amount guaranteed by the seller. The structure also amortises in case some portfolio performance triggers are hit or the seller defaults under its obligations.

Unless the conduit requires a change of servicer, the seller continues to administer the receivables and receives in most cases a servicing fee. Collections are wired to the conduit on a [monthly] basis. Collections are invested by the conduit in short term A1/P1 investments until they are used to purchase new receivables, to pay fees and interests, to repay CP/liquidity line draws, to repay letter of credit or, lastly, to repay the subordinated loan.

Other sellers have a program in the said conduits with a similar structure.

The conduit refinances through a global A1/P1 rated CP issuance program. The CP holders receive a market interest rate, have their paper secured on the trade receivables portfolio and will be repaid out of the collections before the subordinated loan. They are all pari passu and all CPs are exposed to all the transactions of the conduit. They are at risk if losses exceed the subordinated piece/loan and the letter of credit. CPs are repaid at maturity by using the collections on the assets, by issuance of new CPs or by drawing on the liquidity line or the letter of credit.

The conduit benefits from a program-wide letter of credit of approximately 5-10% of its total assets and of liquidity lines of 100% of its total assets. The letter of credit is globally available for each and all the programs in the conduit. The provider of the letter of credit will suffer losses if the losses exceed the subordinated piece retained by the seller. The liquidity providers and the letter of credit provider will earn a commitment fee in line with market rates.

Economic Rationale

The structure is attractive for the seller because it provides funding at a low cost linked to the quality of the assets and not to its corporate rating given that it is non-recourse, and it helps diversify funding sources (bank disintermediation) and limits the risk on the assets.

Thus, banks have a commercial interest in putting in place conduits to offer this kind of structure to their clients. A sponsor typically structures the conduit and may provide the letter of credit, for which risk it earns market remuneration. The liquidity facility and the conduit management may be provided by the sponsor or by other market professionals who get a market fee for their services and who enter into the transaction on the basis of a profitability analysis.

Accounting Analysis and Issues

IAS 39 Exposure Draft – Proposed Improvements

Originator

As the originator has legally transferred the assets to the conduit, we understand that it has legally relinquished its contractual rights top the cash-flows.

As the seller guarantees the losses and funding charges on the transferred pool up to the amount of the subordinated loan i.e. 10-30% of the pool, this amount would be considered as a continuing involvement in the transferred assets. Though, while the subordinated deposit clearly represents a continuing involvement, it is unclear how it can be calculated on a transfer by transfer basis as the economic reality of the transaction is to consider the diversification of the pool and thus to have a global guarantee covering the aggregate pool resulting from the subsequent purchases. (see below – issues)

The guarantee being limited, the remaining 70-90% of the pool could be derecognised.

Though, in some transactions, some repurchase provisions are included, such as repurchase of defaulted assets in order to recover VAT. In most cases, there is no firm option for any party but is determined on a case-by-case transaction. It is unclear whether 37 (b) (i) would apply.

The servicing agreement and collection mandate shall then be recorded as an asset or liability. As such, we understand that it does not represent a continuing involvement. The question is whether such mandate means that there should be a pass-through analysis on the originator's level (37 (a) (ii)).

Moreover, upon each monthly assignment, the originator shall record a gain/loss on the sale of the receivables on the basis of the fair value of the sold assets

Conduit

All the funding sources of the conduit are credit-linked: the CP, the liquidity line, the letter of credit and the subordinated loan. Thus, the conduit transfers all its contractual rights to the cash flows of the receivables. It could thus derecognise 100% of the assets to the extent it meets the pass through arrangement criteria.

As a whole, the conduit has no obligation to pay amounts to the group of transferees unless it collects equivalent amounts from the assets. Though, some funding sources can be refinanced by others (for example in case of drawing on the liquidity line to repay CP). In our opinion, it should not be considered as a failure in the pass-through analysis but the point is not clearly stated in the draft.

Two other points could theoretically lead to a "non pass-through" conclusion if the draft is not clarified :

- In many cases, there is a pledge of the assets in the benefit of CP holders. Moreover, in some situations, the SPV may be selling the assets and using the proceeds to repay CP holders and other funding sources (for example transfers to the seller for VAT recovery, or to a back up servicer or an insurer)
- Transfer of cash flows to the CP holders/liquidity line provider is done on a timely basis, mostly upon interest payment i.e. every month/quarter. Between two payment dates, cash is invested in A1/P1 short term assets and the proceed is ultimately paid to the originator as it decreases the financial cost of carrying the assets.

SIC 12 – Current Guidelines

SIC 12 still applies to this structure as the originator, because of its subordinated loan, which has not transferred the majority of risks on the assets. Should the conduit fail to meet the pass-through requirements, the derecognised part of the assets would come back on the balance sheet of the seller, which is not logical after the IAS 39 analysis. The simultaneous application of IAS 39 and SIC 12 is thus still unclear.

Issues

1. When speaking of trade receivables, there is a general issue linked to fair value calculation: how can sellers and auditors measure the fair value of trade receivables pools in the absence of standard market practices.

2. It is unclear how the measurement of continuing involvement through a subordinated loan applies to this revolving structure: as explained above, the subordinated tranche is calculated by reference of the aggregate pool and not sale-by-sale (which would be impossible for example in structures where sales are made on a daily basis). This approach is in line with IAS 39 ED, which allows to consider a pool of receivables as a single asset. The revolving structure as such is not a continuing involvement as the originator is not obliged to sell new receivables and in case of amortisation, the subordinated loan remains at its latest calculated level and thus represents the maximum obligation of the transferor to pay subsequent decreases in the value of the assets. The accounting entries which would best reflect the substance of the transfer would be to derecognise the assets by application of paragraph 37(a) and to recognise the fair value of the subordinated piece as a measure of the continuing involvement in the pool resulting from the subsequent transfers.

3. Is the legal sale of the receivables sufficient to ensure a systematic application of 37 (a) (i) or are there cases where the originator has to meet pass-through requirements because of its collection mandate? As the servicing mandate is a separate agreement, and given that the seller receives a fee for this service and thus records an asset or a liability on this regard, we don't think that any pass-through analysis should be required.

4. At the conduit level, the prohibition to sell or pledge the assets is very strict. In many cases, such sales or pledges are required by rating agencies and in any case are executed in the interest of CP holders, the price of the transfer being "passed through" to CP holders. This kind of provision should not preclude derecognition as it does not create any control over the assets for the conduit. On the contrary, it is part of the enforcement of the credit-linked structure.

5. In case of the conduit, the transferees are several so that the conduit may be in a position to repay CPs by drawing on the liquidity line for example. Does this possibility to replace a credit linked source by another one disqualify for derecognition because it diverges from the strict wording of 41 (a)? We don't think this would reflect the substance of the structure. On the contrary, we think that it better reflects the economics of the structure to consider the different funding sources as a group of transferees and to make the pass-through analysis on a global basis.

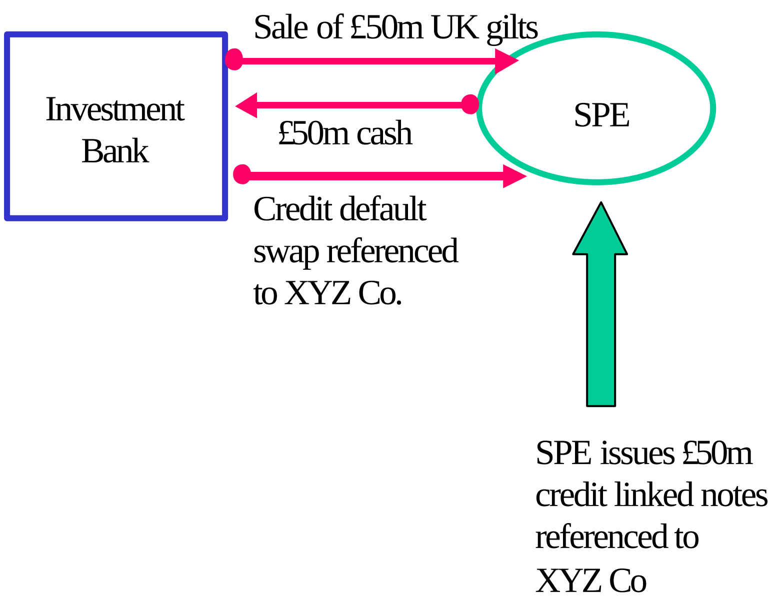
6. What does "transfer without material delay mean"? Due to the very short-term nature of trade receivables, of operational constraints on the side of the servicer, and of standard maturities on the CP market, there is necessarily a time delay between the collection date and the maturity of the CP/the liquidity line draw. Moreover, in a revolving structure, the cash flows are reinvested in new assets, which should not preclude derecognition.

7. Due to the time delay between collection and repayment of CPs, it does not seem logical that the conduit would not be authorised to invest treasury in A1/P1 funds. This gain should not be considered as a benefit as the assets are non-interest bearing: it reduces the financial cost of carrying the asset but does not create any value.

Transaction Example 4

Credit Linked Note Structure

Structure Diagram



Description of Transaction

An SPE issues credit-linked notes to one investor. Under the terms of the note, the principal amount is not repaid in full to the investor if the reference asset, in this case a particular debt issue of "XYZ Co", defaults and a loss occurs. In exchange for accepting the risk of "XYZ Co", the investor receives a higher coupon than would normally be paid on the assets that the SPE holds. The SPE uses the cash proceeds from the credit-linked note issuance to purchase UK Gilts from an "Investment Bank". The UK Gilts pay a LIBOR coupon.

The SPE also enters into a credit default swap with the "Investment Bank". Under the credit default swap, the "Investment Bank" pays a spread according to the underlying credit risk of the reference asset. The SPE pays the "Investment Bank" nothing unless the referenced asset, "XYZ Co", defaults and a loss occurs. If "XYZ Co" defaults, the SPE owes the "Investment

Bank" £50. The SPE pledges the UK Gilts as collateral first for its obligations under the credit default swap, but also for its obligations on repayment of principal under the credit-linked notes (after any loss allocations). If "XYZ Co" defaults and a loss occurs, the SPE sells the UK Gilts and uses the sale proceeds to settle its obligations under the credit default swap. The investor does not receive a return of a corresponding amount of principal under the credit-linked note. On an ongoing basis the SPE uses the LIBOR coupon from the UK Gilts plus the spread from the credit default swap to pay the credit linked note coupon due to the investor.

Economic Rationale

Economically, the investor has sold credit protection to the SPE and is paid for the protection through the high coupon it receives on the credit-linked note. The SPE sells the credit protection to the "Investment Bank" through the credit default swap. Investors buy credit linked notes for many reasons including: (i) to gain credit exposure to the referenced asset; (ii) to replicate the economics of a derivative instrument plus a cash instrument while legally holding a note; (iii) to replicate the economics of a credit default swap that the investor might not have satisfactory credit to obtain in the open market; (iv) or to satisfy an appetite for greater risk and higher returns. Reasons for the "Investment Bank" for a credit-linked note structure include among others: (i) broadening of the investor universe and (ii) reduction of counterparty credit risk compared to an immediate credit default swap with the Investor. The "Investment Bank" uses credit-linked note structure mainly to transform credit-default swaps into credit-linked notes. Generally, there is only one investor, but this is not always the case. There can be many investors and more than one reference asset.

The investor has its principal at risk if the referenced asset defaults but is rewarded through the receipt of higher coupons than UK Gilts would pay.

The "Investment Bank" could be viewed as receiving the benefits of the SPE since it is buying credit protection, albeit at market price.

Accounting Analysis

IAS 39 Exposure Draft - Proposed Improvements

1. Continuing involvement

If the pledge of the UK Gilts to the "Investment Bank" results in continuing involvement, the "Investment Bank" does not record a sale of the UK Gilts. Instead, the UK Gilts remain in the investment bank's inventory and a corresponding liability is recorded. The credit default swap is recognised by the "Investment Bank" and carried at fair value since its value is driven by the credit of the referenced asset (not the transferred asset) with the result that its recognition does not result in recognising the same rights twice. It is unclear from the guidance in paragraph 54 how the "Investment Bank" values the asset and liability to arrive at a net carrying amount reflecting its rights and obligations related to the transfer. The investment bank's rights are that of a secured party. Such security rights are generally not recognised unless the collateral is sold, which in this case will not be possible since the Investment Bank is not entitled to do so. Thus, the asset and liability may be recorded at equal and opposite amounts so that the net of zero represents the investment bank's collateral rights.

If the pledge of the UK Gilts to the "Investment Bank" does not result in continuing involvement, the "Investment Bank" records a sale and recognises the credit default swap.

2. Pass-through requirements

If the "Investment Bank" does achieve sale accounting and is required to consolidate the SPE under SIC 12, it then considers whether the SPE has met the pass through rules in paragraph 41 of the IAS 39 ED. If the UK Gilts are considered to be the transferred asset in isolation, it would appear that none of the criteria are met. The SPE would not meet criterion (b) since it has pledged its assets first to the "Investment Bank" and then to its noteholders. It also seems that criteria (a) and (c) would not be met since the SPE will only pass the cash flows to the noteholders if there is no default of the referenced asset.

However, if the transferred asset is considered to be the package of the UK Gilts and the credit default swap (which is economically the case), the analysis is different. Criteria (a) and (c) are met since the SPE will only have an obligation to remit to the noteholder any net cash collected from the package of the UK Gilts and the credit default swap. Criteria (b) still appears not to be met since the UK Gilts are pledged as collateral to the "Investment Bank" and the noteholders. However, this pledge is for the benefit of the noteholders (rather than the SPE itself) since it allows the SPE to enter into the credit default swap to give the increased return to the noteholders. Thus, it seems that the spirit of criterion (b) has not been breached (see detailed discussion under Issue 2 below). Finally, paragraph 41 of the IAS 39 ED (by reference to paragraph 37) requires that neither the SPE nor any consolidated party, such as the "Investment Bank", have any continuing involvement with the transferred assets. It is unclear if this would be the case if the "Investment Bank" consolidated the SPE under SIC 12 and was a counterparty to a derivative that formed part of the package that the SPE transfers to its noteholders.

Issues

1. Continuing involvement.

Does the pledge of the UK Gilts, as collateral to the "Investment Bank", constitute continuing involvement? If yes, we disagree for two reasons. First, the "Investment Bank" merely has received a pledge of collateral. Such pledges are not normally recorded in the financial statements unless the collateral is sold. To record an asset and a liability is misleading. The "Investment Bank" has no control over the assets in the SPE. It may receive them again in the future, but this is a contingency that is based on events outside the control of the "Investment Bank" and unrelated to the performance of the UK Gilts. In addition, it will never have to pay any amount related to the collateral as a derivative counterparty might under a call option. Thus, the liability is completely fictitious. We believe that the fact that this accounting is so unrepresentative of the economic substance of the transaction highlights the fact, that a pledge of a transferred asset as collateral to the transferor, should not preclude sale accounting. Neither a control approach nor a risks and rewards approach would prevent sale accounting in this instance.

Second, the sale of the UK Gilts is a normal, arm's length market transaction. The act of the SPE pledging the assets to the "Investment Bank" is part of the credit default swap transaction. The risks and rewards of the credit default transaction are completely separate from those of the UK Gilts. It seems incorrect to conclude that the "Investment Bank" is still participating or exposed to the risks of the UK Gilts when this is really a secondary, contingent exposure unrelated to the sale transaction. It seems unusual that if the SPE bought the UK Gilts from another market participant and pledged them as collateral under the same swap with the "Investment Bank", the "Investment Bank" would not record the pledge. Such dramatically different accounting for identical economic situations is troubling and, in our view, indicates a fatal flaw in the accounting model.

2. Pass-through requirements.

As discussed above, the pledge of the UK Gilts as well as the existence of the credit default swap causes the SPE to fail the criteria for pass through arrangements if the UK Gilts are considered in isolation. It is unclear why such arrangements should fall afoul of these criteria since all of the transactions undertaken benefit the noteholders and not the SPE.

One solution to this anomaly would be for the SPE to treat the UK Gilts and the credit default swap as a package, as described above under "Pass through requirements", in order to reflect economic reality. In order to pursue this alternative, the issues of the pledge of the UK Gilts as collateral and the fact that the "Investment Bank" is a counterparty to a derivative which forms part of the transferred package would need to be addressed to clarify that neither constitutes continuing involvement.

On a separate point, it is unclear whether the no continuing involvement criteria would be met if the "Investment Bank" acted as security trustee for the SPE and could sell the assets in the market in the event of default of a referenced asset.

3. SIC 12.

SIC 12 is then applied to the transaction. As discussed at our last meeting, it is unclear whether the Investment Bank, the noteholder, or both entities would have to consolidate the SPE under SIC 12. If the "Investment Bank" is required to consolidate and if there is failed sale accounting at a single entity level, we assume that consolidation under SIC 12 would result in the elimination of the failed sale accounting prescribed by IAS 39 since this would be considered an inter-company transaction. In place of the failed sale accounting, all the assets and liabilities would be included on the consolidated balance sheet of the "Investment Bank".

However, if sale accounting under IAS 39 Exposure Draft is achieved, then it is possible that SIC 12 would still require consolidation of the SPE, in effect overriding IAS 39 Exposure Draft.