ABI comments on the ED Derecognition (proposed amendments to IAS 39 and IFRS 7)

July 2009

We thank for the opportunity to reply to the IASB's consultation on the ED Derecognition (proposed amendments to IAS 39 and IFRS 7) that was published on 31 March 2009. Please find below the remarks of the Italian Banking Association (ABI) to the ED Derecognition.

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1. Current regulations according to IAS 39

Adhering to the general principle of economical substance over legal form, the current regulations provide that an entity can write off a financial activity from his/her financial statement provided that, as a consequence of a transfer, he/she has also transferred the risks and benefits connected to the sold instrument, in other words provided that:

a) the financial activity has been transferred with all of the risks and contractual rights concerning cash flows deriving from the activity itself;
b) alternatively, the entity has maintained the rights to receive financial flows from its activities, exclusively due to a servicing contract for receiving the future financial income from the activity transferred.

For the transfer of a financial activity to be effectively written off from the transferor's financial statement, the latter shall need to evaluate any risks and benefits (risks and rewards) connected to the financial activities being transferred upon transfer.

If the entity does not transfer and not substantially maintain all the risks and benefits of its financial activities, then the entity shall judge the control elements of the financial activities, and:

- in the event the transferor does not retain control, they shall reverse the financial activity and separately recognise the assets/liabilities deriving from rights/obligations deriving from the transfer;
- in the event the transferor retains control, they shall continue to recognise the financial activity at its maximum investment commitment.

2. The proposed modification to IAS 39 concerning derecognition (ED/2009/3)

In March 2009, the IASB published a draft document proposing a modification to IAS 39 and IFRS 7 concerning derecognition. This document contained important news that could affect the accounting techniques for a wide range of corporate operations.

With respect to the current regulations, the main modification is in the elimination of the risks and benefits tests. This amendment focuses on the capability to control.

This aspect is considered as a common element on a corporate level, to define the area of consolidation, pursuant to ED 10 “Consolidation” and, on an asset/liability level to determine the derecognition in the financial statement.

The definition of control is based on the capacity to obtain (access) future gains for activities and consequently, limit access to these gains to other subjects.

Therefore, effectively as a definition of control, the transferor can reverse the transferred activity if the transferee has the real possibility of transferring the asset without any restrictions. In other words:

- *Unilaterally – independently of actions of others;*
- *Without having to impose additional restrictions – Ability to dispose asset in isolation;*
- *For its own benefit – ability to keep for itself the consideration.*

In order to effectively evaluate this capacity of the transferee to transfer the acquired asset, some contractual terms of the original transfer need to be taken into consideration such as the nature of the asset with reference to its fungibility and market availability, the presence of an ample market, in addition to economic limitations that could effectively impede the transfer[1].

Substantially, an asset is subject to *derecognition* if (see § 17A):
- lacking in the contractual rights of the instruments’ cash flow;
- the activity’s transfer was carried out without the presence of continuing involvement;
- the transfer of the activity was carried out with continuing involvement, yet the transferee has the effective possibility to transfer the asset to his/her benefit (see previous definitions).

It is important to note that an asset’s derecognition can be brought about even whilst maintaining the continuing involvement.

[1] Besides the rights and/or restriction for the transferee, one should also consider what can effectively be done with the transferred asset; with respect to the foregoing, it is highly important that there is an active market for the financial activity transferred. Indeed, in this case the transferee would have the possibility to reacquire the security if the transferor possesses and exercises his call option (the transferor therefore would not have maintained control over the transferred financial activity). If, on the other hand, there isn’t an active market, the difficulties to retrieve this financial activity would impede the transferee to transfer the instrument received (the transferor would have retained control over the transferred financial activity).

2.1 Possible impacts of the proposed amendments and considerations

As previously mentioned, the ED introduces some modifications to the current operations that appear somewhat unfriendly, whose main modification concerns Swaps.

Every time a transferee of a Swap can freely transfer the received asset to third parties (with specific reference to Government Bonds or any other listed security), the transferor cancels the transferred activity.

Therefore, this does not represent a close adherence to the substance of the operation, normally carried out by banks for collection purposes, and furthermore producing undesired effects on the financial statement.

Indeed, while the current SWAP operations do not generate volatility on the Profit and Loss Account, the modifications provided for by the ED, the continuing involvement of the transferor represented by the repurchase obligation, these would be accounted as derivatives (see § AG52L) with consequent volatility on the Profit and Loss Account.

A further concern regards the introduction of subjective elements in the control evaluation, specifically in the evaluation made by the transferor of other burdens on the other subject (the transferee) of the *"practical ability to transfer"*. With reference to this aspect some judgmental elements are introduced that take into consideration the existence of other agreements or stipulated contracts of the transferee at the time of the transfer (see AG52Ea), which the transfer would probably not be aware of and therefore to evaluate.
Likewise, the evaluation would be very discretional if an asset is to be considered *actively traded on an accessible market (at the date of transfer)*, as clearly emerged from the financial crisis of the second semester of 2008.

Similarly, the objective of simplifying current regulations does not seem to be completely reached. With specific reference to Italian companies, the idea of representing residual shares maintained with continuing involvement is not particularly mentioned.

On the other hand, the new ED introduces a new form of partial representation, which could render relatively complex the accounting of non-cash investments or swaps[2], as per § 22 A.

[2] IAS 39, § 22A: *"If an entity transfers an entire financial asset or a group of financial assets to another entity in a transfer that qualifies for derecognition and, as part of the transfer, purchases an interest in that entity (which gives it the right to some of the cash flows from that asset or group of assets), it shall treat such interest as a retained part of the asset or group of assets previously recognised. If the transferee has other financial assets or liabilities in addition to those received from the transferring entity, the transferring entity shall split the interest purchased following the guidance in paragraph 21A between (a) an interest in*

In this case the treatment the ED reserves to shareholding interests to transferrals from non-cash investments or swaps seems far more complex.

The proposal doesn't apparently produce any particular modifications to derecognition operations, specifically to the representation of securitisation operations carried out through the use of vehicles.

Moreover, the doubt remains on whether it would be necessary to apply more restrictive measures to the current ones that foresee, for derecognition purposes, the substantial transfer of all risks and benefits, given that the proposed modification speaks of "no control" [3], concerning the issue of control.

Furthermore, certain operations could be carried out with the sole purpose of manipulating the financial statement's results (for example, in the case of selling shares with a short-term reacquisition obligation to realise hidden capital gains) and thereby greatly reducing the substantial representation of the operations and financial statements' comparability.

3. Alternative proposal provided by ED: impacts and considerations

IASB has analysed two accounting models, and only in February was able to select which one to adopt. However, the other model (hereinafter "alternative model") has also been presented as an *alternative view*.
The alternative model foresees derecognition in the event the transferor no longer has the possibility to possess all the benefits related to the asset and has no possibility of preventing access to these benefits to third parties. The reported assets/liabilities as rights/obligations of eliminated activities quoted at fair value.

This "alternative approach" produces <u>major discontinuities in the current accounting practices</u>, far more than the proposed modifications. For example, all Swap operations would be subject to derecognition, as would many cases of securitisation.

Moreover, we believe that the advantages of simplification introduced through derecognition would not be applicable due to the consolidation regulations, and therefore although it would be possible to eliminate an asset in a financial statement, this may not be possible in a consolidated financial statement as it could require the consolidation of the entity that acquired the asset, over which there is a control.

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the previously recognised asset or group of assets, and (b) an interest in new assets or new liabilities".

[3] BC40: *"If following a transfer an entity is not involved in the transferred financial asset in any way, it no longer controls the economic benefits of that asset".*

The simplification granted is counterbalanced by a request for extremely analytical disclosure (also quantitative) for the activities subject to the transfer. This request would entail significant operational costs in order to produce the additional accounting disclosure.

As previously commented, yet with more emphasis, the observation is made on the possibility to perform operations with the sole purpose of modifying the financial statement’s results.

Given the illustration of the critical elements of both approaches proposed by the ED, we express our preference on maintaining the current situation.