STAFF PAPER

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Project	IAS 39 Financial Instruments: Recognition and Measurement		
Paper topic	Accounting for term-structured repo transactions		
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Introduction

1. In August 2013, the IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify whether three different transactions should be accounted for separately (hereinafter referred to as 'separate accounting') or be aggregated and treated as a single derivative (hereinafter referred to as 'aggregate accounting'). With regard to the request, the submitter also asks how an entity should interpret and apply paragraph B.6 of Guidance on Implementing IAS 39 *Financial Instruments: Recognition and Measurement* ('IG B.6 of IAS 39'). Paragraph IG B.6 of IAS 39 provides guidance on whether non-derivative transactions should be aggregated and treated as a derivative.

2. This Agenda Paper is organised as follows:

   (a) Summary of the issue

   (b) Summary of outreach conducted

   (c) Staff analysis

   (d) Agenda criteria assessment

   (e) Staff recommendation

(f) Appendix A– Proposed wording for tentative agenda decision

(g) Appendix B–Diagrams for cash flows in Transactions 1, 2 and 3

(h) Appendix C–Submission.

Summary of the issue

3. The submission describes three transactions as follows:

   (a) **Transaction 1 (bond purchase)**: Entity Alpha purchases a certain amount of medium-long term bonds (the 'Bond') from Entity Beta, through one or more purchase transactions within a certain period and with the same settlement date;

   (b) **Transaction 2 (interest rate swap)**: Entity Alpha enters into one or more interest rate swap contracts with Entity Beta for hedging purposes for an overall notional amount equal to that of the Bond. The trade date and the start date of the interest rate swap are the same as the purchase date and the settlement date[1] respectively of the Bond in Transaction 1. Under the interest rate swap contract, Entity Alpha receives a variable rate of interest (index + spread X) and pays a fixed rate of interest equal to the fixed coupon rate of the Bond. Where there is foreign exchange risk, this is also hedged item with a cross-currency interest rate swap[2]; and

   (c) **Transaction 3 (repurchase agreement)**: Entity Alpha and Entity Beta enter into a repurchase agreement (the 'Repo Agreement'). The trade date of the Repo Agreement is the same as the settlement date of the Bond and also the maturity date of the Repo Agreement matches the maturity date of the Bond. Under this transaction, Entity Alpha sells the Bond at the spot price to Entity Beta and it uses the cash received in this transaction to finance the purchase of the Bond in Transaction 1.

[1] Settlement date is the date when a financial instrument, which was agreed to be transferred between entities at trade date, is actually executed.

[2] For the purposes of the analysis we do not consider this variant.

During the life of the Repo Agreement, Entity Alpha pays Entity Beta a rate of interest (index + spread Y)[3] applied on the spot cost price of the Bond.

4. The submission provides the following additional facts with regard to Transaction 3:

   (a) Entity Alpha pays Entity Beta for the so-called wrong way risk (ie to address a high correlation between the possibility of default by the issuer of the Bond and that by Entity Alpha) in an ‘overcollateralisation’ arrangement[4];

   (b) Entity Alpha pays Entity Beta for liquidity risk, under ‘margin setting’,[2] that arises from the difference between the amount of the repo and fair value of the Bond.

5. The submission also describes the net cash flows between Entity Alpha and Entity Beta depending on a ‘credit event’ of the Bond:

   (a) in the absence of a ‘credit event’, Entity Alpha periodically receives a net flow calculated on the basis of the difference between the spread received with the hedging interest rate swap and that paid with the repo (X - Y)[5];

   (b) in the presence of a ‘credit event’, the Repo Agreement is cancelled and the following take place:

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[3] This spread Y is less than spread X, which is included in Transaction 2.

[4] Repo transactions typically involve **overcollateralization**. The extent of overcollateralization is known as **a “haircut.”** A haircut is the case where less money is lent than the market value of the assets received as collateral. Suppose the lender lends $90 million and receives $100 million of bonds (at market value), then there is said to be a ten percent haircut. The haircut is distinct from “margin” which refers to maintaining the value of collateral should market prices adversely change after the contract is signed. **Margining** is standard practice in repo, occurring **during the whole period of the transaction**. But **this has nothing to do with the haircut which is a “price discount”** relative to the current market price of the collateral and set when the contract is initially signed. (…) (excerpts from ‘Haircuts and Repo Chains’ written by Tri Vi Dang et al, 2013) (emphasis added)

[5] We assume that cash flows from ‘overcollateralization’ and ‘margin setting’ is excluded from this cash flow profile although the submission does not spell out the fact.

(i) Entity Beta delivers the Bond (ie the financial asset underlying the Repo Agreement), or a bond under the scheme of 'cheapest to delivery'[6], to Entity Alpha for payment of the par value of the Bond;

(ii) at the cancellation of the Repo Agreement, the interest rate swap in Transaction 2 ceases to exist, or, alternatively, there may be a provision the gives Entity Beta the option to keep the interest rate swap in existence.

Issues

6. The submitter's questions can be summarised as follows (see Appendix B for more detailed information):

(a) **(Issue 1)** Should Entity Alpha recognise all transactions in the submission separately or as an aggregated item as a derivative?

(b) **(Issue 2)** How should paragraph IG B.6 of IAS 39 be applied in addressing Issue 1?

(i) **(Issue 2.1)** Should all the indicators specified in paragraph IG B.6 be met in order to determine that all transactions should be accounted for as an aggregated item as a derivative?

(ii) **(Issue 2.2)** in the first indicator ("they are entered into at the same time and in contemplation of one another"), would the condition be met when the contracts are not entered into 'at the same time' but spread out over time?

(iii) **(Issue 2.3)** in the second indicator ("they have the same counterparty"), would the condition be met when the counterparty to one or more contracts may change over time?

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[6] This means that Entity Beta can deliver to Entity Alpha a least expensive bond from a list of acceptable types of bonds upon the 'credit event' rather than delivering the Bond underlying the Repo Agreement.

(iv) **(Issue 2.4)** in the fourth indicator ("there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction"), should the transactions be recognised as an aggregated item as a derivative when the first three indicators are met but this fourth indicator is not met?

Summary of outreach conducted

7. In October 2013, we requested information from the International Forum of Accounting Standard-Setters (IFASS) and securities regulators to help us assess the issues against the Interpretations Committee's agenda criteria. Specifically, we asked:

   (a) Is the fact pattern described in the submission common or relevant in your jurisdiction?

   (b) If answered yes to Q1, what is the prevalent approach in your jurisdiction to account for the three transactions in the submission? That is, should all transactions be recognised separately or as an aggregated item as a derivative?

   (c) If answered yes to Q1, what is the prevalent application of paragraph IG B.6 in addressing Issue 1?

   (d) Did you see any diversity in practice in that accounting? If so, please explain how and why the accounting is diversified.

Feedback from the IFASS

8. The breakdown from the IFASS is as follows:

Geographical area	Number of responses
Asia-Oceania	3
Europe	2
North America	2

Latin America (including Mexico)	1
Africa	1
	9

9. With regard to Question 1, one respondent said that the issue is common in its jurisdiction and six respondents said that the issue is not common. The other two respondents said that transactions similar to the transactions in the submission are common in their jurisdictions.

10. With regard to Question 2, two respondents said that the appropriate approach would depend on the individual facts and circumstances. One respondent mentioned that a stakeholder in its jurisdiction said that it is likely be accounted for as a single derivative. Another respondent mentioned that a stakeholder in its jurisdiction said that it would result in accounting for the transactions separately.

11. With regard to Question 3, one respondent said that all of the indicators in paragraph IG B.6 of IAS 39 need to be met in order to aggregate the transactions. Another respondent said that aggregate accounting could be required even when one of the indicators in paragraph IG B.6 of IAS 39 is not met. Another respondent mentioned that even when the indicators in paragraph IG B.6 of IAS 39 are not present, a combination of transactions may result in a single derivative.

12. With regard to Question 4, one respondent said that it is difficult to identify whether there is diversity in practice because the accounting depends considerably on the facts and circumstances. Two respondents said that there is a potential diversity in practice because it is not clear whether indicators in paragraph IG B.6 of IAS 39 are applied consistently in practice.

Feedback from securities regulators

13. With respect to Question 1, two securities regulators said that the issue is not common in their jurisdictions and one securities regulator said that although it is not common the issue is relevant in its jurisdiction.

14. With respect to Question 2, one respondent said that the prevalent approach is to account for the transactions separately and another respondent said that Transaction 1 and Transaction 3 would be aggregated if certain conditions under its GAAP are met.

15. With respect to Question 3, two respondents said that all indicators in paragraph IG B.6 of IAS 39 should be met and another respondent mentioned that under its GAAP, all of the indicators should be met to aggregate the transactions.

16. With respect to Question 4, one respondent said that there is diversity in practice because different application of the indicators in paragraph IG B.6 of IAS 39. Another respondent said that they see diversity in practice because judgement is required for the fourth indicator (ie whether there is no apparent economic need or substantive business purpose for structuring the transactions separately).

Staff analysis

17. In our analysis, we will examine **Issue 1** as follows.

    (a) Should the three transactions be aggregated and treated as a single derivative? **(Analysis 1)**;

    (b) If the three transactions should not be aggregated, what would be the appropriate accounting for the separate transactions?

        (i) Does Transaction 1 (ie bond purchase transaction) meet the derecognition criteria in IAS 39? **(Analysis 3)**

        (ii) Does Transaction 3 (ie repo agreement) meet the derecognition criteria in IAS 39? **(Analysis 4)**

18. In addition, we will examine Issue 2 (ie how should paragraph IG B.6 of IAS 39 be applied in addressing Issue 1?) in **Analysis 2**.

Analysis 1: Should the three transactions be aggregated and treated as a single derivative?

19. To examine whether the three transactions should be aggregated and treated as a single derivative, we note paragraph IG B.6 of IAS 39, paragraph C.6 of Guidance on Implementing IAS 39 ('IG C.6 of IAS 39') and paragraph AG39 of IAS 32 *Financial Instruments: Presentation*. These paragraphs are as follows (emphasis added).

> B.6 Definition of a derivative: offsetting loans
>
> Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are **no transfers of principal at inception** of the two loans, since A and B have a netting agreement. Is this a derivative under IAS 39?
>
> Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement). **The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment**. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. **Indicators of this would include:**
>
> - they are entered into at the same time and in contemplation of one another
> - they have the same counterparty
> - they relate to the same risk

- there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IAS 39.9 does not require net settlement.

C.6 Embedded derivatives: synthetic instruments

Entity A acquires a five-year floating rate debt instrument issued by Entity B. At the same time, it enters into a five-year pay-variable, receive-fixed interest rate swap with Entity C. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument and classifies the instrument as a held-to-maturity investment, since it has the positive intention and ability to hold it to maturity. Entity A contends that separate accounting for the swap is inappropriate since IAS 39.AG33(a) requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract. Is the entity's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. **It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument** ('synthetic instrument' accounting) for the purpose of applying IAS 39. **Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately.** Therefore, the debt instrument and the swap are classified separately. **The transactions**

described here differ from the transactions discussed in Question B.6, which had no substance apart from the resulting interest rate swap.

AG39 The Standard does not provide special treatment for so-called 'synthetic instruments', which are groups of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt. **Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed.** Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented in an entity's statement of financial position on a net basis unless they meet the criteria for offsetting in paragraph 42.

20. While it is not directly on point we also note that there are other examples in IFRS of needing to consider whether separate legal transactions should be aggregated. This guidance is provided in SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*. In that [Interpretation] it is noted that in some circumstances the overall economic effect of a lease transaction cannot be understood without reference to the series of transactions as a whole.

21. When we apply the requirements in paragraphs IG B.6 and IG C.6 of IAS 39 and paragraph AG39 of IAS 32 to the submitter's case, we think that a pre-assessment should be whether the three transactions have equivalent net cash

flows to those of a derivative. As set out in our example in Appendix B, it is apparent that if the three transactions are considered in aggregate the net cash flows of the submitter's transactions are akin to those of a credit default swap with a risk of the bond as the underlying. In summary:

(a) at the inception (diagram 1 in Appendix B): the net cash flow is the 'hair cut' on the repo transaction and the legal title to the Bond 'remains' with Entity Beta. In a credit default swap, it can be considered as an up-front payment for the so-called wrong way risk. As for a credit default swap, Entity Alpha is exposed to the credit risk on the Bond although it does not hold the bond.

(b) during the life of the repo agreement (diagram 2 in Appendix B): a net amount (reflecting the spread between the margin on the floating leg of the swap and on the interest rate on the repo) is paid by Entity Beta to Entity Alpha and margin calls are made as needed on Entity Alpha. In a credit default swap, a premium is paid by a credit protection buyer to a credit protection seller. Margin calls are also set up in a credit default swap.

(c) at maturity assuming a credit event does not occur (diagram 3 in Appendix B): the periodic spread between the margins on the floating leg of the swap and the interest rate on the repo are paid by Entity Beta to Entity Alpha and any accumulated margin call would be repaid. In a credit default swap a premium would be paid by a credit protection buyer to a credit protection seller. Any margin call would also be returned on the maturity of a credit default swap.

(d) at the date when a credit event occurs (diagram 4 in Appendix B): Entity Alpha pays the principal amount of the bond to Entity Beta and Entity Beta returns the accumulated margin calls to Entity Alpha. Entity Alpha also receives back a bond which may be worth less than the amount paid to Entity Beta thus suffering any shortfall in the value of the bond. In a credit default swap, a protection seller would

similarly compensate the protection buyer for this shortfall in value on the occurrence of a credit event.

22. On the basis of the comparison above, we think that the three transactions have equivalent net cash flows to those of a credit default swap. However, this fact alone does not mean that the submitter should aggregate the three transactions. As noted above, paragraphs IG B.6 and IG C.6 of IAS 39 and paragraph AG39 of IAS 32 provide guidance for such assessment.

23. We note that the Implementation Guidance (IGs) accompanying IAS 39 provide *guidance* on how to apply IAS 39. Further we note that IG B.6 of IAS 39 itself clearly sets out *indicators* to be considered in making an assessment of when non-derivative transactions should be aggregated when the 'transactions result, in substance, in a derivative'. We think that this approach was intentional in acknowledgment that facts and circumstances differ and that the assessment will require a considerable level of judgement. For example, an entity may need to exercise its judgement in determining whether the transactions are entered into 'in contemplation of one another' and whether 'there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.'

24. Meanwhile, paragraph IG C.6 of IAS 39 and paragraph AG39 of IAS 32 describes that 'each of the financial instruments [that are used to construct a synthetic instrument] has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and swap are classified separately.'

25. We think that a full understanding of the facts and circumstances surrounding a transaction is required in order to determine whether the transactions should be aggregated.[7] In particular this full understanding is necessary to assess

[7] The submitter says that Entity Alpha argues that it has apparent economic need or substantive business purpose for structuring the transactions separately. According to the submitter, it may be

whether there was an economic reason or a substantive business purpose that caused Entity Alpha (and Beta) to enter into a series of separate transactions rather than into a credit default swap. In our view, the underlying objective of this assessment is ultimately whether the transaction is more faithfully represented by accounting for the transactions as a single derivative or as a series of separate non derivative transactions. In so doing, we think that it would be appropriate to consider the information that would or would not be provided if the transaction were accounted for in aggregate rather than separately.

26. If the three transactions are accounted for in aggregate, the transactions would be a credit default swap. In this case, Entity Alpha would account for the transactions in aggregate as a derivative that would be measured at fair value through profit or loss.

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affirmed:

- that the business purpose of the operation as a whole cannot be considered as simply the sale of protection of a credit default swap, but should be seen as creating an exposure to securities, funded through a maturity match repo to optimize liquidity absorption and with [interest] rate risk [hedged], in order to make a positive contribution to the margin of interest;
- that the solution to pursue this aim has been identified in contracting that is separate and distinct of the purchase of the Bond, of the repo contract and of the hedging interest rate swap;
- that the legal separateness of the individual contracts, in line with the intention of the operation to make a positive contribution to the margin of interest, gives Entity Alpha (and always has) the possibility to manage and trade the contracts separately, thereby allowing it, where market and liquidity conditions offer opportunities, to modify the structure of financing the position it holds on risk. Thus, in this case, in principle, Entity Alpha, in agreement with the Entity Beta, can extinguish the repos separately, independently of the securities and the hedging interest rate swap;
- that, consistent with the business purpose described, the individual contractual elements of the operation are recorded separately.

In addition, the submission states that in the occurrence of a credit event, Transaction 2 (ie the interest rate swap) ceases to exist, or, alternatively, there may be a provision that gives Entity Beta the option to keep Transaction 2 in existence. This may indicate that Transaction 2 can be transferred or settled separately.

Analysis 2: analysis for Issue 2

27. The submitter raised another issue (Issue 2) about how paragraph IG B.6 of IAS 39 should be applied when determining whether Entity Alpha should recognise all three transactions separately or as an aggregated item as a derivative. In this section, we examine Issue 2 (ie Issues 2.1 to 2.4).

28. As shown in Analysis 1, we note that IG B.6 of IAS 39 provides indicators of when aggregation may be required that require the use of judgement.

29. We also note that the indicators in paragraph IG B.6 of IAS 39 are neither definitive nor exhaustive (as reflected in the wording 'Indicators of this would include'). We think that the purpose of these indicators is not to prescribe sufficient and/or necessary conditions to account for a set of non-derivative transactions as a single derivative. Instead, the purpose of these indicators is to provide broad guidance on what could be considered in assessing whether a set of non-derivative transactions, in substance, meets the definition of a derivative set out in IAS 39. In short, we are of the view that IG B6 sets out indicators to consider but those indicators in themselves are not conclusive.

30. Nevertheless, we think that if transactions meet those indicators in paragraph IG B.6 of IAS 39, the transactions would normally be aggregated as a derivative. However, if the transactions do not meet all of the indicators, we do not believe that would preclude the transactions from being accounted for as an aggregated item.

31. On the basis of the analysis above, we think that we cannot properly address Issues 2.1 to 2.4 merely on the basis of the information described in the submission. The reasons that apply to each of the issues within Issue 2 are as follows.

    (a) Issue 2.1 (Should all indicators specified in paragraph IG B.6 be met in order to determine that all transactions should be accounted for as an aggregated item as a derivative?): as analysed in the preceding paragraphs, if all indicators are met, we think that all transactions would *normally* be accounted for as an aggregated item particularly given that the indicators include an assessment of whether there are

substantive business purposes for the transactions being undertaken separately. However, even if some of the indicators are not met, that would not preclude the transactions from being accounted for as an aggregated item. The indicators are simply factors to consider;

(b) Issue 2.2 (in the first indicator ("they are entered into at the same time and in contemplation of one another"), would the condition be met when the contracts are not entered into 'at the same time' but spread out over time?): focussing on the specific question, the indicator is worded to be literally 'at the same time'. The focus would seem to be a practical one. The question is whether legally separate transactions are in effect a single transaction and this is more likely to be the case if the timing is aligned. However, because this is an *indicator* we think that it should be read in that spirit – if for example, transactions are taken within a very short period of time and in contemplation of one another, it would seem inappropriate to read an indicator so closely that the time factor has a profound impact upon the analysis of the appropriate accounting.

(c) Issue 2.3 (in the second indicator ("they have the same counterparty"), would the condition be met when the counterparty to one or more contracts may change over time?): As same as for Issue 2.2, it would be necessary to assess whether inconsistency with this indicator is significant enough to conclude that the transactions should be accounted for separately. Such assessment should be made based on terms and conditions of individual contracts. Furthermore, a change in counterparty would likely require that a new assessment should be made.

(d) Issue 2.4 (in the fourth indicator ("there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction"), should the transactions be recognised as an aggregated item as a derivative when the first three indicators are met but this fourth indicator is not met?): if one indicator is not met, that would not

preclude the transactions from being accounted for as an aggregated item. It would be necessary to assess whether not meeting this indicator is a significant enough factor to conclude that the transactions should be accounted for separately. Such an assessment should be made on the basis of the terms and conditions of the individual contracts.

Analysis 3: Does Transaction 1 (ie the bond purchase transaction) meet the derecognition criteria in IAS 39?

32. In Analysis 1 and 2 above, we noted that a full understanding of the facts and circumstances surrounding the transactions is required in order to determine whether the transactions should be aggregated. If it is concluded that the transactions should not be aggregated, then the appropriate accounting for the separate transactions needs to be considered.

33. In determining the appropriate accounting for the separate transactions, the following consideration needs to be given to:

    (a) Whether Entity Beta should derecognise the bond; Entity Alpha can only recognise the bond if Entity Beta is able to derecognise.

    (b) Whether Entity Alpha should recognise the bond and then whether it should continue to recognise the bond given Transactions 2 and 3.

34. We will perform an analysis with respect to (a) of the preceding paragraph in Analysis 3 and with respect to (b) of the preceding paragraph in Analysis 4.

Symmetry in Entity Alpha and Entity Beta's accounting

35. From the perspective of Entity Alpha's accounting, we note that whether Entity Alpha could recognise the bond in Transaction 1 (ie bond purchase transaction) in its financial statements depends on whether Entity Beta should derecognise the bond or not. In other words, if Entity Beta accounts for Transaction 1 as derecogntion of the bond, Entity Alpha can recognise the bond in its financial statements; and if Entity Beta does not account for

Transaction 1 as derecogntion of the bond, Entity Alpha cannot recognise the bond in its financial statements; instead, Entity Alpha accounts for the transaction as a loan or receivable. This is because paragraph AG 50 states that:

> AG50 **To the extent that a transfer of a financial asset does not qualify for derecognition**, **the transferee does not recognise the transferred asset as its asset.** The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable **as a loan or receivable.** (emphasis added)

36. Accordingly, we think that in order to assess whether Entity Alpha can recognise the bond, it is necessary to first assess whether Entity Beta is able to derecognise the Bond.

Risks and rewards criteria

37. We note the derecognition requirements in paragraphs 17, 18 and 20 of IAS 39.

> 17 An entity shall derecognise a financial asset when, and only when:
>
> (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 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20.
>
> 18 An entity transfers a financial asset if, and only if, it either:

(a) **transfers the contractual rights to receive the cash flows of the financial asset**; or

(b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19. (emphasis added)

20 When an entity transfers a financial asset (see paragraph 18), 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 derecognise 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 (see paragraph 30). (emphasis added)

38. In the fact patterns analysed, we think that Entity Beta transfers the contractual rights to receive the cash flows from the bond to Entity Alpha

through Transaction 1, thus meeting the criteria in paragraph 18(a) of IAS 39. Accordingly, Entity Beta needs to assess whether it retains the risk and rewards of ownership of the bond in accordance with paragraph 20 of IAS 39.

39. We note that paragraph 21 of IAS 39 provides guidance on how to make the assessment required in paragraph 20 of IAS 39.

> 21 The transfer of risks and rewards (see paragraph 20) is evaluated by **comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset.** An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change **significantly** as a result of the transfer (eg because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (eg because the entity has sold a financial asset subject only to an option to buy it back at its fair value at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 19). (emphasis added)

40. We note that paragraph 21 of IAS 39 suggests that an entity should assess the transfer of risks and reward by comparing the entity's exposure, **before and after the transfer**, with the **variability in the amounts and timing of the net cash flows** of the transferred asset.

41. Before the sale of the bond Entity Beta is exposed to the full risks of owning the bond. So is it exposed to the variability of the fixed interest rate risk on the bond and also the credit risk on the interest payments and the principal amount. After entering into Transactions 1 to 3, Entity Beta continues to be exposed to the fixed interest rate risk on the bond but is no longer exposed to the credit risk on the bond (that is replaced by an exposure to the credit risk of Entity Alpha which is not part of the derecognition analysis for the bonds)

42. The assessment of whether Entity Beta transfers substantially all the risks and reward to Entity Alpha would depend on fact patterns of the transaction(s). For example, for a short dated bond with a low quality issuer the credit risk would be the main risk of ownership. In this case, transferring that risk to Entity Alpha may mean that ‘substantially all’ of the risks and rewards are transferred. In contrast, if the bond were a long dated bond with a high quality issuer the interest rate risk could be a significant risk of ownership. In that case, its retention may mean that Entity Beta has neither transferred nor retained substantially all the risks and rewards of ownership.

43. We cannot assess whether Entity Beta has transferred all the risks and rewards of ownership of the bond on the basis of the fact patterns in the submission.

Control criteria

44. Although we cannot determine whether Entity Beta has transferred substantially all the risks and rewards of ownership of the bond in the submission as analysed above, we perform, in this section, the subsequent analysis that would be required in the case in which the conclusion is reached that Entity Beta neither transfers nor retains substantially all the risks and reward of ownership of the bond.

45. We note that to assess against the derecognition criteria, IAS 39 requires that an entity determines whether it has retained control of the financial asset if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial assets (ie paragraph 20(c)(i) of IAS 39). We also

note that paragraphs AG42 to AG44 of IAS 39 provide guidance for assessment of the transfer of control.

AG42 An entity has not retained control of a transferred asset if the transferee has the **practical ability to sell the transferred asset.** An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option. (emphasis added)

AG43 The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist.

In particular:

(a) a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset; and

(b) an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:

(i) the transferee's ability to dispose of the transferred asset must be independent of the actions of others (ie it must be a unilateral ability); and

(ii) the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (eg conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

AG44 That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

46. Applying these requirements to the submitter's case, we think that the assessment of transfer of control would vary depending on circumstances. For example, evaluating whether Entity Alpha (ie the transferee) has the practical ability to sell the bond involves consideration of whether the bond in the submission is traded in an active market or not. Consequently, since the

submission does not include such information, we cannot determine whether Entity Alpha would have the practical ability to sell the bond. Accordingly, we cannot determine whether Entity Beta has transferred control of the bond to Entity Alpha by Transaction 1.

Summary

47. In this Analysis 3, we identified the steps required to determine whether **Entity Beta** can derecognise the bond and that the results of this analysis will depend on the particular facts and circumstances of the transaction. Correspondingly, determining whether **Entity Alpha** can recognise the bond or not as a result of Transaction 1 will also depend on the specific facts and circumstances of the transaction.

48. Consequently, in the following analysis, we will consider both cases, that is, (1) Entity Beta meets the derecognition criteria in IAS 39 (ie Entity Alpha accounts for Transaction 1 as a **purchase of the bond**) or (2) Entity Beta fails to meet the derecognition criteria of IAS 39 (ie Entity Alpha accounts for Transaction 1 as a **collateralised lending**).

Analysis 4: Does Transaction 3 (ie the repo agreement) meet the derecogniton criteria in IAS 39?

49. If Entity Beta derecognises the bond, then it is necessary to determine whether Transaction 3 will meet the derecognition criteria in IAS 39 for Entity Alpha. This is because a repo agreement depending on the terms of the arrangement is accounted for either as a spot sale combined with a forward purchase or as a collateralised borrowing. We also note that to assess whether Transaction 3 meets the derecognition criteria for Entity Alpha, the same steps (ie assessment against 'risks and rewards' criteria and 'control' criteria) apply as considered in Analysis 3.

50. An assessment against 'risks and rewards' criteria for Entity Alpha would be to compare interest risk and credit risk on the bond. In this regard, Entity

Alpha would not be exposed to interest rate risk because it is transferred to Entity Beta through Transaction 2 (ie an interest rate swap) while retaining the credit risk through Transaction 3 (ie a repo agreement). Consequently, the assessment would depend on comparing the bond term and the credit risk with interest rate risk. If the assessment against 'risks and reward' criteria concludes that Entity Alpha neither transfers nor retains substantially all the risks and rewards of ownership of the bond, an assessment against 'control' criteria is necessary. This assessment needs to examine whether Entity Beta has the practical ability to sell the bond. Whether Entity Beta has the practical ability to sell the bond would depend on the liquidity for the bond but also the fact that Entity Beta does not have to return the same bond under the scheme of 'cheapest to delivery' may also be considered.

51. Consistently with the analysis for Entity Beta, we think that we would not be able to determine whether Transaction 3 results in derecogntion of the underlying asset of the repo agreement (ie the same bond as in Transaction 1) merely on the basis of the fact patterns in the submission because that analysis will depend on the specific facts and circumstances of each transaction. In particular, we note that just because the repo agreement is to the maturity of the bond it does not necessarily cause the bond to be derecognised.

52. Accordingly, when we assess Transaction 3 against the derecognition criteria in IAS 39, we note that Transaction 3 will result in either (1) collateralised borrowing or (2) sale of the underlying asset of the repo agreement (ie the same bond as in Transaction 1). Then, combining this assessment for Transaction 3 with the assessment for Transaction 1, we note that from the perspective of Entity Alpha, there are three[8] possible scenarios to consider as follows:

[8] We did not consider another case in which Transacition 1 is collateralised lending and Transaction 3 is sale of bond. This is because if Entity Alpha does not purchase of the bond in Transaction 1, it would be inappropriate to account for Transaction 3 as a sale of the bond.

Table 1. Derecognition assessment on Transactions 1 and 3 for Entity Alpha

	Scenario 1	Scenario 2	Scenario 3
Transaction 1	Purchase of bond	Purchase of bond	Collateralised lending
Transaction 3	Sale of bond	Collateralised borrowing	Collateralised borrowing

Scenario 1 (Transaction 1: purchase of bond, Transaction 3: sale of bond)

53. We note that one may question whether this scenario is feasible or not because Transactions 1, 2 and 3 are considered in the derecognition assessment for Entity Beta and the same set of transactions is being analysed by Entity Alpha. In other words, its argument is that two assessments are interrelated and thus different outcomes are not possible.

54. We note that there has to be consistency in the derecognition assessment of the two transactions. Nevertheless, we think that this scenario is feasible. The reason is as follows.

55. When we examined Transaction 1 in Analysis 3 to assess whether Entity Beta (transferor) retains control of the bond (ie 'control criteria'), the criterion is whether Entity Alpha (transferee) has the practical ability to sell the bond. In other words, the criterion is not directly associated with cash flows of Transactions 2 and Transactions 3. When we examine Transaction 3 to assess whether Entity Alpha (transferor) retains control of the bond, the criterion is whether Entity Beta (transferee) has the practical ability to sell the bond[9]. As

[9] We note that the scheme of 'cheapest to delivery' described in the submission may indicate that Entity Beta (transferee) has the practical ability to sell the bond. This is because (1) 'cheapest to delivery' can imply that Entity Beta sells the bond in an 'active' market and an asset that is similar to the bond is purchased and delivered to Entity Alpha for the repurchase agreement and (2) one of the

noted in Analysis 3, such an assessment would be based on paragraphs AG42 to AG44 of IAS 39 and also depends on facts and circumstances of the individual contracts. Consequently, if Entity Beta derecognised the bond through Transaction 1, thereby meeting 'control criteria', Scenario 1 would be feasible.

56. In Scenario 1, we note that Entity Alpha would not recognise the bond at the inception date of Transactions 1 and 3 because Transaction 3 reverses the effect of Transaction 1. However, that is not equivalent to treating the transactions as a single derivative. This is because subsequent accounting treatments for 'aggregate accounting' would be different from that for 'separate accounting'. For example, if Entity Alpha were to account for the three transactions in aggregate it would measure a derivative at fair value through profit or loss rather than account for interest coupons on an accrual basis.

Scenario 2 (Transaction 1: purchase of bond, Transaction 3: collateralised borrowing) and Scenariso 3 (Transaction 1: collateralised lending, Transaction 3: collateralised borrowing)

57. In Scenario 2, we note that if Entity Alpha were to account for the three transactions separately, it would recognise them as follows:

    (a) an asset (ie the bond) in Transaction 1;

    (b) a derivative in Transaction 2; and

    (c) a liability (ie collateralised borrowing) in Transaction 3.

58. In Scenario 3, we note that if Entity Alpha were to account for the three transactions separately, it would recognise them as follows:

    (a) an asset (ie loan or receivable) in Transaction 1;

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indications that a transferee has the practical ability to sell the transferred asset is that the transferred asset is traded in an active market (paragraph AG42 of IAS 39).

(b) a derivative in Transaction 2; and

(c) a liability (ie borrowing or payable) in Transaction 3.

59. We note that assets and liabilities in (a) and (c) of paragraphs 57 and 58 need to be recognised unless arrangements are in place that would satisfy the offsetting requirements in IAS 32[10]. However, even if the transactions were offset, that would not result in the same accounting as aggregation of the transactions into a single derivative. This is because ‘aggregate accounting’ is different from offsetting; offsetting is a matter of presentation while ‘aggregate accounting’ involves recognition and measurement.

Analysis 5: considerations for disclosure

60. Although the submitter does not ask how to disclose the information, we may consider the implication of the submitter’s issues on disclosure.

61. We note that the submitter’s issues relate to various parts of the requirements in IFRS 7 *Financial Instruments: Disclosures.* Specifically, the relevant requirements include the nature and extent of risks arising from financial instruments (including potentially credit risk and liquidity risk), collateral and transfers of financial assets.

62. We note that the objective of IFRS 7 is to provide information that enables user of its financial statement to evaluate (1) the significance of financial instruments for its financial position and performance and (2) the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

63. Taking into consideration the complex fact patterns in the submitter’s transactions, we think that disclosure of relevant information about these transactions would provide useful information to users and would meet the objective of IFRS 7, even if such information is not specifically required by

[10] The fact pattern described did not set out any arrangements relevant to offsetting.

IFRS 7. At the same time, we note that the decision to provide this information would also be subject to a materiality assessment that should consider the qualitative and quantitative characteristics of the effect that knowledge of the details of the transactions would have on the users of the financial statements.

Summary of staff analysis and staff conclusion

64. On the basis of staff analyses above, our view with regard to **Issue 1** can be summarised as follows:

    (a) In order to determine whether Entity Alpha should aggregate and treat the three transactions as a single derivative, it necessary to make an assessment based on paragraphs I.G B.6 and IG C.6 of IAS 39 and paragraphs AG39 of IAS 32. (see **Analysis 1**);

    (b) If Entity Alpha concludes that the three transactions should not be aggregated, it is necessary to assess the derecognition criteria in IAS 39 in order to determine the appropriate accounting for the separate transactions. The assessment against the derecognition criteria is made as follows:

        (i) Does Transaction 1 meet the derecognition criteria (ie whether Entity Beta should derecognise the bond; correspondingly, Entity Alpha only can recognise the bond if Entity Beta is able to derecognise it)? (see **Analysis 3**);

        (ii) Does Transaction 3 meet the derecognition criteria (ie whether Entity Alpha should recognise the bond and then whether it should continue to recognise the bond given Transactions 2 and 3)? (see **Analysis 4**)

    (c) In order to determine whether Transaction 1 meets the derecognition criteria it is necessary to analyse the specific facts and circumstances of the individual contracts. Consequently,

(i) if Transaction 1 meets the derecognition criteria, Entity Beta derecognises the bond and Entity Alpha accounts for Transaction 1 as a **purchase of the bond**; and

(ii) if Transaction 1 fails to meet the derecognition criteria, Entity Beta does not derecognise the bond and Entity Alpha accounts for Transaction 1 as a **collateralised lending**. (see **Analysis 3**)

(d) On the basis of Analysis 3, when we assess whether Transaction 3 meets the derecognition criteria and combine the assessments for Transactions 1 and 3, there are three possible scenarios. Entity Alpha would have the three scenarios as follows:

(i) (Scenario 1) Transaction 1 is a purchase of the bond and Transaction 3 is a sale of the bond;

(ii) (Scenario 2) Transaction 1 is a purchase of the bond and Transaction 3 is a collateralised borrowing;

(iii) (Scenario 3) Transaction 1 is a collateralised lending and Transaction 3 is a collateralised borrowing. (see **Analysis 4**)

65. Our view with regard to **Issue 2** can be summarised as follows (see **Analysis 2**):

(a) The indicators provided in paragraph IG B.6 require a considerable level of judgement and are neither definitive nor exhaustive;

(b) The purpose of these indicators is not to prescribe sufficient and/or necessary conditions, but to provide broad guidance on assessing whether a set of non-derivative transactions, in substance, meets the definition of a derivative set out in IAS 39;

(c) If transactions meet those indicators, the transactions would normally be aggregated as a derivative. However, the fact that the transactions do not meet some of the indicators would not preclude the transactions from being accounted for as an aggregated item;

(d) Consequently, in order to properly address Issue 2 (ie Issues 2.1 to 2.4) it is necessary to have the full information about the individual contracts.

66. In conclusion, we think that the Interpretations Committee cannot address the submitter's issues in general terms because the assessment require judgements to be made that are dependent on specific facts and circumstances.

67. We do, however, think that the current Standards provide sufficient guidance to enable an entity to identify the analyses that must be made in order to conclude on the accounting.

68. In addition, we think that taking into consideration the complex fact patterns of the submitter's transactions, an entity should consider disclosing relevant information about these transactions even if such information is not specifically required by IFRS 7. The decision to provide this information would be subject to a materiality assessment that should consider the qualitative and quantitative characteristics of the effect that knowledge of the details of the transactions would have on users of the financial statements. (see **Analysis 5**)

Question 1 for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff analysis?

Agenda criteria assessment

69. The staff's assessment of the agenda criteria[11] is as follows:

Source of issue
Issues could include: the identification of divergent practices that have emerged for accounting for

[11] These criteria can be found in the IASB and IFRS Interpretations Committee Due Process Handbook as indicated in the paragraphs below.

particular transactions, cases of doubt about the appropriate accounting treatment for a particular circumstance or concerns expressed by investors about poorly specified disclosure requirements (5.14).	
Criteria	
We should address issues(5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected;	**No.** Majority of respondents to our outreach activity stated that the issue is not common.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	In our outreach activity, some indicated that there is (potential) diversity in practice. In our analysis of this paper, we noted that applying the indicators in paragraph IG B.6 of IAS 39 would involve considerable level of judgement, depending on facts and circumstances of the individual transactions. In order to determine if the resulted potential diversity could be reduced, we would need to understand whether this potential diversity arises from the guidance provided or the judgement that needs to be made.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**N/A**
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when	**N/A**

making changes to IFRSs (5.17)?	
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	**N/A**

Staff recommendation

70. On the basis of the staff analysis above, we recommend that the Interpretations Committee should not take this issue onto its agenda.

71. We have set out proposed wording for tentative agenda decision in **Appendix A**.

Questions 2 and 3 for the Interpretations Committee
2. Does the Interpretations Committee agree with the staff recommendation that the Interpretations Committee should not take this issue onto its agenda? 3. Does the Interpretations Committee agree with the draft tentative agenda decision as set out in Appendix A?

Appendix A—Proposed wording for tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

IAS 39 *Financial Instruments: Recognition and Measurement*—Accounting for term-structured repo transaction

The Interpretations Committee received a request to clarify: ('Issue 1') whether an entity (Entity A) should account for three transactions separately or aggregate and treat them as a single derivative; and ('Issue 2') how to apply paragraph B.6 of Guidance on Implementing IAS 39 ('IG B.6 of IAS 39') in addressing Issue 1. Some key features of the three transactions are as follows:

a. Transaction 1 (bond purchase): Entity A purchases bonds ('the bond') from another entity (Entity B).

b. Transaction 2 (interest rate swap): Entity A enters into interest rate swap contract(s) with Entity B. Entity A receives a variable rate of interest and pays a fixed rate of interest equal to the fixed coupon rate of the bond in Transaction 1. The trade date and the start date of Transaction 2 are the same as the purchase date and the settlement date of Transaction 1, respectively. The maturity date of the interest rate swap in Transaction 2 is the same as that of the bond in Transaction 1. The overall notional amount of the interest rate swap in Transaction 2 matches that of the bond in Transaction 1. In the occurrence of a 'credit event', the interest rate swap ceases to exist, or, alternatively, there may be a provision that gives Entity B the option to keep the interest rate swap in existence.

c. Transaction 3 (repurchase agreement): Entity A enters into a repurchase agreement with Entity B, where the underlying asset is the bond in Transaction 1. The trade date of Transaction 3 is the same as the settlement date of Transaction 1; the maturity date of the repurchase agreement is the same as that of the bond in Transaction 1. During the life of the repurchase agreement, Entity A pays Entity B a

rate of interest. In the occurrence of a 'credit event', the repurchase agreement is cancelled and Entity B delivers the bond to Entity A for payment of the par value of the bond.

The Interpretations Committee noted that in order to determine whether Entity A should aggregate and treat the three transactions as a single derivative, it necessary to make an assessment based on paragraphs I.G B.6 and paragraph B.6 of Guidance on Implementing IAS 39 ('IG C.6 of IAS 39') and paragraphs AG39 of IAS 32. It also noted that the assessment require judgements to be made that are dependent on specific facts and circumstances of the individual contracts.

The Interpretations Committee noted that if Entity A concludes that the three transactions should not be aggregated, it is necessary to assess the derecognition criteria in IAS 39 in order to determine the appropriate accounting for the separate transactions.

The Interpretations Committee also noted that the assessment of Transactions 1 and 3 against the derecognition criteria would result in the following three scenarios from the perspective of Entity A:

a. (Scenario 1) Transaction 1 is a purchase of the bond and Transaction 3 is a sale of the bond.
b. (Scenario 2) Transaction 1 is a purchase of the bond and Transaction 3 is a collateralised borrowing.
c. (Scenario 3) Transaction 1 is a collateralised lending and Transaction 3 is a collateralised borrowing.

On the basis of the analysis above, the Interpretations Committee noted that the fact patterns provided in the request do not provide enough detail to assess whether the three transactions should be accounted for separately or aggregated. It also noted that the current Standards provide sufficient guidance to enable an entity to identify the analyses that must be made in order to conclude on the accounting.

The Interpretations Committee also discussed Issue 2, ie how to apply

paragraph IG B.6 of IAS 39 in addressing Issue 1.

The Interpretations Committee noted that the indicators provided in paragraph IG B.6 of IAS 39 require a considerable level of judgement and are neither definitive nor exhaustive. It also noted that if transactions meet those indicators, the transactions would normally be aggregated as a derivative; however, the fact that the transactions do not meet some of the indicators would not preclude the transactions from being accounted for as an aggregated item.

On the basis of the analysis above, the Interpretations Committee noted that how to apply paragraph IG B.6 of IAS 39 depends on specific facts and circumstances of the individual contracts.

In addition, the Interpretations Committee noted that taking into consideration the complex fact patterns of the transactions, Entity A should consider disclosing relevant information about these transactions even if such information is not specifically required by IFRS 7 *Financial Instruments: Disclosures*. The Interpretations Committee noted that the decision to provide this information would be subject to a materiality assessment that should consider the qualitative and quantitative characteristics of the effect that knowledge of the details of the transactions would have on the users of the financial statements.

The Interpretations Committee considered that in the light of its analysis of the existing IFRS requirements, an interpretation was not necessary and consequently [decided] not to add the issue to its agenda.

Appendix B—Diagrams for cash flows in Transactions 1, 2 and 3

The following diagrams show cash flows, assuming the fact patterns below.

A. Fact patterns

- **Transaction 1**: Entity Alpha purchases a bond from Entity Beta. The features of the bond are as follows.
  - the par value is CU100, which is also the market price on the settlement date;
  - the settlement date is 1 January 20X0;
  - the coupon rate is 10% and is paid on an annual basis; and
  - the remaining maturity is three years.
- **Transaction 2**: Entity Alpha entered into a three-year interest rate swap with Entity Beta, with the following features.
  - Entity Alpha pays fixed rate of 10% and receives LIBOR+3% (assuming LIBOR is 6% at inception);
  - the notional amount is CU100;
  - the inception date of the swap matches the settlement date of the bond;
  - the swap is on-market at inception date and has a fair value of zero; and
  - the swap resets on an annual basis.
- **Transaction 3**: Entity Alpha entered into a repo agreement with Entity Beta. The features of the repo agreement are as follows.
  - the underlying asset is the bond in Transaction 1;
  - under this repo agreement, Entity Alpha sells the bond to Entity Beta at the spot price (ie CU100) on 1 January 20X0 and buys back the bond at par value of the bond (ie CU100) after three years (ie the same date as the maturity date of the bond)[12];

[12] In other words, Entity Alpha borrows money with a collateral of the bond in Transaction 1.

- Entity Alpha pays Entity Beta interest (LIBOR + 1%) on an annual basis during the life of the repo agreement;
- Entity Alpha pays the amount of CU5 to Entity Beta at the trade date for the so-called wrong way risk (ie when there is a high correlation between the possibility of default by the issuer of the bond and that by Entity Alpha) under an 'overcollateralisation' mechanism (so-called 'haircut');
- Entity Alpha provides additional collateral to Entity Beta for liquidity risk, under 'margin setting': That is, Entity Alpha delivers margin to Entity Beta for the difference between the initial repurchase price (ie CU100) of the repo agreement and fair value of the collateral (ie market price of the bond); and
- upon the occurrence of a 'credit event' (including a moratorium[13] of the bond issuer), the repo agreement is cancelled and the following take place over the life of the repo agreement:
  - (i) Entity Beta delivers the bond, or a bond under the scheme of 'cheapest to delivery'[14], to Entity Alpha in return for receipt of the par value of the bond; and
  - (ii) the interest rate swap in Transaction 2 ceases to exist. (Entity Beta has an option to keep the interest rate swap in existence.)

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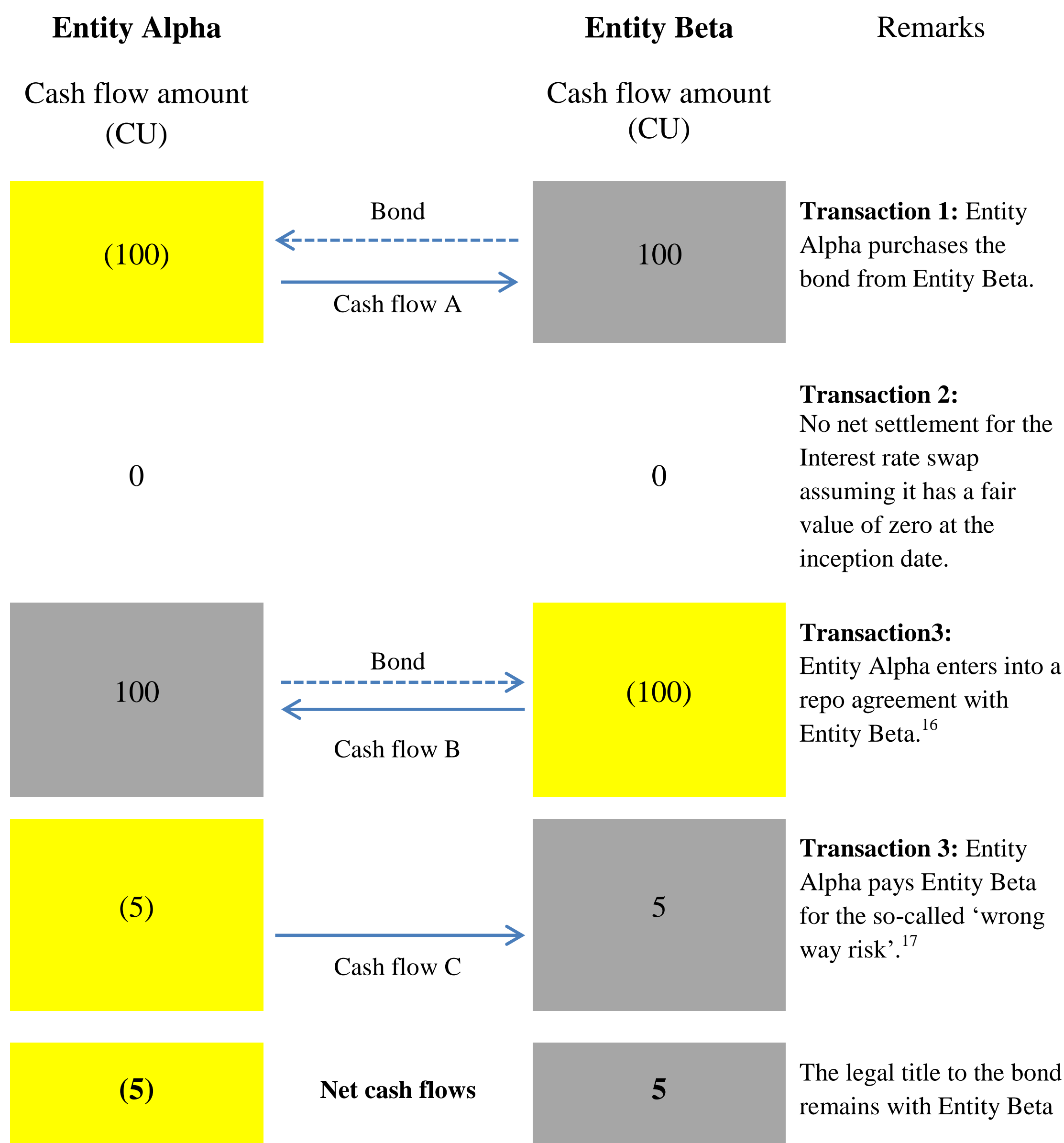
[13] A bond issuer decides to suspend payment to its creditors.

[14] This means that Entity Beta can deliver to Entity Alpha a least expensive bond from a list of acceptable types of bonds (which is would be expected to be specified in the terms of the repo agreement) upon the 'credit event' rather than delivering the bond underlying the repo agreement.

B. Diagrams[15] for cash flows in Transaction 1, 2 and 3

(Diagram 1) At the inception date (on 1 January 20X0):



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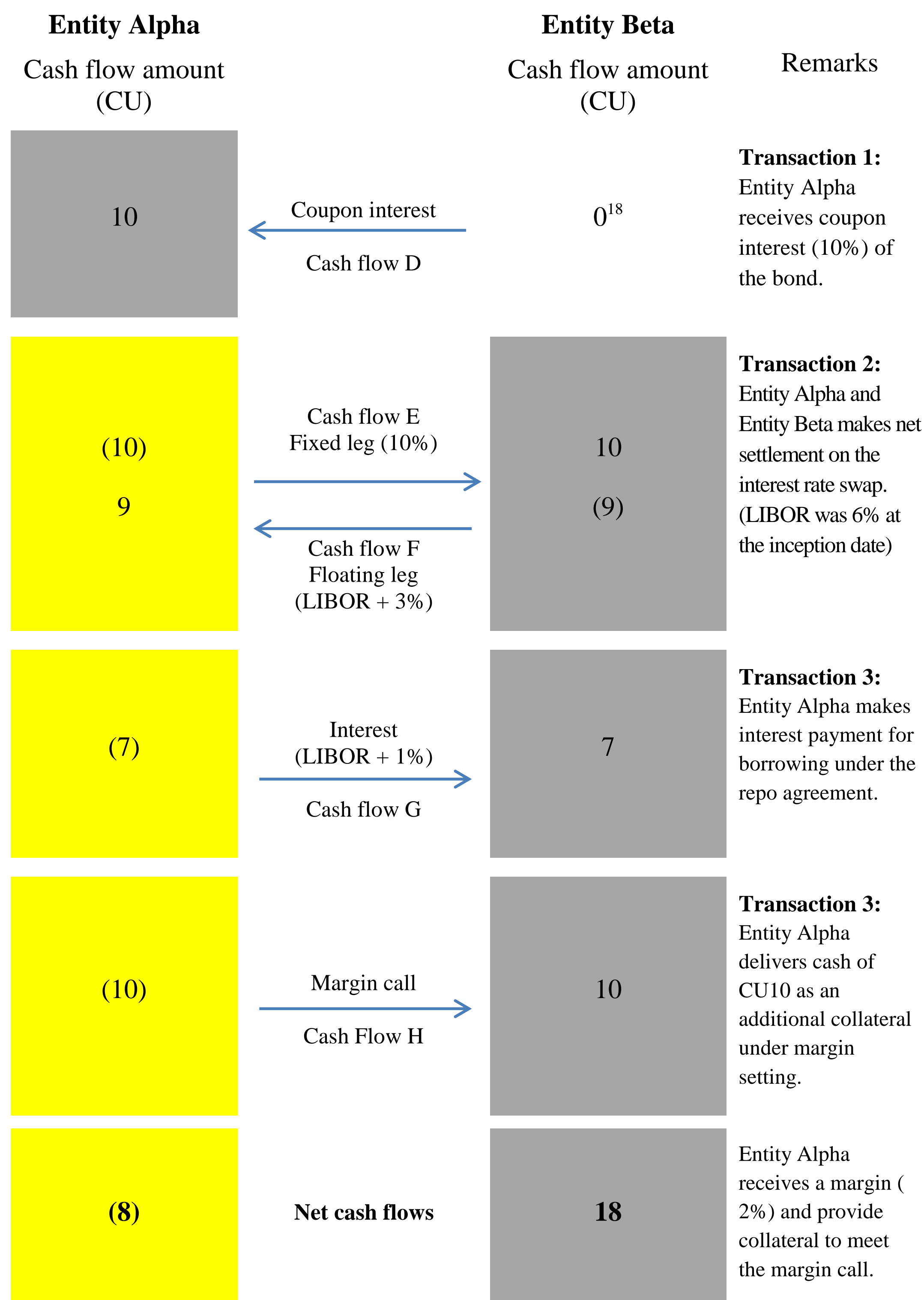
[15] Solid lines represent cash flows and dotted lines represent physical transfer of the bond in Transaction 1. Amounts without brackets represent cash inflows and amounts with brackets represent cash outflows. Grey boxes (in monochrome printouts, the darker boxes) represent cash inflows and yellow boxes (lighter) represent cash outflows.

[16] Entity Alpha borrows money with collateral of the bond purchased in Transaction 1.

[17] 'Wrong way risk' means that there is a high correlation between the possibility of default by the issuer of the bond and that by the Entity Alpha.

(Diagram 2) During the life of the repo Agreement (on 31 December 20X0):



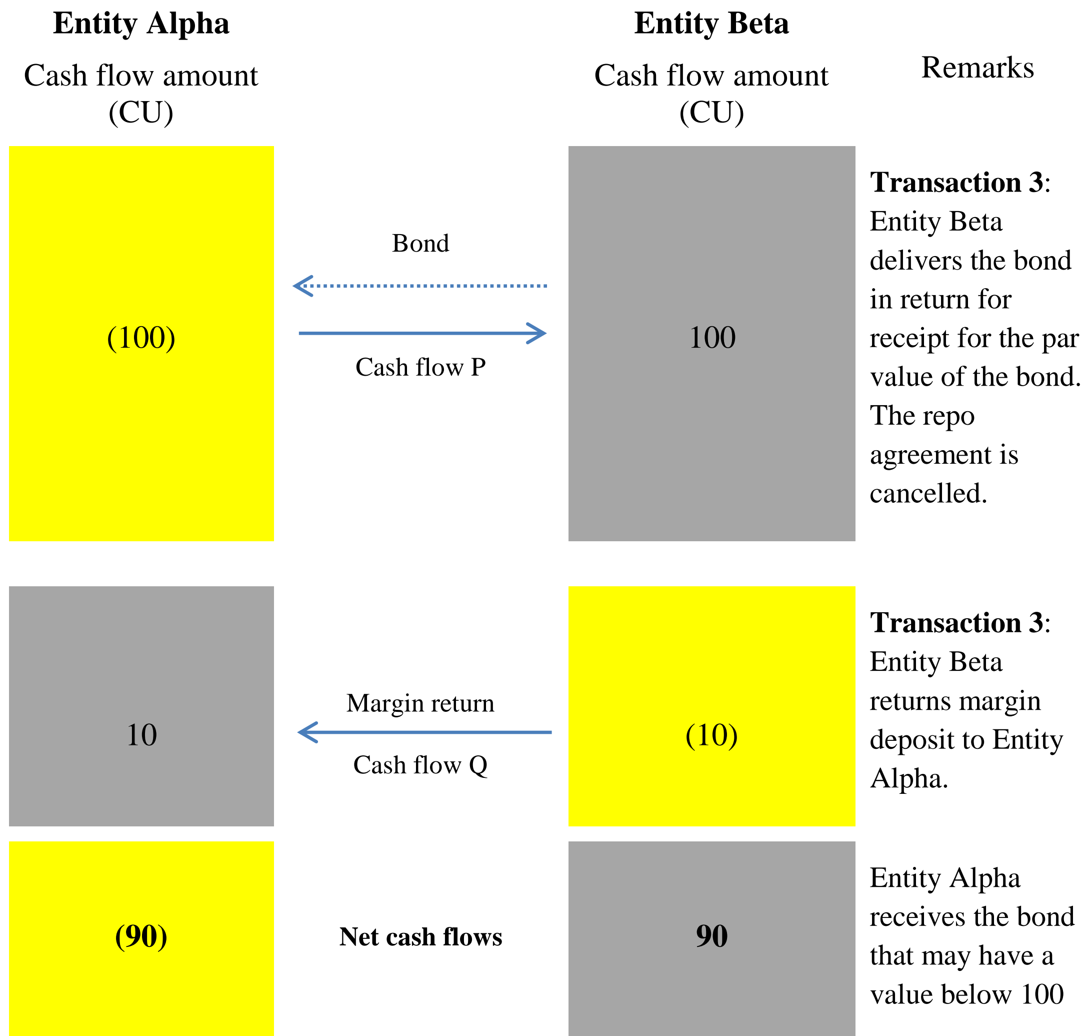
[18] Entity Alpha would typically collect the coupon interest on the bond indirectly from Entity Beta per the repo (with Entity Beta as title holder receiving the coupon from the bond issuer).

(Diagram 3) At maturity (without occurrence of a credit event) (on 31 December 20X2):

Entity Alpha Cash flow amount (CU)		Entity Beta Cash flow amount (CU)	Remarks
110	Principal and coupon interest ← Cash flow I	0[19]	**Transaction 1:** Entity Alpha collects the principal amount (CU100) and the coupon payment (CU10).
(10) 8	Cash flow J Fixed leg (10%) ← → Cash flow K Floating leg (LIBOR + 3%)	10 (8)	**Transaction 2:** Entity Alpha and Entity Beta makes net settlement on the interest rate swap.
(6)	Cash flow L → Interest (LIBOR + 1%)	6	**Transaction 3:** Entity Alpha pays interest for borrowing under the repo agreement
(100)	Bond[20] ← → Cash flow M	100	**Transaction 3:** Entity Alpha repurchases the bond
10	Margin return ← Cash flow N	(10)	**Transaction 3:** Entity Beta returns margin deposit to Entity Alpha.
12	**Net cash flows**	**98**	Entity Alpha receives a margin (2%) and receives collateral under margin call

[19] Assuming that the bond is returned to Entity Alpha on the maturity date the coupon interest and the principal on the bond would be received from the bond issuer directly.
[20] Entity Beta may redeem the bond with the issuer rather than delivering it to Entity Alpha because the maturity date of the bond is the same as that of the repo agreement.

(Diagram 4) At the date when a credit event occurs (on 31 December 20X1):



Appendix C—Submission

REQUEST FOR INTERPRETATION

Application of IAS 39 - Accounting for repo transactions in regard to the application of the principle of the prevalence of the economic substance over contractual form

ISSUE

1. Some entities have made medium-to long-term investments in bonds funded using some repo transactions with the same maturity date, having as counterparts also foreign brokers.

   The issue concerning the accounting for the above operations has arisen in regard to the application of the principle of the prevalence of the economic substance over contractual form stated in the Conceptual Framework.

   In particular, for the above operations, the question is whether the individual contractual elements (the investment and the passive repo transaction) should be recognized separately on the basis of their contractual form or aggregated on the basis of their economic substance.

   In this regard, *Guidance on Implementing,* para. B.6 ("IG B.6") of IAS 39 states:

   "Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

   - *they are entered into at the same time and in contemplation of one another*
   - *they have the same counterparty*
   - *they relate to the same risk*
   - *there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been*

accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IAS 39.9 *does not require net settlement."*

Interpretation issues arise, in this matter, concerning the indicators of IG B.6, as on the basis of these the economic substance of the operations in question would constitute a derivative.

The contractual elements of the operations in question are described below.

<u>*Description of the operations*</u>

2. The operations in question are generally undertaken using the following legally separate contracts:
   1) Entity A purchases a certain amount of medium-long term bonds (the "Bond") from Entity B, through one or more purchase transactions within a certain period and with the same settlement date;
   2) the Entity A stipulates with Entity B one or more interest rate swap contracts for hedging purposes for an overall notional amount equal to that of the Bond, with the trade date the same as that of the purchase date of the Bond and the start date the same as the settlement date of the Bond purchase transaction(s).

      Under the interest rate swap contract, the Entity A receives a variable rate of interest (index + spread X) and pays a fixed rate of interest equal to the fixed coupon rate of the Bond.

      Where there is an exchange rate risk, this is also an hedged item. In this case, a cross-currency interest rate swap would be agreed;
   3) the Entity A and Entity B stipulate a repo contract with a trade date the same as the settlement date of the Bond purchase transaction(s) and with a maturity date the same as that of the Bond.

      On the basis of the repo contract, the Entity A sells Bond at the spot price to Entity B and receives in exchange a cash amount as to the amount necessary to finance the purchase of the Bond (cost price) in point 1 above.

      During the life of the repo, the Entity A pays Entity B a rate of interest (index

+ spread Y)[21] applied on the spot cost price.

Furthermore, provision could be made for cash over-collateralization mechanisms for the Entity A intended to protect Entity B from the so-called wrong way risk (that is, when there is a high correlation between the possibility of default by the issuer of the Bond and that by the Entity A).

In addition, the repo transaction may also allow the granting of a facility by the Entity A in favour of Entity B for an amount equal to that of the repo transaction and guaranteed by the same bonds underlying the repo.

Net cash flows of the transactions

3. The net cash flows between the Entity A and Entity B for the transactions in question differ depending on whether or not, within the duration of the operation, the Bond issuer incurs a "credit event":
   i. in the absence of a "credit event", the Entity A receives a net flow calculated on the basis of the difference between the spread received with the hedging interest rate swap and that paid with the repo (X - Y);
   ii. in the presence of a "credit event", the repo is cancelled and the following flows take place: the Entity A reimburses the debt to Entity B against the repo and the latter returns the Bond received in guarantee or, as an alternative, the security viewed by Entity B as being "cheapest to delivery". At the same moment as the cancellation of the repo, also the interest rate swap ceases to exist, or, alternatively, there may be a provision the gives Entity B the option to keep the interest rate swap in existence.

The risks relating to the operations

4. The operations described above highlight the following risk profiles:
   - exposure of the Entity A to the credit risk with regard to the Bond issuer, which is the "reference entity" of the repo operation; moreover, in the event of a "credit event", the Entity A would also have a possible basis risk represented by the positive difference between the recovery rate of the Bond concerned in the repo transaction and that of the securities received by Entity B as "cheapest to delivery";

[21] This spread Y is less than spread X, included in the interest rate swap in point 2) above.

- for the Entity A, there are no market risks (exchange and interest rates), as these are hedged by swap contracts, but there is an exposure to counterparty risk towards Entity B relating to the possible positive differentials underlying the swap contracts;
- they may expose the Entity A to a liquidity risk, due to the obligation for cash settlement "margin setting" of the positive difference between the amount of the repo and the mark to market of the securities underlying the repo itself. To these amounts would also need to be added any amounts relating to over-collateralization.

Accounting treatment followed by the entities

5.

Usually the entities that have engaged in such operations recognise separately the various contractual elements in their accounts.

In particular, the securities purchased are usually included among the balance sheet assets under "Financial assets available for sale" and are measured at fair value; other than in cases of impairment, the capital gains/losses of the securities are included as a counterpart in 'Other Comprehensive Income', in a reserve of equity for the portion not related to the hedged risk, while the portion related to the hedged risk is recognized in the profit or loss.

The fund relating to the repo transaction is recognized in the liabilities and then measured at its amortized cost.

The swap is included under hedging derivative instruments and measured at fair value with the changes in profit or loss.

The cash payment of any collateral is recognized in the assets and measured at its amortized cost.

Question

6. Given the foregoing, the question that arises is whether the contracts described above (with the exception of the possible "facility") should be recognized separately or as an aggregate item as a derivative (e.g. a credit default swap with physical delivery whereby Entity A sells protection to Entity B relating to the traded securities and in exchange receives recurring commission equal to the net flow in point i)).

In this regard, recognizing what are legally separate contracts as a single aggregated derivative, based on the principle of substance over form, is made if the indicators specified in para. B6 of the Implementation Guidance of IAS 39 are met.

However, the implementation of this paragraph gives rise to the following questions:

a. whether all the parameters specified must be met at the same time or whether it is sufficient that only some of them are;
b. in respect of the first indicator of IG B.6 (*"they are entered into at the same time and in contemplation of one another*"), whether this condition is met also when the contracts are not all stipulated at the same time but spread out over time.

   For example, with regard to the operations described above, one may ask whether this latter indicator holds when:

   the purchases of the securities, while not occurring on the same date, have the same settlement date. In particular, it is possible that prior to the initial settlement between the Entity A and Entity B, the latter may have purchased on the market the securities through numerous spot trades over a period of time preceding the settlement date[22];

   or,

   the creation of the interest rate swap to hedge the rate risk or the stipulation of the repo may not occur at the same time as the purchase of the securities;
c. in respect of the second indicator of IG B.6 ("*they have the same counterparty*"), whether the aggregated recognition is to be applied also when the counterparty to one or more contracts may change over time.

   For example, concerning the case outlined above, the questions are:

   - whether this indicator is to be deemed essential to achieving the business purpose of the operation, in a situation where the same outcome can be obtained with different counterparties (or already having

[22] In this case, the transfer price may be based on the forward price calculated on the basis of the spot price of the repo transaction and of the cost-of-carry represented by the coupon not received and by the cost of *funding* in the period that runs between the date of the spot purchase and the date of the delivery of the security to the Entity A

the security in the portfolio);

- whether this indicator holds also when one of the contracts is extinguished early and a new one is entered into with a different counterparty and whether, in this case, it is necessary to reconsider the accounting treatment of the operations.

d. in respect of the fourth indicator ("*there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction*"), the question is whether the aggregated recognition as a derivative of the aforementioned contracts is to be applied also when, even where the first three indicators of IG B.6 hold, it may be affirmed:

- that the business purpose of the operation as a whole cannot be considered as simply the sale of protection of a credit default swap, but should be seen as creating an exposure to securities, funded through a maturity match repo to optimize liquidity absorption and with rate risk hedging, in order to make a positive contribution to the margin of interest;
- that the solution to pursue this aim has been identified in contracting that is separate and distinct of the purchase of the Bond, of the repo contract and of the hedging interest rate swap;
- that the legal separateness of the individual contracts, in line with the intention of the operation to make a positive contribution to the margin of interest, gives the Entity A (and always has) the possibility to manage and trade the contracts separately, thereby allowing it, where market and liquidity conditions offer opportunities, to modify the structure of financing the position it holds on risk. Thus, in this case, in principle, the Entity A, in agreement with the Entity B, can extinguish the repos separately, independently of the securities and the hedging interest rate swap;
- that, consistent with the business purpose described, the individual contractual elements of the operation are recorded separately.

CURRENT PRACTICE

7. The IAS/IFRS that justify this accounting treatment are:

- IAS 39.15-37 AG 51, on the basis of which the entity recognizes the Bond in its AFS portfolio from the settlement date and it retains it there also following the spot disposal in relation to the repo contract;
- IAS 39.29, on the basis of which the entity recognizes the sale price received in relation to the repo contract as a financial liability;
- IAS 39.72-94, on the basis of which the entity recognizes the interest rate swap among the hedging derivatives of changes in the fair value of the security.

REASONS FOR THE IFRS INTERPRETATION COMMITTEE TO ADDRESS THE ISSUE

a) Is the issue widespread and practical?

8. As reported above, many entities have undertaken the operations described, also for considerable amounts therefore it is expected that the issue is widespread..

b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

9. The accounting literature of the auditing firms reveals differing views on the issue.
   In particular, on the one hand, some believe that the purchase of a security and a repo concerning the same financial asset and occurring at the same time (or more or less at the same time) with the same counterparty should be recognized in an aggregated form as a derivative because they satisfy the indicators of IG. B6.
   On the other hand, others are of the opinion that the application of the guidance in B.6 would indicate, in most cases, separate recognition and that, even where the financial instruments are with the same counterparty, there is usually a substantial business purpose to consider them separately.

c) Would financial reporting be improved through elimination of the diversity?

10. Concerning the accounting practice followed by the entities, as highlighted above, there is no diversity.

d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and *Framework for the Preparation and Presentation of Financial Statements*, but not so narrow that it is inefficient to apply the interpretation process?

11. The issue is sufficiently narrow to be capable of an interpretation by IFRIC.

e) If the issue relates to current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?

12. It is known that, since 2002, IFRIC and IASB have considered the issue of the aggregated accounting treatment of legally separate contracts, and that it has been noted that the issue can be seen as an interpretation of the principle of substance over form.

    However, in spite of the indicators proposed for determining when contracts should be aggregated, and the guidance proposed for the recognition of such contracts, no interpretation or standard has ever been issued.

    In this regard, there appear to be no current or planned IASB projects on the issue.

    With regard to US GAAP, it may be noted that, concerning this issue, the FASB has developed specific criteria as part of its *Accounting Standard Codification* ("ASC") 860-10-40-44, under which, for example, according to one of the various criteria mentioned therein, if the security and the repo financing have the same maturity, they cannot be recognized separately.

    Moreover, it should also be noted that 29 March 2013 marked the end of the consultation period on an amendment to the ASC ("*Exposure Draft of* 15 January 2013 - *Transfers and Servicing (Topic 860) Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings*"), which proposes separate recognition of the security and the repo transaction.