STAFF PAPER

10–11 September 2013

IFRS Interpretations Committee Meeting

Project	**IFRS 7 *Financial Instruments: Disclosures***
Paper topic	Servicing contracts

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Introduction

1. The IASB issued *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7) —herein called 'the transfer disclosures'—in October 2010. The transfer disclosures included the addition of paragraphs 42A-42H to IFRS 7 *Financial Instruments: Disclosures* and are effective for annual periods beginning on or after 1 July 2011.

2. According to paragraph 42B of IFRS 7, the objective of the transfer disclosures is to enable users of financial statements:

   (a) to understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and

   (b) to evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets.

3. Paragraph 42C of IFRS 7 sets out a description of the term 'continuing involvement' in transferred financial assets for the purposes of applying the transfer disclosures:

   > For the purposes of applying the disclosure requirements in paragraphs 42E–42H, an entity has continuing involvement in a transferred financial asset if, as part of the transfer, the entity retains any of the contractual rights or obligations inherent in the transferred financial asset or

> obtains any new contractual rights or obligations relating to the transferred financial asset. For the purposes of applying the disclosure requirements in paragraphs 42E–42H, the following do not constitute continuing involvement:
>
> (a) normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action;
>
> (b) forward, option and other contracts to reacquire the transferred financial asset for which the contract price (or exercise price) is the fair value of the transferred financial asset; or
>
> (c) an arrangement whereby an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more entities and the conditions in paragraph 3.2.5(a)–(c) of IFRS 9 are met.

4. Paragraph B30 of IFRS 7 provides additional guidance on the meaning of ‘continuing involvement’ for the purposes of applying the transfer disclosures:

> An entity does not have a continuing involvement in a transferred financial asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the transferred financial asset nor acquires any new contractual rights or obligations relating to the transferred financial asset. An entity does not have continuing involvement in a transferred financial asset if it has neither an interest in the future performance of the transferred financial asset nor a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future.

5. In October 2012, the IFRS Interpretations Committee (‘the Interpretations Committee’) received a submission that requested clarification through an Annual

Improvement about whether servicing rights and obligations are continuing involvement for the purposes of the transfer disclosures. That submission contained two views:

(a) View 1: servicing rights and servicing obligations do not constitute continuing involvement for the purposes of the transfer disclosures.

(a) View 2: servicing rights and servicing obligation do constitute continuing involvement for the purposes of the transfer disclosures.

Summary of discussions in the previous meetings[1]

6. In January 2013, the Interpretations Committee discussed whether a clarification through Annual Improvements was needed on whether servicing rights and servicing obligations are continuing involvement for the purpose of the transfer disclosures. In that meeting, the Interpretations Committee noted that, on the basis of the wording in paragraph 42C of IFRS 7, it was not clear whether servicing contracts are continuing involvement for the purposes of applying the transfer disclosure requirements. Consequently, the Interpretations Committee recommended that the IASB should consider clarifying the requirements for continuing involvement in paragraph 42C of IFRS 7.

7. In the February 2013 meeting of the IASB, the staff reported the Interpretations Committee's discussions and recommendation to the IASB. In this meeting, the IASB indicated that their intention was that servicing contracts would meet the definition of continuing involvement for the purposes of the IFRS 7 disclosures and that paragraph 42C includes servicing contracts in the transfer disclosure requirements.

8. Also at that meeting, the IASB acknowledged that some interested parties are particularly concerned about the clarity of paragraph 42C(c); specifically, whether that guidance explicitly excludes servicing contracts from the scope of the transfer disclosures. The IASB members noted that paragraph 42C(c) discusses so-called

[1] For further details, please refer to Agenda Papers, *IASB Update* and *IFRIC Update* for each meeting on the project page of this issue on the IASB's website (http://www.ifrs.org/Current-Projects/IASB-Projects/IFRS-7-transfers-of-financial-assets-disclosure-requirements/Pages/Papers-1.aspx)

'pass-through arrangements'. Specifically, that paragraph confirms that the cash flows collected to be passed through are not themselves continuing involvement for the purposes of the transfer disclosures. However, the IASB observed that a servicing contract itself is not a pass-through arrangement because the servicer does not pass through any of the cash flows that it receives as a fee for servicing the transferred financial asset. Consequently, the servicing contract could qualify as continuing involvement.

9. Assessing whether a servicing contract represents continuing involvement in the assets being serviced requires assessment against the description of continuing involvement in paragraph 42C of IFRS 7 and the guidance in paragraph B30 of IFRS 7. Even though a servicing contract itself wouldn't meet the conditions in paragraph 42C(c) of IFRS 7, the IASB members acknowledged that there may be rare circumstances in which a servicing contract does not constitute continuing involvement for the purposes of the transfer disclosures.

10. For example, if the servicer receives its full servicing fee independently and irrespectively of the amount and timing of cash flows arising from the transferred financial assets, then the servicer's return is completely delinked from the future performance of the transferred asset. In other words, "it has neither an interest in the future performance of the transferred financial asset nor a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future." The IASB noted that it expects that such situations would arise very infrequently, and as a result, the IASB would expect that almost all servicing contracts will be within the scope of the transfer disclosures.

11. In May 2013, the staff reported the IASB's discussions to the Interpretations Committee and in the light of those discussions, the Interpretations Committee recommended that the IASB should propose an amendment to paragraph 42C(c) of IFRS 7 to clarify that the requirements in that paragraph do not exclude servicing contracts from the transfer disclosures.

12. In response to the Interpretations Committee's request, we are providing our analysis on how IFRS 7 could be clarified and whether the amendment should be proposed in an annual improvement project.

The proposed amendment to IFRS 7

Guidance on paragraph 42C(c)

13. As illustrated in **Appendix A** to this Agenda Paper, we propose to add a paragraph to the application guidance of IFRS 7 to clarify that paragraph 42C(c) of IFRS 7 does not exclude servicing contracts from the transfer disclosure requirements. This is because, consistent with the IASB's discussions in February 2013, paragraph 42C(c) of IFRS 7 discusses a 'pass-through arrangement' but a servicing contract itself is not a pass-through arrangement. This is because the fee received for servicing the transferred asset is not passed through to the transferee. Paragraph 42C(c) of IFRS 7 is relevant to cash flows that are collected and that are passed through in the servicing contract but is not relevant to the actual servicing fee in the servicing contract. In this regard, that paragraph does not exclude such contracts from the scope of the transfer disclosures.

14. As an example, there is a servicing contract in which an entity retains a right to service the transferred financial assets for a fee that is calculated at 1 per cent of the cash flows actually collected. The entity passes through 99 per cent of the cash flows collected to the transferee immediately with the 1 per cent fee retained. In this case, the entity would regard the cash flows that are passed through as a pass-through arrangement if the conditions in paragraph 42C(c) of IFRS 7 are met. With regard to the 1 per cent of cash flows retained as the servicing fee, we think that paragraph 42C(c) is not relevant. However, the entity needs to assess the fee against the descriptions of continuing involvement in paragraph 42C of IFRS 7 and the guidance in paragraph B30 of IFRS 7. In our view, the servicing fee in this specific fact pattern would constitute continuing involvement because the amount and the timing of cash flows received for the fee depends on the future performance of the transferred financial asset.

15. On the other hand, we note that servicing contracts could take various forms. Accordingly, consistently with the existing requirements in IFRS 7, there may be rare circumstances in which a servicing contract does not represent continuing involvement. This would be the case if the servicer does not have an interest in the future performance of the transferred asset as described in paragraph B30 of

IFRS 7. We think that the proposed amendment should also clarify this principle within the context of a servicing contract.

16. We think that it is appropriate to add this guidance to the Application Guidance of IFRS 7 rather than to amend the requirements in paragraph 42C of IFRS 7. This is because a servicing contract is just one example of an arrangement in which that an entity would need to assess whether the resulting contractual rights or obligations meet the description of continuing involvement for the purposes of applying the transfer disclosure requirements.

Effective date and transition

17. We note that paragraph 42E (b) of IFRS 7 requires disclosure of fair value of the assets and liabilities that represent the entity's continuing involvement in the derecognised financial assets. Retrospective application of this proposed amendment to financial statements for any preceding periods might therefore require an entity to determine fair value for a servicing asset or servicing liability, which the entity might not have previously determined. We are concerned that it might be impracticable for an entity to determine the fair value of such a servicing asset or liability without using hindsight.

18. Consequently, we think that we should provide a specific exemption in the transition requirements for this proposed amendment in respect of comparative periods. This exemption would be that an entity does not need to apply the amendment to any period presented that begins before the date of initial application of the amendment. This is consistent with the transition requirements in paragraph 44M of IFRS 7 in *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7) that added the transfer disclosure requirements.

19. For the same reason, we think that we should provide a first-time adopter with the same transition relief for the application of the amendment. If this relief was not provided, a first-time adopter would be disadvantaged as compared with the current IFRS prepares. This is also consistent with the amendments to IFRS 1 *First-Time Adoption of International Financial Reporting Standards* in *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7). In that

amendment, paragraph E4 was added to Appendix E— Short-term exemption in IFRS 1. Accordingly, we propose to amend IFRS 1 by adding a paragraph to Appendix E of IFRS 1 to ensure that the entity is permitted to use the same transition requirements permitted for existing IFRS prepares.

20. With respect to the effective date of the amendment, we tentatively set the date at 1 January 2016. This effective date is subject to change depending on the progress of the entire annual improvement project. We will provide the Interpretations Committee and the IASB with any updates on the effective date of this amendment.

Assessment against the agenda criteria and annual improvement criteria

21. As discussed in the previous meetings, the results of our outreach indicate that this issue is significantly widespread and there is significant diversity in practice. In addition, we think that the Interpretations Committee can resolve this issue in an efficient manner because it is well-defined and limited to a clarification of the principle in paragraph 42C(c) of IFRS 7. For those reasons, we are of the view that this issue meets the agenda criteria of the Interpretations Committee.

22. The amendments proposed in this Agenda Paper would not change the requirements or guidance that address the assessment of continuing involvement for the purposes of the transfer disclosure requirements in paragraphs 42E-42H of IFRS 7. We propose those amendments to add guidance on application of the continuing involvement guidance to a servicing contract.

23. Accordingly, we are of the view that the potential amendments meet the criteria for inclusion in an annual improvement project of the IASB.

24. For the details of the criteria and our assessment against them, refer to **Appendix B** to this Agenda Paper.

Staff recommendation

25. On the basis of the discussions above, we recommend to the Interpretations Committee that it should recommend to the IASB that it should propose the

amendments illustrated in **Appendix A** as part of the project *Annual Improvements to IFRSs 2012-2014 Cycle*.

Questions for the Interpretations Committee

Question 1
Does the Interpretations Committee agree with the staff recommendation that the Interpretations Committee should recommend to the IASB that it should propose an amendment to IFRS 7 as part of the *Annual Improvements to IFRSs 2012-2014 Cycle*?

Question 2
Does the Interpretations Committee agree with the draft wording for the proposed amendments in Appendix A?

Appendix A—Proposed wording for Annual Improvements

A1. The proposed amendment to IFRS 7 is presented below.

Amendment to IFRS 7 *Financial Instruments: Disclosures*

Paragraphs 44X and B30A are added. New text is underlined. Paragraphs B29-B31 are presented only for the sake of reference in this meeting.

Effective date and transition

…

<u>44X</u> <u>*Annual Improvements to IFRSs 2012-2014 Cycle* issued in [date] added paragraph B30A. An entity shall apply that amendment for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact. An entity need not apply the amendment for any period presented that begins before the date of initial application of the amendments.</u>

Derecognition (paragraphs 42C–42H)

Continuing involvement (paragraph 42C)

B29 The assessment of continuing involvement in a transferred financial asset for the purposes of the disclosure requirements in paragraphs 42E–42H is made at the level of the reporting entity. For example, if a subsidiary transfers to an unrelated third party a financial asset in which the parent of the subsidiary has continuing involvement, the subsidiary does not include the parent's involvement in the assessment of whether it has continuing involvement in the transferred asset in its separate or individual financial statements (ie when the subsidiary is the reporting entity). However, a parent would include its continuing involvement (or that of another member of the group) in a financial asset transferred by its subsidiary in determining whether it has continuing involvement in the transferred asset in its consolidated financial statements (ie when the reporting entity is the group).

B30 An entity does not have a continuing involvement in a transferred financial asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the transferred financial asset nor acquires any new contractual rights or obligations relating to the transferred financial asset. An entity does not have continuing involvement in a transferred financial asset if it has neither an interest in the future performance of the transferred financial asset nor a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future.

<u>B30A</u> <u>When an entity transfers a financial asset, the entity may retain the right to service the financial asset for a fee. For the purposes of applying paragraph 42C(c), such a servicing contract is not an arrangement whereby an entity retains the contractual rights to receive the cash flows of a financial asset and assumes a contractual obligation to pay the cash flows to one or more entities. Accordingly, irrespective of whether the fee to be received is expected to compensate the entity adequately for performing the servicing, paragraph 42C(c) does not</u>

exclude servicing contracts from the disclosure requirements in paragraphs 42E-42H. The entity is required to apply paragraphs 42C and B30 to assess whether the servicing contract is continuing involvement for the purposes of applying those disclosure requirements.

B31 Continuing involvement in a transferred financial asset may result from contractual provisions in the transfer agreement or in a separate agreement with the transferee or a third party entered into in connection with the transfer.

Consequential amendment to IFRS 1 *First-Time Adoption of International Financial Reporting Standards*

Paragraph 39T is added.

Effective date

39T *Annual Improvements to IFRSs 2012-2014 Cycle* issued in [date] added paragraph E4A. An entity shall apply that amendment for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

Appendix E
Short-term exemptions from IFRSs

Paragraph E4A and a footnote are added.

E4 …

E4A A first-time adopter may apply the transition provisions in paragraph 44X of IFRS 7*.

* Paragraph E4A was added as a consequence of *Annual Improvements to IFRSs 2012-2014 Cycle* issued in [date]. To avoid the potential use of hindsight and to ensure that first-time adopters are not disadvantaged as compared with current IFRS preparers, the IASB decided that first-time adopters should be permitted to use the same transition provisions permitted for existing preparers of financial statements prepared in accordance with IFRSs that are included in *Annual Improvements to IFRSs 2012-2014 Cycle*.

Basis for Conclusions on the proposed amendment to IFRS 7 *Financial Instruments: Disclosures*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment

Servicing contracts

BC1 In October 2010, the Board issued *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7). The amendment included the addition of paragraphs 42A-42H to IFRS 7 *Financial Instruments: Disclosures.* Those paragraphs require an entity to provide disclosures for all transferred financial assets that are not derecognised and for any continuing involvement in a transferred asset, existing at the reporting date, irrespective of when the related transfer transaction occurred.

BC2 The Board received a request to clarify whether servicing contracts constitute continuing involvement for the purposes of applying the disclosure requirements in paragraphs 42E-42H of IFRS 7. More specifically, the question was raised as to whether paragraph 42C(c) excludes servicing contracts from the scope of those disclosure requirements.

BC3 The Board observed that their intention was that servicing contracts could meet the description of continuing involvement for the purposes of the transfer disclosure requirements and therefore that paragraph 42C would include servicing contracts in the scope of those disclosure requirements. Specifically, the Board noted that paragraph 42C(c) discusses arrangements whereby an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more entities; ie a 'pass through arrangement'. Paragraph 42C(c) confirms that the cash flows collected to be passed through are not themselves continuing involvement for the purposes of the transfer disclosure requirements. However the Board observed that a servicing contract itself is not a pass through arrangement because the servicer does not pass through the actual cash flows that it receives as a fee for servicing the transferred financial asset. Therefore the Board noted that paragraph 42C(c) is not relevant to servicing contracts and thus that paragraph does not exclude such contracts from the scope of the transfer disclosure requirements.

BC4 However the Board acknowledged that paragraphs 42C and B30 need to be considered and that in rare circumstances, an entity may conclude that servicing contracts are not continuing involvement for the purposes of the transfer disclosure requirements. For example, this may be the case if the servicer receives a fixed servicing fee irrespective of whether any of the transferred asset's cash flows are ultimately collected. In this case, the servicer's return is completely de-linked from the future performance of the transferred asset and therefore the servicer does not have an interest in the financial asset's future performance. However the Board expects that such situations would arise infrequently and, as a result, the Board thinks that almost all servicing contracts will be within the scope of the transfer disclosure requirements. The Board proposes to add additional guidance to the Application Guidance of IFRS 7 to make clear how the guidance in paragraph 42C is applied to servicing arrangements.

BC5 The Board also considered whether the amendment should apply to any period presented that begins before the date of initial application of the amendment. The Board noted that paragraph 42E (b) of IFRS 7 requires disclosure of the fair value of the assets and liabilities that represent the entity’s continuing involvement in the derecognised financial assets. Application of the amendment to such a period might therefore require an entity to determine the fair value for a servicing asset or servicing liability, which the entity might not have previously determined. It might be impracticable for an entity to determine the fair value of such a servicing asset or servicing liability without using hindsight. The Board also noted that paragraph 44M provides similar transition provisions for the transfer disclosure requirements. Consequently, the Board proposes to require the application of the amendment only to annual periods beginning on or after the initial application of the amendment to avoid the risk of hindsight being applied. Furthermore, for the same reason, the Board observed that those transition provisions should be available to first-time adopters. Accordingly, the Board proposes to amend IFRS 1 *First-Time Adoption of International Financial Reporting Standards* to ensure that first-time adopters are not disadvantaged as compared with current IFRS preparers.

Appendix B—Assessment against the Interpretations Committee's agenda criteria and annual improvement criteria

B1. In the table below, we have assessed the issue against the agenda criteria of the Interpretations Committee as described in paragraphs 5.14–5.22 of the *Due Process Handbook*. The table also presents our assessment on the amendment proposed in this Agenda Paper against the annual improvement criteria described in paragraphs 6.10-6.14 of the *Due Process Handbook*.

Agenda criteria of the Interpretations Committee	
We should address issues(5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected;	**Met** The results of our outreach indicate that this issue is significantly widespread.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**Met** The results of our outreach indicate that there is significant diversity in practice.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**Met** This issue can be solved by adding guidance to IFRS 7 on the basis of the existing principles rather than by amending or adding a principle.
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 making changes to IFRSs (5.17)?	**Met** This amendment is sufficiently narrow and well-defined because the scope of the issue is limited to a servicing contract that an entity retains in a transfer of financial asset that qualifies for derecognition of the financial asset in its entirety.
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).	**Met** We are not aware of any existing or forthcoming project of the IASB that would affect the issue discussed in this Agenda Paper.
Additional criteria for annual improvement	

Replace unclear wording Provide missing guidance Correct minor unintended consequences, oversights or conflict	**Met** The potential amendment is intended to provide additional guidance on how an entity should apply the requirements in paragraph 42C of IFRS 7 and guidance in paragraph B30 of IFRS 7 to a servicing contract. The amendment would not change the existing requirements or guidance for the assessment of continuing involvement. Accordingly, we are of the view that it would be a clarification of the existing principle in IFRS 7.
Not change an existing principle or propose a new principle	**Met** See above.
Not be so fundamental that the IASB will have to meet several times to conclude	**Met** We think that the IASB will be able to reach a consensus on the potential amendment on a timely basis because the amendment is to clarify the IASB's original intention when it added the disclosure requirements.