

30 September 2002

The Director of Technical Services
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Dear Sir

Exposure Draft of proposed amendments to IAS32 and IAS39

I am writing on behalf of the Australian Securitisation Forum (ASF), which is the peak body representing the securitisation industry in Australia. The ASF has been in existence for over 10 years and its purpose is to promote the development of securitisation in Australia. Securitisation has brought tangible benefits to the Australian financial system, and to the community at large primarily through reductions in home loan rates.

The Accounting Committee of the ASF includes representatives from major banks, investment banks, NBFIs, rating agencies, trustees and professional accounting firms. We are particularly interested in the proposed changes to the derecognition criteria within IAS39.

Please find attached our response to the questions within the Exposure Draft relevant to the derecognition of financial assets

Yours faithfully

Michael J Codling
Chairman, Accounting Committee

Question 2: Derecognition : continuing involvement approach

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

We agree that the existing IAS 39 has led to some confusion in certain circumstances. However, we believe that the (admittedly simplified) proposed new approach is not clearly better and not more robust than the existing approach. In particular, we are concerned that the introduction of the “continuing involvement” test is not consistent with current accounting concepts or the generally accepted move towards financial components accounting for financial instruments.

The proposed new approach could result in continuing to recognise an asset where there is no expectation of any future economic benefits, and hence is inconsistent with the Framework (which defines an asset as “a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise”).

This could occur, for instance, if derecognition fails as a result of the retention of a call option exercisable at fair value. In such a case the entire asset would be retained on balance sheet despite the fact that all the rewards (economic benefits) and risks of ownership had passed to the transferee.

Another example of a transaction which would fail the continuing involvement test, but which we believe is not in substance a collateralised borrowing, would be where an entity attaches a call option (even at fixed price) to the financial asset sold and the financial asset is readily available. The fact is that the transferee would be able to sell or pledge the asset because it can easily purchase a similar asset to meet its commitment if the transferor exercises its option. Accordingly, the transferee controls the asset, and it should no longer be recorded as an asset of the transferor.

In this example, under the proposed new approach the transferor would recognise a liability at the maximum potential amount payable. It is currently generally accepted that an entity holding a call option has an asset, not a liability. The asset should initially be valued at the consideration received from the transferee (or the reduction in net sale price paid to the transferee).

We also believe it is inappropriate to continue to recognise a financial asset simply because a guarantee has been provided. The transferor does not have the capacity to benefit from the financial asset; and the transferee can sell or pledge the financial asset, demonstrating control.

In this example, under the proposed new approach, a ‘collateralised borrowing’ liability would be established at the maximum value of the guarantee. We believe it would be more appropriate for the transferor to measure its new liability at the fair value of the guarantee provided.

Indeed we believe there are several examples where under the proposed new approach fictitious ‘collateralised borrowings’ may be created and will not be accounted for like other loans. For example, no interest expense will be recorded.

In the securitisation industry, a standard time-based call option (eg at the end of 7 years, any remaining loans will be bought back from the SPE by the transferor at fair value) will preclude derecognition entirely. Even though only a small portion of the original portfolio would be eventually bought back, on the date of original transfer the entire sale proceeds would be treated as a collateralised borrowing.

Another example of the proposals resulting in obvious double-counting would be if an originator retained a 10% subordinated interest in a pool of \$100 transferred assets, then \$10 would fail the derecognition test and a similar proportion of the sale proceeds would be disclosed as financing. However, the fair value of the subordinated interest itself would also be recognised as an asset. Hence the proposed new approach results in a clear double-counting of assets and the creation of a fictitious borrowing.

We also agree with the alternate view expressed in Appendix D4 that another inappropriate consequence of the continuing involvement approach is that it can result in very different accounting by two entities when they have identical contractual rights and obligations only because one entity once owned the transferred financial assets. We believe such accounting results should be limited as far as possible.

Further, we believe that the simple “continuing involvement” test is open to abuse and can be easily structured around. For example, we could envisage two banks agreeing to provide liquidity facilities to each other’s securitisation programme to avoid the continuing involvement test.

We support a full components approach based on control to the derecognition of financial instruments. We recognise that, given the IASB wants to finalise the derecognition requirements in time for adoption by 1 January 2005, there is little time to thoroughly field test any new components criteria. We believe that, globally, the most successfully implemented and well understood components criteria are those embodied in the US FAS 140. We recommend that the IASB adopt these, and continue to work on the (relatively less) shortcomings of FAS 140.

We note that the IASB did not ask for comments in relation to the calculation of any profit or loss on the derecognition of a financial asset. We would observe that securitisation industry participants in Australia, generally, have a range of significant reservations in relation to profit recognition determined in accordance with either the proposed IAS 39, or the existing IAS 39 or FAS 140. At this stage we have not thoroughly field tested their views or possible alternatives. We suggest the IASB needs to fully test this aspect of the IAS 39 proposals before their introduction.

Question 3 : Derecognition : pass-through arrangements

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

No. We believe there are many situations where the “pass-through arrangement” tests would be met where, in substance, the transferor still has a financial asset and a financial liability. Further, the proposals lack clarity and are likely to give rise to conflicting interpretations.

The Basis of Conclusions makes it apparent that these rules were intended to apply where special purpose entities were involved. As currently written, the proposals appear to have wider application and could be open to abuse. For example, many non-recourse debt liabilities and the related assets might be derecognised, whereas it is currently generally accepted that this is not appropriate. However, we also note that it is unclear how the application of the “derecognition of a financial asset” provisions and the “derecognition of a financial liability” provisions interact. Specifically, having met the “pass-through arrangement” tests to derecognise financial assets, whether the related financial liabilities are automatically derecognised or whether the “derecognition of financial liability” provisions also need to be met.

We believe the proposed special rules are not consistent, and need to be, with the set-off criteria in IAS 32 and the established agency arrangement rules (eg loan syndications resulting in derecognition of pro-rata components).

The Basis of Conclusions seem to imply that the financial assets and financial liabilities arising from securitisation transactions may often be derecognised. However, the “pass-through arrangement” tests would not be met in practice by most ‘generally accepted’ securitisation transactions. For example, in a typical Australian securitisation transaction:

- the SPE does not transfer the underlying financial assets or issue beneficial interests in the underlying financial assets; it issues beneficial interests in the SPE
- the SPE (transferor in this case) may have an obligation to pay amounts to the noteholders received from liquidity arrangements or credit enhancement facilities, ie not only from amounts collected from the transferred assets as required by para 41 (a)
- similarly, the SPE will often enter into derivative transactions (eg swaps) to convert cash received to a basis consistent with the SPE’s liabilities; hence again the noteholders (ultimate transferees) will not be paid directly from the amounts collected from the financial assets
- the SPE will inevitably reinvest cash received for a period before passing to the noteholders; it is not clear what is meant by the term “material delay”.

The thrust of the proposals is that an SPE that qualifies as a “pass-through arrangement” would record no assets or liabilities. However, we believe the investors in the SPE would be looking to their financial statements (as a reporting entity) for useful information.

In the longer-term, we believe the IASB should develop an accounting standard specific to securitisation transactions.

In the short term, we strongly recommend that rather than attempting to introduce specific rules for SPEs within IAS 39, the underlying principles and guidance in SIC 12 should be appropriately amended. Considerable uncertainty and concern exists in relation to the application of SIC 12 within the Australian securitisation industry.

Question 10 : Prior derecognition transactions

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

We believe that all derecognition transactions that took place before the issue of the revised IAS 39 should be grandfathered and that entities should only be required to disclose balances that would have been recognised had the new requirements been applied. This is because retrospective application could have significant cost implications, for example, entities may breach their debt covenant requirements. In addition, it may be impossible for entities to unwind securitisation structures given that most of the SPEs operate on auto-pilot.

If grandfathering is not introduced we recommend, as a minimum, a delayed application period of five years to existing transactions.