Australian Accounting Standards Board

URGENT ISSUES GROUP

Issue Summary 00/9

(Initial, 19/10/00)

Securitisation – Consolidation of Special Purpose Entities

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Urgent Issues Group

Issue Summary

Issue: Securitisation – Consolidation of Special Purpose Entities	Reference UIG 00/9 (Initial, 19/10/00)

(a) Description of Transaction/Event

1. In July 1999, the Urgent Issues Group issued Abstract 28 "Consolidation – Special Purpose Entities" to clarify the circumstances under which an entity should consolidate a special purpose entity (SPE) in Australia. In relation to SPEs in general, Abstract 28 has provided some much needed and appropriate guidance.

2. However, in applying Abstract 28 to SPEs involved in the securitisation of financial assets, considerable uncertainty has been created. The uncertainties arise primarily because of differing interpretations of the 'indicators of control' provided in paragraph 13 of Abstract 28. These set out the types of circumstances which would normally indicate a relationship in which an entity controls an SPE and consequently must consolidate the SPE.

3. While Abstract 28 did not introduce any new accounting concepts, the specific 'indicators of control' and the related examples described in Abstract 28 appear to have changed the way in which securitisation SPEs could be viewed. Certainly, many in the industry are concerned that SPEs which were previously not consolidated by the transferor may now need to be consolidated.

(b) Issues and Status

4. *Issue*

   The differing interpretations of the 'indicators of control' could result in inconsistencies in accounting for securitisation transactions in Australia.

   The issue is: Can and should the guidance in Abstract 28 be clarified to avoid the current level of confusion in determining the appropriate accounting?

5. *Status*

   The UIG considered Issue Proposal 00-9 "Securitisation – Consolidation of Special Purpose Entities" at its meeting on 3 August 2000 and agreed to include the issue on its work program. This Issue Summary has been prepared for initial consideration at the UIG meeting on 2 November 2000.

(c) Authoritative Accounting Literature and Other Guidance

6. Australia

(a) Accounting Standards AASB 1024 "Consolidated Accounts" and AAS 24 "Consolidated Financial Reports" (May 1992)

(i) Definitions:

" 'economic entity' means a group of entities comprising the parent entity and each of its subsidiaries;

'parent entity' means an entity which controls another entity;

'subsidiary' means an entity which is controlled by a parent entity;

'control' means the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity." (paragraph 9; paragraph 18 respectively)

(ii) "Whether an entity has control of another entity will always be a question to be decided in the light of the prevailing circumstances. The definition of control depends upon substance rather than form and, accordingly, determination of the existence of control will involve the preparer of the financial reports in exercising professional skill and judgement." (paragraph (xv); paragraph 21)

(iii) "Any of the following factors would normally indicate the existence of control by one entity of another entity:

(a) the capacity to dominate the composition of the board of directors or governing board of another entity;

(b) the capacity to appoint or remove all or a majority of the directors or governing members of another entity;

(c) the capacity to control the casting of a majority of the votes cast at a meeting of the board of directors or governing board of another entity;

(d) the capacity to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of another entity, irrespective of whether the capacity is held through shares or options; and

(e) the existence of a statute, agreement or trust deed, or any other scheme, arrangement or device, which, in substance, gives an entity the capacity to enjoy the majority of the benefits and to be exposed to the majority of the risks of that entity, notwithstanding that control may appear to be vested in another party." (paragraph (xvi); paragraph 22)

(iv) "The concept of control is defined as a capacity, thereby allowing for the role of dominance to be a passive one rather than one which is necessarily actively exercised. If doubt exists as to whether an entity has the capacity to dominate another entity, there may, on occasions, need to be an active demonstration of control. This may be evident, for instance, by an entity being able to obtain financial information, internal management forecasts and budgets, and entity records from the other entity on request." (paragraph (xviii); paragraph 25)

(v) "The definition of 'control' is such that, on rare occasions, an entity may appear to be the subsidiary of two unrelated entities. An example of this would occur where an entity exercises dominance of the decision-making in relation to the operating policies of another entity while another entity simultaneously possesses the capacity to dominate decision-making without exercising that power. This form of control, while rare, may be evident where institutional investors hold investments with the objective of generating positive cash flows through dividends and capital gains rather than for the purpose of managing the operations of the other entity. It is important to establish that the entity actually exercising dominance over the operating policies is not merely doing so, either implicitly or explicitly, in accordance with the wishes of the other 'controlling' entity. The concept of control employed in this Standard is defined in terms of dominance of both the financial and operating policy decisions, which implies a singular line of power. In the example cited in this paragraph, if neither of the entities is in the position of absolute dominance over the third entity, the relationship would be one of joint control determined by implicit agreement rather than control." (paragraph (xxi); paragraph 28)

(vi) "The capacity of one entity to dominate decision-making, in relation to the financial and operating policies of another entity, is insufficient in itself to ensure the existence of control as defined in this Standard. The parent entity needs to be able to dominate decision-making so as to enable that other entity to operate with it as part of an economic entity in pursuing its objectives. This will have the effect of excluding from the definitions of 'parent entity' and 'subsidiary' relationships which do not extend beyond, for instance, that of a liquidator and the entity being liquidated and would normally exclude a lender and borrower relationship and a receivership relationship. Similarly, a trustee whose relationship with a trust does not extend beyond the normal responsibilities of a trustee would not be considered to control the trust for the purposes of this Standard." (paragraph (xxiii); paragraph 30)

(b) UIG Issues Paper 99/4 "Consolidation – Special Purpose Entities" (Final, 29/7/99)

Status

(i) "Two members voted against the Consensus [in Abstract 28] because of concerns that the drafting was not clear and the Consensus may be

misread as amending or compromising the requirements of AASB 1024 and AAS 24 relating to application of the concept of control."

Commentary

(ii) "The Australian Standards AASB 1024 'Consolidated Accounts' and AAS 24 'Consolidated Financial Reports' define control and explain that the determination of control is dependent on the facts in each case. The Standards indicate that majority ownership usually indicates that control exists but acknowledge that control can also arise when an entity does not have an ownership interest. The International Accounting Standard IAS 27 'Consolidated Financial Statements and Accounting for Investments in Subsidiaries' defines control and explains determining the existence of control in a similar way to AASB 1024 and AAS 24. Differences relate to temporary control and restrictions on the repatriation of dividends etc.

Special purpose entities (SPEs) are established to undertake designated activities or to perform specific functions. Where their activities are predetermined they are described as being on 'autopilot'. In these situations, some have argued that because the activities of the SPE are predetermined the sponsor does not control the SPE and, therefore, the SPE should not be consolidated by the sponsor. Others point out that the predetermination of activities may be specified by a sponsor who derives the economic benefits from the activities and that the predetermination is merely a mechanism for ease of administration. They note that control includes the capacity ('the ability or power') to dominate the decision making of another entity and argue that in the case of an SPE, whether on autopilot or not, the sponsor will need to assess whether control exists depending on the facts of the case.

Some argue that because the sponsor has formed the SPE and specified its activities and the manner in which it operates, the sponsor controls the SPE. Others point out that the presence of these characteristics do not necessarily mean that control exists. They note that AASB 1024 and AAS 24 provide that a parent entity must dominate the decision making of another entity so as to enable it to operate in the pursuit of the objectives of the controlling entity.

Some argue that because AASB 1024 and AAS 24 do not specify the conditions which need to be satisfied where an SPE is operating on autopilot, diversity in practice can arise. They point out that SIC-12 'Consolidation – Special Purpose Entities' provides guidance on the application of the concept of control in International Accounting Standards to a particular class of entities and provides examples of circumstances to be considered in determining whether control of the SPE exists. They note that the concepts of control in AASB 1024 and AAS 24 are the same as those in IAS 27 and express the view that the status of the principles and guidance in SIC-12 to Australian reporting entities should be clarified – that is, the UIG should rule on whether the guidance in SIC-12 applies to Australian reporting entities. Some also argue that in view of the similarities in the International and

Australian Standards the provision of similar guidance to Australian reporting entities will assist in achieving a consistent interpretation of the concept of control in respect of SPEs by Australian reporting entities and contribute to the process of international harmonisation.

However, others argue that AASB 1024 and AAS 24 deal with the issue and it is not necessary for the UIG to issue an Abstract to interpret the requirements of these Standards."

7. **International Accounting Standards Committee**

(a) Standing Interpretations Committee Interpretation SIC-12 "Consolidation – Special Purpose Entities" (November 1998)

(i) Abstract 28 is largely a replication of SIC-12.

(b) International Accounting Standard IAS 39 "Financial Instruments: Recognition and Measurement" (December 1998)

(i) "An enterprise should derecognise a financial asset or a portion of a financial asset when, and only when, the enterprise loses control of the contractual rights that comprise the financial asset (or a portion of the financial asset). An enterprise loses such control if it realises the rights to benefits specified in the contract, the rights expire, or the enterprise surrenders those rights." (paragraph 35)

(ii) "If a financial asset is transferred to another enterprise but the transfer does not satisfy the conditions for derecognition in paragraph 35, the transferor accounts for the transaction as a collateralised borrowing. In that case, the transferor's right to reacquire the asset is not a derivative." (paragraph 36)

(iii) "Determining whether an enterprise has lost control of a financial asset depends both on the enterprise's position and that of the transferee. Consequently, if the position of either enterprise indicates that the transferor has retained control, the transferor should not remove the asset from its balance sheet." (paragraph 37)

(iv) "A transferor has not lost control of a transferred financial asset and, therefore, the asset is not derecognised if, for example:

(a) the transferor has the right to reacquire the transferred asset unless either (i) the asset is readily obtainable in the market or (ii) the reacquisition price is fair value at the time of reacquisition;

(b) the transferor is both entitled and obligated to repurchase or redeem the transferred asset on terms that effectively provide the transferee with a lender's return on the assets received in exchange for the transferred asset. A lender's return is one that is not materially different from that which could be obtained on a loan to the transferor that is fully secured by the transferred asset; or

(c) the asset transferred is not readily obtainable in the market and the transferor has retained substantially all of the risks and returns of ownership through a total return swap with the transferee or has retained substantially all of the risks of ownership through an unconditional put option on the transferred asset held by the transferee (a total return swap provides the market returns and credit risks to one of the parties in return for an interest index to the other party, such as a LIBOR payment)." (paragraph 38)

(v) "Under paragraph 38(a), a transferred asset is not derecognised if the transferor has the right to repurchase the asset at a fixed price and the asset is not readily obtainable in the market, because the fixed price is not necessarily fair value at the time of reacquisition. For instance, a transfer of a group of mortgage loans that gives the transferor the right to reacquire those same loans at a fixed price would not result in derecognition." (paragraph 39)

(vi) "A transferor may be both entitled and obligated to repurchase or redeem an asset by (a) a forward purchase contract, (b) a call option held and a put option written with approximately the same strike price, or (c) in other ways. However, neither the forward purchase contract in (a) nor the combination of options in (b) is sufficient, by itself, to maintain control over a transferred asset if the repurchase price is fair value at the time of repurchase." (paragraph 40)

(vii) "A transferor generally has lost control of a transferred financial asset only if the transferee has the ability to obtain the benefits of the transferred asset. That ability is demonstrated, for example, if the transferee:

(a) is free either to sell or to pledge approximately the full fair value of the transferred asset; or

(b) is a special-purpose entity whose permissible activities are limited, and either the special purpose entity itself or the holders of beneficial interests in that entity have the ability to obtain substantially all of the benefits of the transferred asset. However, even if the transferor has derecognised the asset, in some cases the transferor may be required to consolidate the special purpose entity pursuant to IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries, and IASC Interpretation SIC-12, Consolidation – Special Purpose Entities.

That ability may be demonstrated in other ways." (paragraph 41)

(viii) "Neither paragraph 38 nor paragraph 41 is viewed in isolation. For example, a bank transfers a loan to another bank, but to preserve the relationship of the transferor bank with its customer, the acquiring bank is not allowed to sell or pledge the loan. Although the inability to sell or pledge would suggest that the transferee has not obtained

control, in this instance the transfer is a sale provided that the transferor does not have the right or ability to reacquire the transferred asset." (paragraph 42)

(c) "IAS 39 Implementation Guidance Questions and Answers" (September 2000)

(i) "Factors affecting derecognition of financial assets transferred to a special purpose entity

Would the answer change in the same fact situations as are in Questions 35-1 and 35-2, if (1) Company A transferred financial assets in a securitisation transaction to a special purpose entity that it was required to consolidate and (2) the special purpose entity transferred a portion of those financial assets to third-party investors?

No. The evaluation of whether a transfer of a portion of financial assets meets the derecognition criteria under IAS 39 generally will not differ if the transfer is directly to investors or through a special purpose entity that obtains the financial assets and, in turn, transfers a portion of those financial assets to third party investors. If a transfer by a special purpose entity to a third party investor meets the conditions specified for derecognition in IAS 39.35-42 as elaborated on in Question 35-2, the transfer would be accounted for as a sale by the special purpose entity and those derecognised assets or portions thereof would not be brought back on the balance sheet in the consolidated financial statements of the enterprise." (Paragraph 35; Question 35-3)

8. **United States of America**

(a) FASB Statement of Financial Accounting Standards SFAS 125 "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities" (June 1996)

(i) "Previous standards did not accommodate recent innovations in the financial markets. After studying many of the complex developments that have occurred in financial markets during recent years, the Board concluded that previous approaches that viewed each financial asset as an indivisible unit do not provide an appropriate basis for developing consistent and operational standards for dealing with transfers and servicing of financial assets and extinguishments of liabilities. To address those issues adequately and consistently, the Board decided to adopt as the basis for this Statement a financial-components approach that focuses on control and recognizes that financial assets and liabilities can be divided into a variety of components." (paragraph 8)

(ii) "A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor-put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).

b. Either (1) each transferee obtains the right - free of conditions that constrain it from taking advantage of that right (paragraph 25) - to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right - free of conditions that constrain them from taking advantage of that right (paragraph 25) - to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30)." (paragraph 9)

(iii) "Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34)." (paragraph 10)

(iv) "Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor seller) shall:

a. Derecognize all assets sold

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable

to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid)." (paragraph 11)

(v) "If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15)." (paragraph 12)

Implementation Guidance

Qualifying Special-Purpose Entity

(vi) "A qualifying special-purpose entity must meet both of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:

(1) Holding title to transferred financial assets

(2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)

(3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held

(4) Distributing proceeds to the holders of its beneficial interests.

b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor 'can effectively assign his interest and his creditors can reach it.' In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity." (paragraph 26)

Retained Interests

(vii) "Other interests in transferred assets – those that are not part of the proceeds of the transfer – are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 31." (paragraph 33)

Background Information and Basis for Conclusions

Approaches Considered

(viii) "The Board noted that the most difficult questions about accounting for transfers of financial assets concern the circumstances in which it is appropriate to remove previously recognised financial assets from the statement of financial position and to recognise gain or loss. One familiar approach to those questions views each financial asset as a unit that should not be derecognised until the risks and rewards that are embodied in that assets have been surrendered. Variations on that approach attempt to choose which risks and rewards are most critical and whether all or some major portion of those risks and rewards must be surrendered to allow derecognition." (paragraph 99)

(ix) "In addition to reviewing the US accounting literature, the Board reviewed the approach described by the International Accounting Standards Committee (IASC) in its Proposed International Accounting Standard, *Financial Instruments*, Exposure Draft E40 (1992), later revised as Exposure Draft E48 (1994). In E40, derecognition of financial assets and liabilities would have been permitted only upon the transfer to others of the underlying risks and rewards, presumably all risks and rewards. That approach could have resulted in an entity's continuing to recognise assets even though it had surrendered control over the assets to a successor entity. The approach in E40 was similar to that taken in Technical Bulletin 85-2. The Board concluded that the approaches proposed in E40 and provided in Technical Bulletin 85-2 were unsatisfactory because the result does not faithfully represent the effects of the transfer of assets and because of the potential for inconsistencies." (paragraph 100)

(x) "In response to comments received on E40, the IASC proposal was revised in E48 to require the transfer of *substantially all* risks and rewards. That modification did not overcome the inconsistency noted in paragraphs 97 and 100 of this Statement and added the prospect of difficulties in application because of the need to identify, measure, and

weigh in the balance each of possibly many and varied risks and rewards embodied in a particular financial asset. The number of different risks and rewards would vary depending on the definitions used. Questions would arise about whether each identified risk and reward should be substantially surrendered to allow derecognition, whether all risks should be aggregated separately from all rewards, and whether risks and rewards should somehow be offset and then combined for evaluation. That modification also might lead to wide variations in practice depending on how various entities interpreted *substantially all* in the necessarily subjective evaluation of the aggregated, offset, and combined risks and rewards. Moreover, viewing each financial asset as an indivisible unit is contrary to the growing practice in financial markets of disaggregating individual financial assets or pools of financial assets into components. The IASC is continuing to study that issue in its financial instruments project." (paragraph 101)

(xi) "The Board also noted that application of a risks-and-rewards approach for derecognising financial assets would be highly dependent on the sequence of transactions leading to their acquisition. For example, if Entity A initially acquired an undivided subordinated interest in a pool of financial assets, it would recognise that subordinated interest as a single asset. If, on the other hand, Entity B initially acquired a pool of financial assets identical to the pool in which Entity A participated, then sold a senior interest in the pool and continued to hold a subordinated interest identical to the undivided interest held by Entity A, Entity B might be judged under a risks-and- rewards approach to have retained substantially all the risk of the entire pool. Thus, Entity B would carry in its statement of financial position the entire pool of financial assets as well as an obligation equal to the proceeds from the sale of the undivided senior interest, while Entity A would report its identical position quite differently. Those accounting results would disregard one of the fundamental tenets of the Board's conceptual framework; that is, 'accountants must not disguise real differences nor create false differences.' " (paragraph 102)

(xii) "The Board also considered the approach required by the United Kingdom's Accounting Standards Board in Financial Reporting Standard No 5, 'Reporting the Substance of Transactions', a variation of the risks-and-rewards approach that requires the surrender of substantially all risks and rewards for derecognition of financial assets but permits, in limited circumstances, the use of a *linked presentation*. Use of the linked presentation is restricted to circumstances in which an entity borrows funds to be repaid from the proceeds of pledged financial assets, any excess proceeds go to the borrower, and the lender has no recourse to other assets of the borrower. In those circumstances, the pledged assets remain on the borrower's statement of financial position, but the unpaid borrowing is reported as a deduction form the pledged assets rather than as a liability; no gain or loss is recognised. That approach had some appeal to the Board because it would have highlighted significant information about transactions that many believe have characteristics of both sales and

secured borrowings. The Board observed, however, that the linked presentation would not have dealt with many of the problems created by the risks-and-rewards approach. Further, the Board concluded that it is not appropriate for an entity to offset restricted assets against a liability or to derecognise a liability merely because assets are dedicated to its repayment, as discussed in paragraphs 218-221". (paragraph 103)

Objectives of the Financial-Components Approach

(xiii) "The concepts underlying the financial-components approach could be applied by analogy to accounting for transfers of non-financial assets and thus could result in accounting that differs significantly from that required by existing standards and practices. However, the Board believes that financial and non-financial assets have significantly different characteristics, and it is not clear to what extent the financial-components approach is applicable to non-financial assets. Non-financial assets have a variety of operational uses, and management skill plays a considerable role in obtaining the greatest value from those assets. In contrast, financial assets have no operational use. They may facilitate operations, and financial assets may be the principal 'product' offered by some entities. However, the promise embodied in a financial asset is governed by contract. Once the contract is established management skill plays a limited role in the entity's ability to realise the value of the instrument. Furthermore, the Board believes that attempting to extend this Statement to transfers of non-financial assets would unduly delay resolving the issues for transfers of financial assets, because of the significant differences between financial assets and non-financial assets and because of the significant unresolved recognition and measurement issues posed by those differences. For those reasons, the Board concluded that existing accounting practices for transfers of non-financial assets should not be changed at this time. The Board further concluded that transfers of servicing assets and transfers of property subject to operating leases are not within the scope of this Statement because they are non-financial assets." (paragraph 114).

(b) Emerging Issues Task Force Abstract EITF 96-20 "Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities" (September 1996)

(i) "The Task Force reached a consensus that the Statement 125 definition of control should be applied when assessing whether an SPE should be consolidated only when all of the following criteria are met:

(a) The entity being considered is a qualifying SPE that meets all of the conditions of paragraph 26 of Statement 125. As a result, the SPE has a standing at law distinct from the transferor and its activities are permanently limited to those set forth in paragraph 26 of Statement 125.

(b) The assets held by the qualifying SPE are financial assets, such as receivables from credit cards, mortgage loans, or securities,

that represent a contractual right to cash (or another financial instrument) from, or an ownership interest in, an entity that is unrelated to the transferor.

(c) The financial assets held by the qualifying SPE are not the result of a structured transaction (or a series of transactions) that has the effect of (a) converting nonfinancial assets, for example, real estate or servicing assets, into a financial asset or (b) recognizing previously unrecognized financial assets."

(c) Proposed Statement of Financial Accounting Standards "Accounting for Transfers of Financial Assets – An amendment of FASB Statement No. 125" (June 1999)

(i) "Paragraphs 9(b) and 9(c) are replaced by the following:

b. If the transferee is a qualifying special-purpose entity (SPE) (paragraph 26):

(1) The holders of beneficial interests in that entity have the right to pledge or exchange those interests and no condition both constrains them from taking advantage of that right and provides more than a trivial benefit to the transferor (paragraph 25D).

(2) The transferor does not retain effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets, other than through a cleanup call (paragraphs 26I and 26J)." (paragraph 5(b))

(ii) "The following headings and paragraphs are added after paragraph 26:

Conditions for a Qualifying SPE

26A. Having standing at law depends in part on the nature of the SPE. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor can effectively assign his interest and his creditors can reach it. In that circumstance, it appears that the trust does not have standing at law distinct from the transferor. A transferee must have standing at law distinct from the transferor to be a qualifying SPE.

26B. The powers of the SPE must be limited to those activities allowed in paragraph 26 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

26C. The investors other than the transferor and its affiliates may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 30).

26D. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing assets. A qualifying SPE also may not hold the unguaranteed residual value of a sales-type or a direct financing lease, because an unguaranteed residual value does not arise from the collection of financial assets such as the minimum lease payments of a sales-type or direct financing lease.

26E. The following examples illustrate whether a power or requirement to sell or distribute assets is in response to the occurrence of a specified event or circumstance outside the control of the transferor or its affiliates that causes the fair value of those transferred assets to decline by a specified degree below the fair value of those assets at the date of transfer and, therefore, is a permitted activity of a qualifying SPE:

a. A qualifying SPE may be required to put transferred assets to the servicer (or to a third party or back to the transferor or its affiliates) in response to a failure to properly service transferred assets that could result in the loss of a substantial third-party credit guaranty.

b. A qualifying SPE may be required to sell transferred assets to a third party in response to (1) a default by the obligor, (2) a downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating, (3) the insolvency of the transferor, or (4) a decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

c. An SPE is not qualifying if it has a power that allows it to choose to either sell transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure.

d. A qualifying SPE may *not* be required to sell marketable equity securities upon a specified decline from their 'highest fair value' if that power could result in selling the asset for an amount that is more than the fair value of those assets at the time they were transferred to the SPE.

e. A qualifying SPE may *not* be required to sell transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

26F. A qualifying SPE may sell or distribute transferred assets in response to a BIH (other than the transferor or its affiliates) exercising a right to put that holder's beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets

b. Cash (which may require that the SPE sell those assets to a third party or issue beneficial interests to comply with the put)

c. New beneficial interests in those assets.

26G. A qualifying SPE may have the power to sell or distribute assets on termination of the SPE or maturity of the beneficial interests, but only on fixed or determinable dates that are specified at inception. For example:

a. If an SPE is required to sell long-term mortgage loans at the earlier of (1) the specified maturity of beneficial interests in those mortgage loans or (2) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception.

b. If that SPE has the power to sell transferred assets on two specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Assets of Qualifying SPEs in Consolidated Financial Statements

26H. Assets held in a qualifying SPE are effectively the assets of its Investors. Therefore, assets sold to a qualifying SPE shall not be recognized as assets, and related beneficial interests shall not be recognized as liabilities, in consolidated or other financial statements of a transferor, servicer, or sponsor of the qualifying SPE.

Agreements That Maintain Effective Control over Assets Transferred to Qualifying SPEs

26I. If the transferee is a qualifying SPE and the transferor retains effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets, other than through a cleanup call**,** then sale accounting is precluded under paragraph 9(b). For example, a transferor's unilateral ability to cause a qualifying SPE to return specific transferred assets, for example, in response to its decision to exit a market or a particular activity, provides the transferor with effective control over the transferred assets. Similarly, a transferor has maintained effective control over specific transferred assets if (a) the transferor or its affiliates may reclaim the transferred assets, for example, at termination of the qualifying SPE or at maturity or redemption of the beneficial interests, *and* (b) either the price the transferor is to pay is fixed or determinable or the transferor holds the residual interest in the transferred assets. To illustrate, if a transferor can reclaim transferred assets in which it holds the residual interest at termination of the qualifying SPE by purchasing them in an auction, then sale accounting would be precluded because that ability provides the transferor with effective control over the assets.

26J. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control over specific assets if the reclaimed assets would be randomly selected and the amount of the assets reacquired is limited (paragraph 58A(c)). Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service the transferred assets that could result in the loss of a third-party guaranty (paragraph 26E(a)) or only after a BIH other than the transferor or its affiliate requires a qualifying SPE to repurchase that beneficial interest (paragraph 26F(b))." (paragraph 5(k))

(iii) Paragraph 30 is replaced by the following heading and paragraph:

"Changes That Result in the Transferor's Regaining Control of Assets Sold

A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor's regaining control of assets previously accounted for appropriately as having been sold. Such a change is accounted for in the same manner as a purchase of the assets from the former transferee in exchange for liabilities assumed (paragraph 11). After that change, the transferor recognizes in its financial statements those assets together with liabilities to Investors in those assets (paragraph 26C). The transferor initially measures those assets and liabilities at fair value *on* the date of the change, as if the

transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for relief from obligations to the Investors." (paragraph 5(l))

9. **Canada**

(a) Emerging Issues Committee Abstract EIC-9 "Transfer of Receivables" (November 1989)

Issue

(i) "An enterprise enters into a transaction involving the transfer of receivables to another entity. The transfer may be of a 100% interest or of only a portion of a receivables portfolio. The transferee may acquire an undivided interest in the receivables or may purchase units, shares or other securities in a special purpose entity set up to purchase the receivables. The transferor would receive consideration for the receivables transferred and may also agree to service the receivables for a fee. The transferor may retain varying degrees of continuing involvement with the receivables in question.

The issue is as follows: Under what conditions would it be appropriate to reflect a transfer of receivables as a sale rather than as a financing?"

EIC Discussion

(ii) "The committee understands that this issue will be specifically addressed in the Accounting Standards Committee's project on financial instruments. In the meantime, the EIC is making its views as to the appropriate accounting treatment for this issue publicly available for the guidance of users, preparers and auditors of financial information. The discussion that follows does not apply to transfers of receivables between a parent and its not-consolidated finance subsidiary.

The committee agreed it would be appropriate to approach the Issue using the general principles set out in CICA 3400 and CICA 3065. These Sections focus on the concept of transferring the significant risks and rewards of ownership. As noted in CICA 1000, it is necessary to look to the substance of all the related transactions involved rather than their legal form. This approach may be inconsistent with U.S. GAAP and therefore SFAS 77, which focuses on the control of the assets involved, should not be viewed as an adequate source of guidance for Canadian purposes.

For the purposes of the discussion, the committee considered the following as examples of the significant risks and rewards of ownership of receivables.

Risks

- Losses resulting from uncollectible amounts (credit risk).

- Decreases in the value of fixed-rate receivables caused by increases in market interest rates or reductions in yield caused by downward movement in the interest rates on variable rate receivables (interest rate risk).

- Funding risk for mortgages or other receivables that are traditionally renewed on maturity.

- Reductions in yield caused by the debtor making payments at other than scheduled due dates. Delayed payments can reduce the yield if adequate penalties do not exist and reinvestment risk can occur when the debtor is able to prepay before maturity and adequate penalties are not charged.

- Decreases in the value of foreign currency denominated receivables caused by decreases in the relative value of the foreign currency (exchange rate risk).

Rewards

- Entitlement to receive cash flows from the receivables.

- The right to pledge the receivables as collateral for borrowings or commitments.

- The right to sell the receivables for consideration or use to satisfy liabilities.

- Favourable changes in the value of fixed rate receivables caused by decreases in market interest rates or increases in yield caused by upward movement in the interest rates on variable rate receivables.

- Increases in the value of foreign currency denominated receivables caused by increases in the relative value of the foreign currency.

The committee reached a consensus that for a transaction involving a transfer of receivables to be recognized as a sale, both of the following conditions should exist:

i. the transferor has transferred the significant risks and rewards of ownership of the receivables; and

ii. reasonable assurance exists regarding the measurement of the consideration derived from the transfer of the receivables.

If the transaction is regarded as a sale, it will be necessary to recognize the related gain or loss on sale. The calculation of the gain or loss should take into account all aspects of the transaction including the transferor’s expected losses under recourse provisions and the extent to

which the transferor remains exposed to risks in addition to credit risk. Any gain on sale should be deferred to the extent it is unrealized.

In assessing whether the risks of ownership have been transferred, all of the terms of a transaction must be examined. An assessment of the extent to which credit risk has been transferred should be considered in all transactions. Recourse in respect of credit losses may be provided by the transferor in various forms. These include put options for cash, substitution of good receivables for defaulted receivables, holdback reserves, subordinated interests in a pool of receivables and amounts held in spread accounts available to absorb credit losses. Financial innovation will likely create other forms of recourse. For accounting purposes, recourse in any form should be treated in the same way.

The committee reached a consensus that for the transfer to be recognized as a sale, the recourse provided by the transferor must be reasonable in relation to the losses expected to be incurred on the receivables transferred. The actual level of recourse judged to be reasonable would be a matter of professional judgment and would depend on the nature of the receivables in the portfolio.

In determining whether the level of recourse is reasonable, it would be appropriate to consider the statistical loss experience risk and the concentration risk. Statistical loss experience risk may be assessed by reviewing the historical loss and delinquency rates applicable to the portfolio including trends, volatility and sensitivity to major economic events. Concentration risk may come from large single obligors, a large number of obligors from a single industry or obligors concentrated in one or more geographic areas. Differing risks may make a certain level of recourse reasonable for a particular receivables portfolio but not reasonable for another. While it is not possible to quantify precisely what constitutes a reasonable level of recourse, it is unlikely that a sale of receivables has occurred if the total recourse exceeds 10 percent of the proceeds received.

In the course of discussing the issue, the committee considered the following conditions that may also be inherent in a particular transaction.

The committee reached a consensus that the retention of significant interest rate risk or significant exchange rate risk would normally preclude the transferor from recognizing the transfer as a sale. The committee also reached a consensus that the retention of significant potential rewards from favourable changes in interest rates or exchange rates would normally preclude the transferor from recognizing the transfer as a sale. The determination of whether the significant risks and rewards have been retained would be a matter of professional judgment in the circumstances taking into account all of the terms of the particular transaction.

The committee reached a consensus that the existence of a fixed price call option held by the transferor would preclude sales treatment unless

the terms of the option indicate that the likelihood is remote that it will ever be economic to exercise the option. For example, the existence of a call at the transfer price would give the transferor the ability to benefit from increases in the value of the receivables. Therefore the likelihood of exercise would not be remote. The committee also reached a consensus that the existence of a fair market value call option should not preclude sales treatment.

The committee reached a consensus that the existence of a fixed price put option held by the transferee on the portfolio of receivables transferred would preclude sales treatment. This position is consistent with CICA 3400 which prohibits sales recognition when the transferee has the right to rescind the transaction. However, the committee reached a consensus that the existence of a fair market value put option should not preclude sales treatment if it can be reasonably viewed as a second and independent transaction rather than a rescission of the original transaction. The transferor should consider whether the terms of the put would have to be disclosed under the requirements of CICA 3280.

The transferor may retain participation in the future cash flows from the receivables such as subordinated participating interest in a pool of receivables or a residual interest in a spread account. The committee reached a consensus that the retention of a significant participation in the future cash flows from the receivables is inconsistent with the contention that the rewards have been transferred and the receivables have been sold to another party. In such a case, the transferee does not have access to all of the rewards, e.g. the cash flows, from the receivables. However, the rewards that have been transferred, such as the entitlement to a substantial part of the cash flows and the right to pledge or sell the receivables, may be significant enough in combination with the transfer of the significant risks to characterise the transaction as a sale.

In reviewing transfers of receivables involving special purpose entities that are not consolidated, it is necessary to determine whether a transfer of the risks and rewards of ownership has really occurred. For example, it is necessary to consider the ability of the special purpose entity to meet the obligations it has assumed under the terms of the transaction and whether the potential rewards to the special purpose entity are materially limited."

10. **United Kingdom**

(a) Financial Reporting Standard FRS 5 "Reporting the Substance of Transactions" (April 1994)

(i) "*Summary*

General

(a) Financial Reporting Standard 5 'Reporting the Substance of Transactions' requires an entity's financial statements to report the substance of the transactions into which it has entered. The FRS sets out how to determine the substance of a transaction (including how to identify its effect on the assets and liabilities of the entity), whether any resulting assets and liabilities should be included in the balance sheet, and what disclosures are appropriate. The FRS also contains some provisions in respect of how transactions should be reported in the profit and loss account and the cash flow statement.

(b) The FRS will not change the accounting treatment and disclosure of the vast majority of transactions. It will mainly affect those more complex transactions whose substance may not be readily apparent. The true commercial effect of such transactions may not be adequately expressed by their legal form and, where this is the case, it will not be sufficient to account for them merely by recording that form.

(c) Transactions requiring particularly careful analysis will often include features such as –

(i) the party that gains the principal benefits generated by an item is not the legal owner of the item,

(ii) a transaction is linked with others in such a way that the commercial effect can be understood only by considering the series as a whole, or

(iii) an option is included on terms that make its exercise highly likely.

…

Identification and recognition of the substance of transactions

(e) A key step in determining the substance of any transaction is to identify whether it has given rise to new assets or liabilities for the entity and whether it has increased or decreased the entity's existing assets or liabilities. Assets are, broadly, rights or other access to future economic benefits controlled by an entity; liabilities are, broadly, an entity's obligations to transfer economic benefits.

(f) The future economic benefits inherent in an asset are never completely certain in amount; there is always some risk that the benefits will turn out to be greater or less than expected. Whether the entity gains or suffers from such variations in benefits is evidence of whether it has an asset.

…

(i) Following its recognition, an asset may be affected by a subsequent transaction. Where the transaction does not significantly alter the entity's rights to benefits or its exposure to risks, the entire asset should continue to be recognised. Conversely, where the transaction transfers to others all significant rights to benefits and all significant exposure to risks, the entity should cease to recognise the asset in its entirety. Finally, in other cases where not all significant benefits and risks have been transferred, it may be appropriate to amend the description or monetary amount of an asset and, where necessary, recognise a liability for any obligations it has assumed.

Linked presentation for certain non-recourse finance arrangements

(j) A special form of presentation, termed a 'linked presentation', should be used for certain non-recourse finance arrangements. This presentation shows, on the face of the balance sheet, the finance deducted from the gross amount of the item it finances. It should be used where, although the entity has significant rights to benefits and exposure to risks relating to a specific item, the item is financed in such a way that the maximum loss the entity can suffer is limited to a fixed monetary amount. For use of a linked presentation it is necessary that both -

   (i) the finance will be repaid only from proceeds generated by the specific item it finances (or by transfer of the item itself) and there is no possibility whatsoever of a claim on the entity being established other than against funds generated by that item (or the item itself), and

   (ii) there is no provision whatsoever whereby the entity may either keep the item on repayment of the finance or re-acquire it at any time.

…

Quasi-subsidiaries

(l) Sometimes assets and liabilities are placed in an entity (a 'vehicle') that is in effect controlled by the reporting entity but does not meet the legal definition of a subsidiary. Where the commercial effect for the reporting entity is no different from that which would result were the vehicle a subsidiary, the vehicle will be a 'quasi subsidiary'.

(m) The FRS requires the assets, liabilities, profits, losses and cash flows of any quasi-subsidiary to be included in the consolidated financial statements of the group that controls it in the same way as if they were those of a subsidiary. However, where a quasi-subsidiary is used to finance a specific item in such a way that the provisions of paragraph j above are met from the point of view of the group, the assets and liabilities of the quasi subsidiary should be included in consolidated financial statements using the linked presentation described in paragraph j."

(ii) "Where a transaction involving a previously recognised asset results in no significant change in –

(a) the entity's rights or other access to benefits relating to that asset, or

(b) its exposure to the risks inherent in those benefits,

the entire asset should continue to be recognised. In particular this will be the case for any transaction that is in substance a financing of a previously recognised asset, unless the conditions for a linked presentation given in paragraphs 26 and 27 are met, in which case such a presentation should be used." (paragraph 21)

(iii) "Where a transaction involving a previously recognised asset transfers to others –

(a) all significant rights or other access to benefits relating to that asset, and

(b) all significant exposure to the risks inherent in those benefits,

the entire asset should cease to be recognised." (paragraph 22)

(iv) "Paragraphs 21 and 22 deal with most transactions affecting items previously recognised as assets. In other cases where there is a significant change in the entity's rights to benefits and exposure to risks but the provisions of paragraph 22 are not met, the description or monetary amount relating to an asset should, where necessary, be changed and a liability recognised for any obligations to transfer benefits that are assumed. These cases arise where the transaction takes one or more of the following forms:

(a) a transfer of only part of the item in question;

(b) a transfer of all of the item for only part of its life; and

(c) a transfer of all of the item for all of its life but where the entity retains some significant right to benefits or exposure to risk." (paragraph 23)

(v) "In applying paragraphs 21-23 above and paragraph 26 below, 'significant' should be judged in relation to those benefits and risks that are likely to occur in practice, and not in relation to the total possible benefits and risks." (paragraph 25)

(vi) "In determining whether another entity (a 'vehicle') gives rise to benefits for the reporting entity that are in substance no different from those that would arise were the vehicle a subsidiary, regard should be had to the benefits arising from the net assets of the vehicle. Evidence of which party gains these benefits is given by which party is exposed to the risks inherent in them." (paragraph 32)

(vii) "In determining whether the reporting entity controls a vehicle regard should be had to who, in practice, directs the financial and operating policies of the vehicle. The ability to prevent others from directing those policies is evidence of control, as is the ability to prevent others from enjoying the benefits arising from the vehicle's net assets." (paragraph 33)

(viii) "Where the financial and operating policies of a vehicle are in substance predetermined, contractually or otherwise, the party possessing control will be the one that gains the benefits arising from the net assets of the vehicle. Evidence of which party gains these benefits is given by which party is exposed to the risks inherent in them." (paragraph 34)

(ix) "Whatever the substance of a transaction, it will normally have commercial logic for each of the parties to it. If a transaction appears to lack such logic from the point of view of one or more parties, this may indicate that not all related parts of the transaction have been identified or that the commercial effect of some element of the transaction has been incorrectly assessed." (paragraph 51)

(x) "It follows that in assessing the commercial effect of a transaction, it will be important to consider the position of all of the parties to it, including their apparent expectations and motives for agreeing to its various terms. In particular, where one party to the transaction receives a lender's return but no more (comprising interest on its investment perhaps together with a relatively small fee), this indicates that the substance of the transaction is that of a financing. This is because the party that receives a lender's return is not compensated for assuming any significant exposure to loss other than that associated with the creditworthiness of the other party, nor is the other party compensated for giving up any significant potential for gain." (paragraph 52)

(xi) "In deciding whether or not an entity is a quasi-subsidiary, access to the whole of the benefit inflows arising from its gross assets and responsibility for the whole of the benefit outflows associated with its liabilities are not the key considerations. In practice, many subsidiaries do not give rise to a possible benefit outflow for their parent of an amount equal to their gross liabilities – indeed, the limiting of benefit

outflows in the event of losses occurring may have been a factor for the parent in establishing a subsidiary. In addition, as the liabilities of a subsidiary have a prior claim on its assets, the parent will not have access to benefit inflows of an amount equal to those gross assets. For this reason, it is necessary to focus on the benefit flows associated with the net assets of the entity. Often evidence of where these benefits lie is given by which party stands to suffer or gain from the financial performance of the entity – i.e. which party has the risks inherent in the benefits." (paragraph 96)

(xii) "Control is the means by which one entity determines how the assets of another entity are employed and by which the controlling entity ensures that the resulting benefits accrue to itself and not to others. Control may be evidenced in a variety of ways depending on its basis (e.g. ownership or other rights) and the way in which it is exercised (interventionist or not). Control includes the ability to restrict others from directing major policies, but a power of veto will not of itself constitute control unless its effect is that major policy decisions are taken in accordance with the wishes of the party holding that power. One entity will not control another where there is a third party that has the ability to determine all major issues of policy." (paragraph 97)

(xiii) "In some cases, arrangements are made for allocating the benefits arising from the activities of an entity such that active exercise of control is not necessary. The party or parties who will gain the benefits (and bear their inherent risks) are irreversibly specified in advance. No party has direct control in the sense of day-to-day direction of the entity's financial and operating policies, since all such matters are predetermined. In such cases, control will be exercised indirectly via the arrangements for allocating the benefits and it will be necessary to look at the effects of those arrangements to establish which party has control. It follows that, for the reasons set out in paragraph 96 above, the party possessing control will be the one that gains the benefits arising from the net assets of the entity." (paragraph 98)

Securitised Assets – Application Note D

(xiv) "Derecognition (i.e. ceasing to recognise the securitised assets in their entirety) is appropriate only where the originator retains no significant benefits and no significant risks relating to the securitised assets." (paragraph D7)

(xv) "Whilst the commercial effect of any particular transaction should be assessed taking into account all its aspects and implications, the presence of all of the following indicates that the originator has not retained significant benefits and risks, and derecognition is appropriate:

(a) the transaction takes place at an arm's length price for an outright sale;

(b) the transaction is for a fixed amount of consideration and there is no recourse whatsoever, either implicit or explicit, to the originator for losses from whatever cause. Normal warranties given in respect of the condition of the assets at the time of the transfer (e.g. in a mortgage securitisation, a warranty that no mortgages are in arrears at the time of transfer, or that the income of the borrower at the time of granting the mortgage was above a specified amount) would not breach this condition. However, warranties relating to the condition of the assets in the future or to their future performance (e.g. that mortgages will not move into arrears in the future) would breach the condition. Other possible forms of recourse are set out in paragraph 83; and

(c) the originator will not benefit or suffer if the securitised assets perform better or worse than expected. This will not be the case where the originator has a right to further sums from the vehicle that vary according to the eventual value realised for the securitised assets. Such sums could take a number of forms, for instance deferred consideration, a performance-related servicing fee, payments under a swap, dividends from the vehicle, or payments from a reserve fund.

Where any of these three features is not present, this indicates that the originator has retained benefits and risks relating to the securitised assets and, unless these are insignificant, either a separate presentation or a linked presentation should be adopted." (paragraph D8)

(xvi) "Whether any benefit and risk retained are 'significant', should be judged in relation to those benefits and risks that are likely to occur in practice, and not in relation to the total possible benefits and risks. Where the profits or losses accruing to the originator are material in relation to those likely to occur in practice, significant benefit and risk will be retained. For example, if for a portfolio of securitised assets of 100, expected losses are 0.5 and there is recourse to the originator for losses of up to 5, the originator will have retained all but an insignificant part of the downside risk relating to the assets (as the originator bears losses of up to ten times those expected to occur). Accordingly, in this example, derecognition will not be appropriate and either a linked presentation or a separate presentation should be used." (paragraph D9)

(d) Analysis of Issues

11. The issues can be best explained and analysed by reference to an example of a typical securitisation of financial assets. This section will therefore:

- provide an example of a typical securitisation transaction;
- analyse how the question of control was addressed prior to the issue of Abstract 28; and

- analyse the concerns which have arisen in relation to the application of Abstract 28.

Securitisation Transactions

12. The appendix to this Issue Summary provides a brief explanation of the securitisation process. In a typical securitisation transaction, financial assets are transferred (from the transferor) to an SPE, commonly a trust. The trust issues to investors beneficial interests which are usually structured as debt instruments but may be in the form of equity instruments. The SPE is usually overseen by an independent trustee and typically operates in a strict and predetermined manner to collect proceeds from the assets, make distributions to the investors and otherwise protect the investors.

13. The manner in which securitisation transactions are structured is often such that the transferor retains an interest in the transferred financial assets. This retained interest is often legally structured as either a participation in the SPE's activities (such as through a right to service the assets) or as a right to a component of income (perhaps via an SPE distribution entitlement).

14. A simplified mortgage securitisation might be structured as follows:

	%
Interest received by the SPE:	
Current floating retail rate on mortgage loans	7.50
Interest paid by the SPE:	
Current floating rate due to the investors	6.65
	0.85
Expenses:	
Servicing fees	0.35
Other expenses	0.30
Residual : interest-only strip	0.20

15. In this example, the SPE will receive from the borrowers a floating return (currently 7.50%) on its assets. The investors will receive from the SPE a 6.65% return on their funds invested, and are entitled to 100% of the principal of the SPE's loan assets (the funds invested by the investors are equivalent to the principal receivable by the SPE on its loans) subject to credit losses. In this simple example, any principal credit losses suffered on the mortgage loans will be borne by the investors. A servicer will receive 0.35% for servicing the loans.

16. In this example, the transferor has the rights to any cash remaining in the SPE after the investors have been paid their interest and principal and all expenses of the SPE have been paid. This receivable is often referred to as an interest-only strip as it reflects the element of interest that is not sold through to the investors. However, there are many different forms of securitisation structure; this is merely one illustration for the purposes of this analysis.

Control of the SPE

17. The fundamental issue is whether the SPE is controlled by the transferor and should therefore be consolidated by the transferor. The end result should be that the assets and liabilities recognised on the *consolidated* statement of financial position of the

transferor are those that are controlled by the transferor. This would be consistent with the requirements of Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements" which defines assets to be "future economic benefits controlled by the entity as a result of past transactions or other past event" and control of an asset to mean "the capacity of an entity to benefit from the asset in the pursuit of the entity's operations and to deny or regulate the access of others to that benefit".

18. In determining which future economic benefits are controlled by the transferor subsequent to the securitisation transaction, accounting standards acknowledge that assets can be split into separate portions in certain circumstances, some of which might be sold and others retained. Accounting Standards AASB 1004 and AAS 15 "Revenue" state that "Revenue arising from the sale of goods or the disposal of other assets must be recognised when, and only when, all the following conditions have been satisfied: (a) the entity has passed control of the goods or other assets to the buyer (b) ….". Paragraph 6.1.1 of AASB 1004/AAS 15 explains "The assessment of when control of an asset is lost by the seller (passes to the buyer) requires an examination of the circumstances of the transaction. In most cases, the transfer of control coincides with the transfer of the legal title or the passing of possession to the buyer …. In addition, there may be a passing of control over some of the future economic benefits embodied in goods or other assets and a retention of others."

19. This acknowledgement is particularly relevant to *financial assets*. Both International Accounting Standard IAS 39 "Financial Instruments: Recognition and Measurement" and FASB Statement of Financial Accounting Standards SFAS 125 "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities" recognise that transfers of financial assets often occur in which the transferor has some continuing involvement either with the assets transferred or with the transferee. This continuing involvement, in the normal course of events, takes the form of separately identifiable contracts or legal obligations. In such circumstances, the pronouncements require the transferor to derecognise the portions that it no longer controls, and to continue to recognise only those portions that it does control.

20. That is, it is not appropriate to account for the financial assets transferred as an inseparable unit that has been either entirely sold or entirely retained. Instead, the transferor would continue to recognise any retained interests in the financial assets and recognise any new assets obtained or liabilities incurred as part of the transaction.

21. Both IAS 39 and SFAS 125 provide specific criteria and guidance for determining when a portion of a *financial asset* is no longer controlled and should be derecognised by the transferor.

22. A key concept underpinning these Standards is that the economic benefits provided by a *financial asset* (generally, the right to future cash flows) are derived from the contractual provisions that underlie the asset. The IAS 39 derecognition criteria are grounded on whether the transferor has lost control of the *contractual rights* that comprise the financial asset (or a portion of the financial asset).

23. For the purposes of analysing the example above, it is assumed that the transferor has met the derecognition criteria in relation to the major portion of the mortgage loans. Accordingly, in its own financial report the transferor would only continue to recognise a small portion of the mortgage loans as its asset (the interest-only strip).

24. However, it is still necessary to consider whether the transferor controls the SPE and should therefore consolidate the SPE. Consolidation would have the effect of reversing the sale and reinstating the original financial assets on the consolidated statement of financial position of the transferor.

25. The key question becomes, does it make sense to effectively reverse the sale accounting treatment in respect of financial assets that have met the strict criteria to allow derecognition, when an entity has been created to effect that sale and facilitate the orderly distribution of the benefits (cashflows) of those assets to the investors?

Prior to the Issue of Abstract 28

26. Prior to the issue of Abstract 28, most in the securitisation industry would have answered "no" to this question, given the example described. The first reference points in Australia have been Accounting Standards AASB 1024 "Consolidated Accounts" and AAS 24 "Consolidated Financial Reports". AASB 1024 and AAS 24 define control as "the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity."

27. Usually the activities of the SPE are predetermined and permanently limited by the legal documents establishing the SPE (that is, the SPE operates on 'autopilot'). While the transferor typically has a large involvement in the predetermination of the activities of the SPE, many hold the view that the specified activities are not principally for the benefit of the transferor. They argue that the SPE is constructed and acts principally for the benefit of the investors. Ratings agencies and other parties are usually also involved in the predetermination of the SPE's activities to ensure that it remains independent of the transferor, and that the investors are not directly exposed to the creditworthiness of the transferor, but to the underlying assets of the SPE only. The SPE's activities are usually limited to holding the transferred financial assets, collecting proceeds, distributing the proceeds, and selling or distributing assets on a specified date or in response to a need to protect the investors. All of these permitted activities are established for the benefit of the investors as a whole because the transferred financial assets cannot otherwise be separated into pro-rata portions and sold to the individual investors. Typically the only parties that can alter the activities of the SPE after its formation are the investors. For these and related reasons, many in the securitisation industry would have concluded that the transferor did not control the SPE described in the example above.

28. In addition, AASB 1024 and AAS 24 identify a number of factors which "would normally indicate the existence of control by one entity of another entity". One of the factors is where, in substance, the transferor has "the capacity to enjoy the majority of the benefits and to be exposed to the majority of the risks of that entity". There have been differing interpretations of the various benefits and risks of a securitisation SPE and their relevance to the analysis of control. In our securitisation example, the vast majority of the benefits of the assets of the SPE go to the investors. Plus the investors are exposed to all the credit risk, and the vast majority of the prepayment risks and interest rate risk associated with the SPE's assets. Many would have taken this as further evidence that the transferor does not control the SPE or its assets. However, AASB 1024 and AAS 24 do not provide explicit guidance on analysing control of an SPE.

29. Therefore, prior to the issue of Abstract 28, many in the Australian securitisation industry would have also referred to the relevant US pronouncements when determining if an SPE should be consolidated. The US securitisation industry is by far the world's largest and most developed market, and the US standard setters have produced specific guidance on when an SPE involved in a securitisation of financial assets should be consolidated.

30. Applying the US pronouncements, the conclusion in the circumstances described above is that the residual entitlement retained by the transferor does not give the transferor the ability to control the SPE nor all (or the majority of) the financial assets held by the SPE. The transferor can in no way influence what should happen with the transferred assets (the principal repayments and 6.65% return). It can no longer exchange or pledge the transferred assets. The principal repayments, for example, belong to the investors. Even if the transferor went into liquidation, its creditors could not reach those principal repayments.

31. Under this approach, through the securitisation transaction the transferor has realised the rights to the contractual benefits that comprise the transferred assets, and its continuing interest in the activities of the SPE does not alter this.

32. Hence, under the US pronouncements, where the transferor's retained interest is structured as an entitlement to 'residual' SPE income, this is not always considered to be an equity-type interest. Instead, in the circumstances described, the right to 'residual' distributions is itself considered to be a financial portion of the original financial asset. Each separate financial portion of the original financial asset can be accounted for separately in the hands of its new (or continuing) owner.

33. Accordingly, under the US pronouncements, the transferor would not consolidate the SPE in the above example. The outcome is therefore that the *consolidated* statement of financial position of the transferor would record only the interest-only strip, being the retained portion of the original mortgage loans. This asset meets the SAC 4 definition referred to earlier. Moreover, it means that the transferor would not record the entire original mortgage loans, which many consider no longer meet the SAC 4 definition of an asset for the transferor.

Application of Abstract 28

34. Abstract 28 introduced much uncertainty to the securitisation industry primarily because of differing interpretations of the 'indicators of control' in paragraph 13 of Abstract 28. The indicators of control were meant to clarify circumstances under which an entity should consolidate an SPE in Australia.

35. Paragraph 13 states that "the following circumstances, for example, would *normally* indicate a relationship in which an entity controls an SPE ..." (emphasis added). Many read this to mean that if any of the individual circumstances are present, then consolidation is necessary, rather than deciding the question of control in light of all the prevailing circumstances. In comparison to the equivalent paragraph in the Standing Interpretations Committee Interpretation SIC-12 "Consolidation – Special Purpose Entities", the only difference is that SIC-12 uses the word "may" rather than the words "would normally". Many believe it would be preferable to use the word "may" in Abstract 28 also.

36. The ‘indicators of control’ in Abstract 28 fall into three categories:

- activities
- decision-making
- residual risks and benefits.

Activities

37. The specific circumstance in paragraph 13(a) of Abstract 28 is particularly broad: “in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE’s operations”. The paragraph makes no reference to the SPE’s activities being conducted *principally* on behalf of the entity, or the *majority* of its activities being on behalf of the entity. However, paragraphs 13(b), (c) and (d) of Abstract 28 all refer to *majority*.

38. As paragraph 13(a) is written, virtually all SPEs would need to be consolidated, given that the sponsoring entity would not have formed an SPE if that SPE’s activities were not going to be conducted on behalf of the sponsor to *some* degree.

39. Consider for example a ‘standard’ investment management unit trust. Typically the sponsor of the unit trust will be the Manager. The Manager will create and market the unit trust so that it can earn recurring management fees. However, it is the unitholders who will principally benefit from the activities of the unit trust; the specified investment activities of the unit trust are conducted principally on behalf of the unitholders to maximise the return on their investment. Notwithstanding that the activities of the unit trust are conducted on behalf of the Manager to *some* degree, the Manager is not deemed to control the unit trust typically.

40. In the example of the securitisation transaction above, many would consider that the SPE was formed *principally* on behalf of the investors. Investors such as superannuation funds cannot otherwise readily and affordably purchase, for example, mortgage loan assets (or the majority components thereof). Securitisation vehicles normally act as a conduit to facilitate those purchases. Furthermore the SPE’s ongoing activities are being conducted *principally* on behalf of those investors. It is the investors who are entitled to the majority of the cashflows stemming from the SPE, and the activities of the SPE in the example above are conducted principally to protect and fulfil the investors’ rights.

41. Others might consider that the SPE was formed principally on behalf of the transferor to enable the sale of financial assets. However, in the circumstances of the example given, it would then be considered that the activities of the SPE were conducted principally in order to effect that *sale*; not for the transferor to retain control of the transferred assets.

Decision-making

42. Paragraph 13(b) of Abstract 28 requires the SPE normally to be consolidated if:

> "in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the entity has delegated these decision-making powers".

43. This is further explained in the Appendix to Abstract 28. Paragraph (b) states that:

> "The reporting entity, in substance, has the decision-making powers to control or to obtain control of the SPE or its assets, including certain decision-making powers coming into existence after the formation of the SPE. Such decision-making powers may have been delegated by establishing an 'autopilot' mechanism."

44. The examples to paragraph 13(b) in the Appendix to Abstract 28 focus on the decision-making powers coming into existence *after* the formation of the SPE. Some would agree that it is critical to consider which (if any) parties have the capacity to influence decision-making after the SPE has been formed, whether on 'autopilot' or not. If the transferor could, for example, unilaterally dissolve the SPE and reacquire the assets, or change the permitted activities of the SPE subsequent to its formation, then the transferor would probably be deemed to control the SPE. Therefore these commentators believe that the reference to the powers coming into existence *after* the formation of the SPE should be included in the black letter of paragraph 13(b).

45. Also, the explanation in the Appendix to Abstract 28 looks at whether the reporting entity "in substance, has the decision-making powers to control or to obtain control of the SPE or its assets". Some consider this more appropriate than the Consensus in paragraph 13(b) referring to "decision-making powers to obtain the majority of the benefits of the activities of the SPE". In isolation, the phrase *the majority of the benefits* is capable of misinterpretation. Some believe this refers to the gross benefits from the assets held by the SPE. Others believe it relates to the net benefits arising from the net assets of the SPE. This issue is, and should be, separately dealt with in paragraph 13(c) of Abstract 28 (specifically through the examples provided in the Appendix to Abstract 28).

46. As a separate concern, some believe that the second half of paragraph 13(b) of Abstract 28 is superfluous, given that the potential impacts of 'autopilot' arrangements are dealt with elsewhere in Abstract 28. Specifically, paragraph 12 states that "In the context of an SPE, control *may* arise through the predetermination of the activities of the SPE (operating on 'autopilot') or otherwise" (emphasis added).

47. Some, however, believe that the second half of paragraph 13(b) can be interpreted to mean that whenever an entity sets up an SPE on 'autopilot' the entity controls the SPE and that this view is supported by paragraphs 18 and 19. Others do not support this view. Consider again the example of the 'standard' investment management unit trust. The unit trust is created by the Manager and its permitted activities can be predetermined by the Manager so that, once the unit trust is formed, the Manager has no decision-making authority outside the specific investment mandate. That is, it could be considered that the unit trust acts on 'autopilot'. However, the Manager is usually not deemed to control the unit trust. Following this approach, an entity does not have control over an SPE *simply* by virtue of establishing the SPE or predetermining the SPE's activities. The other indicators need to be considered, such as determining who the SPE principally acts for and the distribution of the benefits of its activities.

48. Accordingly, these commentators consider that it is appropriate to soften the language used in paragraph 18 of Abstract 28, which states that "the predetermination of the activities of the SPE through an 'autopilot' mechanism *often* provides evidence that the ability to control has been exercised by the party making the predetermination for its own benefit at the formation of the SPE and is being perpetuated" (emphasis added), and in paragraph 19, which states that "Predetermination of the activities of an SPE by an entity (the sponsor or other party with a beneficial interest) is *often a demonstration of control* over ongoing activities as determined by that entity and would not represent impaired control as referred to in AASB 1024, paragraph (vii), and AAS 24, paragraph 11" (emphasis added). Many believe that this commentary should be redrafted to clarify that the predetermination of activities does not necessarily establish control.

49. In relation specifically to SPEs involved in the securitisation of financial assets, some consider that the example analysed above is another illustration that an SPE operating on 'autopilot' with some benefit accruing to the sponsor/transferor does not necessarily mean the sponsor/transferor controls the SPE.

50. Abstract 28 could be even more useful, however, if it provided specific examples of circumstances when an SPE should be considered *not* controlled by an entity, even if on 'autopilot'. This is explored further below.

Residual risks and benefits

51. The last two indicators in paragraph 13 of Abstract 28 are:

"(c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or

(d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities."

52. Some consider that there is some duplication and circularity between these paragraphs. Paragraph 13(c) recognises that the entity with access to the majority of benefits will be exposed to the majority of risks, while paragraph 13(d) refers to the retention of the majority of the residual or ownership risks of the SPE or its assets as the mechanism by which an entity may obtain the benefits of the SPE.

53. It may therefore be appropriate to combine paragraphs (c) and (d). The UK Financial Reporting Standard FRS 5 "Reporting the Substance of Transactions", for example, states several times that "Evidence of which party gains these benefits (arising from the net assets of the vehicle) is given by which party is exposed to the risks inherent in them".

54. Combining paragraphs 13(c) and (d) would also be consistent with paragraph (xvi) of AASB 1024 and paragraph 22 of AAS 24, which state:

"Any of the following factors would normally indicate the existence of control by one entity of another entity:

…

(e) the existence of a statute, agreement or trust deed, or any other scheme, arrangement or device, which, in substance, gives an entity the capacity to enjoy the majority of the benefits *and* to be exposed to the majority of the risks of that entity, notwithstanding that control may appear to be vested in another party." (emphasis added)

55. The examples provided in the Appendix to Abstract 28 imply that the benefits of the SPE primarily envisaged by Abstract 28 are the residual distributions from the SPE, usually represented by distributions of net cash flows or earnings; that is, the benefits arising from the net assets of the SPE. Most would consider this to be entirely appropriate and consistent with overseas guidance.

56. As an example, consider a company which held an investment security which was fully geared by bank borrowings. Assume that the company created an SPE, transferred the investment security and borrowings into the SPE, and predetermined that the SPE must continue to hold the investment security and use the investment earnings to repay the interest expense, and to pay the excess (net earnings) back to the company. Assume also that the company maintains the ability to change the activities of the SPE or to wind-up the SPE. Some would argue, however, that it is the bank (and not the company) that receives the majority of the *gross* benefits of the activities of the SPE. Others would argue that this should not alter the analysis of control and that it is the *net* benefits of the SPE's activities that are important. The company receives the net earnings of the SPE, and they would argue that this is another indicator that the company controls the SPE.

57. In the simple securitisation example described earlier, some would view the transferor to be entitled to the residual income and thereby receiving the benefits arising from the activities of the SPE. Even though the amount of the net assets of the SPE might be negligible (often representing the nominal equity invested when the SPE was constituted, perhaps by an independent third party), the return on those net assets might be seen to pass to the transferor. This is also evidenced by the fact that the transferor is exposed to the risks associated with those net benefits, such as prepayment risk and interest rate risk. Application of paragraphs 13(c) and (d) of Abstract 28 might therefore result in the conclusion that the transferor controls the SPE.

58. However, as explained in paragraph 27, the residual interest might *not necessarily* give the transferor an equity-type interest in the SPE such that the transferor can in fact control the SPE or all (or the majority of) the financial assets held by the SPE. As analysed earlier, this might be the case where the financial assets transferred to the SPE meet the criteria for derecognition as assets of the transferor, and the SPE operates on 'autopilot' with its permitted activities being only to hold transferred financial assets, collect proceeds, distribute the proceeds, and sell or distribute assets on a specified date or in a response to a need to protect the investors. Without repeating the earlier analysis, many consider that the transferor's retained ownership of a 'residual' interest in such circumstances should not result in it consolidating the SPE.

59. The example of the 'standard' investment management unit trust can also be analysed. In some trusts, the fees earned by the Manager vary with the performance of the trust. While the majority of the trust's earnings accrue to the unitholders, some would argue that the Manager retains the residual interest in the performance of the trust.

However, such trusts are not typically considered to be controlled by the Manager for reasons articulated earlier.

60. Another example can be used to illustrate this point further. Consider a securitisation structure in which the transferor receives residual trust income through an interest-only strip. If the transferor sold 70% of that interest-only strip to a third party as an investment, would that third party then be deemed to control the trust and need to consolidate all its assets and liabilities? To many this would not seem appropriate. The reason could be that the interest-only strip does not confer an equity-type interest in the SPE. In the US, where the securitisation market is more developed, interest-only strips are traded as individual investments.

61. Again, Abstract 28 recognises that the indicators of control are specific circumstances that would normally *but not always* indicate a relationship in which an entity controls an SPE. However, confusion and inconsistent application of Abstract 28 might be reduced if Abstract 28 also contained some specific 'indicators of non-control'.

62. Specifically, these might recognise that some SPEs are merely conduits to the effective transfer of portions of financial assets from one entity to others, and that the transferor cannot, for example, unilaterally invade the SPE and acquire or change the assets *or* alter the investor liabilities, and therefore the SPE should not be consolidated by the transferor. Such circumstances could be similar to those provided in equivalent US pronouncements.

63. These US circumstances are *only* relevant if the transfer is of *financial* assets. Non-financial assets have significantly different characteristics; they have a variety of operational uses, and management skill plays a considerable role in obtaining the greatest value from those assets. The promise embodied in a financial asset is governed by contract and, once the contract is established, management skill plays a limited role in the entity's ability to realise the value of the investment.

64. An SPE can therefore be established on 'autopilot' and still realise the full value of financial assets transferred to it. If non-financial assets were transferred to an SPE, it is less clear that the full value of these assets could be realised without management involvement. That is, the SPE's activities could not be entirely predetermined and decision-making would be required. For example, if real estate was transferred to an SPE, decision-making might be required in relation to tenant selection and negotiation of rent.

(e) Recommendations

65. The purpose of this Issue Summary is to recommend amendments to Abstract 28 in the context of securitisations of financial assets. However, Abstract 28 applies to SPEs used in any transaction. Therefore the recommendations are drafted so that they do not compromise the application of Abstract 28 to transactions other than securitisations of financial assets.

66. The recommended amendments below relate only to paragraph 13 of Abstract 28. If adopted, it might also be necessary to amend other paragraphs and the Appendix to Abstract 28.

67. It is suggested that the word "may" should be used in paragraph 13 rather than the words "would normally", such that it reads "the following circumstances, for example, may indicate a relationship in which an entity controls an SPE ….".

68. The following amendment to paragraph 13(a) of Abstract 28 is recommended (refer italics inserted):

> "in substance, the activities of the SPE are being conducted *principally* on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operation".

69. It is recommended that the following paragraph should replace paragraph 13(b) of Abstract 28:

> "in substance, the entity has the decision-making powers to control or to obtain control of the SPE or its assets, including any decision-making powers coming into existence after the formation of the SPE".

70. It is recommended that paragraphs 13(c) and (d) of Abstract 28 should be combined as follows:

> "in substance, the entity has rights to obtain the majority of the benefits arising from the activities of the SPE, and is exposed to the majority of the risks inherent in those benefits".

71. It is suggested that Abstract 28 should also include some "indicators of non-control", being specific circumstances which would normally indicate a relationship in which an entity does not control an SPE and consequently should not consolidate an SPE.

72. One recommended set of specific circumstances in which an entity would normally be deemed not to control an SPE are in relation to the securitisation of financial assets (and only of financial assets) where:

    (a) the entity has lost control of the financial assets; and

    (b) the SPE operates on 'autopilot'; that is, its activities are permanently limited by the legal documents establishing it; and

    (c) the SPE operates principally on behalf of the investors, with its permitted activities limited to:

        (i) holding title to those financial assets;

        (ii) issuing beneficial interests to the investors;

        (iii) collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to the investors, and otherwise servicing the assets held;

        (iv) distributing cash entitlements to the investors; and

        (v) paying operating expenses and other sundry entitlements.

What is securitisation?

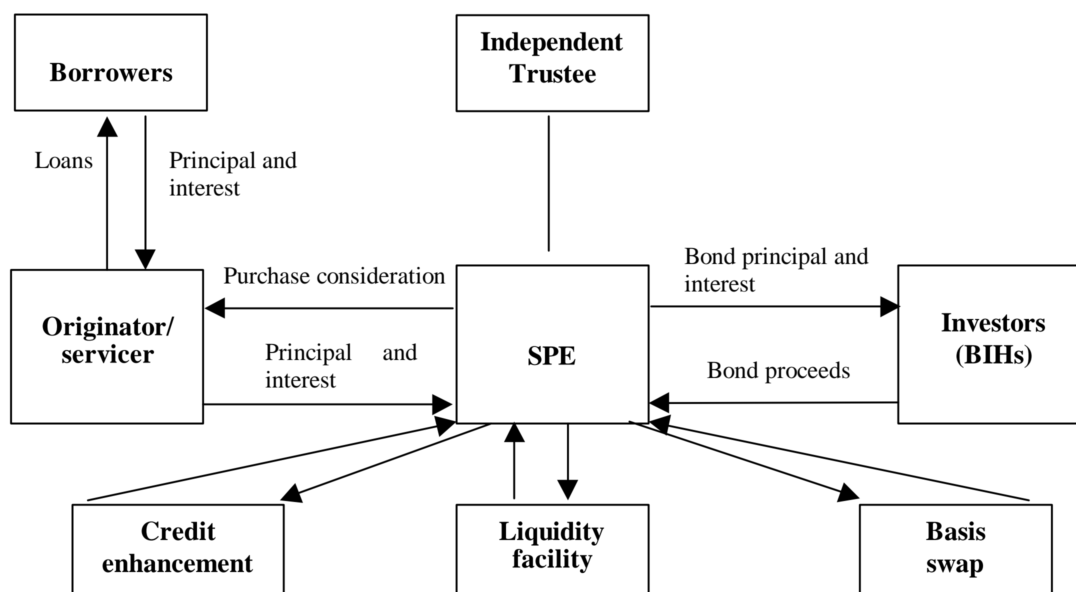
Securitisation is a process whereby non-tradable assets are pooled and converted into securities to allow them to be issued to and traded between investors.

Securitisation issues can be either mortgage-backed or backed by other asset classes. To date in Australia, most issues have tended to be mortgage-backed securities. However, several types of non-mortgage loan assets have recently been securitised in Australia, such as credit card receivables, public utility consumer debtors and corporate trade debtors.

One of the key elements in any securitisation is the investors' faith in the securities issued and in the SPE itself. The SPE of a financial securitisation transaction is usually structured to be independent of the transferor such that the investors are not directly exposed to the credit deterioration or bankruptcy of the transferor, but to the underlying assets of the SPE only. Many Australian securitisation structures obtain ratings of AA+ or better. This can usually only be achieved by the transferor and/or other parties providing credit and other enhancements to the underlying pool of assets.

The following example principally relates to mortgage-backed securitisations. However, the majority of the considerations involved in mortgage-back securitisations also relate to securitisation of other assets.

Typically, mortgage securitisation is executed through the transfer of assets from the originator (eg mortgagee) to a special purpose entity (SPE) which in turn issues bonds to investors. A typical securitisation structure is illustrated below:



The typical cash flows associated with a variable rate mortgage loan securitisation, where the originator is a bank, are:

- at the outset, a lender (the originator) makes loans to borrowers
- assets are sold by the originator to an SPE (normally a trust but sometimes a company) in exchange for cash consideration.
- the SPE issues beneficial interests (to beneficial interest holders or BIHs) which can be in the form of debt instruments or equity instruments. In this example, the SPE issues debt securities collateralised by the transferred assets to institutional and other investors. There will typically be multiple classes of securities with different terms and priority of repayment. The investors acquire the securities for cash, which the SPE uses to fund the purchase of the transferred assets from the originator
- the SPE pays regular servicing fees to the servicer (perhaps a subsidiary of the originator)
- a counterparty will often provide a basis swap to the SPE to provide more certainty to the investors. Effectively the risk of fluctuating interest rates on the home loans is passed to the counterparty, and they provide a fixed basis rate sufficient to pay the investors
- the securities issued by the SPE are credit-enhanced by a mortgage insurer. The mortgage insurer receives a premium from the SPE and pays cash into the SPE for qualifying losses
- typically the originator will have the rights to any cash remaining in the SPE after the investors have been paid their interest and principal and all expenses of the SPE have been paid. This is commonly swept out of the SPE each month. This instrument or receivable is often referred to as an interest-only strip as it reflects the element of interest that is not sold through to the investors.