A F E P

Association Française des Entreprises Privées

IASB
30 Cannon Street
London EC4M 6XH
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Paris, July 16, 2009

Re: *ED « Derecognition »*

We welcome the opportunity to comment on the IASB exposure draft dealing with "*Derecognition*".

While we support the efforts undertaken by the IASB to respond promptly to issues that the financial crisis has enlightened, we do not think that the proposed changes are likely to bring the expected improvements without creating other difficulties.

Our main comments and concerns are as follows:

1- The IASB should analyse and describe what difficulties and weaknesses it is attempting to solve; the introduction to the standard describes weaknesses in quite a theoretical fashion, invoking the complexity of an approach combining risks and rewards and control, and the difficulty to apply the risks and rewards notion in practice. We do not think that this is the appropriate analysis in order to identify possible improvements, in light of what the financial crisis has been teaching us. The document should describe the types of transactions or circumstances where existing derecognition requirements have failed either to trigger derecognition when it should have happened or to prevent derecognition when it should not have happened. The mere mention that users call for more transparency in the transfers of assets through securitisations does not tell us enough of what the Board should seek to achieve.

2- We do not believe that the exposure-draft adequately captures the consequences to be expected from the proposed changes. In IN10, the IASB announces that the proposed changes would not change most of the derecognition outcomes stemming from the existing literature, making a specific and only mention of transfers including repurchase agreements of readily obtainable assets. We would have expected the ED to explain why and how this change brings improvement in light of the financial crisis. We would also have expected that the switch from a model that allowed partial derecognition to an "all or nothing" model, and as a result, the implicit prohibition of derecognition of any securitisation, to be identified as a major change and an adequate response to the concerns raised by the financial crisis.

3- While the proposals claim to rationalise the IFRS derecognition model into a model that is solely based on control, we believe that de facto the model remains a mixed model, the new notion of continuing involvement encapsulating the previous "risks and rewards" model. The change is therefore more in the wording and the articulation of the derecognition tests than in the concepts. As a result we are not convinced that the existing uncertainties in practice would be lifted.

4- The notion of "practical ability to transfer" fails, in our view, to characterise whether the transferor has retained, or transferred, control of the transferred assets. Moreover, the nature of assets – either readily obtainable or not – or the restrictions that are imposed on the transferee cannot be, in themselves, valid discriminating factors of control, from the perspective of the transferor.

5- Triggering derecognition of transfers with repurchase agreements, the only change that the IASB has enlightened, is not a welcomed change in our view. Those transactions are financing agreements, not substantially different from pledged borrowings, and should remain accounted as such.

In summary, we believe that the IASB should not pursue the proposals included in the exposure draft since they do not solve the issues at stake and create new concerns. We agree nonetheless that the existing derecognition requirements need improvement. We agree with the Board that the alternative view is not the direction to follow. In order to identify the desirable improvements, the analysis of what assets and liabilities entities, and more particularly financial institutions, should report in their balance sheets, and why, should be carried out as an initial step in the project. In the meanwhile, the IASB could, as an urgent response to the financial crisis, improve the existing disclosure requirements.

In addition to these main comments, answers to the detailed questions of the invitation for comment are provided in the appendix.

Should you wish any supplementary comment or explanation, please do not hesitate to contact us.

ACTEO	AFEP	MEDEF
Patrice MARTEAU	**Alexandre TESSIER**	**Agnès LEPINAY**
Chairman	Director General	Director of economic and financial affairs

Appendix to our letter on IASB ED “Derecognition”. Answers to the specific questions raised in the invitation for comments

Preliminary comment

In answering to the following questions, we have strived to deal with the question in isolation of the others. However, this is a difficult exercise, as all conditions set for derecognition inter-act together in whether an asset would qualify for derecognition. As a result, undesirable outcomes may stem from several conditions taken together, and not exclusively from the specific feature under assessment. For the same reason, we find difficult to suggest any better direction that the IASB could take.

Question 1: Assessment of ‘the Asset’ and ‘continuing involvement’ at reporting entity level

Do you agree that the determination of the item (ie the Asset) to be evaluated for derecognition and the assessment of continuing involvement should be made at the level of the reporting entity (see paragraphs 15A, AG37A and AG47A)? If not, why? What would you propose instead, and why?

We agree with the proposal for the reasons provided in the DP.

Question 2—Determination of ‘the Asset’ to be assessed for derecognition

Do you agree with the criteria proposed in paragraph 16A for what qualifies as the item (ie the Asset) to be assessed for derecognition? If not, why? What criteria would you propose instead, and why?

We can accept to retain the existing limitations to portions of assets that can qualify for derecognition.

We understand the clarification on the interdependence of retained and transferred portions’ economic performances as ensuring that derecognition does not happen when the entity remains exposed to risks and rewards of the cash flows transferred. Such a clarification seems to enhance further “the all or nothing” continuing involvement test (see our answer to question 4 point 2). We believe that altogether the proposed test is too restrictive on derecognition.

We have also noted that a group of assets would no longer be required to be made of similar assets to be assessed for derecognition. We wonder whether this change is intended, and if so, what the reasoning of the Board has been.

Question 3—Definition of a transfer

Do you agree with the definition of a transfer? If not, why? How would you propose to amend the definition instead, and why?

We understand that the definition of a transfer has been broadened with the view of ensuring that all arrangements are subject to assessment. We agree and support the reasoning expressed in BC 38 and 39. However we wish to formulate three reservations:

- we agree provided that the notion of "economic benefits" is not meant to be larger, wider, than the notion of "contractual rights to receive the cash flows" in IAS 39.18;

- the broadening of the definition could result in a need for extensive documentation and successive assessments that would represent a useless administrative burden for entities;

- the broadening of the definition, along with the changes brought to the derecognition test, may lead to derecognition of assets in arrangements that would not have qualified as pass-through arrangements in the existing IAS 39; the difficulty relies in how the new wording "agrees to pass" should be interpreted:

    - first, the new wording suggests that it no longer solely applies to transfers that take place immediately; the "agrees to pass" notion seems to potentially encapsulate agreements that could come into effect some time after the agreement has been reached;

    - second, the new wording is loose enough to encompass circumstances under which the arrangements would not need to secure the economic benefits of the transferred assets to the sole benefit of transferees (i.e. other claimants to the entity could have rights on the transferred assets in case of bankruptcy, for example). The examples given in AG52L g) and f) have not helped clarify this point totally. We are left unaware of the intention of the Board in this area. Indeed we do not know whether BC24 rejects convergence with SFAS 140 for a pure question of legal form or because the full restriction of access to others is not a condition identified by the Board as necessary. As a result (and taking into account that portfolios of dissimilar assets now would qualify), we have not been able to conclude whether, for example, assets held under unit-linked contracts would satisfy the proposed derecognition test.

For the above reasons, we believe that the definition of a transfer needs revision and clarification. Otherwise the proposed requirements would, taken as a whole, open the door to numerous uncertainties in practice.

Question 4— Determination of 'continuing involvement'

Do you agree with the 'continuing involvement' filter proposed in paragraph 17A (b), and also the exceptions made to 'continuing involvement' in paragraph 18A? If not, why? What would you propose instead, and why?

We understand that the continuing involvement notion would be playing a central role in the new derecognition test. We support such a filter. We also support the exceptions made to continuing involvement in paragraph 18A.

However, through the continuing involvement approach proposed, significant differences would arise in how risks and rewards would interact with derecognition, and we do not believe that those differences are for the better.

1. ***Elimination of the assumption that if an entity retains substantially all risks and rewards, it retains control.***

   We observe that, according to the proposed derecognition test, an entity would have to derecognise readily available assets even though it has retained substantially all the risks and rewards. We do not think that such an outcome is desirable. We believe that in those circumstances when an entity retains substantially all risks and rewards of assets, the entity should be deemed to control those assets.

   As pointed out by the Board, the change from the existing requirements would require derecognition of easily tradable assets transferred with a repurchase agreements. Those transactions, often referred to as 'repos', are widely used by banks in some European countries (such as France) in order, for example, to secure financings from central banks. Those financing arrangements not only lead to the entity retaining substantially all the risks and rewards of the transferred assets, but often include other features (transferor's right to proceed to exchange of assets at any time during the arrangement, transferor's right to receive any coupon…) that further demonstrate the transferor's control of the transferred assets. Repos and pledged borrowings (the asset is pledged to the counterparty in guarantee of a loan) can be used indifferently, but repos are often preferred because they give the lender easier access to the benefits of the guarantee in the event of bankruptcy (no need to go to court to obtain ownership of the collateral). The difference between the two arrangements is therefore more a question of legal form than of economic substance. Since they are used indifferently on a large scale, there is a high risk of lack of comparability if one qualifies for derecognition and not the other.

   We understand that some view a repo as the equivalent to a sale combined with a standalone forward and explain that after the transfer entities that are obliged to a repurchase agreement should account for the transaction as a standalone forward. However, in practice and in substance, repos after transfer of assets are generally not equivalent to standalone forwards. The initial price of a standalone forward is generally zero, whereas the implicit price of the forward of a repo is - approximately – equal to the haircut (excess of value of the collateral over the loan) less the difference between the return on the assets and the transferor's cost of funding.

Morevoer, the analysis in substance of repos shows that:

- o The risk borne by the money lender on the assets “transferred” is no more, no less, than the risk borne by any lender in the value of a pledge;
- o The money lender has control of a loan originated to the entity, of which credit risk reflects the value of the assets “transferred”;

Repos create significant financing liabilities that need to be reported in banks’ statements of financial position. Any requirement not to account for those liabilities would trigger an outcome that the financial crisis has highlighted as highly undesirable.

Repos are a valid example of how an approach restricted to the analysis of legal rights and obligations at a point in time may conflict with the substance over form principle, and hence fail to provide relevant financial reporting. While we agree with the Board that consistency in the analysis at the item level is required to prepare robust standards, a consistent theoretical model may conflict with the overriding objective of providing useful information to users. A supplementary analysis from a broader economic perspective is needed.

2. Adoption of an “all or nothing” approach

Present requirements in IAS 39 allow partial derecognition of a group of assets and accounting for any “continuing involvement” retained, i.e. for any interests – assets and liabilities – the entity retains. The test proposed appears far more restrictive, although the IASB fails to highlight that fact.

The outcome of existing requirements is that any transfer of, say senior interests, in a securitisation vehicle leads to derecognition of those interests. In the proposed model, such derecognition would be prohibited, as the entity would retain continuing involvement and fail the “practical ability to transfer” test that follows, as it is usual in practice that securitisation vehicles are restricted from re-transferring the assets transferred. Since in practice the main objective in securitisation transactions is to allow some form of tranching, changes brought to the existing requirements would de facto lead banks to keep all assets transferred through securitisations on their balance sheets.

In addition, transfers of receivables in which all contractual cash flows are transferred but some form of guarantee is retained along with servicing rights (for example, a non-recourse factoring transaction where the transferor agrees to compensate the factor for late payments) would fail derecognition under the proposed standard, whereas they are at least partially derecognised under current IAS 39 (to the extent of the transferor’s continuing involvement). Indeed:

- the obligation to compensate for late cash inflows would constitute a continuing involvement under the proposed standard, and
- the transferee would not be considered to have the practical ability to transfer the asset without restrictions, because it would have to impose the transferor as the servicer. (which fails the ‘ability to transfer test’ per paragraph AG52D of the ED)

As a result, we think that virtually all non-recourse factoring transactions would fail to qualify for derecognition under the proposed standard, because virtually all of them involve some form of continuing involvement (first loss or late payment guarantee) and the retention of servicing rights by the transferor. We believe that such restrictions are far too excessive.

At this stage we do not think that the IASB has undertaken any analysis or debate that would bring us in a position to say whether such outcomes are changes that the financial crisis would be calling for. We would have expected the IASB to make that change more apparent, and to explain why and how that change was necessary in light of the financial crisis. In that case as in others in this project, we believe that the IASB should first consider what assets and liabilities an entity should report in its balance sheet and why.

Question 5—'Practical ability to transfer for own benefit' test

Do you agree with the proposed 'practical ability to transfer' derecognition test in paragraph 17A(c)? If not, why? What would you propose instead, and why?

(Note: Other than the 'for the transferee's own benefit' supplement, the 'practical ability to transfer' test proposed in paragraph 17A(c) is the same as the control test in IAS 39.)

Do you agree with the 'for the transferee's own benefit' test proposed as part of the 'practical ability to transfer' test in paragraph 17A(c)? If not, why? What would you propose instead, and why?

The "practical ability to transfer" test proposed maintains the existing test for control of an asset by an entity after transfer has occurred (IAS 39-23, AG42-44), making it play however a more central role than it does at present. We believe the existing test is not satisfactory and that making it more central to the derecognition test would make these inadequacies more critical.

Control needs in our view to be tested from the perspective of the entity, the question to answer is whether the entity has control.

The mere fact that the transferee is not able to re-transfer the asset does not necessarily imply that the transferor has kept control of it. A supplementary necessary condition would be, in our view, that the transferor benefits from the constraint borne by the transferee. Indeed some restrictions imposed in transfer agreements, such as the transferor remaining responsible for servicing the assets, do not in our view prevent transferees from benefiting from the contractual rights transferred. Similarly those restrictions are no indication that the transferor still has control.

On the other hand, the fact that the transferee cannot re-transfer the asset freely or without incurring undue costs does not necessarily imply that the transferee does not have access to all of the economic benefits of the asset by holding it.

Question 6—Accounting for retained interests

Do you agree with the proposed accounting (both recognition and measurement) for an interest retained in a financial asset or a group of financial assets in a transfer that qualifies for derecognition (for a retained interest in a financial asset or group of financial assets, see paragraph 21A; for an interest in a financial asset or group of financial assets retained indirectly through an entity, see paragraph 22A)? If not, why? What would you propose instead, and why?

(Note: The accounting for a retained interest in a financial asset or group of financial assets that is proposed in paragraph 21A is not a change from IAS 39. However, the guidance for an interest in a financial asset or group of financial assets retained indirectly through an entity as proposed in paragraph 22A is new.)

We agree with the proposal of the Board not to change the existing principle of accounting for retained interests. In principle, we could have welcomed the addition in paragraph 22A as helpful. However we are unsure that the supplementary guidance would have any practical implication. Indeed separate vehicles are generally set up in securitisation arrangements. The objective of securitisation being to create a priority order in the waterfall of payments, securitisation vehicles issue disproportionate interests in the securitised portfolios of assets. This combined with the fact that securitisation vehicles are restricted in their right of disposal of the transferred assets leads us to conclude that securitisations in which the transferor has retained an interest would fail derecognition systematically. We therefore do not see in what circumstances paragraph 22A would be used in practice, the issuance of proportionate interests through a securitisation being, in our view, pointless.

Question 7—Approach to derecognition of financial assets

Having gone through the steps/tests of the proposed approach to derecognition of financial assets (Questions 1–6), do you agree that the proposed approach as a whole should be established as the new approach for determining the derecognition of financial assets? If not, why? Do you believe that the alternative approach set out in the alternative views should be established as the new derecognition approach instead, and, if so, why? If not, why? What alternative approach would you propose instead, and why?

We do not believe that the alternative approach should be implemented at all as:

- it is in our view incompatible with a mix-measurement model as we have in IAS 39 today and as the Board is contemplating in its comprehensive review of IAS 39;
- it would substitute quite extensive disclosures to recognition of assets and liabilities, for quite theoretical reasons, and therefore does not appear to potentially lead to more useful information.

We do not recommend either that the proposed changes be adopted. The significant change in outcome from present requirements (accounting for REPOs) is a change that is highly undesirable, as it brings legal form over economic substance. It shows, we believe, that the proposed changes are the result of quite an accelerated, quickly handled, project in which necessary thinking has been curtailed. Since the financial crisis has highlighted needs for ***supplementary*** off-balance sheet information, and no area where ***recognition*** of assets and liabilities would have failed to lead to a relevant representation of entities' financial positions, we believe no change, at present (and before an in-depth analysis is undertaken and possible consequences of changes assessed in practice before any implementation), should be brought to the existing requirements, except for revised disclosures.

Question 8—Interaction between consolidation and derecognition

In December 2008, the Board issued an exposure draft ED 10 Consolidated Financial Statements. As noted in paragraphs BC28 and BC29, the Board believes that its proposed approach to derecognition of financial assets in this exposure draft is similar to the approach proposed in ED 10 (albeit derecognition is applied at the level of assets and liabilities, whereas consolidation is assessed at the entity level). Do you agree that the proposed derecognition and consolidation approaches are compatible? If not, why? Should the Board consider any other aspects of the proposed approaches to derecognition and consolidation before it finalises the exposure drafts? If so, which ones, and why? If the Board were to consider adopting the alternative approach, do you believe that that approach would be compatible with the proposed consolidation approach?

In ED10 as in the ED on derecognition, the Board clearly focuses accounting principles on the notion of control (both alternatives presented in the ED on derecognition are consistent in this area).

In our letter of comments on ED10 we have supported the Board's proposed definition of control and of consolidation being triggered by both power and return criteria. We have nonetheless highlighted that how to identify appropriately the return criterion still called for some extensive work.

The same weakness appears we believe in the ED on derecognition and results in control being assessed on bases that turn out not to be economically relevant.

However we do not believe that the IASB has made both sets of proposals consistent. In our view there are significant differences between those two sets:

- In ED10, the Board has strived to adopt as principle-based an approach as possible; the derecognition proposals appear quite rule-based;
- The derecognition ED has introduced more changes in wording than in concepts. As we have indicated in our answer to question 4, we believe that the continuing involvement test plays the role of the "previous" risks and rewards model. Furthermore we do not think that the "practical ability test" is a fair characterisation of whether transferors have control;
- Any form of continuing involvement in association with some form of restriction borne by transferees prevents derecognition. ED10 has introduced the notion that the consolidating entity must be the party that has the relative higher share of interests in the consolidated entity;

- Guidances on agency relationships also differ from one another. Where ED10 has selected indicators, none of which being a necessary condition, the derecognition ED brings in AG49A, as a rule, a list of criteria that all need to be met for the relationship to qualify. Item c), i.e. the ability to remove the agent, would in our jurisdiction most often not be met.

Question 9—Derecognition of financial liabilities

Do you agree with the proposed amendments to the principle for derecognition of financial liabilities in paragraph 39A? If not, why? How would you propose to amend that principle instead, and why?

We believe that derecognition of financial liabilities as happens in practice today is satisfactory. We note in the Board's basis for conclusions that proposed changes are not based on any identified need for improvement, but rather on a drafting alignment with definitions of assets and liabilities in the framework. We further note that the Board is actively working on a conceptual framework project where those definitions of assets and liabilities are reviewed and assessed. We therefore believe that no change is desirable at this time.

Question 10—Transition

Do you agree with the proposed amendments to the transition guidance in paragraphs 106 and 107? If not, why? How would you propose to amend that guidance instead, and why?

We agree with the Board that retrospective application would be too cumbersome and support the proposal of adopting a prospective transition, even though similar transactions would in the same period end up being accounted for differently.

However we disagree strongly with the disclosure requirements that suggest that some significant burden related to retrospective application (identification in detail of the initial arrangements and individual tracking) would have to be carried out.

Question 11—Disclosures

Do you agree with the proposed amendments to IFRS 7? If not, why? How would you propose to amend those requirements instead, and why?

We are not opposed to disclosing risks associated with off balance sheet items, as we indeed believe that such information is useful to users. We are however opposed to successive additions to disclosure requirements, more particularly disclosure related to financial instruments that seem to add to each other endlessly, each time taken from a somewhat different angle. Such a process prevents companies from preparing notes to financial statements presented in as relevant and comprehensive a fashion as possible.

Moreover we are opposed to disclosures that allow users recast a second balance sheet on the basis of different accounting principles. Whenever the Board decides that users should not be followed in what they favour, the Board reasoning should be robust enough to conclude that no such disclosure is needed.

We would encourage the Board to fundamentally rethink the approach to disclosure requirements of off balance sheet risks. Firm principles should be set, and illustrative guidance provided wherever helpful, in a comprehensive manner. No disclosure based on different accounting principles from those applied in compliance with IFRS should be required.