

Structured finance

- accounting developments: Special purposes entities – Consolidation and Disclosure

*Special purpose entities –
new standards on
consolidation and
disclosure*

June 2011

The IASB (the International Accounting Standards Board) issued various new standards in May 2011, two of which are of particular relevance to those involved in securitisation and structured finance:

IFRS 10 (Consolidated Financial Statements) introduces new rules which will impact which party, if any, consolidates a special purpose entity (SPE) created as part of a structured finance transaction.

IFRS 12 (Disclosure of Interests in Other Entities) is designed to enhance the financial statement disclosures that banks and other parties make concerning their involvement in other entities, particularly unconsolidated SPEs.

It is uncertain at this stage how some of the provisions of IFRS 10 will be interpreted, but we provide below some first impressions of the potential impact of the two new standards on those involved in structured finance.

Consolidation (IFRS 10)

What is the issue?

The IASB has issued the long-awaited IFRS 10, 'Consolidated financial statements'. IFRS 10 replaces the guidance on consolidation in IAS 27, 'Consolidated and separate financial statements', and SIC 12, 'Consolidation –

special purpose entities'. The revised standard is effective for annual periods beginning on or after 1 January 2013, with earlier application permitted.

IFRS 10 changes the definition of control so that the same criteria are applied to all entities to determine control. Whilst application guidance is provided which indicates a variety of different ways in which a reporting entity (the 'investor') might control another entity, the standard gives few 'bright lines' and little guidance on how to weight differing indicators. Consequently, considerable judgement may be required in order to determine which party, if any, consolidates a (SPE) involved in a structured finance transaction.

SPEs are typically designed so that voting rights are not the dominant factor in deciding who controls the entity, the activities of the company being largely laid out in the transaction documents and the contractual arrangements entered into on or before closing of the transaction. In such cases, IFRS 10 requires an investor to consider the purpose and design of the SPE, including a consideration of the risks the SPE was expected to be exposed to, the risks it was designed to pass on to the parties involved with the SPE and whether the investor is exposed to some or all of those risks or potential returns. One then considers which activities have a significant

impact on the SPE's returns and determines which parties have an ability to direct each of those activities. Superficially some aspects of IFRS 10 might look similar to the substance based approach of SIC 12, but in practice IFRS 10 may result in some significant changes.

Revised definition of control

IFRS 10 states that an investor controls an SPE when it is exposed, or has rights, to variable returns from its involvement with the SPE and has the ability to affect those returns through its power over the SPE. This revised definition of control focuses on the need to have both power and variable returns before control is present. Power is the current ability to direct the activities that significantly influence returns. Returns must vary and can be positive, negative or both.

The existing guidance under SIC 12

Where the financial and operating policies of an SPE are largely predetermined, as they are in most structured finance transactions, SIC 12 requires one to consider various indicators of control including:

- Activities of the SPE and whether they are in substance being conducted on behalf of another party;
- Decision taking concerning the SPE – and whether a party has effective control of the SPE or its assets, whether or not through contractual rights;
- Benefits arising from the SPE's activities and whether a single party has the majority of those benefits;
- Risks and whether a single party is exposed to the majority of the residual or ownership risks related to the SPE.

When applying SIC 12 in practice, the focus tended to be on whether a party had the majority of the risks and rewards, not least because this was relatively easy to assess by looking at which party provided credit enhancement and was entitled to any excess spread or other residual cashflows from the SPE. 'Risks and rewards' in this context was generally considered as exposure to the variability in the cashflows of the SPE, so in a securitisation transaction the party holding rights to the express spread and providing the credit enhancement would have a majority of risks and rewards even if the more senior notes were all issued to third parties.

Changes resulting from IFRS 10

IFRS 10 also states the need to consider the purpose and design of the structure and the indicators of control referred to in SIC 12 also appear in IFRS 10. However, IFRS 10

introduces some differences in approach and emphasis that will result in a change in the consolidation treatment of a number of structured finance entities. In particular:

Whilst IFRS 10 states that having a large exposure to variability of returns is a relevant indicator, more weight is given to the question of whether a party has a practical ability to direct the relevant activities of the SPE. Consequently a party which previously consolidated an SPE because it was exposed to the majority of the risks and rewards from the entity may now be able to avoid consolidation if it lacks control over decision making over those activities that significantly affect the SPE's returns. Conversely, a party which has decision taking power and some significant financial interest in the SPE, may now need to consolidate even though it does not have the majority of the risks and rewards

Whereas SIC 12 considered whether a party had effectively predetermined the policies of an SPE at inception, the focus of IFRS 10 appears to be on which party exercises the limited decisions that remain to be taken during the life of the transaction. This may result in a party such as a servicer or asset manager being deemed to have 'power' in relation to an SPE, even if the only relevant activity is deciding what to do when an asset defaults. The servicer would only consolidate however if it also had exposure to variable returns from its involvement with the SPE and the ability to use its power to affect the amount of those returns.

The standard introduces a distinction between the roles of agent and principal, so that if one concludes that a servicer has power, but does not itself benefit significantly from its decision making, then it will not be considered to control the SPE. One then has to consider whether the servicer is an agent, acting for another party which should be regarded as exercising power. IFRS 10 gives some indicators to assist in determining whether a party is acting an agent. For structures involving a number of parties however, determining whether an independent service provider is acting for any particular party may be difficult to assess.

The standard recognises that if kick out rights exist, this may indicate that a service provider, such as an asset manager, is an agent rather than a principal. However, it requires those rights to be substantive and kick out rights which can only be exercised in certain circumstances or which require a degree of coordination between a large number of individual investors which is unlikely to occur in practice, will not be regarded as substantive.

“The new rules could have a significant impact on balance sheet size”

IFRS 10 also refers to de facto agency and the possible existence of a special relationship investee, which suggests that an investor has more than a passive interest in an SPE. However, it stresses that the existence of any individual indicator, or a particular combination of indicators, does not necessarily mean that the power criterion is met. Generally it appears that the standard requires a clear linkage between power and a financial interest in an SPE, and the mere fact that a party is involved in the design of a structure and has the majority of the exposure to an SPE will not be sufficient in isolation to assume that it controls the SPE.

It is currently unclear exactly how one assesses the purpose and design of an SPE under IFRS 10. Under SIC 12 one looked broadly at the substance of the relationship between an entity and an SPE. Under US GAAP, it has been the practice to look at each financial instrument to which the SPE is a party and determine whether it creates variability or absorbs variability in the cashflows of the SPE, only those counterparties absorbing variability being considered as potentially controlling the SPE. IFRS 10 makes no reference to creating or absorbing variability. However IFRS 12, the new standard on 'Disclosures of interests in other entities' does draw this distinction and by implication an entity whose sole involvement with an SPE is to use it as a funding mechanism or to buy credit protection would not control the SPE for that reason alone.

Which structures will be affected?

The standard leaves considerable room for judgement and it may be some time before a consensus emerges on some aspects of the application of the new standard in practice. But banks and other market participants will need to review the SPEs that they are involved with to determine the full impact of the new requirements, and those with an extensive involvement in structured finance activities may find that they will need to start consolidating some SPEs but cease to consolidate others, as the effect of the standard will vary according to the type of SPE.

For standard RMBS structures where the originator retains servicing of the asset pool and provides credit enhancement, the originator will generally continue to consolidate the SPE, although it's possible that some SPEs within a master trust structure where credit enhancement is provided at a 'funding' rather than at an 'issuer' level will no longer be consolidated by the originator. Those structures using third party servicers (as many

non conforming RMBS structures have done) will require more careful consideration, irrespective of whether the originator retains some 'skin in the game'.

The new rules are likely to have an impact on those structures which are actively managed, such as certain types of CDO. Asset managers often have both a performance related fee and a direct financial interest in the SPE. Generally this did not result in consolidation of the SPE by the asset manager under SIC 12 unless those financial interests in aggregate gave the manager the majority of the risks and rewards. One of the examples set out in IFRS 10 indicates that an asset manager may need to consolidate where it holds no more than a 20% pro rata interest in the notes issued by an SPE.

Repackaging vehicles where an investor currently consolidates an SPE (or a silo within a multi issuance vehicle) solely on the basis that it owns all the whole of a note series, may also be impacted. If the investor has no ongoing influence over the activities of the SPE it may no longer be required to consolidate under IFRS 10.

Whilst the standard indicates that an investor holding protective rights will not be regarded as having power, it is possible that the directing and controlling party concepts built into certain CMBS and CRE CDO structures may be considered to be more than protective, and the party deemed to control a structure may change as a result.

An SPE whose prime purpose is to provide funding to an entity was often consolidated by that entity on the basis of the 'activities' indicator in SIC 12. If the relationship between the SPE and the borrower only creates rather than absorbs variability from the SPE's perspective, the borrower may avoid consolidating the SPE. So in securitisation structures involving more than one SPE, an originator might conclude that it is no longer required to consolidate issuing SPE and any hedging derivatives in the structure if it does not provide any credit enhancement to that SPE. Similarly synthetic CDO structures where a bank buys credit protection from an SPE were often consolidated by the bank under SIC 12 but may not be under IFRS 10.

In some structures where servicing standards are prescribed in detail in the transaction documents, little if any ongoing decision taking capacity may exist. It is a little unclear as to whether it is possible to have entirely 'brain-dead' or 'autopilot' structures, where everything is hardwired into the transaction documents, and there is no discretion concerning ongoing activities. If so, the new

"IFRS 10 may give a very different result to SIC 12"

“IFRS 12 introduces extensive disclosure requirements relating to unconsolidated structured entities”

rules may result in no party having power over certain SPEs (and therefore no party consolidating), rather like QSPEs under former US GAAP.

IFRS 10 is also likely to put focus back on the derecognition provisions of IAS 39. Where a transaction involves the transfer of assets from a seller to an SPE, it has been possible for a seller to achieve partial derecognition of the assets providing some significant risk is transferred to third parties, even if the seller retained the majority of the risks and rewards. But such transactions were not popular as the seller would normally have to consolidate the SPE in any event. IFRS 10 may provide an opportunity for a seller to achieve a significant reduction in its balance sheet as a result of a transfer of assets to an SPE which it does not consolidate, even if it retains the majority of the risks and rewards relating to the assets transferred.

Disclosure (IFRS 12)

As noted in the introduction to IFRS 12, the reviews by the Financial Stability Board and others of the reasons for the credit crisis highlighted the need to improve transparency concerning the risks to which a reporting entity was exposed from its involvement with structured entities, including those that it had sponsored.

The IASB has taken this opportunity to bring together the disclosure requirements for subsidiaries, joint arrangements, associates, consolidated and, perhaps most importantly, unconsolidated structured entities in a single standard IFRS. IFRS 12 requires an entity to disclose information that enables users of financial statements to understand and evaluate the nature and extent of its interests in other entities, the risks associated with those interests and their impact on its financial position, financial performance and cash flows.

An entity must disclose information about significant judgements and assumptions it has made (and changes to those judgements and assumptions) in determining whether it controls another entity and whether it is an agent or a principal (see discussion above regarding IFRS 10) in relation to its involvement with other entities.

The standard specifically addresses disclosures relating to a structured entity, which it defines as “an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements” and so would encompass the majority of SPEs seen in structured finance transactions.

An interest in a structured entity includes any contractual or non-contractual involvement that exposes an entity to variability of returns from the performance of the SPE and would capture any arrangement by which an entity exercised control over an SPE as well as the provision of any form of funding, liquidity support or, credit enhancement, and any fees receivable for the SPE.

Even where an entity consolidates a structured entity it will be required to disclose the terms of any contractual arrangements that could require the parent or its subsidiaries to provide financial support such as liquidity arrangements or credit rating triggers that might result in an obligation to purchase assets of the structured entity or provide additional financial support.

The standard also requires extensive disclosure in relation to interests in unconsolidated structured entities. This must include disclosure concerning qualitative and quantitative information about its interests in those entities, including, but not limited to, the nature, purpose, size and activities of the structured entity and how the structured entity is financed.

Certain details will also be required concerning SPEs which an entity has previously sponsored even if it has no remaining interest in those SPEs at the reporting date. Moreover where financial or other support is provided to an SPE (irrespective of whether or not it is consolidated by the entity) without there being a contractual obligation to do so, the entity must disclose the reasons for providing the support as well as its nature and extent.

“Banks may face a daunting task in assessing the impact of the new rules”

The implications

IFRS 10 and IFRS 12 apply for annual periods beginning on or after 1 January 2013, subject to EU endorsement. Early adoption is permitted for IFRS 10 and encouraged for IFRS 12. Those entities with extensive involvement with SPEs that are considered structured entities may face a daunting task in considering whether or not each SPE needs to be consolidated under the new rules and then additionally identifying any contractual or other structural features which may require some form of disclosure. They will also need to review existing processes for structured trades involving SPEs to ensure that the information necessary for disclosure purposes is captured within the reporting systems.

Banks will wish to start an immediate assessment process to determine whether the standards will lead to a significant change to the size of their balance sheet, what amendments will be required to reporting systems, and the extent of any one off projects to capture missing data in relation to existing structures.

PwC’s Structured Finance Group has extensive experience at assessing the accounting treatment for SPEs with a wide variety of contractual and structural features relevant to the application of the standard. We have performed such assessments at a number of major banks and can leverage our experience to assist clients in an efficient assessment of the key risk areas.

Contacts



James Hewer
+44 (0)20 7804 9605
james.hewer@uk.pwc.com



Mark Davis
+44 (0)20 7212 4011
mark.w.davis@uk.pwc.com



Dave Haley
+44 (0)20 7804 4255
dave.haley@uk.pwc.com

www.pwc.com/securitisation

© 2011 PricewaterhouseCoopers LLP. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.