Changing the rules

Executive summary

- Since the 1980s the securitisation market has grown into a widespread financing and/or risk transfer technique used throughout North America, Europe, Asia and Australasia.
- Treasurers who are contemplating or have recently completed a securitisation transaction need to consider a number of accounting and tax developments.

While the accounting treatment has never been the main driving force behind securitisations, it remains an important consideration, particularly as the regulatory treatment in many markets is still linked in some form to the accounting treatment. Although this may change from 2007 with Basel II, there is a keen interest in the accounting.

The accounting standards now applied in all UK companies depend on the nature of the company. This includes both the originator of the assets to be securitised and the special purpose vehicles (SPVs) used to facilitate the securitisation.

Listed companies will need to account for a securitisation under international financial reporting standards (IFRS). Just because an SPV has listed debt it does not need to report under IFRS, but it will need to think about the implications of those elements of IFRS brought into UK GAAP by FRS25 *Financial Instruments: Disclosure and Presentation* and FRS26 *Financial Instruments: Measurement*, which apply to company-only accounts that have listed debt or equity. *Figure 1* summarises what accounting standards apply to the originator and SPV in a typical securitisation transaction.

UK GAAP: THE DEMISE OF LINKED PRESENTATION Since its issue in 1994, the relevant accounting pronouncement in the UK has been FRS5 *Reporting the Substance of Transactions*, which introduced the concept of linked presentation and quasi-subsidiaries. The concept of linked presentation is well understood by preparers and users of financial statements and was applicable to many UK securitisation transactions, but the concept of linked presentation is now virtually extinct for the following reasons:

- The concept does not exist under IFRS, and UK entities with listed securities applying IFRS for accounting periods from 2005 will need to follow IAS39 and SIC-12 *Consolidation: Special Purpose Entities*, which in many cases is likely to mean continued recognition;
- Recent changes to UK GAAP and company law have widened the definition of a subsidiary undertaking to take in many SPVs previously accounted for as quasi-subsidiaries, while FRS5 makes linked presentation unavailable in consolidated financial statements for legal subsidiaries; and
- The Accounting Standards Board (ASB) has decided to implement the derecognition criteria as set out in IAS39 into UK GAAP through FRS26. This will only apply to companies with listed equity or debt in their company-only financial statements or those applying fair value accounting. However, the ASB intends to converge UK GAAP to IFRS, which will probably remove the availability of linked presentation for financial assets altogether. Full convergence is expected by the end of 2009.

There is also a view among some standard setters that linked presentation results in a meaningless 'net asset' that contains a variety of components such as mortgage assets, derivatives, cash, other assets and liabilities.

THE SCOPE OF EU REGULATION Those companies with securities listed on EU stock exchanges that are regulated markets have to present group financial statements in accordance with IFRS for accounting periods that began on or after 1 January 2005.

Companies with only listed debt and no listed equity fall within the scope of this EU regulation although it applies only to consolidated accounts and many SPVs that only have listed debt are single companies that do not have to prepare consolidated accounts (see *Figure 1*).

IN THE SECOND OF A THREE-PART SERIES, **SIMON STEPHENS, ADAM OWEN** AND **MICHELLE MITCHELL** EXPLORE SOME RECENT ACCOUNTING AND TAX DEVELOPMENTS IN THE SECURITISATION INDUSTRY.

Under IFRS, the relevant standards for securitisation transactions are:

- IAS27, which, among other things, details the accounting principles under which an entity should consolidate another entity;
- SIC-12, which is interpretation guidance focusing on the consolidation of SPVs; and
- IAS39, which covers the recognition, measurement and derecognition of financial assets and liabilities.

IAS39 introduced the decision tree shown in *Figure 3*, which illustrates how to evaluate whether and to what extent a financial asset is derecognised. Under IAS39, derecognition principles and tests apply both at consolidated and entity level (that is, at the consolidated level it is necessary to apply SIC-12 before considering derecognition).

The transfer of risks and rewards is set out in IAS39 as the change to the exposure to the variability in the present value of the net cashflows. If there is no change in exposure to variability before and after the transaction, then substantially all the risks and rewards have been retained. Conversely, if its exposure to such variability is no longer significant in relation to the total variability in the present value of future net cashflows, then it can demonstrate it has transferred substantially all the risks and rewards. If neither is true (in other words, if the entity has neither transferred nor retained substantially all the risks and reward), then continuing involvement may apply.

The standard does not provide a definition of "substantially all" or "significant" or provide quantitative benchmarks or any rebuttable presumption and we would not advocate a hard and fast rule. But it does provide some guidance. To avoid retaining substantially all risks and rewards, some economic risk transfer from the originator to a third party is required as a minimum.

One strong indication of risk is the pricing of the relevant tranches. What price, if any, is being paid for an investor to assume risk?

In many traditional structures the senior notes achieve AAA ratings and the originator retains the junior notes. The senior note holders bear almost no risk, so the risk taken by the originator and derecognition is not appropriate. In other cases where third-party investors purchase the junior or mezzanine tranches, the originator may not have retained substantially all the risks and rewards and further analysis will be required. Some asset classes are now liquid enough for the originator to sell rather than retain the junior or 'equity' tranches. This transfers the risk and reward and brings the originator one step closer to derecognition.

Figure 2 indicates one way of analysing risks and rewards to determine whether recognition, derecognition or continuing involvement are appropriate.

In this analysis we compare the before-loss cashflows to those after each of three transactions:

- Transaction 1: only catastrophic risk has been transferred to third-party investors and continued recognition is appropriate.
- Transaction 2: the variability in cashflows before and and after the transactions indicates that substantially all risks and rewards have been transferred, so derecognition is appropriate.

Figure 1. Applicable accounting standards

Applicable accounting standards	Listed originator	Unlisted originator	SPV (assume listed debt)
Periods commencing before 1 January 2005	Old UK GAAP (pre-FRS25 and 26) in consolidated and company-only financial statements.	Old UK GAAP in consolidated and company-only financial statements.	Old UK GAAP.
Period commencing after 1 January 2005	IFRS in consolidated financials. Option to apply IFRS or New UK GAAP (with FRS25 and 26) in company-only financial statements.	If no listed debt and not using fair value option under Companies Act 1985, can apply IFRS or old UK GAAP in consolidated and company-only financial statements. If has listed debt or using fair value option, choice is between IFRS and new UK GAAP.	Option to apply IFRS or new UK GAAP (with FRS 25 and 26).

- Transaction 3: there has been neither transfer nor retention of substantially all the risks and rewards, so continuing involvement may be appropriate if control has been retained.

ACCOUNTING IN SPVS The above analysis deals with the question of whether or not the securitised asset can be derecognised from the originator's balance sheet. IFRS also affects accounting in the SPV, as FRS26 brings elements of IAS39 into UK GAAP for certain entities.

The introduction of IFRS (or new UK GAAP) for certain companies is of particular importance in the UK as it can affect individual company accounts (rather than just consolidation, as in many European countries), and the taxation of loan relationships in the UK closely follows the accounting treatment.

The new accounting standards for debt and derivatives introduce prescriptive methods of accounting for financial assets, financial liabilities and associated hedges that could result in large fluctuations in profit, and therefore fluctuating tax liabilities, compared with under old UK GAAP. In the issuing SPV the fundamental focus is on the reliability of cashflows, including taxation (usually virtually nil), so as to maintain the SPV's integrity and rating.

TAX IMPACT ON SPVS Given the attempted harmonisation of the accounting and regulations of transactions, a new set of tax issues are appearing, particularly in the UK, which has resulted in extensive industry lobbying. This lobbying appears to have borne fruit with the radical response proposed by HM Revenue & Customs (HMRC).

An interim solution The accounting within SPVs leads to potential volatility in the income statement. Ultimately, in the absence of the proposed measures, a tax liability could arise that the SPV does not have the cash resources to meet.

The Finance Act 2005 introduced a temporary regime that required securitisation companies to prepare tax computations for accounting periods beginning on or after 1 January 2005 and ending before 1 January 2007 (extended to 2008 by the Finance Act 2006) using old UK GAAP. This creates a divorce between the accounting treatment in the financial statements and the accounting treatment followed for tax purposes, albeit that tax still has an accounting base.

Although pragmatic, this approach inevitably created a number of issues, including:

- Does the SPV fall into the definition of a securitisation company so that the provisions in the Finance Act 2005 apply?
- If the SPV does fall into the rules, does it actually want or need to be in the new provisions? and
- For tax purposes the results of the SPV will need to be recalculated as if old UK GAAP applied.

Although these are all valid points, the legislation seems to serve its purpose albeit with a resultant administrative burden.

It was always recognised that this was only a temporary solution and new legislation is shortly to be introduced.

A permanent solution? A permanent solution is now close, with HMRC releasing draft legislation that provides for securitisation companies' tax to be based on something other than IFRS accounting.

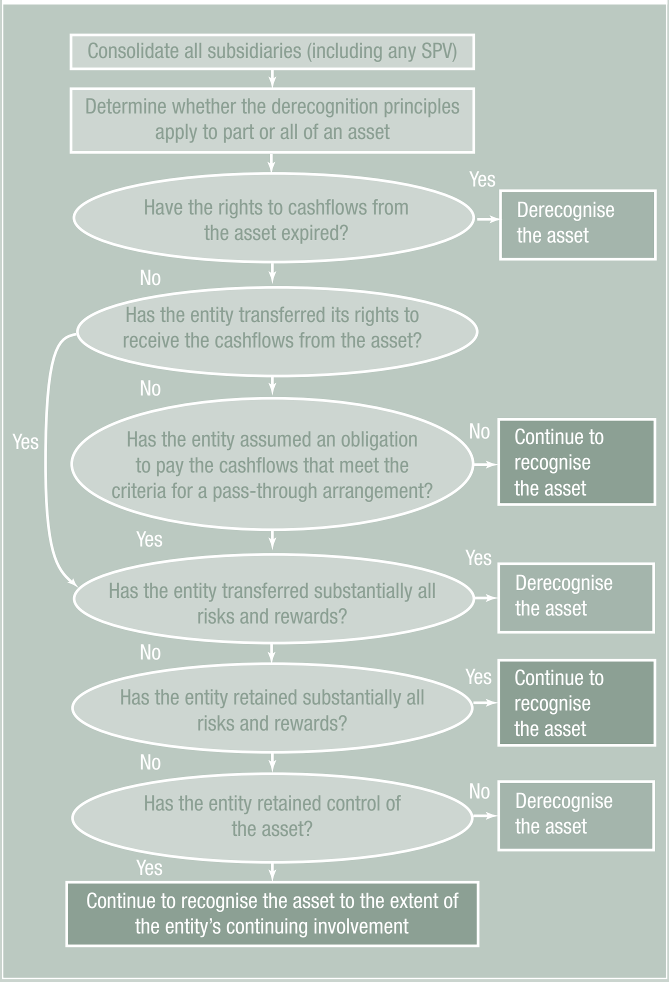
On current drafting, a securitisation company must meet what is termed the "payments condition" for the legislation to apply. The definition of a securitisation company is very much in line with the temporary regime, but it seems to catch the vast majority of companies it is aimed at while leaving out companies that should be left out. The payment condition aims to ensure that cashbox companies cannot be smuggled into the regime by requiring securitisation companies to pay out all their receipts within a given period except to the extent that cash reserves are required for credit enhancement and similar purposes.

This provides for the taxable profits of securitisation companies to be based on the profit retention provided for in the legal documentation (the "waterfall"), rather than being driven by the accounting treatment as is currently the case. Although this completely divorces the tax treatment from the accounting treatment, which is a notable shift from the UK's traditional position, in a more fundamental sense the taxable profit is being based solidly on the real commercial profit (of which, usually in other contexts, the accounting profit is the best available measure).

The proposals create a specific securitisation regime in the UK,

Figure 2. Risk and reward analysis, for recognition, derecognition and continuing involvement

Figure 3. IASB decision tree



which is likely to make the UK a more attractive location for SPVs.

There may also be an impact on the taxation of the originator in that in particular circumstances there may well be an effective acceleration of profits taxable in the originator because of the timing of deferred consideration income.

Overall though, a current tax issue could actually result in a positive impact on the securitisation sector as a whole.

SECURITISATION'S KEY MATTERS The significant changes in accounting, tax and regulation are all key matters for treasurers considering securitisation as a funding option. The structuring of any transaction needs to keep abreast of the introduction of IFRS and its tax impact as well as the forthcoming regulatory changes. Of course, any successful securitisation needs to meet investor needs. Treasurers together with their advisers will need to consider the impact the proposed changes will have on not just the originator but also on investor appetite – an altogether different topic.

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