The implications of IFRS 9

What does IFRS 9 mean for you and does it help or hinder capital relief calculations? By Geoffrey Wynne, partner and head of the trade and export finance practice, and Dyna Yates, associate, at international law firm Sullivan in London.
The International Financial Reporting Standards 9 (“IFRS 9”) came into force from 1 January 2018. They provide standards on the treatment of assets and how credit risk mitigants (“CRMs”) can be used by financial institutions, insurers and others. These standards are important because ultimately, they impact the ability of an institution to optimise their balance sheet. Through an understanding of the reporting standards, institutions may benefit from capital relief on certain assets.

This article considers the impact of IFRS 9 on capital relief for assets from a legal perspective. In determining whether CRMs are relevant, it considers whether or not it is possible to achieve de-recognition of an asset from an accounting perspective as well as a legal true sale. These are not the same under IFRS 9. If an institution is unable to achieve de-recognition of an asset they may want to benefit from CRMs. The extent to which they are able to may depend on whether the assets to which they are seeking to apply the CRM are considered to be “trading book” versus “non-trading book” assets.

This article looks at how helpful IFRS 9 may be and what the future may hold. Does IFRS 9 pose more questions or does it bring more clarity?

How do I get capital relief?

Capital relief on assets is not a new subject, but how it might be achieved – and at what level – is impacted by IFRS 9.

The ability to benefit from capital relief reduces the amount of capital an institution must hold in relation to assets on its balance sheet. From this perspective it is something institutions want to understand to ensure they are maximising their assets and making use of the tools available to them.

Whilst IFRS 9 is an accounting standard, it is necessary to consider how legal aspects in respect of certain assets might impact their balance sheet treatment. In particular, the ability of institutions to remove assets from their balance sheet by achieving “de-recognition of assets” and the legal perspective, by achieving a legal true sale.

This means that CRM is not actually needed since those assets will be removed from the balance sheet. For the purposes of this article, the term “assets” refers to what is on an institution's balance sheet. It may for example include an institution's exposure in respect of a loan facility.

To some extent how an asset is classified may impact its treatment. We discuss this in relation to “trading book” and “non-trading book” assets below.

De-recognition and legal true sale

How to achieve a legal true sale

Achieving both de-recognition of assets and legal true sale removes assets from balance sheets allowing institutions to hold less capital and/or to spread their risks. Both may necessarily be required.

To achieve a legal true sale, an institution will seek to place the asset outside its reach. The asset should no longer be under the control of the institution wishing to transfer the asset and it should have no recourse in respect of it. This means that it should not have any risk on that asset and should not be able to benefit from that asset following its transfer.

The idea is that an insolvency practitioner should not be able to claim that the asset forms part of the transferring institution’s estate in event of an insolvency.

Breaking this down further, the following should be considered when trying to achieve a legal true sale:

- **The legal nature of the transfer itself:** this relates to how the transfer of title is achieved. Possibilities include a legal or equitable assignment. The latter indicates that certain requirements for a legal assignment, such as the delivery of a notice of assignment, have not been carried out. It could also be a novation. A novation has the effect of extinguishing the contract between the original parties. A new contract is created between the obligor and the transferring institution. The new contract is on the same terms as the previous contract except for the party to whom the obligations are now owed – being the new institution rather than the transferring institution. Contrast to an assignment, whether legal or equitable, it is possible to transfer both the rights and obligations in the underlying transaction by novation. Another consideration, for institutions, is to ensure that the underlying asset does not contain any restriction that would prevent the transfer from being effective, for example a prohibition on assignment.

- **The objective intention of the parties involved:** the courts would look at the transaction as a whole and will consider what the intention of the parties really was. For example, if the transferring institution has a right or obligation to buy back the assets at a point in future or to benefit from payments in respect of that asset, this may go against a true sale analysis. However, since the courts would look at the transaction as a whole, this factor alone would not be determinative.

- **Whether the associated risks and rewards has been transferred:** the transferring institution should not cherry pick what it wishes to retain in respect of the assets and associated rights being transferred. For example, it cannot transfer the obligations and retain the benefits. There should be no recourse to the institution from which the asset is being transferred. The transferring institution should also not have any right to deal with the assets, for example inspect them or sell them (after the transfer). Contrast with security, there should be no equity of redemption (right to benefit from any increased value by paying off the price).

These are all considerations when trying to achieve a legal true sale. The accounting test looks at the substance, whereas the legal test looks at the form. This includes the legal relationships and looking at who the parties are, for example the protection provider, the protection recipient and the underlying obligor. “Protection”, referring to methods of transferring risk, such as insurance.

The below table provides an overview of certain techniques which could achieve de-recognition and/or legal true sale.

<table>
<thead>
<tr>
<th>Technique</th>
<th>Achieves de-recognition?</th>
<th>Achieves legal true sale?</th>
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</thead>
<tbody>
<tr>
<td>Non-Payment Insurance</td>
<td>✗</td>
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<tr>
<td>Unfunded Sub-Participation</td>
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<tr>
<td>Funded Sub-Participation (without transfer of ownership)</td>
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<tr>
<td>Funded Sub-Participation (with transfer of ownership)</td>
<td>✓</td>
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<tr>
<td>Novation and Assignment</td>
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Funded sub-participation with transfer of ownership

In a funded sub-participation with a transfer of ownership, the participant will provide funds to the lender upfront. This might be a percentage of the amount they are sub-participating in or may be connected to individual drawdowns in the case of a loan with multiple drawdowns where the lender has already provided funds to the obligor. In return for the “participation amount” the sub-participant can share in the receipts from the underlying obligor to the transaction. In this example, the lender transfers an ownership interest in the participant’s portion of the underlying asset.

At the time of funding by the participant, there is a transfer to the participant of the lender’s rights against the obligor, in respect of the participant’s proportion of the underlying asset. The legal mechanism for effecting the ownership transfer depends on the applicable law. Under English law, the transfer might happen by way of an equitable assignment of a portion of the lender’s rights to receive repayment. An equitable assignment can be effective to transfer title in only part of the lender’s rights in respect of a particular asset.

We referred above to certain requirements in respect of the legal nature of the transfer itself. One such requirement for a legal assignment is that 100 per cent of the asset be transferred. This would not be the case in the above scenario, which is why it is only capable of being an equitable assignment. However, this does not impact the true sale analysis from a legal perspective.

Assignment or novation

In the case of an assignment or novation, a lender may sell all, or a portion of, an asset. The new lender will become the “lender of record” in respect of the sold portion and has direct recourse to the obligor. This recourse includes the right to receive repayments. In this scenario, the original lender has no ongoing role in respect of the sold asset and a new contract is created between the new lender and the obligor. If the obligor has the right to make further drawdowns under a loan agreement, the new lender will have the obligation to fund in place of the original lender. As such the consent of the obligor is required. This is in contrast to an assignment, where the obligor’s consent is not required, unless it is stated as being so in the relevant contract being assigned. This highlights the importance of due diligence.

In both of the above examples, the credit risk of the obligor is transferred to the participant and/or new lender/assignee, either in respect of the participated portion of the risk or in respect of the portion of the asset novated or assigned. CRM is not relevant.

Credit Risk Mitigation

CRMs mitigate the exposure of an institution to its client. The relevant CRMs require that the beneficiary of the CRM is to have a relationship with the underlying transaction. The Capital Requirements Regulation (CRR) sets out the eligibility criteria for CRMs from Article 194 and following of CRR. Each of Non Payment Insurance, unfunded sub-participation and funded sub-participation without a transfer of ownership, are capable of exhibiting a relationship with the underlying transaction for these purposes.

Trading Book vs Non-Trading Book

CRR distinguishes between “trading book” and “non-trading book” assets for the purposes of calculating capital requirements. As the definition for “trading book” (being “all positions in financial instruments and commodities held by an institution either with trading intent, or in order to hedge positions held with trading intent”) and “trading intent” are inherently subjective, there is a possibility that an asset could reasonably fall into both categories. As a result, a given asset could result in different capital relief. This is potentially confusing for institutions who want to achieve CRM. They may be encouraged to take a prudent approach that results in the requirement to hold more capital. IFRS 9 sets out how to test which book is relevant. Parties need to consider this closely as the rules differ for CRM.

Summary

Institutions need to be aware of the different considerations that come about when considering a true sale from both an accounting and a legal perspective.

Since the two perspectives are tested from different viewpoints it is important to involve both accounting and legal functions in the analysis. When considering the legal true sale, look at the transaction as a whole. Whilst a single aspect may weigh in favour of, or against a legal true sale, that alone will not determine the outcome. Institutions should also consider the impact of local laws on their chosen method of transfer. There may be local law steps that must be adhered to in order to evidence a valid transfer, via either assignment or a novation.

If an asset is capable of being both “trading book” and “non-trading book”, consider how the classification may impact the institution, from a capital requirements perspective.

What does the future hold?

Proposed amendments to the CRR are due to come into force in 2020 and beyond. The updated regulations are set to include a more objective text by providing for certain assets to be allocated to the “trading book” or “non-trading book” by default, although trading intent will still remain as the key determining factor. This may help institutions that currently have no definitive way of allocating assets.

The guidance in respect of IFRS 9 to date has been sparse. However, this should improve. Institutions should watch for further updates in this regard and if necessary, provide feedback on the regulation to the regulator.