

IFRS industry insights

The new consolidation standard – insights for the financial services industry



IFRS 10 uses control as the single basis for consolidation, replacing the more risks and rewards focused approaches included in SIC-12.

The International Accounting Standards Board's (the 'IASB' or the 'Board') recently issued consolidation standard is likely to have a significant impact on the financial services industry in general and banks in particular. IFRS 10 *Consolidated Financial Statements* replaces the consolidation guidance previously contained in IAS 27 *Consolidated and Separate Financial Statements* and SIC 12 *Consolidation – Special Purpose Entities*. Concurrent with the issuance of IFRS 10, the IASB also issued:

- IFRS 11 *Joint Arrangements*;
- IFRS 12 *Disclosures of Interests in Other Entities*;
- IAS 27 *Separate Financial Statements* (revised 2011), which has been amended for the issuance of IFRS 10 but retains the current guidance for separate financial statements; and
- IAS 28 *Investments in Associates and Joint Ventures* (revised 2011), which has been amended for conforming changes based on the issuance of IFRS 10 and IFRS 11.

In addition to IFRS 10, the standard likely to have the most significant effect on the banking industry is IFRS 12. IFRS 10 and IFRS 12, as well as IFRS 11, IAS 27 (revised 2011) and IAS 28 (revised 2011) are effective for annual periods beginning on or after 1 January 2013.

This Industry Insight publication highlights many of the issues banks are likely to encounter as they adopt IFRS 10 and IFRS 12 and provides insight and examples to assist in the implementation of the new standards.

Assessment of control

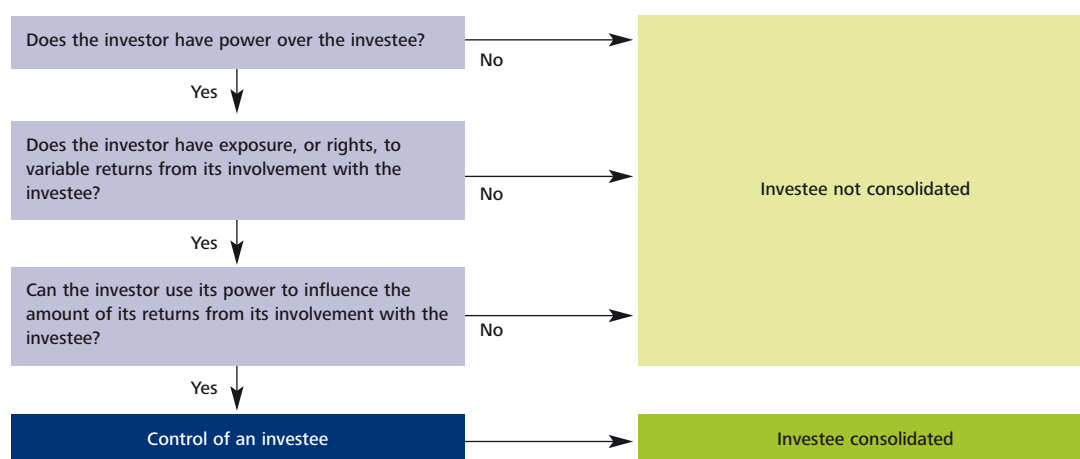
IFRS 10 uses control as the single basis for consolidation, replacing the more risks and rewards focused approaches included in SIC-12. IFRS 10 introduces the following three elements of control:

- power over the investee;
- exposure, or rights, to variable returns from involvement with the investee; and
- the ability to use power over the investee to affect the amount of the investor's returns.

An investor must possess all three elements to conclude it controls an investee. The assessment of control is based on all facts and circumstances and the conclusion is reassessed if there is an indication that there are changes to at least one of the three elements of control.

IFRS 10 defines power as “existing rights that give the current ability to direct the relevant activities” and adds that the relevant activities are those that significantly affect the investee’s returns.

IFRS 10 Consolidation Assessment



Observation

In developing IFRS 10, the IASB identified the following four areas of current divergence in determining whether an investee should be consolidated:

- where an investor controls an investee with less than a majority of the voting rights;
- special purpose entities and application of SIC-12’s ‘economic substance’ notion;
- issues around principal vs. agent relationships; and
- consideration of protective rights.

The Board considered that a perceived difference in emphasis between IAS 27 and SIC-12 has led to an inconsistent application of the concept of control. As a result, the decision was taken to withdraw the separate guidance in SIC-12. Whether the consolidation assessment under IFRS 10 will change for a particular entity as compared to under IAS 27 and SIC-12 may depend on exactly how IAS 27 and SIC-12 have been interpreted and applied historically.

IFRS 10 defines power as “existing rights that give the current ability to direct the **relevant activities**” and adds that the relevant activities are those that significantly affect the investee’s returns. The standard provides examples of rights that may give an investor power over an investee including:

- voting or potential voting rights;
- rights to appoint, reassign or remove key management personnel who have the ability to direct the relevant activities;
- rights to appoint or remove another entity that directs the relevant activities;
- rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and
- other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

IFRS 10 clarifies that variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee.

Observation

For banks, the 'relevant activities' are likely to depend on the type of entity. The first step in the consolidation assessment will be to understand the purpose and design of the entity in order to identify the relevant activities and who has the current ability to direct those activities.

In a securitisation structure, the most relevant activities may be managing receivables in default (i.e., restructuring the terms with the borrower, seizing collateral or managing the foreclosure process). In some securitisation structures, the servicer may have responsibility for these activities. In other securitisation structures, such as commercial mortgage backed security trusts, a 'special servicer' may be responsible for managing receivables upon default. These activities may be determined to be the only relevant activities of the entity even though they are not performed until defaults occur.

Banks may also sponsor other structured entities. In a commercial paper conduit ('CP conduit'), the relevant activities may include the decisions of when and how to issue commercial paper, the approval as eligible sellers of receivables into the conduit, the approval of receivables for sale to the conduit and when to access the liquidity facility. In a collateralised debt obligation ('CDO') where the collateral pool of investments is actively managed, the investment decisions may be the relevant activities.

As part of a diversified product offering, banks may also manage investment funds. For investment funds, the relevant activities may be the investment decisions.

The second step in the consolidation assessment requires an investor to assess whether it is exposed, or has rights, to variable returns from its involvement with the investee. IFRS 10 clarifies that variable returns are returns that are not fixed and have the potential to vary as a result of the performance of an investee. The standard provides examples of returns which include:

- dividends, other distributions (such as interest payments on debt securities) and changes in the value of the investor's investment in that investee;
- servicing and management fees, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits and access to future liquidity; and
- returns that are not available to other interest holders.

IFRS 10 does not require an entity to have the majority of risk and return for consolidation and having the majority of risk and return does not result in automatic consolidation.

Observation

Because of the complexity in many of the structures banks are often involved with, the forms of financial involvements may vary widely.

For securitisation structures, the servicer will typically earn a fixed percentage servicing fee based on the outstanding principal of the loans in the securitisation trust. Additionally, the servicer may hold an investment in the notes issued by the trust, typically in the subordinated (or 'equity') tranche of notes. Other forms of financial involvements with a securitisation trust may include call or put options on either the receivables in the trust or the notes issued by the trust. Also, there may be guarantee arrangements associated with the securitisation trust, such as insurance provided by monoline insurers.

For CDOs, the management agreement may include a multi-tiered fee arrangement for management services (typically a base management fee, a subordinated management fee and then an incentive management fee based on the rate of return achieved by the subordinated note holders). Similar to other securitisation structures, the CDO manager may also retain an interest in one of the issued note classes.

In a CP conduit, the sponsor may provide a liquidity facility and earn a fee for providing access to the liquidity facility. Both the fee and the guarantee would be considered financial involvements with the CP conduit. Additionally, sponsors may provide overcollateralisation to the conduit in exchange for the residual returns of the conduit.

Similarly, for money market mutual funds, the sponsor may be obliged to provide credit support to the fund should the net asset value (NAV) of the fund 'break the buck' but will earn a management fee based on the assets under management (AUM). Other funds such as hedge funds or private equity funds may have both a base management fee as well as an incentive fee where the manager shares in the returns on the investments once the investors have reached an established hurdle rate of return. In these types of funds, managers are often required to make a direct investment in their managed funds in order to better align the interests of the investors with their own.

It may be obvious that some of these involvements (e.g., direct investments, incentive fees, performance guarantees) provide variable returns as they are directly linked to the performance of the entity. However, even a fixed base management fee (e.g., 2% of AUM) would have a variable return element as the AUM amount is directly tied to investment performance.

The third and final step in the consolidation assessment considers the interaction between the first two steps. Specifically, can the investor use its power to influence its returns from its involvement with the investee? For banks, the determination of whether their power influences their returns will often depend on whether the bank is a principal or an agent engaged to act on the behalf of, and for the benefit of, other investors and therefore does not control the entity. For example, if a single investor may remove the bank from its decision making role, then the bank would always be considered to be an agent of the investor and therefore not required to consolidate. However, if no single investor holds unilateral removal rights, then a bank, in assessing whether it is a principal or agent, would consider the following factors:

- the scope of its decision-making authority over the investee;
- the rights held by other parties;
- the remuneration to which they are entitled in accordance with the remuneration agreement(s); and
- their exposure to variability of returns from other interests that it holds in the investee.

Furthermore, for an investor to be considered an agent, its remuneration must be commensurate with the services provided and the remuneration agreement must include only terms, conditions or amounts customarily present in other similar arrangements negotiated on an arm's length basis.

IFRS 10 also discusses when an investor's relationships with other parties may result in those parties acting on behalf of the investor (as 'de facto agents' of the investor).

Observation

As discussed above, a bank's remuneration for its involvement in structures may take many forms and levels. Banks may receive a fixed percentage fee based on the amount of receivables being serviced, the guarantee or liquidity facility provided or the assets being managed. However, other arrangements may also include incentive based fees contingent on the performance of the entity and the return achieved by the investors.

In assessing the exposure to variability of returns, a bank should consider that the greater the magnitude of, and variability associated with, its overall economic interests (including remuneration), the higher the likelihood the bank is a principal. Additionally, if the exposure to variability of returns of the bank is different from that of other investors (e.g., because of subordination of interests) banks should consider how that may influence their decision making.

Observation

IFRS 10 highlights that the subordination of interests may increase the exposure to variability. For example, banks may hold a portion of the subordinated notes in a structure (e.g., a securitisation vehicle) to better align their own interests with those of the investors. The resulting exposure to variability from investments in the subordinated notes may impact the consolidation assessment.

IFRS 10 also discusses when an investor's relationships with other parties may result in those parties acting on behalf of the investor (as 'de facto agents' of the investor). The standard clarifies that the arrangements with other parties need not be contractual and provides examples of parties who might act as 'de facto agents' of the investor:

- the investor's related parties;
- a party that received its interest in the investee as a contribution or loan from the investor;
- a party that has agreed not to sell, transfer or encumber its interests in the investee without the investor's prior approval (except for situations in which the investor and the other party have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties);
- a party that cannot finance its operations without subordinated financial support from the investor;
- an investee for which the majority of the members of its governing body or for which its key management personnel are the same as those of the investor; and
- a party that has a close business relationship with the investor, such as the relationship between a professional service provider and one of its significant clients.

When a bank identifies other parties as 'de facto agents', they would consider the other investors' decision-making rights and exposure, or rights, to variable returns together with their own interests when assessing whether it controls the entity.

The following examples are adapted from the application examples contained in IFRS 10 and illustrate the provisions of the IFRS 10 consolidation model being applied to structured entities and investment funds.

Example: Securitisation trust

A bank creates a bankruptcy remote securitisation trust. The purpose of the securitisation trust is to issue tranching asset-backed securities to investors in order to fund purchases of loan assets. The bank will transfer the loans it originates to the securitisation trust. The securitisation trust hires a third party to service the loans in the trust in exchange for a servicing fee. The bank does not invest in notes issued by the securitisation trust. The bank agrees that the trust would put back to the bank any defaulted receivables at par. The bank would then manage those defaulted receivables (i.e., restructure the terms with the borrower, seize collateral or manage the foreclosure process).

Does the bank have power over the investee?

The relevant activity is the management of the receivables upon default because it is the only relevant activity that can significantly affect the trust's returns. Managing the receivables before default is not a relevant activity because it does not require substantive decisions to be made that could significantly affect the trust's returns. The servicer's activities before default are predetermined and amount only to collecting cash flows as they fall due and passing them on to investors. Therefore, only the bank's right to manage the loans upon default should be considered when assessing the overall activities of the trust that significantly affect the trust's returns. The design of the trust ensures that the bank has decision-making authority over the activities that significantly affect the returns at the only time that such decision-making authority is required. The terms of the put agreement are integral to the overall transaction and the establishment of the trust. Therefore, the terms of the put agreement together with the founding documents of the trust lead to the conclusion that the bank has power over the trust even though the bank takes ownership of the receivables only upon default and manages the defaulted receivables outside of the legal boundaries of the trust.

Does the bank have exposure, or rights, to variable returns from its involvement with the investee?

The put agreement for defaulted loans exposes the bank to variability from its involvement with the securitisation trust.

Can the bank use its power to influence the amount of returns from its involvements with the investee?

The bank's decision making over managing defaulted loans will influence the amount of returns from its involvement with the trust. For example, if the bank decides to modify a loan by lowering the interest rate on the loan or extending the maturity date, then the bank may absorb a lower loss as compared to the loan going through the default process.

Example: Multi-seller commercial paper conduit

A bank sponsors a multi-seller commercial paper conduit. The conduit will issue short term commercial paper and purchase high quality receivables from multiple transferors. Each of the selected transferors to the conduit will service their own receivables for a market based servicing fee. The transferors also provide overcollateralisation by selling receivables to the conduit at a discount to par. The sponsor selects the transferors to participate in the conduit, approves the assets to be sold to the conduit and makes funding decisions on issuing commercial paper. The sponsor receives a market based fee for its role in sponsoring the conduit and is also entitled to any residual return of the conduit. The sponsor also provides both credit support and a liquidity facility to the conduit. The credit support absorbs losses of up to 5% of losses once the overcollateralisation from the transferors has been absorbed. The liquidity facility requires the sponsor to provide temporary liquidity to the conduit should the conduit not be able to fund itself through issuance of short term commercial paper.

Does the bank have power over the investee?

The sponsor has power over the relevant activities of the conduit as it selects the transferors to participate in the conduit, approves the receivables transferred to the conduit and makes funding decisions on behalf of the conduit.

Does the bank have exposure, or rights, to variable returns from its involvement with the investee?

While the sponsor receives a market based fee for its role as servicer, it also has additional involvements with the conduit through its right to the residual returns of the conduit in addition to downside risk through providing of credit support and a liquidity facility. Each of these involvements would result in variable returns.

Can the bank use its power to influence the amount of returns from its involvements with the investee?

The sponsor has power over the activities that most impact the financial performance of the conduit, namely selecting the transferors to participate in the conduit, approving the receivables transferred to the conduit and making funding decisions on behalf of the conduit. The sponsors' involvements are directly impacted by these activities; should the conduit perform well the sponsor receives the residual profits while if the conduit has problems the sponsor absorbs 5% of losses and may have to provide additional liquidity. This variability of returns is different from that of other investors (the commercial paper holders) who only absorb losses after the overcollateralisation and the sponsor credit support have been absorbed. Also, should the investors of the short-term commercial paper choose not to reinvest in further commercial paper the bank will provide the funding the conduit needs through its liquidity facility. Considering these factors indicates that the sponsor would be acting in the role of a principal rather than an agent.

As all three of the consolidation criteria have been met, the sponsor would conclude it controls the commercial paper conduit and therefore should consolidate.

Example: Hedge fund

A bank sponsors and manages a hedge fund. The fund offering memorandum details the investment objective of the fund but the bank has sole discretion in executing the investment objective.

The bank receives as compensation for its investment management services a 1% and 20% fee (an annual management fee of 1% of assets under management ('AUM') and an incentive fee of 20% of returns above a hurdle rate of return). The bank has also decided to take a strategic investment in the hedge fund retaining a 20% ownership interest. The bank's downside risk is capped at their equity investment and accrued carried interest (e.g., the incentive fee earned to date); it has no obligation to fund investor losses.

The investors in the fund have been provided with simple majority 'kick-out' rights, but are only exercisable upon the bank's breach of the investment management agreement.

Does the bank have power over the investee?

While the bank is required to act in accordance with the investment objective established in the fund offering memorandum, the investors hold only protective rights through the ability to remove the bank for breach of contract, and the bank is still considered to have power over the hedge fund as they have existing rights providing the current ability to direct the relevant activities (i.e., executing the investment objective by strategic asset allocation).

Does the bank have exposure, or rights, to variable returns from its involvement with the investee?

The bank's 20% ownership stake in the hedge fund, as well as their 1% and 20% fee arrangements, both expose the bank to variability of returns from the activities of the fund.

Can the bank use its power to influence the amount of returns from its involvements with the investee?

Each of the bank's interests in the hedge fund (management fee of 1% of AUM, incentive fee of 20% of returns above the hurdle return rate of return, and a 20% ownership stake in the fund) are influenced by the bank's power over strategic asset allocation.

The bank's 20% stake in the fund along with the remuneration received could create exposure to variability of returns from the activities of the fund that it is of such significance to indicate the bank is acting in the role of principal rather than as an agent.

In assessing the consolidation criteria above, the bank might consider a 20% investment to be sufficient to conclude it controls the hedge fund and therefore should consolidate it. Should the bank's ownership stake in the fund change over time, it would need to reconsider the implications for the consolidation conclusion.

Example: Collateralised debt obligation

A bank establishes and manages a collateralised debt obligation ('CDO') entity that issues debt securities with five tranches of senior notes and a subordinated (or 'equity') note class which represents 10% of the total capital in the CDO.

Using the proceeds raised through the note issuance, the bank manages the collateral pool in accordance with the indenture agreement by investing in loans and other debt securities. As compensation for providing investment management services, the bank earns a market based fee commensurate with the level of service which includes a base management fee of 40 basis points of the outstanding collateral pool, a subordinated management fee of 60 basis points of the outstanding collateral pool and an incentive fee of 10% of excess cash flows once the subordinated note holders have received a hurdle rate of return.

To align the interests of the bank with the note holders, the bank is also required to hold 35% of the equity tranche, the remaining 65% of the equity tranche is widely held by third party investors. The other equity investors hold simple majority 'kick out' rights and may remove the bank without cause by simple majority vote.

Does the bank have power over the investee?

While the bank is required to act in accordance with the investment objective established in the indenture agreement and the equity note holders hold substantive removal rights, the bank is still considered to have power over the CDO as they have existing rights providing the current ability to direct the relevant activities (i.e., executing the investment objective by strategic asset allocation). Even though the removal rights can be exercised without cause, they receive little weighting in the consolidation analysis because they are held by a group of widely held investors and require a majority to exercise.

Does the bank have exposure, or rights, to variable returns from its involvement with the investee?

Each component of the bank's fee arrangements in the CDO (the 40 basis point management fee, the 60 basis point subordinate fee and the 10% excess cash flow incentive fee) as well as the 35% ownership interest in the equity tranche expose the bank to variability of returns from the activities of the fund.

Can the bank use its power to influence the amount of returns from its involvements with the investee?

Each component of the bank's fee arrangements in the CDO as well as the 35% ownership interest in the equity tranche are influenced by the bank's power over strategic asset allocation.

The bank holding 35% of the equity tranche, along with the remuneration for investment management services, creates subordinated exposure to losses and rights to returns of the investee which are of such significance that it indicates the bank is acting in the role of principal rather than as an agent.

As all three of the consolidation criteria have been met, the bank would conclude that it controls the CDO and therefore should consolidate.

Observation

The examples included in IFRS 10 are intended to illustrate the application of the general concepts of the principal/agent guidance rather than to create 'bright lines' of, for example, the level of investment exposure that would lead to the determination that a bank is acting as a principal. A significant amount of judgement will sometimes be required in determining whether a decision maker is a principal or agent.

Disclosures of involvements in other entities

In addition to the issuance of IFRS 10, the IASB also issued IFRS 12 with the objective of improving disclosures around the nature of, and risks associated with, an entity's interests in other entities and their impact on the financial statements. Involvements with other entities include interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. The greatest effect of IFRS 12 for banks is likely to be the required disclosures for consolidated subsidiaries and unconsolidated structured entities.

For interests in unconsolidated structured entities, IFRS 12 requires disclosure of information about the nature and extent of an entity's interests in unconsolidated structured entities and the nature of, and changes in, the risks associated with those entities.

For interests in subsidiaries, the disclosure requirements are intended to provide financial statement users with information on the group's composition and non-controlling interest holders' interests in the group's activities and cash flows. Specifically, information should be provided on:

- the nature and extent of significant restrictions on an entity's ability to access or use assets, and settle liabilities of the group;
- the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
- the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control; and
- the consequences of losing control of a subsidiary during the reporting period.

In addition, the following detailed disclosures on non-controlling interests are required at an individual subsidiary level for each subsidiary with non-controlling interests material to the group:

- the name of the subsidiary;
- the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary;
- the proportion of ownership interests held by non-controlling interests;
- the proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interests held;
- the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period;
- accumulated non-controlling interests of the subsidiary at the end of the reporting period; and
- summarised financial information about the subsidiary.

For interests in unconsolidated structured entities, IFRS 12 requires disclosure of information about the nature and extent of an entity's interests in unconsolidated structured entities and the nature of, and changes in, the risks associated with those entities. An entity that has an interest in an unconsolidated structured entity should disclose:

- the carrying amounts and line items in the statement of financial position where the assets and liabilities related to its interests in unconsolidated structured entities are recognised;
- an estimate of the entity's maximum exposure to loss from its interests in unconsolidated structured entities; and
- a comparison of those two amounts.

Additionally, if an entity has provided any financial or other support (whether contractually required or not) or intends to provide support to consolidated entities or unconsolidated structure entities, it should disclose information around those arrangements. Finally, for any unconsolidated structured entities the entity sponsors but in which it no longer has an interest at the reporting date, the entity should disclose how it determined it was the sponsor, what income it received during the reporting period and the carrying amount at the time of transfer of all assets transferred to the structured entity during the reporting period.

Observation

For larger banks with diversified product offerings, the disclosure requirements for unconsolidated structured entities may prove challenging. Of particular note are the disclosures around funding including the forms of funding, the weighted average life of the debt funding and a maturity analysis of assets and liabilities. For entities with numerous securitisation structures or other structured entities, determining the appropriate level of aggregation for such information may be a key consideration.

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