

Staff Paper

Project

Consolidation

Topic

Disclosures – Risks from sponsoring structured entities

Introduction

1. The recent financial crisis has highlighted that a reporting entity can be exposed to risks from the sponsorship of structured entities, even though it has not retained any continuing involvement in those entities. Neither IFRSs nor US GAAP currently contain disclosure requirements that, in the absence of an ongoing involvement, would inform users of financial statements about a reporting entity's risk exposure from its sponsoring activities. The purpose of this agenda paper is to discuss whether a reporting entity should provide specific risk disclosures for its sponsoring activities.
2. This agenda paper:
 - (a) analyses whether there is a need for a reporting entity to provide information about its risk exposure from its sponsoring activities; and
 - (b) explains which disclosures could address this information need.

Is there a need for a disclosure?

3. The Board has tentatively decided that a reporting entity should disclose information that helps users of financial statements understand the nature of, and changes in, the risks associated with the reporting entity's involvement with structured entities. As a consequence, a reporting entity would be required to

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Staff paper

provide risk disclosures, when it has sponsored an unconsolidated structured entity and has retained an ongoing involvement in the structured entity, for example by holding debt or equity instruments of the structured entity.

4. However, that decision would not require a reporting entity to provide the disclosure if the reporting entity does not retain any ongoing involvement with the structured entity through explicit or implicit interests. However, sponsoring a structured entity can create risks for a reporting entity, even though the reporting entity does not retain any ongoing involvement with the structured entity. This is particularly the case when the reporting entity selects the assets in which the structured entity invests or markets the structured entity to prospective investors. If the structured entity encounters difficulties it is possible that the reporting entity could be challenged on its advice or actions (ie was the reporting entity negligent, did it provide adequate advice to investors etc) or may choose to act to protect its reputation.
5. The Board has tentatively decided in the consolidation project to require disclosure regarding the provision of support to another entity when there was no contractual or constructive obligation to do so and whether a reporting entity has any current intentions to provide support or other assistance in the future. While helpful, the disclosure requirement provides an incomplete picture of the reporting entity's risk exposure from its sponsoring activities because:
 - (a) the disclosure requirement applies only once the reporting entity has provided support to the structured entity;
 - (b) a reporting entity's risk exposure from its sponsoring activities is wider than the risk to provide implicit support to the structured entity. For example, a reporting entity that does not intend to provide any implicit support might face a litigation risk from its sponsorship of a failed structured entity
6. There is currently also no other disclosure requirement that would inform users of financial statement about a reporting entity's risk exposure from its sponsoring activities:

Staff paper

- (a) The disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* do not result in information being provided about sponsorship because there is no financial instrument associated with the sponsorship of itself that could trigger the disclosures.
 - (b) The disclosures that the staff has developed in the IASB's derecognition project would only apply if the reporting entity transfers its own financial assets to the structured entities. They would not apply if the reporting entity arranges for other parties to transfer financial assets into the structured entity.
 - (c) The unconsolidated structured entity does not meet the definition of a related party according to IAS 24 *Related Parties*.
7. We have discussed the lack of disclosure with users of financial statements. Users have confirmed that they believe that it would be very useful to have information about the scale of a reporting entity's operations that is derived from transactions with unconsolidated structured entities, ie to have more information about a reporting entity's business model and the risks associated with that business model. This would be particularly useful to help users understand the likely impact on the performance of the reporting entity either due to a loss of income or a restriction on their ability to carry out their usual business activities if there was a significant decrease in the use of such entities for investing or financing purposes. Those users also confirmed that their request for such information precedes the financial crisis, and is not simply a reaction to it.

What would the disclosure look like?

8. ED10 proposed that, for unconsolidated structured entities that the reporting entity has set up or sponsored, the reporting entity should disclose a summary of:
- (a) income from the reporting entity's involvement with structured entities, including a description of the types of income presented in the summary; and

Staff paper

- (b) the value of assets transferred to those structured entities, at the date the transfers were made.

These disclosures would be required for all unconsolidated structured entities that the reporting entity has set up or sponsored, including those structured entities whose assets were acquired from a third party. The disclosure requirements would apply, regardless of whether there is a continuing involvement with the structured entity.

- 9. The proposals were not intended to help assess the actual risk of failure or recourse (including as a result of negligence) to the reporting entity but they would give a sense of the scale involved and the extent of the reporting entity's reliance on such entities to facilitate its business. For example, as the credit crisis developed investors became concerned about the extent that banks had been involved with structured investment vehicles (SIVs). However, few banks reported information about the extent of their involvement with establishing SIVs. It was, therefore, difficult to assess the potential exposure a particular entity might have to such vehicles. The proposed disclosure requirements were designed to give users of financial statements a sense of the scale of the operations the reporting entity had managed with these types of transactions.
- 10. Most respondents to ED 10 recommended that the Board should remove the proposed disclosure requirement because they did not believe that when a reporting entity has no ongoing involvement with a structured entity, the reporting entity could be exposed to risks from its sponsoring activity other than general business risk.
- 11. However, if the Board affirms the proposed disclosure requirements, respondents asked the Board to define the terms "sponsor", "income from the reporting entity's involvement with structured entities" and "value of the assets transferred". Respondents asked the Board to clarify as of which date the assets transferred should be measured and whether the information to be disclosed should be cumulative or only reflect the current reporting period. In addition, respondents asked the Board to provide application guidance as to how the information to be disclosed could be aggregated.

Staff paper

12. We believe that respondents' requests for clarification could be addressed as follows:
- (a) The term "sponsor" remains undefined, but the reporting entity should be required to explain in the disclosures how it has interpreted the term.
 - (b) 'Income' should be described to include not only fee income from sponsoring the structured entity, but also any other income that the reporting entity derives from the structured entity during the reporting period; for example fee income from the provision of services, gains or losses if the reporting entity sells assets to the structured entity, and interest income or fair value gains or losses from any equity or debt instruments that the reporting entity might hold in the structured entity.
 - (c) The disclosure standard should clarify that a reporting entity must disclose the carrying amount of the assets that the reporting entity or other parties transferred to those structured entities at the time that the transfers were made. This means, that a reporting entity could disclose the carrying amount of the assets transferred in accordance with local GAAP, rather than being required to convert those amounts into IFRSs or US GAAP. The disclosure would be for the current reporting period only.
 - (d) The Board has already decided to provide general guidance in the final consolidation standard as to how the information to be provided could be aggregated.
13. The disclosure requirement proposed in ED10 would apply to all structured entities that the reporting entity has sponsored, including those that the reporting entity has an ongoing involvement with. However, the Board has tentatively decided that the final consolidation standard should include specific risk disclosures for a reporting entity's involvement with unconsolidated structured entities. Therefore, we believe that a reporting entity should be exempt from the disclosures discussed in this paper when the reporting entity has sponsored a structured entity and has retained an ongoing involvement with that entity.

Staff paper

14. The revised disclosure requirement would be as follows:

A reporting entity shall disclose for unconsolidated structured entities that the reporting entity has sponsored, but with which the reporting entity has no involvement at the reporting date, a summary of:

(a) income from the structured entities that it has sponsored, including a description of the types of income presented in the summary; and

(b) the carrying amount of the assets that the reporting entity or other parties have transferred to those structured entities at the time that the transfers were made.

The reporting entity shall present the information in tabular format, unless another format is more appropriate, and separate the activity into relevant categories (such as by type of structured entity or asset that exposes the reporting entity to different risks). The reporting entity shall also explain its policy as to how it determines whether it has sponsored a structured entity.

15. The appendix to this paper contains an example of how the disclosure requirement could be applied.
16. In our view, the proposed disclosure requirement does not impose excessive costs on preparers of financial statements because we would expect that a preparer that has sponsored the structured entity is in the position to request the required information from the structured entity and will often have already obtained that information for risk management purposes.
17. As with all disclosures, the disclosure requirement would only apply to material items. In addition, the reporting entity would be able to aggregate the information to be disclosed in accordance with the general aggregation principle in the final disclosure standard.

Staff recommendation

18. Some staff agree with those respondents who asked the Board not to finalise the proposed disclosure requirement. Those staff argue that reporting entities face many risks from their past activities and such business risks should be addressed more generally, perhaps in Management Commentary. Therefore, those staff believe that the proposed disclosure requirement, if considered necessary, should

Staff paper

not be part of a disclosure package that addresses a reporting entity's exposure to risk from its involvement with unconsolidated structured entities.

19. In addition, those staff believe that the disclosures about the nature and extent of a reporting entity's involvement with unconsolidated structured entities already agreed to by the Board are sufficient (ie, to require a reporting entity to disclose qualitative and quantitative information about its involvement with unconsolidated structured entities, including information about the nature, purpose, and activities of structured entities, including how those activities are financed). They believe that if a reporting entity does not have any continuing involvement with a structured entity then including this requirement would contradict the disclosure objective, according to which a reporting entity should disclose the nature of, and changes in, the risks associated with the reporting entity's *involvement* with unconsolidated structured entities.
20. In their view, the proposed disclosure would mainly assist users in identifying a reporting entity's implicit commitment to provide support or other assistance to unconsolidated structured entities (reputational risk). Therefore, those staff believe that the proposal would effectively double-guess the reputational risk disclosures in the final disclosure standard that the Board has already agreed upon.
21. Other staff recommend that the Board finalise the proposed disclosures to provide users of financial statements with information about the extent to which a reporting entity sponsors structured entities. Users of financial statements have consistently requested this information because the sponsorship of structured entities can expose a reporting entity to significant risks that the reporting entity would otherwise not be required to disclose. Those staff believe that the proposed disclosure requirement will help users of financial statements to better understand the risks that were instrumental in the recent financial crisis.

Staff paper

Question for the Board

Does the Board agree that a reporting entity should be required to disclose for unconsolidated entities that the reporting entity has sponsored, but with which the reporting entity has no involvement at the reporting date:

- (a) income from the structured entities that it has sponsored; and
- (b) the carrying amount of the assets that the reporting entity or other parties have transferred to those structured entities at the time that the transfers were made?

The reporting entity should present the information in a tabular format, unless another format is more appropriate, and separate the activity into relevant categories (such as by type of structured entity or asset that exposes the reporting entity to different risks). The reporting entity should also explain its policy as to how it determines whether it has sponsored a structured entity.

Staff paper

Appendix – Example

1. During 20X1 XYZ Bank sponsored a number of structured entities. As the sponsor, XYZ Bank facilitates the establishment of structured entities on behalf of third parties. The structured entities are established to securitise third party receivables, to hold assets leased by third parties and for investing purposes (for example, collateralised debt obligations are used to provide investment opportunities for investors). XYZ Bank generally does not control those entities.
2. XYZ Bank considers itself to be a sponsor of a structured entity when it facilitates the establishment of the structured entities by providing structuring, accounting, funding and operations services on behalf of third parties.
3. The table below includes XYZ Bank's fees from sponsoring structured entities and any other income that XYZ Bank had from those entities in the reporting period. The structured entities are grouped according to the type of assets held by those entities.

Type of asset in unconsolidated entity	Total fee income for the year ended	
	20X1 CU million	20X0 CU million
Collateralised debt obligations	1,025	820
Residential mortgage-backed securities	6,055	4,844
Commercial mortgage-backed securities	878	703
Assets under lease	332	265
Credit card receivables	189	151
Total	8,479	6,783

4. The table below provides a summary of the assets transferred to the structured entities that XYZ Bank has sponsored in the reporting period as at the date of transfer. Most of those structured entities do not prepare financial statements in accordance with IFRSs. The amounts presented in the table are the values of the assets in the statutory financial statements of the structured entities. The values

Staff paper

included in the table have not been adjusted to reflect the different measurement dates.

Type of asset in unconsolidated entity	Assets transferred during the year	
	20X1 CU million	20X0 CU million
Collateralised debt obligations	14,650	11,720
Residential mortgage-backed securities	86,500	69,200
Commercial mortgage-backed securities	12,546	10,037
Assets under lease	4,739	3,791
Credit card receivables	2,695	2,156
Total	121,130	96,904