esma European Securities and Markets Authority

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IFRS IC
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Accounting exposure to Greek sovereign debt

Dear Mr. Upton,

Further to the 26 October 2011 Euro Summit Statement, the Hellenic Republic announced on 21 February 2012 the key terms of a voluntary transaction, known as the Private Sector Involvement (the "transaction"). This transaction was conducted in the context of the Greek economic reform program that has been agreed with the European Union and the International Monetary Fund. The transaction involves an invitation to private sector holders of Greek Government Bonds (GGBs) to exchange their holdings with new bonds to be issued by the Hellenic Republic.

ESMA has now considered the implications from the transaction for European issuers and preparers of IFRS financial statements in particular. ESMA considers that IAS 39 – *Financial Instruments: Recognition and Measurement* does not provide explicit guidance on the accounting treatment of a debt exchange or more generally the modification of terms for financial assets. This results in difficulties to understand how the standard should be applied to the bond exchange and could raise enforceability issues.

ESMA has identified different rationales that can be followed in analysing an exchange as either a derecognition or as a modification in terms of a financial asset. These rationales are detailed in the appendix to our letter and are illustrated with the main characteristics of the Greek Private Sector Involvement exchange.

While for this specific case ESMA identified strong arguments to account the transaction as a derecognition of the original financial asset, we anticipate difficulties in terms of enforceability in case a different approach would be followed by issuers.

ESMA would wish to have your views as to whether the rationales outlined in this appendix are in line with the principles set out in IFRS. Due to the lack of explicit guidance on a type of transaction that is quite widespread and the importance for the financial markets and investors, ESMA would also invite the IFRS Interpretations Committee to clarify the standard.

We would be happy to further discuss these issues with you.

Yours sincerely,

Julie Galbo
Chair Corporate Reporting Standing Committee

Steven Maijoor
ESMA Chair

APPENDIX – ESMA's detailed comments on the application of IAS 39 to the transaction

The objective of this appendix is to set out the rationale followed in identifying the appropriate accounting treatment to be applied to this transaction, the characteristics of which are described in the background section below. Several interpretations of IAS 39 are considered to be possible in this case.

A. Background of the transaction

1. The Hellenic Republic announced on 21 February 2012 the key terms of a voluntary transaction further to the 26 October 2011 Euro Summit Statement, known as the Private Sector Involvement, and in the context of its economic reform program, that has been agreed with the European Union and the International Monetary Fund. The transaction involves an invitation to private sector holders of certain Greek Government Bonds (GGBs) to exchange their holdings with new bonds to be issued by the Hellenic Republic.

2. The key terms applicable to each eligible privately held GGB are as follows :

   (a) 53.5% of the principal amount of the GGB will be forgiven;

   (b) 31.5% of the principal amount of the GGB will be exchanged into 20 new Greek government bonds with maturities of 11 to 30 years; and

   (c) the remaining 15% will be in short-dated securities issued by the European Financial Stability Facility (EFSF).

3. The coupon on the new Greek government bonds under (b) above will be structured so that it will be 2% for the three years period from February 2012 to February 2015; then 3% for the following five years (February 2015 to February 2020); and 4.3% for the period from February 2020 to February 2042.

4. Securities linked to the Gross Domestic Product (GDP): subscribers to the plan will receive, for each new bond, a GDP linked security of an initial nominal amount of €100. Holders of this security are not entitled to receive principal in the amount of, or interest based on, the notional amount. The only amounts payable in respect of these securities are the payments contingent upon and determined on the basis of the performance of the gross domestic product of the Hellenic Republic.

5. All issuers will obtain 20 new bonds for each old bond with different maturities irrespective of their former portfolio.

6. Public companies involvement: other Greek public institutions (such as the Public Railway Company, Athens Urban Transport Organisation etc) are included in the PSI. The characteristics of the exchange are the same, i.e. they receive GGBs with the same terms as those for other bondholders.

B. IFRS requirements considered as part of the analysis

De-recognition of financial assets:

7. The requirements for de-recognition of financial assets as set out in IAS 39 paragraphs 16-23 emphasise the expiration of rights to receive cash flows and transfer of risk and rewards associated with the ownership of the asset. Nevertheless they do not address specifically cases of exchange of debt instruments or substantial modification from the lender's perspective as a consequence of a troubled debt restructuring due to financial difficulty of the borrower.

8. On the other hand, when there is a debt exchange or modification of terms of an existing financial liability, IAS 39 paragraph 40 explains how an exchange should be differentiated from an extinguishment. It is not explicit in the standard that an exchange must automatically, by its legal form, lead to an extinguishment or expiry of bonds.

C. Analysis of the transaction

9. The first consideration is whether to apply de-recognition to the whole asset, or only a part of it, in accordance with IAS 39 paragraph 16. Since the proportionate shares of cash-flows can be specifically identified, it is considered that IAS 39 paragraph 16 (a) (ii) is applicable. Analysis of the elements included in the deal led to the conclusions that:

   (a) The 53.5% part of the original asset to be forgiven has to be derecognized in accordance with IAS 39 as no future cash flows are to be received from that part of the asset (IAS 39 paragraph 17(a)).

   (b) The 15% part of the original asset that will be exchanged against short term securities from EFSF has to be derecognized as those cash flows are transferred and replaced with instruments issued from a different counterpart, with different characteristics and credit risk (IAS 39 paragraph 17(b)).

10. While there is general agreement that the parts mentioned above should be de-recognised, there is a lack of consensus over the IFRS accounting treatment of the 31.5% part of the old bond to be ex-

changed against the new 20 bonds with different maturities and interest rates ("the exchange"). The rest of this note is concerned only with this element of the transaction.

11. On the basis of this analysis there appears to be two possible outcomes which can be supported under IFRS for the exchange: de-recognition of the original asset or modification of the original asset. The chart attached at the end of the appendix illustrates the different rationales followed in the analysis.

D. Analysis of the exchange

12. In analysing the exchange, the preliminary step was to identify what the relevant IFRS requirements are and to determine whether IAS 39 contains specific principles to be applied to the exchange of bonds **from the lender's perspective**. In answering that question, two approaches have been identified.

Approach A:.

13. Even if IAS 39 does not make any specific reference to "exchange" of financial assets, the derecognition criteria specified under IAS 39 paragraphs 16 to 23 are relevant and should be used in order to determine whether the old bond should be de-recognised or not.

Approach B:

14. IAS 39 does not provide any specific guidance related to an "exchange" of financial assets from the lender's perspective. Therefore, bondholders should choose another accounting method by applying IAS 8 – *Accounting Policies, Changes in Accounting Policies* paragraphs 10 to 12. Paragraph 11 states that the first source of information to be used in making a judgement about the accounting policy to be applied is the requirements of IFRS dealing with similar and related issues.

D.1. Approach A

15. Following approach A, the de-recognition steps from IAS 39 paragraph 17-23 are analysed in detail.

Question 1: Does the exchange fall under the scope of IAS 39 paragraph 17 (a)?

16. IAS 39 paragraph 17(a) requires an entity to derecognise a financial asset when "the contractual rights to the cash flows from the financial assets expire". Since there is no definition of the concept

of "expiration" of cash flows, the questions arises whether the Greek exchange can be considered under this category.

View 1: de-recognition is appropriate under IAS 39 paragraph 17(a)

17. From a legal and stricto sensu approach, the exchange implies that the cash-flows from the original asset are not due anymore, and therefore they are considered expired. Therefore the original asset has to be derecognised.

18. Alternatively, an entity might perform a quantitative and qualitative evaluation of whether the cash flows of the original bond against the new instruments to be received are substantially different. By looking to the substance of the exchange, it can be concluded that the substitution of the 31.5 % of an old bond with 20 new bonds with changed maturities and coupons involves significant changes in the contractual terms and future cash flows. These cannot be considered as a revision of estimated cash flows as is dealt with in IAS 39 paragraph AG8, but should rather be viewed as an expiration of the cash flows from the 31.5 % of the old bond. Accordingly, the 31.5 % of the old bond should be derecognised in accordance with IAS 39 paragraph 17(a).

View 2: de-recognition is not appropriate under IAS 39 paragraph 17(a)

19. If it is considered that the contractual rights to receive the cash flows of the "original" financial asset have expired, it would mean that there is no exchange de facto. The Greek debt would have expired because of a full forfeiture of the cash flows. As a result, the deliverance of the new bonds would not be part of any exchange and the new bonds received should be considered as a grant from the Greek Government.

20. There is no expiration from the bondholder's perspective but only a transfer of the original cash flows in consideration for the new bonds received from the Greek Government. The fact that the Greek Government will cancel the "old" bonds received by setting them off against its own liability will only have an impact on the Greek Government and not on the bondholders.

21. The arguments above support the view that the contractual rights to receive the cash flows of the "original" financial asset have not expired, but effectively continue through the granting of the new bonds. Consequently IAS 39 paragraph 17(a) would not apply and the new bonds would be in effect a modification of the old bonds.

Question 2: Does the exchange fall under the scope of IAS 39 paragraph 17 (b)?

22. IAS 39 paragraph 17(b) requires an entity to derecognize a financial asset when the entity transfers (IAS 39 paragraphs18 and 19) the financial asset and the transfer qualifies for de-recognition (IAS 39 paragraph20). The standard does not define the concept of "transfer", but indicates the criteria to be fulfilled for a transaction to qualify as a "transfer".

View 1: exchange does not fall within scope of IAS 39 paragraph 17(b)

23. In the absence of a definition of a "transfer", this notion is interpreted by some as implying a transfer to a third party. In the case of the Greek exchange, the counterparties are the same and therefore this does not fall under IAS 39 paragraph 17(b). Therefore, in accordance with this view, **derecognition based on this criterion is not possible.**

View 2: exchange does fall within scope of IAS 39 paragraph 17(b)

24. An exchange can be seen as constituting a form of transfer in that the cash flows of the old bonds are transferred back to the Greek Government, in exchange for the new bonds. Further analysis of the conditions under which the exchange is done is needed in order to evaluate the extent to which a bondholder retains the risk and rewards of ownership (IAS 39 paragraph20 to 23). This view is further analysed under Question 3.

Question 3: Are risk and rewards related to the exchange transferred [IAS 39 paragraph20]

25. Once an entity has established that it has transferred a financial asset, it should carry out the risks and rewards test. IAS 39 paragraph 21 indicates that an entity transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer **significant** in relation to the total variability in the present value of the future net cash flows associated with the financial asset. IAS 39 does not provide any guidance as to what is meant by significant when comparing the exposure to the variability before and after the transfer; therefore judgement is needed to assess what is significant on the basis of the specific facts and circumstances.

26. When analyzing whether risks and rewards are retained or not, IAS 39 envisages different ways of conducting such analysis, even if a legal transfer of the rights to the cash flows has occurred. IAS 39 paragraph AG51 provides examples of situations where risks and rewards are retained such as: forward contracts, put or call options, total return swaps, interest rate swaps in some limited cases,

guarantees... Of course, not all exchanges will preclude de-recognition. Substance over form should be carefully assessed in every case.

View 1: outcome will depend on the analysis instrument by instrument

27. When assessing the variability in cash flows before and after the exchange, changes in the bonds characteristics (i.e. maturities, interest rates...) should be further analysed in order to determine whether a significant change in the exposure to variability has occurred. When such analysis is not conclusive, an entity should further look whether it retained control of the financial asset or not, as required by IAS 39 paragraph 20 (c). The outcome of such analysis might be different when performing the case on an instrument by instrument basis, because of the different characteristics of the original assets to be exchanged.

28. Some argue that when conducting such analysis, the fact that the cash flows of the new instruments are 53.5% lower due to the loss incurred should be taken into account and this is indicative for proving that significant changes have occurred. Others consider that this argument cannot be used because it has been assumed that partial derecognition is applicable in accordance with IAS 39 paragraph 16 and therefore each element of the transaction should be analysed independently.

View 2: entity has not transferred substantially all the risks and rewards

29. IAS 39 paragraph AG51 does not include explicitly an exchange of bonds as the paragraph does not try to include all types of ways of retaining risks and rewards. Since it refers to synthetic arrangements such as total return swaps which do not lead to de-recognition, it could be presumed that an actual bond swap would be treated similarly. This is an example in which a financial asset is transferred but simultaneously a total return swap is entered into. A total return swap can be considered in substance as being just a "synthetic" asset, therefore if a synthetic asset is enough to preclude derecognition, a "pure" or "real" asset received in exchange should preclude derecognition as well.

30. In the case of the exchange of the old Greek bonds for new Greek bonds with fixed interest rates and maturities of 11 to 30 years, the bondholder is still substantially exposed to the same risks and rewards, being mainly:

(a) similar credit risk related to exposure to the same counterparty Greek Government

(b) significant liquidity risk and

(c) similar market risk due to the long maturity of some of the new bonds with fixed interest rates.

On the basis of the elements included above, at least continuing involvement should be assessed and therefore the original asset is **not derecognized, but treated as a modification**.

D.2. Approach B

31. If it is considered that the exchange is not in the scope of IAS 39, a bondholder will apply IAS 8 paragraphs 10 to 12. These require management to use its judgement in developing and applying an accounting policy that results in information that is reliable and relevant to the economic decision making needs. In making this judgement, two views have been identified.

View 1: An entity will choose to apply analogy with financial liabilities de-recognition criteria

32. In applying IAS 8, an entity might find relevant to apply IAS 39 paragraph 40 provisions for financial liabilities. IAS 39 paragraph 40 states that an exchange between an existing borrower and lender of debt instruments with **substantially different terms** shall be accounted for as an extinguishment of the original financial liability and recognition of a new financial liability. Paragraph AG62 provides further detail on the way this should be evaluated, including a quantitative (10%) test.

33. In the case of the Greek exchange, the results of the quantitative test will depend on the characteristics of the portfolio of the old bonds. Among other elements, an entity will have to assess whether modifications of the maturity (new bonds mature between 11 and 30 years whereas previous bonds mature between 1 month to 15 years) and interest rates are considered significant.

34. The outcome might be different, either **de-recognition of asset or modification**, based on the analysis on an instrument by instrument basis.

35. There is some criticism against this view because de-recognition rules for financial assets and liabilities are based on different principles. Impairment rules exist for financial assets in order to reflect losses, while there is no equivalent on the financial liability side. Therefore, an analogy with financial liabilities should not be applied, as principles, objectives and underlying "philosophies" are different.

View 2: An entity will chose to look further to other guidance

36. In this view it is considered that IAS 39 does not provide sufficient elements to conclude on the accounting treatment, and an entity will apply IAS 8 paragraph 11 or 12 and use its judgement in developing and applying an accounting policy that results in information that is relevant to the economic decision making needs and reliable.

37. In doing so, IAS 8 paragraph11 and 12 consider the following sources:

(a) Requirements in IFRSs dealing with similar and related issues,

(b) The Framework,

(c) "Most recent pronouncements of another standard-setting body that uses a similar conceptual framework"

38. ESMA has not carried out further analysis in this respect.

E. Other matters to be analysed in relation to the exchange

39. This section deals with other specific matters identified as part of the analysis of the exchange.

Question 4: What is the accounting treatment if the bonds are not derecognised?

40. Two views seem possible regarding the accounting treatment in case the analysis concludes not to derecognise the bonds:

(a) Apply IAS 39 paragraph AG62: a modification of a liability has no profit and loss impact and the effect is dealt with through a modification of the effective interest rate and no profit and loss impact is accounted. The rationale for this view is to apply the analogy with a modification of a liability in full.

(b) Apply IAS 39 paragraph AG8: the carrying amount of the asset is recalculated by "computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss".

41. Whether (a) or (b) is applied would seem to depend on whether IAS 39 paragraph 17 or IAS 39 paragraph 40 has been applied.

42. In the case that the former bonds were classified as loans and receivables and the exchange is considered to be a modification, there is a question whether the bonds can continue to be classified as loans and receivables if the market of the new bonds is active,. The standard is silent on this point, leaving some to argue the bonds can still be loans and receivables, even if there is an active market.

Question 5: What is the accounting treatment of the new bonds in case there is derecognition?

43. IAS 39 paragraph AG 5 states that "in some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate". The question arises whether it is possible to apply this paragraph for the new Greek bonds. If so, in practice the effective interest rate will be lower than the effective interest rate computed without using AG5.

Question 6: What is the accounting treatment of the GDP linked securities?

44. IAS 39 does not define the meaning of a non-financial variable specific to a contract's party and does not indicate the accounting treatment for such instrument. Different views seem to exist with respect to the accounting treatment of the GDP linked securities.

45. In this case, the instrument is considered not being a derivative as the variable is a non-financial variable specific to a party to the contract (IAS 39 paragraph 9). The following options have been identified:

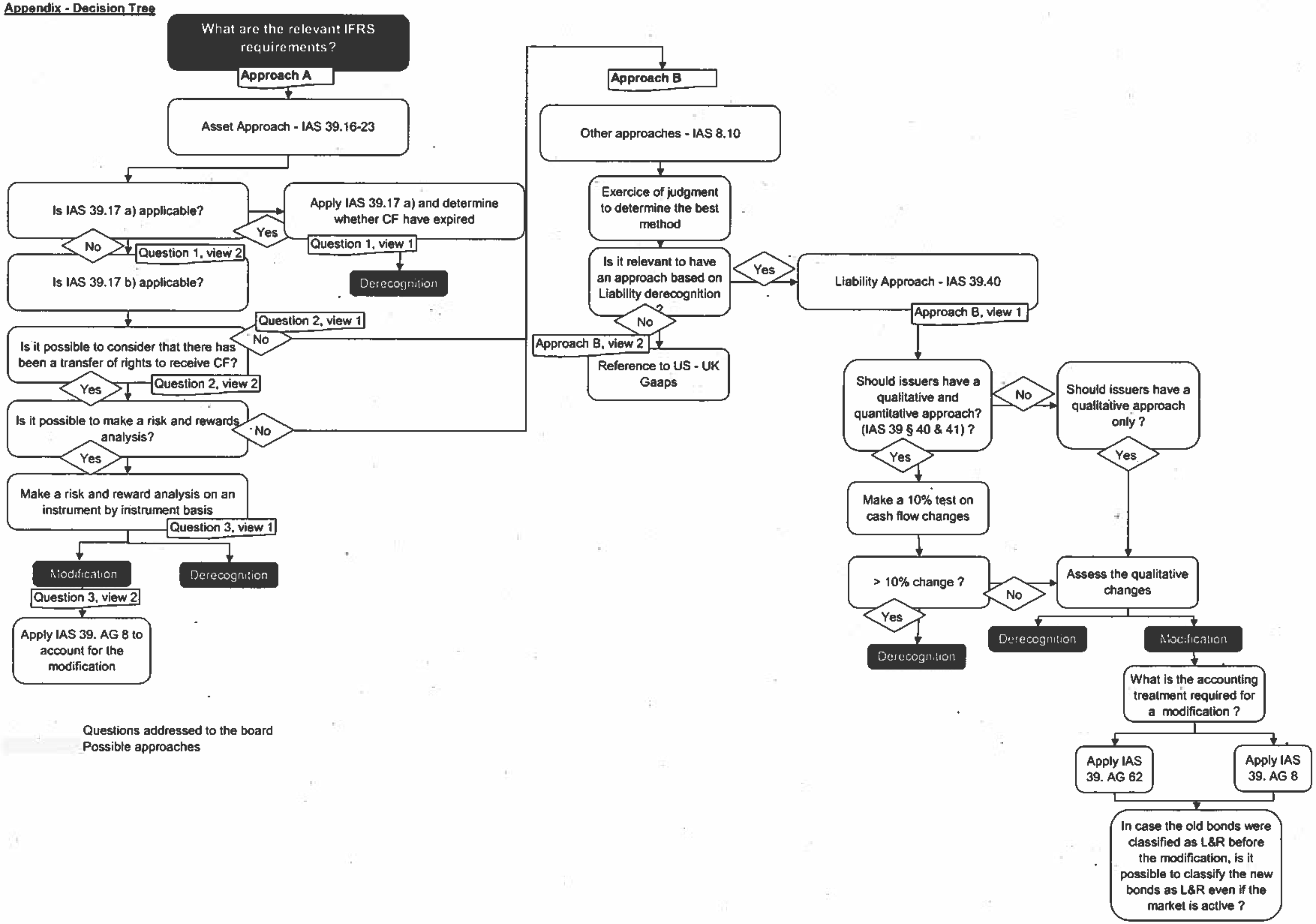
(a) The instrument is close to a derivative and it should be accounted at fair value through profit or loss;

(b) The instrument should be accounted at amortised cost and apply IAS 39 paragraph AG8 to account for the modification of cash-flows;

(c) The instrument should be classified as available for sale,

(d) The instrument is not in the scope of IAS 39 and the entity will apply IAS 18 - *Revenue* to recognise revenues from the instrument and IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* to account for an accrual if needed.

Appendix - Decision Tree


What are the relevant IFRS requirements?
Approach A
Asset Approach - IAS 39.16-23
Is IAS 39.17 a) applicable?
Yes
Apply IAS 39.17 a) and determine whether CF have expired
Question 1, view 1
Derecognition
No
Question 1, view 2
Is IAS 39.17 b) applicable?
Question 2, view 1
No
Is it possible to consider that there has been a transfer of rights to receive CF?
Yes
Question 2, view 2
Is it possible to make a risk and rewards analysis?
No
Yes
Make a risk and reward analysis on an instrument by instrument basis
Question 3, view 1
Modification
Derecognition
Question 3, view 2
Apply IAS 39. AG 8 to account for the modification
Approach B
Other approaches - IAS 8.10
Exercice of judgment to determine the best method
Is it relevant to have an approach based on Liability derecognition ?
Yes
No
Approach B, view 2
Reference to US - UK Gaaps
Liability Approach - IAS 39.40
Approach B, view 1
Should issuers have a qualitative and quantitative approach? (IAS 39 § 40 & 41) ?
No
Should issuers have a qualitative approach only ?
Yes
Yes
Make a 10% test on cash flow changes
> 10% change ?
No
Yes
Derecognition
Assess the qualitative changes
Derecognition
Modification
What is the accounting treatment required for a modification ?
Apply IAS 39. AG 62
Apply IAS 39. AG 8
In case the old bonds were classified as L&R before the modification, is it possible to classify the new bonds as L&R even if the market is active ?
Questions addressed to the board
Possible approaches