

The Deloitte logo is positioned in the top left corner. It features the word "Deloitte" in a white, sans-serif font, followed by a small green dot. The background of the entire page is a high-angle, panoramic view of a modern office building's interior, characterized by a curved glass wall and a polished floor that reflects the light. The view outside the window shows a city skyline at dusk or dawn, with a prominent skyscraper visible. The overall color palette is dominated by blues and greens, with a warm glow from the sun setting or rising. In the bottom right corner, there are several decorative elements: a series of green circles of varying sizes connected by a thin green line, and a larger, more complex graphic consisting of blue and green lines and circles that resemble a stylized path or data flow.

# Chapter 4

## How do securitizations fare under IFRS?

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### International securitization accounting—IFRS 9

The derecognition criteria under US GAAP was discussed in [chapter 3](#). But what about transfers involving companies following international standards? The securitization accounting framework under IFRS is included within IFRS 9, *Financial Instruments*.

#### Does IFRS 9 use the same control-based approach as ASC 860?

No. While ASC 860 focuses on whether a transferor has surrendered control over a financial asset, IFRS 9 applies a combination of risks and rewards and control tests. The risks and rewards tests seek to establish whether, having transferred a financial asset, the entity continues to be exposed to the risks of ownership of that asset and/or the benefits that it generates. The control tests are designed with a view to understanding which entity controls the asset (i.e., which entity can direct how the benefits of that asset are realized).

The use of both types of tests is often criticized for being a mix of two accounting models that can create confusion in application. IFRS 9 addresses this criticism by providing a clear hierarchy for application of the two sets of tests: risks and rewards tests are applied first, with the control tests used only when the entity has neither transferred substantially all the risks and rewards of the asset nor retained them.

Inherent in the IFRS 9 derecognition model is the notion of “stickiness”; it is more difficult to remove an asset from an entity's balance sheet than it is to recognize that asset in the first place. Derecognition cannot be achieved by merely transferring the legal title to a financial asset to another party. The substance of the arrangement must be assessed in order to determine whether an entity has transferred the economic exposure associated with the rights inherent in the asset (i.e., its risks and rewards) and, in some cases, control of those rights.

### What is the IFRS 9 framework for derecognition following a transfer?

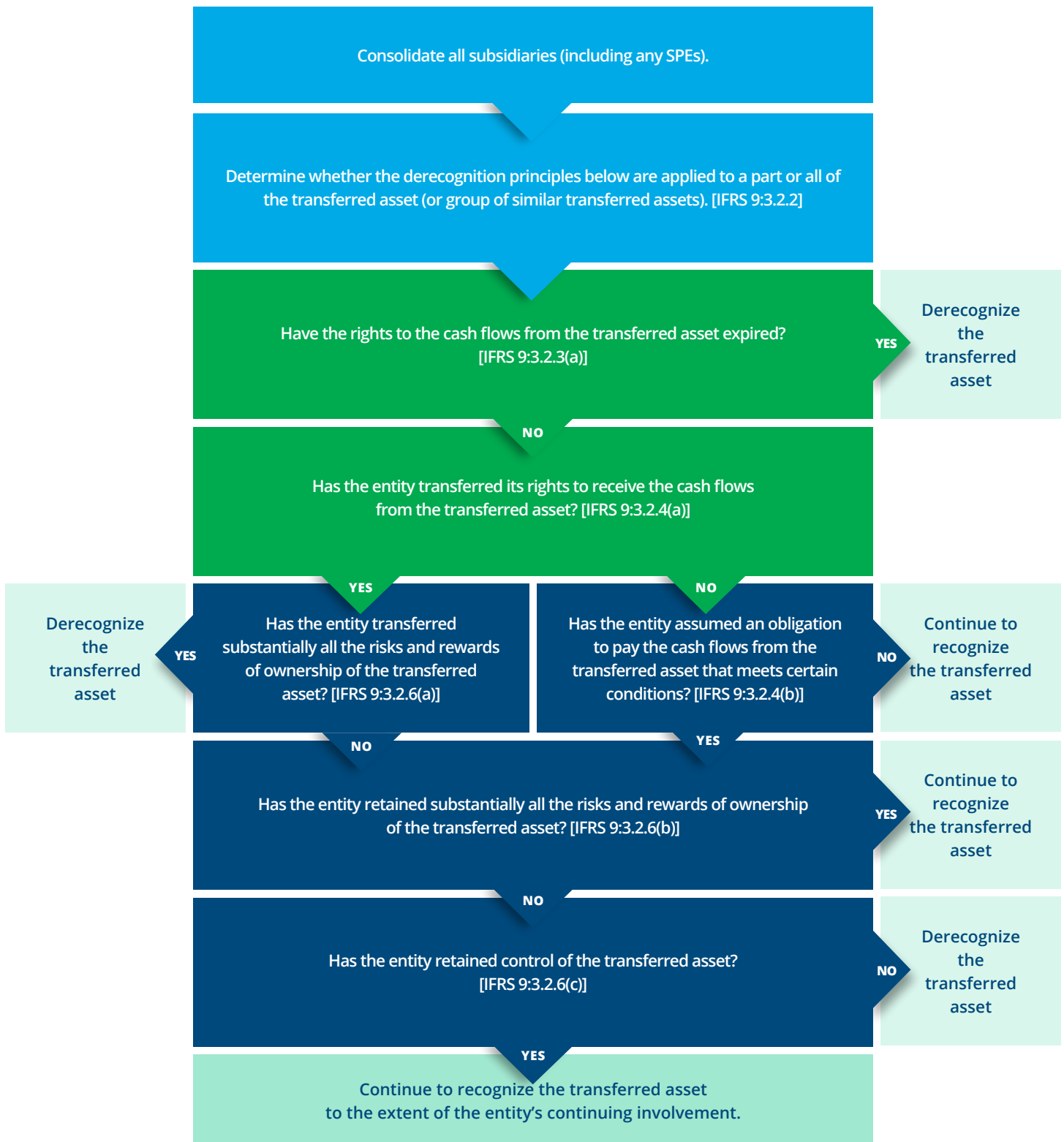
Whether a transfer qualifies for derecognition does not directly depend on whether the transfer is directly to investors in a single step or goes through an SPE that transfers assets or issues beneficial interests to investors.

Securitizers first consolidate all subsidiaries according to IFRS 10 (see [chapter 2](#)) and then evaluate the transaction in its totality. Whether the transfer qualifies for full, partial, or no derecognition will depend on the proportion of risks and rewards transferred to the investors compared to the amount retained by the transferor:

1. If substantially all the risks and rewards of ownership of the financial asset are transferred, the transferor derecognizes the financial asset and recognizes separately as assets or liabilities any rights and obligations created or retained in the transfer.
2. If substantially all the risks and rewards of ownership of the financial asset are retained (e.g., the transferor continues to absorb most of the likely variability in net cash flows), the transferor continues to recognize the financial asset and any associated liability for the proceeds.
3. If neither the transferee nor the transferor has substantially all the risks and rewards of ownership (e.g., a significant amount, but not substantially all, of the risks and rewards has been passed), the transferor either:
  - Derecognizes the transferred assets as in (1) above, if the transferor has not retained control of the financial assets, or
  - Continues to recognize the financial assets only to the extent of its continuing involvement in them, if the transferor has retained control of them.



## IFRS 9 derecognition decision tree



### Step 1: Have I consolidated all subsidiaries, including any SPEs?

See [chapter 2](#) for a discussion of the consolidation requirements under IFRS.

### Step 2: Do I look at the entire asset or just the transferred portion?

The second step is determining exactly what is being considered for derecognition purposes. Specifically, this involves determining whether a whole financial asset, a group of financial assets, a part of a financial asset, or a part of a group of similar financial assets is being evaluated for derecognition.

A part of a financial asset (or a group of similar financial assets) is considered separately for derecognition only if it comprises: (1) specifically identified cash flows (e.g., an IO or principal-only strip), (2) a fully proportionate (pro rata) share of the cash flows (e.g., rights to 90 percent of all cash flows of a financial asset), or (3) a fully proportionate (pro rata) share of specifically identified cash flows (e.g., 90 percent of the cash flows of an IO strip). In all other cases, the financial asset (or assets) is considered in its entirety.

For example, if an entity transferred to a securitization trust all the principal and all but 1 percent of the interest flows from a pool of financial assets, and the retained interest strip was *pari passu* with the transferred interest cash flows, the transferred interest receipts and all of the principal would be the financial asset for which the transfer would be evaluated. On the other hand, if the 1 percent interest strip was subordinated for purposes of providing credit enhancement to the investors' principal, then the entire asset (e.g., pool of loans) would be the financial asset for which the transfer would be evaluated. These conclusions are not affected by whether the trust issued to outside investors' various classes of beneficial interests to achieve credit or time tranching.

IFRS 9 does not provide guidance on what makes assets "similar." Similar generally means that the two instruments have contractually specified cash flows similar in amounts, timings, and risk characteristics. Consideration should be focused on the similarity of terms such as prepayment features, interest rates, and currency denomination. By definition, there will always be some differences between similar instruments—otherwise they would be identical. A portfolio of mortgages transferred by a bank is often deemed to

contain similar financial assets. Similarly, a portfolio of corporate bonds transferred by a bank is often deemed to contain similar financial assets. However, no two portfolios are ever precisely alike. A transfer of a portfolio of mortgages would need to be assessed separately from a transfer of a portfolio of corporate bonds even if the two transfers are made at the same time.

### Step 3: Have the rights to the cash flows from the asset expired?

A financial asset is derecognized when the rights to the cash flows from that asset expire. The rights to the cash flows expire when, for example, a financial asset reaches its maturity and there are no further cash flows arising from that asset, or a purchased option reaches its maturity unexercised. An entity may have a right to receive certain or all cash flows from a financial asset over a specified period of time, which may be shorter than the contractual maturity of that financial asset. In that case, the entity's right to the cash flows expires once the specified period expires.

### Step 4: Have I transferred my rights to receive the cash flows from the asset?

A transfer may involve transferring the contractual rights to the cash flows of a financial asset, or it may involve retaining the contractual rights to the cash flows, but assuming a contractual obligation to pass on those cash flows to other recipients (i.e., a pass-through arrangement). In a pass-through arrangement, the transaction is treated as a transfer of a financial asset if, and only if, all of the following conditions are met:

- There is no obligation to pay amounts to the eventual recipients unless equivalent collections are received from the original asset.
- The terms of the transfer arrangement prohibit selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows (i.e., no control of the future economic benefits associated with the transferred asset).
- An obligation exists to pass on or remit the cash flows that the entity has collected on behalf of the eventual recipients without material delay and is prohibited from reinvesting the cash flows received in the short settlement period between receiving them and remitting them to the eventual recipient in anything other than cash or cash equivalents, and any interest earned on such investments must be passed on to the eventual recipients.

## Outright transfers of contractual rights

### What if I don't transfer legal title to the asset(s)?

In 2006, the International Accounting Standards Board (IASB) considered a number of derecognition issues, including whether any transfer in which legal ownership of the asset is not transferred can be considered an outright transfer of contractual rights under IFRS 9:3.2.4(a). In other words, would the pass-through test be applicable to all transfers in which legal ownership of the financial asset is not transferred? The IASB indicated that a transaction in which an entity transfers all the contractual rights to receive the cash flows, without necessarily transferring legal ownership of the financial asset, would not be treated as a pass-through pursuant to IFRS 9:3.2.4(b) and would be considered an outright transfer of contractual rights. An example might be a situation in which an entity transfers all the legal rights to specifically identified cash flows of a financial asset (e.g., a transfer of the interest or principal of a debt instrument). Conversely, application of the pass-through test would be required in situations in which the entity does not transfer all the contractual rights to cash flows of the financial asset, such as disproportionate transfers. The IASB's view on this issue would mean that in a transfer of all the legal rights to cash flows for a full proportionate interest in an asset (say, 50 percent of all cash flows), even though legal title of the asset was not transferred to the transferee, the transferor would apply the outright transfer test to the transfer and would, therefore, avoid the pass-through tests in IFRS 9:3.2.4(b).

### What if the transfer involves conditions?

The IASB has also previously considered whether conditional transfers should be treated as pass-through transactions. Conditions attached to a transfer could include provisions ensuring the existence and value of transferred cash flows at the date of transfer or conditions relating to the future performance of the asset. The IASB indicated that such conditions would not affect whether the entity has transferred the contractual rights to receive cash flows. However, the existence of conditions relating to the future performance of the asset might affect the conclusion related to the transfer of risks and rewards (as further discussed below) as well as the extent of any continuing involvement by the transferor in the transferred asset.

### Can I retain servicing rights?

IFRS 9:3.2.4(a) focuses on whether an entity transfers the contractual rights to receive the cash flows from a financial asset. The determination as to whether the contractual rights to cash flows have been transferred is not affected by the transferor retaining the role of an agent to administer collection and distribution of cash flows. Retention of servicing rights by the entity transferring the financial asset does not, in itself, cause the transfer to fail the requirements in IFRS 9:3.2.4(a). However, careful judgment must be applied to determine whether the entity



providing servicing is acting solely as an agent for the owner of the financial asset (i.e., whether it has transferred all risks and rewards). The existence of servicing does not prevent an entity from transferring the contractual rights to the cash flows of the asset under IFRS or US GAAP.

A transferor may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an IO strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an IO strip receivable. The fair values of the servicing asset and IO strip receivable are used to allocate the carrying amount of the receivable between the part of the larger asset that is derecognized and the part that continues to be recognized. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognized at fair value.

## Pass-through arrangements

### Does the possibility of default by the transferor matter?

The likelihood that the transferor will default under a pass-through arrangement as a result of a default on other creditor obligations is not considered an impediment to meeting the pass-through criteria because the transferor is assumed to be a going concern. In most instances, the transferee will limit this risk by ensuring that the transferred assets reside in a bankruptcy-remote SPE so that the wider credit risk of the transferor is not borne by the transferee.

**What about inclusion of credit enhancement?**

A transferor may provide credit enhancement in a transfer arrangement so that it suffers the first loss on the asset up to a specified amount. In these circumstances, if the debtor fails to pay, the transferor absorbs the first loss fully, with the eventual recipient suffering a loss only after the first loss has been fully absorbed. A credit enhancement may be in the form of overcollateralization or may be in the form of purchasing a subordinated interest in a consolidated SPE (in the latter case, the entity is applying the pass-through tests at a consolidated level). Providing credit enhancement will not, in itself, result in failure of the pass-through tests if all cash received by the transferor on transferred assets is paid on to the eventual recipient, although the credit enhancement may result in failure of derecognition due to the transferor retaining substantially all the risks and rewards of ownership of the assets (see further discussion below on consideration of retaining risks and rewards). The pass-through tests must be considered prior to considering the entity's exposure to risks and rewards.

If a greater amount of cash is realized on the assets than is needed to pay the eventual recipient (i.e., the eventual recipient's initial investment is fully paid), then the entity will retain the remainder of the cash and will not pass it on. In all cases, the entity passes any cash it collects on behalf of the eventual recipients.

**How is "without material delay" interpreted?**

"Without material delay" does not mean instantaneously, nor does it imply an extended length of time. The contractual arrangement will need to be considered in full in order to make an assessment as to whether the time frame between the collection of cash flows on the underlying assets and the point at which they are passed on to the eventual recipients is material in the context of the contractual arrangements of the transfer.

In some arrangements, the cash collected on the underlying assets occurs sporadically throughout a period of time. For example, if an entity retains the rights to the cash flows arising on a group of credit card receivables, the payments arising on those credit cards are likely to occur on any given day throughout the

month. The contractual arrangement of the transfer may require that those cash flows are remitted to the eventual recipients weekly, monthly, quarterly, or even annually. There is a trade-off between passing on the cash flows almost as soon as they arise and the administrative burden that goes along with passing on those cash flows. It is likely that biannual payments to the eventual recipients (and certainly annual payments) would be considered to be subject to a material delay because the conditions specified above fail and, therefore, derecognition would be inappropriate in these circumstances. It appears reasonable that the entity can invest the cash flows from the assets for up to three months without breaching the condition that all cash flows must be passed to the eventual recipient without material delay.

Any significant delay in passing on the cash flows of a transferred asset alters the credit risk characteristics for the eventual recipient when compared to the original transferred asset. The holder is exposed not only to the original transferred asset but also to additional credit risk from the reinvestment of the cash flows from the original asset.

**How does this apply to revolvers?**

In a revolving structure, cash received on the assets is reinvested in buying new receivable assets. In other words, cash revolves into new assets instead of being returned immediately to the investors. Upon maturity, the reinvested assets are used to repay the beneficial interest holders. Such revolving structures generally do not meet the pass-through tests because they involve a material delay before the original cash is passed on to the eventual recipients, and the reinvestment would typically not be in cash or cash equivalents.

**Step 5: Have I transferred substantially all of the risks and rewards of ownership of the asset?**

Determining the extent to which the risks and rewards of the transferred asset have been transferred and retained is critical in determining the accounting outcome for a transfer. The greater the risks and rewards retained, the greater the likelihood of continued recognition. The degree to which risks and rewards have been transferred and its effect on the accounting outcome can be illustrated in the table below.

Situation		Accounting
Substantially all risks/rewards transferred		Derecognize old assets
More risk/reward transferred to investors	Control passed—transferee can unilaterally sell entire asset	Recognize any new assets and liabilities
	Control retained	Recognize assets and liability up to continuing involvement level plus any retained interest
Substantially all risks/rewards retained		Recognize all assets, proceeds are liability



When an entity transfers substantially all of the risks and rewards of ownership of the financial asset, the asset should be derecognized. The entity may have to recognize separately any rights and obligations created or retained in the transfer.

IFRS 9 provides three examples of transferring substantially all the risks and rewards of ownership:

1. Unconditionally selling a financial asset.
2. Selling a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase.
3. Selling a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiring).

In the first example, it is clear that there has been a transfer of all the risks and rewards of ownership of the asset. In the second example, the entity has sold the asset and, although it can call the asset back, this can only be done at the fair market value of the asset at the time of reacquisition. The entity is in the same economic position as having sold the asset outright, with the ability to go into the market to reacquire the asset (i.e., it has transferred the full price risk of the asset). In the third example, the option is highly unlikely ever to be exercised and has very little value, which is substantially the same economic position as an unconditional sale.

There is no bright line provided in IFRS 9 as to what is meant by a transfer of “substantially all” of the risks and rewards of ownership, and a significant degree of judgment is required when applying the risks and rewards test. There are other references in IFRS 9 to various yardsticks that need to be met when applying certain paragraphs. For example, when comparing the old and new terms of a financial liability, the terms are considered to be “substantially different” if the present value of the cash flows under the new terms is at least 10 percent different from the discounted present value of the remaining cash flows of the original financial liability. While IFRS 9 does not apply the 90 percent test to derecognition of financial assets, it would seem imprudent to conclude that substantially all the risks and rewards of ownership have been transferred when the computations show that the entity still retains more than 10 percent of the exposure to the variability in present value of the expected future cash flows post-transfer.

IFRS 9 acknowledges that in many cases it will be clear whether or not substantially all of the risks and rewards of ownership have been transferred. When it is unclear, then an entity will have to evaluate its exposure before and after the transfer by comparing the variability in the amounts and timing of the net cash flows of the transferred asset. If the exposure to the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer, then the entity has not transferred substantially all of the risks and rewards of ownership.

Typical risks included in a risk-and-reward analysis are interest rate risk, credit risk (i.e., risk of default), prepayment risk, late-payment risk, and currency risk. The overall securitization has liquidity risk associated with the fact that there is a mismatch in the timing of cash inflows and outflows. It is important to recognize that liquidity risk arising in the securitization entity from differences in the contractual timing of cash flows of the assets and the notes issued to acquire the assets is not part of the transferred asset. This compares to late-payment risk and credit default risk, which are inherent in the asset. However, if an asset pays late, the transferee may not be able to meet its obligations under the notes. This liquidity risk is not part of the transferred asset because it arises only when the assets are placed inside the securitization entity. The liquidity risk associated with late-payment risk is, therefore, not included in the transferor’s risks and rewards assessment in determining derecognition for the transferor. However, the impact of liquidity risk would be included as part of the risks and rewards analysis of the securitization entity in determining whether an entity should consolidate the securitization entity. Derivatives are also often included in contractual arrangements that transfer financial assets and may affect the analysis of whether the risks and rewards of those assets have been transferred. Their presence and contractual terms may not be obvious, and careful review of all the terms of the transfer agreement is required.

The computational comparison is an expected value approach (i.e., all reasonably possible outcomes should be considered, with a greater weight given to those outcomes that are more likely to occur and considering all risks inherent in the expected cash flows) using a discount rate based on appropriate current-market interest rates. There is no example in IFRS 9 of the methodology to be used in performing the risks and rewards assessment. Whichever methodology is used, it should be applied consistently to all transfers that are similar in nature (i.e., one can’t simply “cherry pick” the methodology that indicates the desired degree of transfer of risks and rewards). A common approach is to use a standard deviation statistic as the basis for determining how much variability has been transferred and retained by the transferor. To apply this approach, the transferor will need to consider various future scenarios that will impact the amount and timing of cash flows of the transferred assets and calculate the present value of these amounts both before and after the transfer. In the case of a transfer of debt instruments, scenarios will incorporate, among other factors:

- Changes in the amount of cash flows due to changes in the rate of default by the borrower and recovery of any collateral in the case of default.
- Changes in the timing of when cash flows are received due to changes in prepayment rates.

The expected cash flows on the transferred assets will be allocated to the transferor and the transferee based on the rights and obligations following the transfer. For example, if the transferor guarantees part of the transferred assets or invests in a subordinated loan, a subordinated IO strip or excess spread issued by the transferee, this will result in some of the exposure to the assets coming back to the transferor.

The transferor will need to assess the probability of the various scenarios occurring so that it can take the various present values described above and multiply them by those probabilities in order to determine probability-weighted present values. These values are used for calculating the standard deviation, which can be thought of as the exposure, or volatility, that the transferor has to the transferred asset both before and after the transfer. This will form the basis for judging whether the transferor has retained or transferred substantially all the risks and rewards of ownership of the transferred assets.

### Example

Entity A has a portfolio of similar prepayable fixed-rate loans with a remaining maturity of two years and a coupon and effective interest rate of 10 percent. The principal and amortized cost is \$10,000. On 1/1/X0, Entity A transfers the loans for cash consideration of \$9,115 to Entity B, an entity not consolidated in Entity A's consolidated financial

statements. In order to acquire the loans, Entity B issues a senior note, linked to the performance of the transferred assets, to third parties where the holders of the notes obtain the right to \$9,000 of any collections of principal plus interest thereon at 9.5 percent. Entity A agrees to retain rights to \$1,000 of any collections of principal plus interest thereon at 10 percent, plus the excess spread of 0.5 percent on the remaining \$9,000 of principal. Collections from prepayments are allocated between the transferor and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from Entity A's retained interest of \$1,000 until that interest is exhausted. Entity A's retained interest is therefore subordinate to the senior notes because it suffers the loss of any defaults on the transferred assets prior to the holders of the senior notes. Interest is due on the transferred assets annually on the anniversary of the date of transfer.

In order to determine the extent to which Entity A has retained the risks and rewards of the transferred assets, Entity A considers a number of scenarios where amounts and timings of cash flows on the transferred assets vary and assigns a probability for each scenario occurring in the future. For illustrative purposes, only four scenarios are included in the table that follows, although, in practice, a larger number of scenarios is likely to be required. A risk-free rate of 8.5 percent is used to determine net present values.



Note: The net present values for each scenario are multiplied by the probability of each scenario to determine a probability-weighted present value. The variance before and after the transfer is determined using the probability-weighted present values as illustrated below.

Probability-weighted present value (using 8.5% risk-free discount rate) <sup>1</sup>				
Scenario	Probability	Total loans	Transferred senior	Retained subordinate & IO
1	20%	\$2,000	\$1,800	\$200
2	30%	3,041	2,725	316
3	30%	3,079	2,747	332
4	20%	1,980	1,817	163
<b>Total</b>		<b>\$10,100</b>	<b>\$9,089</b>	<b>\$1,011</b>

Probability-weighted squared deviations <sup>2</sup>				
Scenario	Probability	Total loans	Transferred senior	Retained subordinate & IO
1	20%	\$2,000	\$1,584	\$24
2	30%	403	10	538
3	30%	8,003	1,374	2,746
4	20%	8,000	3	7,683
<b>Total variance</b>		<b>\$18,406</b>	<b>\$2,971</b>	<b>\$10,991</b>
Standard deviation (square root of variance)		\$136	\$55	\$104

Entity A determines whether substantially all of the risks and rewards of ownership of the transferred assets are retained by dividing the variability retained after the transfer by the variability of the portfolio as a whole ( $\$104/\$136 = 76$  percent). Consequently, Entity A concludes that substantially all the risks and rewards of ownership are neither transferred nor retained. Entity A would then need to address whether it has control of the transferred asset (described in detail further below) to determine whether Entity A can derecognize the asset in full or continue to recognize its continuing involvement in the transferred assets.

It is worth noting that the sum of variability of Entity A after the transfer (\$104) plus variability of the senior note holders (\$55) is greater than the variability of the portfolio as a whole (\$136). This arises because the portfolio of loans as a whole has less risk due to the diversification of the loans within the portfolio. Some of this diversification is reversed when the portfolio is split into pieces. More complex mathematical techniques can be applied to show Entity B's variability to the loans after transfer that includes the diversification effect that exists in the portfolio prior to the transfer. Such techniques are beyond the scope of this manual.

If a transfer results in a financial asset being derecognized in its entirety, but the transferor obtains a new financial asset or assumes a new financial liability, or a servicing liability, the transferor recognizes those new assets, liabilities, or servicing at fair value, and any resulting gain or loss is reflected in current earnings. If the asset derecognized was part of a larger financial asset, the carrying amount of the larger asset is allocated between the part sold and the part retained based on their relative fair values as of the transfer date.

#### Step 6: Have I retained substantially all of the risks and rewards of ownership?

The previous section discussed how to perform the "substantially all" risks and rewards assessment. If substantially all of the risks and rewards of ownership of a financial asset have been retained, one would continue to recognize that financial asset.

IFRS 9 provides examples of retaining substantially all the risks and rewards of ownership, including:

- a) Selling and repurchasing the same financial asset where the repurchase price is a fixed price or the sale price plus a lender's return.

<sup>1</sup> For example, under Scenario 2, the loan pays a total of \$11,000 one year from today. Of that amount, \$9,855 is paid to the senior interests, and \$1,145 is retained by the subordinated interests. The present values of those amounts, discounted for one year at 8.5 percent, are \$10,138, \$9,083, and \$1,055, respectively. Weighting each by the 30 percent probability assigned to Scenario 2 gives us \$3,041, \$2,725, and \$316, respectively.

<sup>2</sup> For example, the deviation of the total loan amount in Scenario 1 from the overall average is the difference between \$10,000 and \$10,100, which equals \$100. Squaring that deviation gets us to \$10,000, and weighting it by the 20 percent probability of Scenario 1 yields \$2,000.



- b) Lending securities.
- c) Selling a financial asset together with a total return swap that transfers the market risk exposure back to the seller.
- d) Selling a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiring).
- e) Selling short-term receivables with a guarantee by the seller to compensate the transferee for credit losses that are likely to occur.

Derivatives commonly found in transfers of financial assets include put options, call options, forward or repurchase contracts, forward sales contracts, and swap agreements. Put options provide the transferee with the right to require the transferor to repurchase some or all of the financial assets that were sold (e.g., to repurchase delinquent receivables). Call options provide the transferor with the right to repurchase some or all of the financial assets sold to the transferee. Forward or repurchase agreements require the transferee to sell and the transferor to buy some or all of the financial assets that were sold before their scheduled maturity. Forward sales contracts require the transferor to sell and the transferee to buy additional financial assets in the future. Swap agreements effectively change one or more cash flows of the underlying transferred assets (or debt issued by a special purpose entity). For example, an interest-rate swap may convert a variable-rate asset to a fixed-rate asset.

Derivatives can operate automatically or require exercise by one of the parties; they can be exercised freely or only after the occurrence of a future event. Such a future event may be certain of occurring (e.g., the passage of time), or may be conditional upon another event (e.g., a loan becoming delinquent). For conditional events, the certainty of occurrence varies—their occurrence may be considered to be probable, possible, or remote. The exercise price of a derivative can be fixed above, below, or equal to the market value of the financial assets at inception or it can be variable, equal to the market value at exercise date, or the result of a formula that is a function of market conditions or other future events. Derivatives can be combined to form different types of derivatives. Each of these factors impacts the extent to which risks and rewards have been retained by the transferor.

A fixed-price repurchase transaction, in essence, establishes a lending arrangement where the transferor is always going to reacquire the asset in the future. The fixed price is usually set to reflect the cost of borrowing over the period of the transaction. Because the transferor is required to reacquire the asset for a fixed price, the transferor is exposed to the market risk of the asset. The same analysis would apply to a securities lending transaction.

A sale of a financial asset combined with a total return swap that transfers the market risk of the asset back to the transferor also establishes what, in essence, is a lending arrangement. Under the terms of total return swaps, the transferor usually pays an amount

equivalent to a borrowing rate to the transferee over time, and the transferee will settle with the transferor amounts based on the performance of the asset. For example, in the transfer of an equity security with a total return swap, if the equity price goes up, the transferor receives the benefits of the rise in value of the transferred equity security from the transferee and pays an amount equivalent to a borrowing rate to the transferee. And if the equity security price decreases, the transferor pays an amount equivalent to a borrowing rate and, in addition, pays an amount equivalent to the fall in value of the equity security. The transferor continues to be exposed to the market risk in the equity security price after the transfer and therefore has retained substantially all of the risks and rewards of ownership of the asset.

When an entity sells an asset but retains the right to buy the asset back at a price that is sufficiently low that the option is highly likely to be exercised (e.g., a deep-in-the-money option), the entity retains substantially all the risks and rewards of ownership. Similarly, when an entity sells an asset and gives the transferee the right to put the asset back at a sufficiently advantageous price so that the option is likely to be exercised, the entity retains substantially all the risks and rewards of ownership. However, the same analysis is not appropriate when the option is not deep in the money and further derecognition tests should be applied.

If the transferor has retained substantially all the risks and rewards of ownership, derecognition of the financial asset does not occur, and the transferor continues to recognize the transferred asset in its entirety. The transferor also records a financial liability for the consideration received. Going forward, the transferor continues to recognize any income on the transferred asset and any expense incurred on the financial liability. The asset and liability are not offset, and there is no offsetting of income from the transferred asset against expense incurred from the associated liability. If the transferred asset is measured at amortized cost, the option in IFRS 9 to designate a financial liability at fair value through profit or loss is not permitted for the associated liability.

For transfers that do not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if doing so would result in recognizing both the derivative and either the transferred asset or the liability arising from the transfer twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being derecognized and therefore would not be separately recognized as a derivative asset. Also, the transferee does not recognize the transferred asset as its own asset. The transferee derecognizes the consideration paid and recognizes a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.

### Step 7: I have neither transferred nor retained substantially all risks and rewards. What now?

If an entity has neither transferred nor retained substantially all of the risks and rewards of ownership of transferred assets, an assessment as to whether or not it has retained control of the asset is then required. A financial asset is controlled when an entity has the ability to sell the asset. When the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without the imposition of additional restrictions on the transfer, the transferee controls the asset and, therefore, the transferor must have relinquished control.

When the transferred asset is traded in an active market, the transferee generally has the practical ability to sell the asset. This is because there is a ready market and the transferee can repurchase the asset if and when it is required to return the asset back to the transferor. However, the fact that the transferred asset is traded in an active market is not in itself sufficient to conclude that the transferee has the “practical ability” to sell the asset. For example, the settlement terms of repurchase, which are driven by the market conventions, may differ significantly from the settlement terms in the transfer agreement such that the transferee will not be able to gain access to the asset quickly enough to deliver the asset to the transferor so as to comply with the contractual provisions of the transfer agreement. In this case, the transferee is forced to hold the asset in order to ensure that it can deliver the asset back to the transferor when required.

Other factors may affect the entity’s practical ability to sell an asset:

- A financial asset that would satisfy the call option or forward contract may have to be purchased from a third party at a price significantly above its estimated fair value, thus indicating that the assets are not liquid.
- Financial assets available to satisfy the call option or forward contract may be held by one or a small number of investors, thus indicating that the assets are not liquid.
- The quantity of financial assets necessary to satisfy the call option or forward contract may be too large compared to that traded in the market, and the terms of the transfer do not allow delivery of the assets over a period of time.

Intuitively, the wider the range of assets that may be used to satisfy the call option, the more likely it is that the entity has the practical ability to sell the asset. For instance, assets identical to those originally transferred may not be readily obtainable; however, if the call option permits delivery of assets that are similar to the transferred assets, they may be readily obtainable. When a call option permits settlement in cash as an alternative to delivering the financial asset, and the cash settlement alternative does not contain an economic penalty rendering it unfeasible, the transferee has the practical ability to sell the asset as cash, which is a readily obtainable asset.

Unilateral and unrestricted ability to sell means that there can be no strings attached to the sale. If the transferee has to attach a call option over the asset when it sells it, or introduce conditions over how the asset is serviced, in order to satisfy the terms of the original transfer, then “strings” exist and the test of practical ability is not met.

The “strings” can be created by other instruments that form a contractual part of the transfer arrangement and are sufficiently valuable to the transferee, so that if the transferee were to sell the asset, it would rationally include similar features within that sale. For example, a guarantee may be included in the initial transfer and may have such potential value to the transferee that the transferee would be reluctant to sell the asset and forgo any payments that may fall due under the guarantee. The transfer agreement may have an explicit restriction that prohibits the transferee from selling the asset. When that restriction is removed or lapses, and, as a result, the transferee has the practical ability to sell the asset, derecognition would be appropriate.

The fact that the transferee may or may not choose to sell the asset should not form part of the decision-making process; it is the transferee’s practical ability to do so that is important. If control of the financial asset is not retained, the financial asset is derecognized, and any rights and obligations created or retained in the transfer would be separately recognized.



If control of the financial asset is retained, the financial asset should continue to be recognized to the extent of the continuing involvement in the financial asset. Continuing involvement represents the extent to which the transferor continues to be exposed to the changes in the value of the transferred asset. A corresponding liability is also recognized and measured in such a way that the net carrying amount of the asset and the liability is:

- The amortized cost of the rights and obligations retained, if the asset is measured at amortized cost, or
- The fair value of the rights and obligations retained, if the asset is measured at fair value.

The liability that is recognized at the date of transfer will not necessarily equate to the proceeds received in transferring the asset, which would ordinarily be the case if the asset continued to be fully recognized and the proceeds received were recognized as a collateralized borrowing. In some cases, the liability appears to be the “balancing figure” that results from applying the specific guidance for continuing involvement accounting. IFRS 9 acknowledges that measuring the liability by reference to the interest in the transferred asset is not in compliance with the other measurement requirements of the standard. This requirement for consistent measurement of the asset and the associated liability means that the entity is not permitted to designate the liability as at fair value through profit or loss if the transferred asset is measured at amortized cost.

The entity cannot offset the asset and the associated liability, and any subsequent changes in the fair value of the asset and the liability are measured consistently. Any income on the asset to the extent of the entity’s continuing involvement and any expense incurred on the associated liability are also not offset.

When an entity transfers assets but retains a guarantee over the transferred assets that absorb future credit losses, and that guarantee (as well as other continuing involvement) results in the transferor neither transferring nor retaining substantially all the risks and rewards of ownership, the transferor must recognize the guarantee as part of its continuing involvement. Assuming, for illustrative purposes only, that the guarantee represents the transferor’s only continuing involvement in the transferred asset, then:

- The transferred asset at the date of transfer will be measured at the lower of: (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay, and
- The associated liability is measured initially at the amount in (ii) above plus the fair value of the guarantee.

The initial fair value of the guarantee is recognized in profit or loss on a time-proportion basis in accordance with IFRS 15, *Revenue from Contracts with Customers*, and the carrying amount of the asset is reduced by any impairment losses.

## What are some common forms of “continuing involvement”?

### Cleanup calls

The servicer of transferred assets, which may be the transferor, may hold either of two types of options to reclaim previously transferred assets. A removal-of-accounts provision is an option to repurchase assets, usually subject to certain limitations on how the particular assets are selected for call, how frequently, and in what total amount the call can be exercised. A cleanup call is an option to purchase remaining transferred financial assets if the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a removal-of-accounts provision or cleanup call results in the transferor neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.

### Amortizing interest rate swaps

A transferor may transfer a fixed-rate financial asset that is paid off over time and enter into an amortizing interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate. If the notional amount of the swap amortizes such that it equals the outstanding balance on the transferred financial assets at any point in time, the swap would generally result in the transferor retaining substantial prepayment risk. As such, the transferor either continues to recognize the entire transferred asset or continues to recognize the transferred asset to the extent of its continuing involvement. However, if the amortization of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the transferor retaining prepayment risk on the asset. Therefore, it would not preclude derecognition of the transferred asset if the payments on the swap are not conditional on interest payments being made on the transferred asset, and the swap does not result in the transferor retaining any other significant risks and rewards of ownership.

### Subordinated retained interests and credit guarantees

The transferor may provide credit enhancement by subordinating some or all of its interest retained in the transferred asset. Or, the transferor may provide a credit guarantee that could be either unlimited or limited. If the transferor retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognized in its entirety. If the transferor retains some, but not substantially all, of the risks and rewards of ownership and has retained control, the transferor continues to recognize the assets to the extent of the amount of cash or other assets that the transferor could be required to pay.

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