Impact of new accounting standards on the Financial and Wealth Accounts

Introduction

Over the course of 2011 to 2013, many Canadian companies presently reporting their financial statements under Canadian Generally Accepted Accounting Principles (CGAAP) will be switching to the International financial reporting standards (IFRS) as set forth by the International Accounting Standards Board. Most federally regulated entities are required to implement IFRS for their fiscal year commencing in 2011. Of particular interest to the Canadian System of National Accounts is how this change-over will affect the way in which Canadian corporations value and report assets and liabilities on their balance sheets.

One important change concerns the recording of securitized receivables as well as the associated asset-backed securities (ABS). This note provides a brief explanation of the impact that this transition, beginning in the first quarter of 2011, will have on the Canadian Financial Flow Accounts and the National Balance Sheet Accounts (NBSA) estimates.

Securitization

In securitization, companies raise funds through the issuance of debt (asset-backed securities) that is secured by their receivables (securitized assets). For example, when a bank issues a mortgage to a homeowner, the bank has an asset (the mortgage) and the homeowner has a liability (the mortgage). The bank, either on its own or through a third party, can then take this mortgage and package it with other mortgages, then issue an asset-backed security. The periodic payments from the mortgages provide the regular income stream to back the periodic coupon and/or maturity payments of the ABS. Like a bond, the ABS can be structured to have specific yield and maturity characteristics and can be sold to an investor.

Under the outgoing CGAAP, through the process of securitization and due to the subsequent sale of the corresponding debt or ABS, the originators of ABS do not report the securitized receivables and the corresponding securities on their own balance sheets. Under the incoming IFRS, these ABS and receivables will now be reported on the balance sheets of the companies themselves, as the originators of the ABS.

This is an important change in financial reporting. As mentioned, currently the transfers of receivables off balance sheet are reported as sale transactions, but this will not be the case under IFRS. The consolidation on the originators' balance sheets will be the biggest change with respect to the Financial Flow Accounts and the National Balance Sheet Accounts. It is important to note that at the economy-wide level, neither lending via credit markets nor credit market debt will change; only the sectoral composition or distribution of the credit market assets and liabilities will be affected.

Securitized assets are reported to Statistics Canada through the Quarterly Survey of Securitized Receivables and Asset-Backed Securities. This survey collects balance sheet and income statement information according to specific instrument, revenue and expense classifications. Most importantly, the survey requires a breakdown of the types and amounts of assets that were securitized. The estimates of flows and levels of securitized assets and asset-backed securities are incorporated in the Issuers of Asset Backed Securities (IABS) institutional sector in the Financial Flow Accounts and the National Balance Sheet Accounts framework.[1] The primary assets of this sector are the securitized receivables; and the primary liabilities are the asset-backed securities.

The securitization market

A securitized asset can be any form of receivable with a predictable cash flow, such as a loan, lease or a mortgage that can be pooled and used as collateral to issue fixed-income securities. Due to the nature of these receivables, the original lenders are typically financial institutions or financial intermediaries, such as banks, near-banks, sales financing and consumer loan companies—however, many companies that are in the business of making loans or extending credit to their customers, for example the sales financing arm of a major retailer, also avail themselves of this procedure. The primary benefit of this method to companies was that it allowed them to move assets and their related liabilities off balance sheet. Moving the assets and liabilities off balance sheet allowed companies to reduce capital adequacy ratios, which are monitored by regulators.[2] This practice, in turn, enabled companies to increase lending activities. However, any assets and liabilities that are accounted for on balance-sheet under IFRS and are sold through securitization will now be required to be included in the calculation of a regulated institution's regulatory capital ratios and may cause many companies and trusts to reduce their participation in securitization transactions.

The two broad classes of asset-backed securities in Canada are: (1) *National Housing Act*-insured mortgage-backed securities (NHA-MBS); and (2) other asset-backed securities. Each is structured uniquely, is host to a different range of investors and can be originated in different sectors of the Canadian economy.

National Housing Act-insured Mortgage-Backed Securities

In 1987, the federal government created a program that would enable financial institutions (i.e. banks, life insurance companies, credit unions, caisse populaires, trusts or mortgage loan companies) registered with the Canada Mortgage and Housing Corporation (CMHC) to securitize mortgages federally insured under the *National Housing Act* (NHA). The purpose of this CMHC program was to provide additional sources of funds for residential mortgage financing (including social housing), while encouraging lower interest rates and longer-term mortgage financing.[3] Under this program, an approved issuer pools all or some of their NHA-insured mortgages and issues mortgage-backed securities backed by the future cash flows on these assets. Under current Canadian accounting rules, this enables the lender to remove the pool of mortgages off their balance sheet. Similarly, the securities are not reported as liabilities. As the mortgage holders make their periodic payments, these funds are channeled to the investors in the NHA-MBS. The mortgagees are generally unaffected by, and are even unaware of, the transaction.

Other asset-backed securities

The second type of securitization applies to all other types of assets, such as commercial loans, car leases, credit card balances, agricultural and equipment retail sales contracts; inventory credit; franchise loans; heavy equipment leases; office equipment leases; non-NHA-insured residential and commercial mortgages; and other miscellaneous receivables as securitized assets. The particular securitized assets are presently detailed on the asset side of the IABS sector in the Financial Flow Accounts and National Balance Sheet Accounts.

These deals involve the creation of what is known as a special purpose vehicle (SPV). These are essentially investment trusts that are setup either by a particular company or by a third party, such as a bank, for the purpose of issuing ABS and holding the assets. In either case, the SPV is a completely separate entity from the original lender and their financial reports are not consolidated.

The role of the SPV is to purchase, at an arm's length, a pool of loans or receivables from the originating company or financial intermediary. Under CGAAP the originator is able to sell the securitized assets to the trust and remove them from their own balance sheet. In turn, the trust issues fixed-income securities, and uses the proceeds to pay the lender for the assets. Again, the debtors are generally unaware of the transaction between the lending institution and the special purpose trust.

Also included in this category, are a particular type of ABS issued by the Canada Housing Trust (CHT), a special purpose vehicle and variable interest entity reported in the consolidated annual financial statements of the Canada Mortgage and Housing Corp. The CHT sells Canada Mortgage Bonds to investors and uses the proceeds to purchase pools of mortgage-backed securities (MBS) that have been created by CMHC-approved lenders.

The Issuers of Asset-Backed Securities sector

The size of the IABS sector in the *National Balance Sheet Accounts* is roughly $635 billion as of the fourth quarter of 2010. Of this value, $332 billion correspond to NHA-MBS, and almost $303 billion fall under the "other ABS" category outlined above.

The wide variety of receivables underlying asset backed securities means that the originators of these receivables range over a number of sectors of the economy. As a result once these assets and associated liabilities are consolidated with the accounts of the originators as required under IFRS, the data for this wide range of sectors will be affected. Based on the fourth quarter 2010 data, the value of all ABS (except CHT) presently held in the IABS sector originated from other NBSA sectors in the following proportions as shown in the table below.

Table: Distribution of asset-backed securities across National Balance Sheet Accounts sectors

Sector	%
Chartered banks	79
Other financial institutions	11
Investment dealers	4
Sales finance and consumer loans corporations	1
Private non-financial companies	1
Credit unions	2
Other	2

As companies and trusts have varying year-ends, the changes in reporting will not all occur at once, but will be completed over the course of the entire implementation period, beginning in 2011.

Challenges of International financial reporting standards implementation

The implementation of IFRS entails significant challenges—not least of which will be that the standards are yet to be finalized. Further complicating any anticipation of the effects of IFRS implementation are the two different ways SPVs can be structured in Canada. SPVs may be structured as either single-sellers, which securitize the receivables of their "parent" company only; or as multi-sellers, which provide a financial service to other companies by securitizing their receivables for a fee. The multi-seller structure significantly obscures the originators of the receivables backing the ABS issued from that SPV, making it difficult to estimate which sectors will show these changes to asset and liability positions with the implementation of IFRS.

Also, the changes to the regulatory capital ratios calculated under IFRS accounting alluded to earlier, may cause many companies to make adjustments to their holdings of ABS throughout the coming year either through sale or non-renewal upon maturity. Therefore, the constitution of the IABS sector itself will likely undergo sizable changes beyond just the direct effects of IFRS implementation.

Finally, some federally regulated entities will not fully implement IFRS until the quarter ending on or after December 31, 2012. Given the above uncertainties, it is only over the course of the implementation process, that the complete effects of IFRS on the IABS sector within the NBSA will become fully evident. The Canadian System of National Accounts will continue to publish updates on this issue as needed to provide more detail to users.

Notes

1. The Financial Flow Accounts and National Balance Sheet Accounts provide data for the IABS sector beginning in 1987 on an annual basis, and 1990 on a quarterly basis.
2. Such as the Asset-to-Capital Multiple of deposit taking institutions, the borrowing multiple of cooperative credit associations and the Capital Equivalency Deposit of foreign bank branches.

3. See the Canada Mortgage and Housing Corporation, *NHA Mortgage-backed Securities: Your questions answered*, 1990 and *Strategic Plan 1992 – 1996*, Ottawa: CMHC, 1991.