Project: **Replacement of IAS 39 *Financial Instruments: Recognition and Measurement***

Topic: **Reflecting changes in own credit risk for financial liabilities not measured at amortised cost**

Introduction

1. In the exposure draft *Financial Instruments: Classification and Measurement* ('the ED') the Board highlighted the interaction between the ED proposals and the issues addressed in the Board's discussion paper *Credit Risk in Liability Measurement* ('the DP'). The Board noted that the responses to the DP would be relevant to the project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and that the Board intended to consider the responses in the reconsideration and finalisation of the proposals in the ED.

2. Almost all respondents to the DP, including users, stated that measuring some types of financial liabilities at fair value and recognising fair value changes arising from changes in own credit risk in profit or loss does not provide useful information. (Although there was not a specific question in the ED on this issue, the feedback from almost all respondents to the ED and other outreach activities undertaken by the staff was consistent with the responses to the DP).

3. The staff notes that this view is a long-standing view of many of our constituents. For example, this topic was exhaustively discussed in the discussion paper *Reducing Complexity in Reporting Financial Instruments*, and the responses to that discussion paper are totally consistent with the views expressed by respondents to the more recent due process documents.

4. Some respondents to the ED asked the Board to defer work on the project to replace IAS 39 or scope out financial liabilities until the Board reaches a

This paper has been prepared by the technical staff of the IASCF 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 IFRIC 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.

decision regarding recognising changes in own credit risk in current measurements of liabilities. Others also proposed that the Board first makes decisions regarding the financial statement presentation project. Others suggested that this phase of the project to replace IAS 39 should address the issue of own credit risk when a current measurement of financial liabilities is required.

Purpose of this paper

5. **This paper sets out possible approaches for the Board to address the concerns summarised in the preceding section. This paper recommends an approach that the Board should take in this project.**

6. The staff recognises that the concerns raised are far broader than financial liabilities. However, if the Board wishes to issue a standard on the classification and measurement of financial instruments according to the Board's own timetable the Board must decide whether to, and how to, address this concern in the context of financial liabilities, or scope financial liabilities out of any new standard.

7. The approaches presented in the paper, the staff analysis and the staff recommendation only address financial liabilities within the scope of this project.

8. This paper does not address whether a fair value definition should include or exclude the effects of changes in own credit risk (this is covered by the fair value measurement project).

9. The staff also notes that any decisions made on this issue may impact other ongoing projects, including:

   (a) non-financial liabilities and liabilities outside the scope of this project, including insurance liabilities and post-employment benefits; and

   (b) financial statement presentation.

10. In terms of structure, this paper:

    (a) summarises the ED proposals for financial liabilities, and the comments received from respondents to the ED and the staff outreach programme

    (b) summarises potential approaches the Board could take to address the concerns expressed

    (c) discusses the candidates for the identified potential approaches. Namely, whether they should be applied to all financial liabilities measured at fair value or only some, and

    (d) analyses the identified potential approaches to address the concerns expressed.

Interaction with other agenda papers

11. Own credit risk and the treatment of hybrid contracts with financial liability hosts are interrelated.

12. This paper identifies two possible approaches that could address the broad concerns raised by constituents. The Board could decide to require one of those approaches. That decision will impact the Board's decision on whether to eliminate bifurcation accounting for hybrid contracts with financial liability hosts. That is, a trade-off for the Board might be to:

    (a) require one of the approaches discussed in this paper, and to eliminate bifurcation accounting for hybrid contracts with financial liability hosts, or

    (b) not require one of the approaches discussed in this paper, but to maintain bifurcation accounting for hybrid contracts with financial liability hosts.

13. This is further discussed in agenda paper 3 for this meeting.

14. Furthermore, we note that the issue of own credit risk is also relevant to other types of financial liabilities that may be measured at fair value – for example,

financial liabilities measured at fair value through profit or loss by use of the fair value option.

Proposals in the ED

15. The ED proposes two principal measurement methods for the subsequent measurement of financial liabilities within its scope:

    (a) amortised cost

    (b) fair value.

16. As currently defined in IAS 39, fair value includes an entity's own credit risk for financial liabilities (see *inter alia* paragraph IAS 39.AG82(b) that addresses factors to consider in determining fair value using valuation methods).

17. Fair value is the measurement attribute applied on initial recognition and hence, credit risk is recognised in **all initial measurements** of financial liabilities within the scope of IAS 39 regardless of whether the item is subsequently measured at fair value or amortised cost.

18. The ED proposes requiring or allowing particular financial liabilities to be measured at fair value with changes in fair value (including changes in fair value arising from changes in own credit risk) recognised in profit or loss when such changes occur.

19. For financial liabilities subsequently measured at amortised cost, the carrying value is not updated for changes in credit risk (or any other market factor). For such financial liabilities, changes in own credit risk (as well as changes in other market factors) are recognised only if an item is transferred or settled (ie, derecognised) prior to maturity.

Comments received in the comment letters to the ED and during the outreach programme[1]

20. **General comments:** Many commentators were concerned about the financial reporting effects of changes in an entity's own credit risk that would arise as a result of the proposals in the ED.

21. As noted previously, some respondents to the ED asked the Board to defer work on the project to replace IAS 39 or scope out financial liabilities until the Board reach a decision regarding recognising changes in own credit risk in current measurements of liabilities. Others also proposed that the Board first make decisions regarding the financial statement presentation project. Others suggested that this phase of the project to replace IAS 39 should address the issue of own credit risk when a current measurement of financial liabilities is required.

22. Respondents had the following specific concerns related to the fair value effects of changes in own credit risk and the ED proposals for financial liabilities:

    (a) the proposed elimination of bifurcation accounting for hybrid contracts with a financial host that are financial liabilities[2]

    (b) the impact of the 'basic loan features' criterion for some types of financial liabilities issued by entities (in particular, more subordinated instruments)

    (c) the proposed accounting for tranches in waterfall structures from the perspective of the issuer.

23. In general, these commentators believed that more types of financial liabilities[3] would be required to be accounted for at fair value on an ongoing basis than is the case today.

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[1] For an analysis of comments received on the DP, please refer to agenda paper 13 of the main September Board meeting.
[2] See agenda paper 3 for this meeting.
[3] Although no quantitative analysis was provided.

24. **Initial measurement:** Almost all respondents that addressed the issue agreed that credit risk should be reflected in the amount initially recognised in the financial statements. This is consistent with the comments received on the DP. The staff interprets this as a general consensus that fair value on initial recognition is the most decision-useful measurement attribute for the initial measurement of financial liabilities.

25. **Subsequent measurement:** Almost all respondents (including users) believed that reflecting changes in own credit risk does not result in decision-useful information, in particular for financial liabilities that contractually or legally cannot, or are highly unlikely to be, transferred or settled prior to maturity.

26. Such respondents preferred using amortised cost, a current measurement that does not reflect changes in own credit risk in profit or loss (eg a measurement that keeps the credit spread constant) or presenting changes arising from own credit risk in other comprehensive income (OCI).

27. A few respondents believed that reflecting changes in own credit risk in profit or loss is decision-useful in all situations.

28. Some respondents noted that they would reconsider their views on the ED proposals (eg whether hybrid contracts should be classified in their entirety) if the Board appropriately addresses the issue of own credit risk.

Potential approaches for the Board to address concerns raised

29. At the time of writing the paper the Board has tentatively decided:

    (a) the basic classification model, and

    (b) that financial liabilities should remain in the scope this phase.

30. Consistent with these tentative decisions, the staff believes the Board could use the following approaches to address the issue discussed in this paper:

    (a) **Approach A:** specify another measurement approach for (some) financial liabilities

(b) **Approach B:** present changes in fair value related to changes in own credit risk outside profit or loss (ie, OCI) for some or all financial liabilities measured at fair value.

31. Of course the Board could simply confirm the proposals in the ED for financial liabilities. In light of the comments received on both the ED and the DP, and the Board's decisions on scope of the project and the general classification model, the staff thinks that is not a viable way forward. Constituents of all types, including users, expressed concerns over the usefulness of presenting changes in own credit risk in profit or loss. (The Board could alternatively decide to address some of the concerns of constituents by requiring the bifurcation of hybrid financial liabilities. That issue is discussed in paper 3.)

32. Before discussing the potential approaches A and B in more detail, it is worth noting that both alternatives could be applied to some or all financial liabilities not measured at amortised cost. The following section considers the possible candidates to which either of the approaches could be applied. Following that, we will then move on to look at the 2 approaches in greater detail.

The candidates for either of the potential approaches

33. If the Board wishes to apply potential approaches (a) or (b) to only some financial liabilities, then they could be applied to:

(a) all financial liabilities not measured at amortised cost, apart from held for trading liabilities; or

(b) all financial liabilities not measured at amortised cost, apart from held for trading liabilities or liabilities for which a fair value option election is made; or

(c) all financial liabilities that (i) are not eligible for amortised cost measurement, but (ii) are managed as part of a contractual cash flow business model.

34. It is worth noting that (b) and (c) are similar in terms of the instruments that are captured. The difference is that (c) would require that an instrument is part of the business model with the objective of paying contractual cash flows rather than realising fair value changes, whereas (b) would not make that requirement.

35. So let's look at (a).

36. Most respondents noted that for financial liabilities held for trading (including derivatives) subsequent measurement should be at fair value and that includes changes in own credit risk.

37. The staff agrees. In such cases the entity is in a position to realise fair value, including changes in its own credit risk. **Therefore the staff recommends that the Board define a subset of instruments** to which either (a) a current measurement approach other than fair value is applied, or (b) if fair value is applied, then changes in fair value related to changes in own credit risk are presented outside profit or loss.

38. So let's consider (b) and (c).

39. Historically much of the concern regarding the effects of changes in own credit risk of financial liabilities measured at fair value was expressed in the context of the fair value option. Obviously, many hybrid financial liabilities are currently required to be bifurcated and so the concerns about such instruments did not previously arise (even for the derivative components separately accounted for).

40. In many of the responses to the ED proposals, as well as the outreach activities, the concerns regarding own credit risk were expressed in the context of financial liabilities that did not have basic loan features but for which the entity would simply pay contractual cash flows as they fell due.

41. Some respondents highlighted that the business model under which the financial liability is issued would indicate if the entity would be able to (legally and/or contractually) realise any fair value changes arising from changes in own credit risk, or if an entity would actually ever realise such changes if they had the legal and/or contractual ability to do so.

42. Both (b) and (c) described above would address the concerns regarding hybrid financial liabilities and the financial reporting effects of fair value changes arising from changes in own credit risk.

43. Both (b) and (c) would exclude financial liabilities designated under the fair value option. The staff notes that the fair value option is an option, unlike the situation that a financial liability does not have basic loan features despite the entity either being unable to or unlikely to ever realise fair value changes arising from changes in own credit risk.

44. The staff also notes that the Board will reconsider the fair value option in the context of hedge accounting as well as insurance phase II. Therefore the staff believes that changing the fair value option to some other measurement or presentation option is premature.

45. In summary, **the staff recommends that** if the Board decides to require that either (a) a current measurement approach other than fair value, or (b) if fair value is applied, then changes in fair value related to changes in own credit risk are presented outside profit or loss, that the financial liabilities to which such approaches are applied to are **all financial liabilities that (i) are not eligible for amortised cost measurement, but (ii) are managed as part of a contractual cash flow business model. That is (c) as described in paragraph 33**.

46. The staff believes that (c) is more consistent with the overall classification model being developed by the Board.

Let's now look at the potential approaches identified earlier in this paper

47. Having defined the subset of financial liabilities that are candidates for an alternative accounting we can now address what that alternative accounting could be.

48. As mentioned in paragraph 30, the staff believes that there are two choices for the Board to address the issue of own credit risk:

    (a) specify another measurement approach for (some) financial liabilities

(b) present changes in fair value related to changes in own credit risk outside profit or loss (ie, OCI).

Specify another measurement method for (some) financial liabilities

49. The Board could specify another current measurement method that incorporates own credit risk only on initial measurement. This would apply to the subset identified in the preceding paragraphs.

50. Generally, respondents to both the ED and the DP agreed that own credit risk should be incorporated in the initial measurement of a financial liability.

51. Many respondents noted that for some financial liabilities subsequent changes in own credit risk should not be reflected in current measurement (or at least have no impact on profit or loss). However, many believed it is appropriate to reflect **other** changes in market risks in the measurement.

52. The measurement approach described in the DP on credit risk is to keep the credit spread (as determined on initial recognition) constant, ie use a 'frozen credit spread' but reflect changes in other risks in subsequent measurement.

53. If such a 'frozen credit spread' approach is used, on initial recognition the credit spread has to be determined. In most cases the credit spread of a financial liability is not directly observable, even at inception, but has to be inferred.

54. Of course, the Board has discussed this issue many times in the past. Most recently, in the context of the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*. (The staff notes that respondents to the DP on credit risk could not or did not suggest a more appropriate approximation method that was different to that contained in IFRS 7 today).

55. So let's consider possible methods to determine the initial credit spread.

56. IFRS 7 uses an approximation approach (see below). Other possible methods include adjusting other available credit information (eg using spreads of credit default swaps) or attempting to "rebuild" the original pricing of credit risk.

57. The staff thinks that if the Board decides to require a current measurement method that excludes changes in credit risk, then a default method to determine the frozen credit risk spread should be provided (this could be a practical expedient), but that alternative methods should also be permitted if the entity believes this more faithfully represents the initial credit spread.

58. That default method could use the guidance given in IFRS 7.10, .B4 & .IG11 as a starting point. This approach attributes all parts of the internal rate of return (which is based on the **contractual** cash flows) that are not the benchmark/risk-free interest rate to the credit spread. However, this assumes that the internal rate of return (yield to maturity) includes only the effects of time value of money and credit risk. Other risk factors (eg liquidity risk) under this approach are assumed to form part of credit risk.

59. The staff notes that this approach has some significant drawbacks that are difficult to assess or quantify. Namely:

    (a) the cut is an approximation and works best for simple instruments that only have interest and credit risks incorporated

    (b) the identified candidates for such an accounting treatment will include contractual features that may result in such an approximation becoming less faithfully representational (because the candidates will not have basic loan features).

    (c) the approximation approach – if not modified – locks in all other risk components except for benchmark/risk-free interest risk because it treats such risks as forming part of credit risk.

60. In summary, the more complex the instrument is the more numerous the other factors that could be included in the frozen spread if the approach is not modified.

61. IFRS 7.B4 acknowledges this problem and requires adding back the effect of other significant risks (eg the fair value of an embedded derivative).

62. To mitigate this problem the Board could decide to allow the default method only for relatively simple instruments where the effect of non-basic loan features is insignificant. Otherwise, the credit spread must be determined using more sophisticated methods that are a better approximation of the credit spread. For example, any risks other than credit should be incorporated in the expected cash flows to ensure that the spread to be frozen only includes the credit risk portion.

63. We believe whatever approach the Board decides on, an entity should be required to disclose the methods and inputs used to determine that credit spread[4].

64. Further, the question is whether to require or permit a current measurement using a frozen credit spread. The comments received imply that the effects of changes in own credit risk do not provide useful information in certain circumstances. Hence, the staff believes for such financial liabilities any such measurement method should be **required**.

65. If the Board decides to require such a measurement, the question arises whether to continue to require the fair value disclosures in accordance with IFRS 7.25. The staff notes that many users, even if they do not prefer to have changes in own credit risk recognised in the primary financial statements, want to have fair value information available in the notes. Hence, we recommend keeping the fair value disclosures in IFRS 7 if the Board decides to use a frozen credit spread approach.

Present changes in fair value related to changes in own credit risk outside profit or loss

66. An alternative to a 'frozen credit spread' **measurement** approach would be a **presentation** approach to allow or require an entity to present any changes in fair value that result from changes in own credit risk in OCI. In other words, the liability would be measured at fair value but the change in fair value would be

[4] This is in line with the IASB's expert advisory panel guidance, see paragraph 159-164 of the final report of the panel.

disaggregated into a credit risk-related component (presented in OCI) and the residual fair value component (presented in profit or loss).

67. This approach would maintain the two measurement methods for financial assets and financial liabilities – fair value and amortised cost.

68. However, this would increase the use of OCI and be contrary to the requests of many respondents to the ED (and the DP on credit risk) that the Board complete the financial statement presentation project and in doing so articulate the purpose of OCI presentation before expanding the use of OCI.

69. In addition, the same issues as for a frozen credit spread approach arise with regard to disaggregating fair value changes. Indeed, this issue would be exacerbated as the split would have to be performed on an ongoing basis as it would have to be reassessed at every reporting date (and not only at inception).

70. Hence, the staff thinks at this point the Board should not pursue a split presentation approach.

Staff recommendation

71. The staff recommends:

- **(a) adopting a frozen credit spread for some, but not all, financial liabilities that are not measured at amortised cost.**
- **(b) this measurement should be <u>required</u> for all financial liabilities that (i) are not eligible for amortised cost measurement, but (ii) are managed as part of a contractual cash flow business model.**
- **(c) the IFRS should <u>not prescribe a method</u> to determine the initial credit spread, but should <u>provide a default method</u> an entity can use in case of simple instruments.**
- **(d) <u>disclosures about the methods and inputs</u> used to isolate the credit spread should be <u>required</u>.**

(e) **the fair value disclosures for all financial liabilities should continue to be required in accordance with IFRS 7.**

Questions to the Board
Does the Board agree with the staff recommendation to: 1. require a frozen credit spread measurement method for some financial liabilities that are not measured at amortised cost 2. require a frozen spread measurement method for all financial liabilities **that (i) are not eligible for amortised cost measurement, but (ii) are managed as part of a contractual cash flow business model.** 3. provide the default method to isolate the initial credit spread, but not prescribe a method 4. require disclosures about the methods and inputs used to isolate the initial credit spread 5. continue requiring fair value disclosures in accordance with IFRS 7? If not, why and what does the Board wish to do, and why?