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Project	<b>Financial Instruments: Replacement of IAS 39</b>
Topic	<b>Hedge accounting: hedges of credit risk using credit derivatives—alternatives to risk components</b>

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## Introduction

### *Background and purpose*

1. Agenda paper 21A sets out why IFRSs today do not provide useful and relevant information for situations in which financial institutions use credit derivatives to manage the credit exposure of their lending portfolios. It describes how financial institutions manage credit exposure of loans and loan commitments and the accounting implications.
2. The purpose of this paper is to:
  - (a) set out the alternatives for how the Board could proceed;
  - (b) provide the Board with a staff recommendation; and
  - (c) ask the Board a question

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

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

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

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

## Alternatives

### *Is there a need for a solution?*

3. The staff note that the objective of financial statements and financial reporting is to provide relevant and useful information to users. During our outreach activities, both preparers and users have raised the hedging of credit risk using credit derivatives as a significant issue and the accounting outcome in such situations as a weakness of IFRSs (ie IFRSs today do not reflect the economic substance of the credit risk management activities of financial institutions). Financial institutions frequently communicate to the market that the reported profit or loss volatility due to the accounting mismatch are non-recurring items. From our outreach activities, we learnt that users strip out the effect of gains and losses arising from credit derivatives and frequently rely on non-GAAP information or other information produced by management.
4. Also, in our feedback from our outreach activities, almost all investors believe that accounting should reflect the entity's internal risk management approach and the economic implications of an entity's hedging strategy.
5. Hence, the staff consider that a better accounting solution for situations in which credit risk is hedged by credit derivatives is needed.
6. The following sections of the paper discuss alternatives that the Board could consider in addressing this issue.

### *Is hedge accounting an alternative?*

7. The current hedge accounting model requires that in order to be eligible as a hedged item, a risk component is measurable so that hedge ineffectiveness is determined and recognised in profit or loss. As discussed in agenda paper 21A, identifying a credit risk component of a loan or loan commitment is very difficult. The overall feedback from many constituents who commented on this issue is that they agree that in practice entities generally have not been able to determine the credit risk element inherent in a bond in a way that meets the requirements for designation of risk components as hedged items.

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8. To accommodate hedges of credit risk under hedge accounting, a different hedge accounting requirement specifically for this type of risk component would have to be developed or the current hedge accounting requirements significantly modified (eg in relation to eligible hedged items and effectiveness testing). This adds complexity to an already complex area and would expand the scope of the current hedge accounting project.

***Is the fair value option (FVO) an alternative?***

9. As discussed in agenda paper 21A, the FVO is not a solution for situations in which credit risk is hedged by credit derivatives. The reasons are:
  - (a) loan commitments outside the scope of IAS 39 *Financial Instruments: Recognition and Measurement* are not eligible for the FVO; hence, many credit exposures do not qualify; and
  - (b) the FVO can only be chosen on initial recognition of the financial instrument and for the instrument in its entirety; hence, this does not allow accommodating the way the credit exposures are managed (ie purchasing credit protection for a proportion of the total exposure and after its initial recognition).

***What other alternatives could the Board consider?***

10. So if the Board wants to provide a solution for situations in which credit risk is hedged by credit derivatives another alternative would be needed. That alternative could be to provide a means of electing fair value (through profit or loss—FVTPL) accounting that is more aligned with credit risk management. During our outreach activities, credit portfolio managers have suggested that such an approach is more consistent with their credit risk management strategy (in lieu of applying hedge accounting).
11. The staff think the Board has at least the following alternatives in relation to such an election of FVTPL accounting:

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- (a) **alternative 1:** permit (subject to qualification criteria):
  - (i) electing FVTPL *only at initial* recognition;
  - (ii) designation of a component of nominal amounts; and
  - (iii) discontinuation.
- (b) **alternative 2:** permit (subject to qualification criteria):
  - (i) electing FVTPL at initial recognition *or subsequently* (if subsequently, the difference between carrying amount and fair value is recognised immediately in *profit or loss*)
  - (ii) designation of a component of nominal amounts; and
  - (iii) discontinuation.
- (c) **alternative 3:** permit (subject to qualification criteria):
  - (i) electing FVTPL at initial recognition *or subsequently* (if subsequently, the difference between carrying amount and fair value is *amortised or deferred*);
  - (ii) designation of a component of nominal amounts; and
  - (iii) discontinuation.

12. Alternatives 1, 2 and 3 could also apply to loan commitments that fall outside the scope of IFRS 9 if the additional qualification criteria are met.

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13. The following table summarises the different alternatives described above and compares them with the accounting outcome that can be achieved today:

	<b>Outcome achievable today</b>	<b>Alternative 1<sup>^</sup></b>	<b>Alternative 2<sup>^</sup> &amp; 3<sup>^</sup></b>
Designate at FVTPL at initial recognition	√	√	√
Designate at FVTPL subsequent to initial recognition	×	×	√*
Discontinuation of FVTPL	×	√*	√*
Redesignate at FVTPL	×	×	√*
Designate a component of nominal amounts	×	√*	√*

\*subject to additional qualification criteria

<sup>^</sup> also apply to loan commitments that meet the scope exception (if the additional qualification criteria are met)

### ***The qualification criteria***

14. The staff think that the following qualification criteria could apply to alternatives 1, 2 and 3.

#### *Qualification for electing FVTPL*

15. The election of FVTPL comprises designation (both at initial recognition and subsequently).
16. **Scope:** the staff think the FVTPL election should be available for a financial instrument<sup>1</sup> that is managed such that an economic relationship with credit

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<sup>1</sup> References to ‘financial instrument’ in the following sections refer to the financial instrument in such an economic relationship (ie the instrument that is not the credit derivative).

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derivatives on the basis of the same credit risk exists that causes offsetting changes in fair value of the financial instrument and the credit derivatives.

17. **Qualifying criteria:** the staff think that the following qualifying criteria could be set for electing FVTPL for a financial instrument:
- (a) a clearly defined set of links between the financial instrument and the credit derivative can be established through matching of the name (ie the borrower or holder of the loan commitment matches the reference entity of the credit derivative); and
  - (b) the seniority (ie the seniority of the financial instrument matches that of the instruments that can be delivered under the credit derivative).
18. The above qualification criteria are set with the view to accommodate economic hedges of credit risk that would otherwise qualify for hedge accounting but for the fact that the credit risk component within the hedged exposure cannot be measured. The above qualification criteria are also consistent with regulatory requirements and the risk management strategy underlying the current business practice of financial institutions.

*Qualification for discontinuation*

19. The staff think that the following criteria could be set to qualify for discontinuation of FVTPL for a financial instrument under alternatives 1, 2 and 3:
- (a) an accounting mismatch no longer exists because the credit derivative expires or is sold, terminated or settled; or
  - (b) the credit exposure of the financial instrument is no longer managed on a fair value basis using credit derivatives, for example:
    - (i) improvements in credit quality of the borrower; or
    - (ii) changes to capital requirements imposed on the financial institution.

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20. The two criteria are related in that change in the credit risk management under (b) would typically be accompanied by the disposal of the credit derivative under (a) because the maintaining credit protection involves a cost to the entity. The only difference that including (b) as a separate criterion makes is that for diversified financial institutions a credit derivative that is no longer used for credit risk management might be transferred to the trading book. However, as noted in agenda paper 21A (paragraph 14) the CDSs for hedging purposes are typically kept and managed in the bank's books separately from trading CDSs. Therefore, the staff would not expect that criterion (b) makes a difference in many cases. Hence, if Board members are concerned that criterion (b) might lead to inappropriate discontinuation of FVTPL then discontinuation could be limited to qualifying under criterion (a).
21. Given the rationale for electing FVTPL entities would typically discontinue FVTPL if the qualifying criteria above are met because that would ensure alignment with how the exposure is managed (ie the credit risk is no longer managed on a fair value basis). However, the staff note that on the basis that the financial instrument would not qualify for election of FVTPL in the circumstances when the discontinuation criteria apply, it would be logical to make discontinuation of FVTPL *mandatory* if these criteria are fulfilled.

*Loan commitments that meet the scope exception of IAS 39*

22. The staff think that the loan commitments that fall outside the scope of IAS 39 could also qualify for election of FVTPL (provided the above qualification criteria are met). The staff learnt that most of the hedges for credit risk are against loan commitments that fall outside the scope of IAS 39.<sup>2</sup> The staff also learnt during the outreach activities that credit portfolio managers manage credit exposures of loans and loan commitments the same way. The staff note that loan commitments are derivatives but the Board decided to simplify the

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<sup>2</sup> See paragraph 6 of agenda paper 21A.

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accounting for particular types of loan commitments and hence excluded them from the scope of IAS 39<sup>3</sup>.

**Staff analysis**

23. This section of the paper sets out mechanics and provides analyses on the different alternatives for the FVTPL election.

**Alternative 1:***Mechanics*

24. Alternative 1 permits electing FVTPL for a part of the nominal amount of the financial instrument (nominal component) if qualifying criteria are met. This is available *only* at initial recognition. FVTPL can be discontinued if the qualification criteria are met. Loan commitments that fall outside the scope of IFRS 9 could also be eligible under this alternative if the qualification criteria are met.
25. Under alternative 1, at the date of discontinuation of FVTPL (subject to the criteria for discontinuation set out in paragraph 19), the fair value of the financial instrument at that date will be its deemed cost. For loan commitments outside the scope of IFRS 9 the measurement and recognition criteria of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would apply.

*Analysis*

26. Alternative 1 permits an election for a nominal component. The staff note that in the basis for conclusions to IAS 39 the Board was concerned that allowing the designation of a component of nominal amounts could provide an incentive for

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<sup>3</sup> IAS 39.BC16.



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entities to ‘cherry pick’<sup>4</sup>. But does this rationale apply to the situation addressed in this paper?

27. The staff note that
- (a) the business model that provides the context for the issue addressed in this paper is about *holding* the loan. This is because:
    - (i) investment grade *bank loans* are largely illiquid instruments and hence not frequently sold;
    - (ii) many of such loans result from lines of credit (loan commitments) that the holder of the commitment would not consent to be transferred to potential secondary investors (because for the line of credit the credit standing of the facility provider is crucial);
    - (iii) these instrument are typically used by banks to form an anchor relationship with clients that generates business opportunities for other services and products (cross-selling).
  - (b) for financial instruments in the scope of IFRS 9 the accounting mismatch arises only for instruments not classified as FVTPL; loans that are classified as amortised cost are subject to the business model test, which means that they are held in a business model with the objective to collect contractual cash flows; the Board addressed the issue of ‘cherry picking’ in this context by way of requiring information on the gains or losses from derecognising assets measured at amortised cost. This information allows users of financial statements to understand the extent and frequency of selling and the associated gains and losses.
  - (c) for loan commitments outside the scope of IFRS 9 the staff note that because of the business model (see (a) above) the sale of loan

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<sup>4</sup> IAS 39.BC86A.

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commitments is rather less likely than for loans. Moreover, loan commitments that can be settled net in cash or for which the resulting loans are sold are within the scope of IFRS 9<sup>5</sup> and hence mandatory classification as FVTPL applies. Hence, the above considerations that apply to loans also apply to loan commitments (assuming that equivalent disclosure of information would be required).

28. Hence, the staff consider that election of FVTPL should be allowed for a nominal component in the situation addressed in this paper.
29. A significant disadvantage of alternative 1 is that in many situations in practice—when a financial institution obtains credit protection for an exposure subsequently to its initial recognition—this alternative is not aligned with the credit risk management strategy and hence would not reflect its effect.
30. We learnt from our outreach activities that credit portfolio managers engage in an active and flexible management strategy that is responsive to the different level of expected credit risk exposure over time. Hence they typically hedge depending on the circumstances from time to time and not all at initial recognition.
31. In Example 1 of agenda paper 21A, Bank ABC would not be able (under alternative 1) to elect FVTPL for the 5 year loan commitment (ie LC C) in 2011 to offset the fair value changes of the CDS.
32. One advantage of alternative 1 is that it is less complex than alternatives 2 and 3 because by not permitting the election of FVTPL subsequent to initial recognition, the difference at later points in time between carrying amount and fair value of the financial instrument will not arise (see discussion below).

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<sup>5</sup> See IFRS 9.2.1 in conjunction with IAS 39.4(a)-(b).

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**Alternative 2:***Mechanics*

33. In addition to the election of FVTPL at initial recognition under alternative 1, alternative 2 *also* permits that election *after initial recognition*. This also means that the election is available again for an exposure for which FVTPL was elected previously (which logically cannot apply if the election is restricted to initial recognition).
34. For example, this could happen if a volatile longer term exposure deteriorating before and then protected by credit default derivatives, then significantly improved so that the credit derivatives were sold, but then again deteriorated and was protected again. This ensures that an entity that uses a credit risk management strategy that protects exposures that drop below a certain quality or risk level could align the accounting with their risk management.
35. When the financial instrument is elected for FVTPL after initial recognition, a difference could arise between its carrying amount and fair value. This difference is a result of change in measurement basis. This paper refers to this type of difference as a measurement change adjustment (MCA). Alternative 2 proposes to recognise the MCA in profit or loss immediately.
36. At the date of discontinuation of FVTPL, the fair value will be its deemed cost (like alternative 1).
37. If the financial instrument is elected again after a previous discontinuation the MCA at that date is also recognised immediately in profit or loss (in line with election of FVTPL subsequent to initial recognition (see paragraph 35)).

*Analysis*

38. A significant advantage of alternative 2 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It is reflective of how credit exposures are managed. Credit exposures are actively managed by credit risk portfolio managers. Alternative 2 allows the effects of such an active and flexible risk management approach to be reflected appropriately and

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significantly reduces the measurement inconsistency between the financial instruments and the credit derivatives.

39. A disadvantage of alternative 2 is that it is more complex than alternative 1.
40. Another disadvantage of alternative 2 is that it might appear susceptible to earnings management. An entity can decide at what time to elect FVTPL for the financial instrument and thus when the difference between the carrying amount and fair value at that date would be recognised in profit or loss.
41. The accounting impact of immediately recognising the MCA in profit or loss may also deter entities from electing FVTPL. For example, when an entity decides to take out credit protection at a time when the fair value has already moved below the carrying amount of the loan because of credit concerns in the market, by electing FVTPL, it will immediately recognise a loss. During our outreach activities users have raised concerns about accounting requirements having changed risk management behaviour rather than reflecting it (ie accounting driving business decisions).
42. On the other hand, the advantage of recognising the MCA immediately in profit or loss is that it is operationally simpler than alternative 3.
43. The staff note that the Board could propose disclosures (set out in paragraph 52 below) on credit derivatives that have been used to manage the credit exposure.

**Alternative 3:**

*Mechanics*

44. Alternative 3 provides the same eligibility of FVTPL and its discontinuation as alternative 2. Hence, it also facilitates an accounting outcome that reflects the credit risk management strategy of financial institutions (see paragraph 33)).
45. A key difference between alternatives 2 and 3 is the treatment of the MCA (ie the difference that could arise between the carrying amount and fair value of the financial instrument at designation after initial recognition). Alternative 3

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proposes that the MCA is amortised for loans and deferred for loan commitments that fall into the scope of IAS 37.

46. More specifically, alternative 3 proposes the following in relation to the MCA:

(a) *loans within the scope of IFRS 9:*

- (i) the MCA is amortised over the life of the instrument;
- (ii) when the MCA plus the fair value is greater than the carrying amount had the loan being continued to be measured at amortised cost, the amount above amortised cost is recognised as impairment (to the extent of the unamortised MCA);
- (iii) any unamortised MCA at the date of discontinuation is added to the fair value of the financial instrument as its new deemed cost.

(b) *loan commitments within the scope of IAS 37:* the MCA is deferred until the *earlier of:*

- (i) the discontinuation of FVTPL; and
- (ii) recognition of a provision under IAS 37 (ie when the 'probable' threshold is met).

Appendix A sets out illustrative examples to illustrate how the MCA could be accounted for.

*Analysis*

47. Like alternative 2, a significant advantage of alternative 3 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It allows the effects of an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the financial instruments and the credit derivatives. An advantage of alternative 3 over 2 is that it would be less susceptible to earnings management and not deter the election of FVTPL in

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scenarios after initial recognition of the exposure when its fair value has already declined (see paragraphs 40 and 41, respectively).

48. However, a disadvantage of alternative 3 is that it is also the most complex of all the alternatives.
49. The staff note that the MCA under alternative 3 would have presentation implications. The staff note that the MCA could be presented in the balance sheet in the following ways:
  - (a) *add to the fair value of the loan*: This results in a mixed amount that is neither fair value nor amortised cost.
  - (b) *separate line item next to the financial instrument (similar to the Board's tentative decision on fair value hedge accounting in July 2010<sup>6</sup>)*: This results in additional line items on the face of the balance sheet and may easily be confused as a hedging adjustment<sup>7</sup>.
  - (c) *defer in other comprehensive income (OCI)*.
50. The period amortisation charge of the MCA for loans could be presented in the income statement as:
  - (a) *(part of) interest revenue*: The staff note that the financial instrument is no longer measured at amortised cost<sup>8</sup>.
  - (b) *other gains or losses*.

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<sup>6</sup> Agenda paper 8<sup>a</sup>.

<sup>7</sup> If presented as a separate line item on the balance sheet the MCA may be confused with fair value hedging adjustments. The staff note that the MCA is a not valuation adjustment amount (but an adjustment due to the change in measurement basis). Presenting it in the same way as fair value hedge adjustments would provide the misleading impression that the MCA is of the same nature as the fair value hedge adjustments.

<sup>8</sup> Interest revenue is recognised for financial assets measured at amortised cost (ie using the effective interest method). For financial instruments measured at FVTPL, all changes are recognised as gains or losses in the income statement (or other line items that are not interest revenue under the effective interest method).

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51. The staff note that the following disclosures could also be proposed to provide transparency on the MCA. A reconciliation of changes in the MCA balance during the period would include for example the following reconciling items:

- (i) additions as a result of electing FVTPL;
- (ii) releases:
  - (a) amortisation
  - (b) impairment
  - (c) discontinuation
  - (d) transfers to allowance account for credit losses; and
- (iii) the effect of foreign exchange movements.

52. The staff also note that the Board could propose a reconciliation of the nominal amount and the fair value of the credit derivatives that have been used to manage credit exposure of the financial instrument (that qualifies and was elected for FVTPL).

**Staff recommendation**

53. The staff note that the accounting for hedges of credit risk using CDSs has been a long standing and prevalent (but specific) issue in practice for financial institutions despite the option available in IAS 39 to apply hedge accounting to risk components of financial instruments (see paragraphs 20 to 24 of agenda paper 21A).

54. Expanding the scope or amending the hedge accounting model to accommodate hedges of credit risk may have wide reaching unintended consequences on hedge accounting that may also affect other industries and other hedging transactions. Hence, the staff do not recommend expanding the scope nor amending the hedge accounting model. The alternatives considered in this paper reflect that for a particular scenario hedge accounting is not the most efficient and appropriate solution.

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55. Due to the specificity of the issue and noting that it solely relates to financial instruments, the staff consider that an election of FVTPL may provide a solution to this long standing issue by facilitating alignment with the credit risk management.
56. Of course the Board could decide not to provide any of the alternatives analysed in this paper. However, users have repeatedly raised their concerns that current IFRSs do not produce meaningful information on CDS hedges when financial institutions seek protection from credit losses. Hence, this significantly impairs the usefulness of financial statement for such entities. Therefore, the staff recommend to propose a solution for these situations.
57. To better reflect the credit risk management and produce more meaningful and relevant information, alternatives 1, 2 and 3 permit to elect FVTPL.
58. Alternative 1 is the next simplest of the three alternatives. Although alternative 1 proposes changes to the current requirements to better reflect credit risk management, it would not facilitate alignment with how credit exposures are hedged and managed in many cases. Hence, the staff consider that on balance alternative 1 would not provide a sufficiently significant improvement to justify the introduction of this accounting treatment.
59. Alternatives 2 and 3 would facilitate alignment with credit risk management. However, they also introduce additional complications. These alternatives would introduce an adjustment that could arise as a result of subsequent changes in the measurement basis—the MCA. The treatment of the MCA is more complex in alternative 3 than alternative 2. However, alternative 2 might appear to be somewhat susceptible to earnings management and deter the election of FVTPL in scenarios after initial recognition of the exposure when its fair value has already declined. Hence the staff does not recommend alternative 2.
60. The staff note that alternative 3 would be limited in its application to entities that manage credit risk of financial instruments using credit derivatives. The qualification criteria ensure that a clear link between the credit derivative and the financial instrument is established (see paragraph 17).



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61. The staff note that alternative 3 is a surrogate to hedge accounting due to the operational difficulty in isolating and measuring credit risk in practice.
62. Credit portfolio managers view CDSs as an insurance policy that protects the financial institution from future credit losses. The staff is of the view that to require an instrument that acts economically like an insurance policy to be accounted for as if it belonged to a trading book ignoring the context of the protected credit exposure does not provide users with the most meaningful and relevant information. The staff has learnt from outreach activities that users seek alternative sources for more meaningful and relevant information (eg investor presentations, non-GAAP measures etc). From this perspective, IFRSs has not served its purpose well in these situations.
63. The staff acknowledges that alternative 3 would give rise to an accounting adjustment resulting from a change in measurement basis (ie the MCA). Alternative 3 sets out an accounting treatment for the MCA that makes it less susceptible to potential earnings management than alternative 2. The staff acknowledges that alternative 3 introduces complexity. However, the staff note that the added complexity is limited in its effect (because alternative 3 would be limited in its application (see paragraph 60). It would only impact financial institutions that elect this particular accounting treatment and does not have a far and wide reaching impact across different industries.
64. On balance, the staff recommend alternative 3 despite its complexity because in the staff's view, alternative 3 would produce the most meaningful and relevant information for users of all alternatives considered and in the staff's view would improve the quality of financial reporting.

**Question 1—alternatives to risk components for hedges of credit risk**

Does the Board agree with the staff recommendation to adopt alternative 3?

If the Board does not agree, which alternative does the Board prefer and why?

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**Should discontinuation of FVTPL be mandatory?**

65. The qualification criteria for discontinuation are set out in paragraph 19.
66. The staff note that entities would typically discontinue FVTPL if the qualifying criteria for discontinuation are met. The staff however note that if discontinuation is not mandatory, entities could continue to use FVTPL even though the CDS has been terminated (see paragraph 21). The staff therefore recommend making discontinuation of FVTPL mandatory if the discontinuation criteria are fulfilled.

**Question 2—Discontinuation of FVTPL?**

Does the Board agree with the staff recommendation to require discontinuation of FVTPL if the qualification criteria in paragraph 19 are met?

If the Board does not agree, which alternative does the Board prefer and why?

**Presentation of the MCA**

67. The MCA could be presented different ways (see paragraph 49 and 50). The staff note that including the MCA in the fair value of the loan would result in a mixed measurement amount that is neither fair value nor amortised cost. The staff also note that presenting the MCA as a separate balance sheet line item would increase the number of line items on the balance sheet. The MCA is not a valuation adjustment (but an adjustment due to the change in measurement basis) and might be confused with the fair value hedge adjustment. Hence, the staff recommendation is to present the MCA in (accumulated) OCI.
68. The staff recommends the period amortisation charge of the MCA for loans be presented in other gains or losses in the statement of comprehensive income. The staff does not recommend presenting the amortisation charge as (part of) interest revenue as the loan is no longer measured at amortised cost.

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**Question 3—Presentation of MCA**

Does the Board agree with the staff recommendation to:

- (a) defer the MCA in OCI; and
- (b) present the period amortisation charge of the MCA for loans in other gains or losses?

If the Board does not agree, which alternative does the Board prefer and why?

**Disclosures**

- 69. The staff recommend the Board to propose a disclosure of the reconciliation of the MCA balance as set out in paragraph 51 to provide transparency to users of the movements of the MCA balance.
- 70. The staffs also recommend the Board to propose a reconciliation of the nominal amount and fair value of credit derivatives used to manage credit exposure as set out in paragraph 52 to enable users to evaluate the level of credit risk protection entered into by the entity.

**Question 4—Disclosure**

Does the Board agree with the staff recommendation to propose:

- (a) a reconciliation of the MCA balance; and
- (b) a reconciliation of the nominal amount and fair value of credit derivatives used to manage credit exposure?

If the Board does not agree, which alternative does the Board prefer and why?

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**Appendix A**

- A1. Under alternative 3, when FVTPL is elected for the financial instrument after initial recognition, a difference could arise between its carrying amount and fair value. Alternative 3 proposes that the MCA is amortised for loans and deferred for loan commitments (see paragraph 45).
- A2. This appendix sets out illustrative examples to demonstrate the mechanics of the amortisation and deferral mechanism of the MCA for a loan and a loan commitment, respectively.
- A3. The staff note that there are several possible ways to present the MCA (see paragraph 49). In the following illustrative examples the MCA is presented in OCI.

**Example 1: loan***Year 1*

- A4. Bank ABC originates a loan to Company XYZ of CU100 million (m) for 7 years.

*Year 2*

- A5. The amortised cost of the loan is CU98m and the fair value is CU95m.
- A6. Bank ABC purchases a 6-year CDS hedge for CU1m to hedge the credit exposure of 100% of the nominal amount of the loan (ie CU100m). Bank ABC elects FVTPL to offset the fair value changes from the CDS credit derivative. This results in a MCA of CU3m.

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A7. The entries are:

DR CDS           CU1m

CR Cash                 CU1m

*To recognise the purchase of the CDS.*

DR OCI           CU3m

CR Loan asset           CU3m

*To change the measurement for the loan from its amortised cost carrying amount to fair value and recognise the MCA in OCI.*

*Year 3*

A8. The fair value of the loan is CU91m. The fair value of the CDS is CU6m

A9. The amortised cost of the loan without the FVTPL election would have been CU99m.

A10. The entries are:

DR Profit or loss       CU4m

CR Loan asset                 CU4m

*To recognise the loan at fair value.*

DR CDS derivative    CU5m

CR Profit or loss           CU5m

*To recognise the derivative at fair value.*

DR Profit or loss       CU0.5m

CR OCI                         CU0.5m

*To amortise the MCA<sup>9</sup>*

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<sup>9</sup> This example assumes straight line amortisation for simplicity.

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A11. The fair value of CU91m plus the unamortised difference of CU2.5m (total of CU93.5m) is less than the carrying amount had the loan being continued to be measured at amortised cost (CU99m). Hence no impairment on the unamortised MCA is recognised in year 3.

*Year 4*

A12. The fair value of the loan is CU76m. The fair value of the CDS is CU23m

A13. The amortised cost of the loan without the FVTPL election would have been CU75m.

A14. The entries are:

DR Profit or loss	CU15m
CR Loan asset	CU15m

*To recognise the loan at fair value.*

DR CDS derivative	CU17m
CR Profit or loss	CU17m

*To recognise the derivative at fair value.*

DR Profit or loss	CU0.5m
CR OCI	CU0.5m

*To amortise the MCA<sup>10</sup>.*

DR Profit or loss	CU2m
CR OCI	CU2m

*To recognise the impairment of the MCA (see below paragraph).*

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<sup>10</sup> This example assumes straight line amortisation for simplicity.

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A15. Impairment on the MCA is recognised because the fair value of CU76m plus the unamortised MCA of CU2m (total of CU78m) is higher than the carrying amount had the loan being continued to be measured at amortised cost (CU75m).

A16. The following table summarises this example:

<i>Year</i>	<i>1</i>	<i>2</i>	<i>3</i>	
<b>CDS</b>				
FV	0	1	6	
<b>Loan</b>				
FV	100	95	91	
Amortised cost if FVTPL had not been elected	97	98	99	
<b>Unamortised measurement change adjustment (MCA)</b>				
Opening	0	0	3	
Change of measurement	0	3	0	
Amortisation	0	0	(0.5)	
Impairment	<u>0</u>	<u>0</u>	<u>0</u>	<u>UUXXXXXXXXXXXXXXXXXX</u>
Closing	0	3	2.5	

**Example 2: loan commitment—subsequent discontinuation**

*Year 1*

A17. Bank ABC issues a loan commitment to Company XYZ for CU150 million (m) for 5 years.

*Year 2*

A18. Bank ABC purchases a 4-year CDS hedge for CU4m to hedge the credit exposure of 100% of the nominal amount of the loan commitment (ie CU150m).

A19. Bank ABC elects FVTPL to offset the fair value changes from the CDS credit derivative. The fair value of the loan commitment is CU(5)m.

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A20. The entries are:

DR OCI	CU5m
CR Loan commitment	CU5m

*To recognise the loan commitment at fair value and the MCA in OCI.*

DR CDS	CU4m
CR Cash	CU4m

*To recognise the purchase of the CDS.*

*Year 3*

A21. The fair value of the loan commitment is CU(15)m. The fair value of the CDS is CU15m.

A22. The entries are:

DR Profit or loss	CU10m
CR Loan commitment	CU10m

*To recognise the loan commitment at fair value.*

DR CDS derivative	CU11m
CR Profit or loss	CU11m

*To recognise the derivative at fair value.*

*Year 4*

A23. The fair value of the loan commitment is CU(7)m. The fair value of the CDS is CU2m. Bank ABC unwinds the CDS hedge in accordance with its credit risk management strategy and discontinues FVTPL of the loan commitment.



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A24. The entries are:

DR Loan commitment           CU8m

CR Profit or loss                   CU8m

*To recognise the loan commitment at fair value.*

DR Profit or loss           CU13m

CR CDS derivative                   CU13m

*To recognise the derivative at fair value.*

DR Cash                           CU2m

CR CDS derivative                   CU2m

*To realise the unwinding of the derivative*

DR Loan commitment           CU7m

CR OCI                           CU5m

CR Profit or loss                   CU2m

*To discontinue fair value accounting of the loan commitment*

A25. The following table summarises this example:

Year	1	2	3	4
<b>CDS</b>				
FV	0	4	15	2
<b>Loan commitment</b>				
FV	0	(5)	(15)	(7)
IAS 37	0	0	0	0
<b>Deferred measurement change adjustment (MCA)</b>				
Opening	0	0	5	5
Change of measurement	0	5	0	0
Impairment (probable threshold)	0	0	0	0
Discontinuation	<u>0</u>	<u>0</u>	<u>0</u>	<u>(5)</u>
Closing	0	5	5	0

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**Example 3: loan commitment—(probable threshold met)**

A26. The fact pattern is the same as example 3 in years 1 to 3.

*Year 4*

A27. The fair value of the loan commitment is CU(20)m. The fair value of the CDS is CU21m. Had the loan commitment being continued to be accounted for under IAS 37, the probable threshold would have been met and would require Bank ABC to recognise a provision of CU(20)m.

A28. The entries are:

DR Profit or loss      CU5m

CR Loan commitment      CU5m

*To recognise the loan commitment at fair value.*

DR Profit or loss      CU6m

CR CDS derivative      CU6m

*To recognise the derivative at fair value.*

DR Profit or loss      CU5m

CR OCI      CU5m

*To recognise in profit or loss the deferred MCA.*

A29. The MCA is recognised in profit or loss because had the loan commitment being accounted for under IAS 37 the threshold would have been met and a provision recognised. (The entire amount of the MCA is recognised in profit or loss in this instance because the provision amount under IAS 37 is greater than the MCA).

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A30. The following table summarises this example:

<i>Year</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
<b>CDS</b>				
FV	0	4	15	21
<b>Loan commitment</b>				
FV	0	(5)	(15)	(20)
IAS 37	0	0	0	(20)
<b>Deferred measurement change adjustment (MCA)</b>				
Opening	0	0	5	5
Change of measurement	0	5	0	0
Impairment (probable threshold)	0	0	0	(5)
Discontinuation	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Closing	0	5	5	0