Project **Fair value option for financial liabilities**

Topic **Loan commitments and financial guarantee contracts**

Purpose of this paper

1. At the board meeting on 14 September, the Board tentatively decided that for all liabilities designated under the fair value option (FVO) changes in the credit risk of the liabilities ought not to affect profit or loss (P&L) unless such treatment would create a mismatch in P&L (in which case, the entire fair value change would be required to be presented in P&L).

2. This paper addresses an issue related to the **scope** of that decision. Specifically this paper asks the Board whether its tentative decision should apply to the following liabilities:

   (a) **loan commitments issued** that are designated under the FVO[1] (see paragraph 4(a) of IAS 39); and

   (b) **financial guarantee contracts issued** (as defined in paragraph 9 of IAS 39) that are designated under the FVO[2] (see paragraph AG4 of IAS 39).

[1] This is a narrow subset of loan commitments. Only some loan commitments within the scope of IAS 39 (see paragraphs 2(h) and 4 of IAS 39). Of those within the scope of IAS 39, only some are designated under the FVO (see paragraph 4(a) of IAS 39). For example, an entity may designate a loan commitment under the FVO if it manages risk exposures related to loan commitments on a fair value basis. [As noted in paragraph 2(h), issued loan commitments that are **not** within the scope of IAS 39 are accounted for pursuant to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.]

[2] Similar to footnote 1, this is a narrow subset of financial guarantee contracts. Only some financial guarantee contracts are within the scope of IAS 39 (see paragraphs 2(e) of IAS 39). Of those within the scope of IAS 39, only some are designated under the FVO (see paragraph AG4(a) of IAS 39).

Feedback received

3. This question was raised by at least one respondent to the exposure draft *Fair Value Option for Financial Liabilities* (ED).

4. CL 108 stated that the proposals should **not** apply to loan commitments and financial guarantee contracts because such instruments meet the definition of a derivative or are sufficiently similar to a derivative from an economic perspective.[3] Therefore, all changes in their fair value should be presented in P&L.

5. Furthermore, CL 108 noted that the Board's intention seemingly has always been to address the issue of 'own credit risk' for non-derivative liabilities.

Staff recommendation

6. We recommend that the Board's tentative decisions described in paragraph 1 should **not** apply to loan commitments and financial guarantee contracts.

7. In addition to the comments outlined above in paragraphs 4 and 5, we also note that the IASB's exposure draft *Insurance Contracts* (published in July 2010) proposes that contracts currently defined in IFRS as 'financial guarantee contracts' should be brought within the scope of the IFRS on insurance contracts (and, thus, be scoped out of IFRS 9). We think that, at this time, the Board should not change the accounting for financial guarantee contracts in the

[3] Paragraph BC15 of IAS 39's basis for conclusions acknowledges that a commitment to make a loan at a specified rate of interest during a fixed period of time meets the definition of a derivative. That paragraph points out that a loan commitment is a written option for the potential borrower to obtain a loan at a specified rate.

Paragraph AG4 of IAS 39 provides some application guidance on financial guarantee contracts—including implying in paragraph AG4(b) that something that meets the definition of a financial guarantee contract is not a derivative as defined in paragraph 9 of IAS 39. That is because a contractual precondition for a payment under a financial guarantee contract is that the holder has suffered a loss. A credit-related contract without that precondition is a derivative and do not meet the definition of a financial guarantee contract. That is consistent with paragraphs BC193-BC196 in the IASB's exposure draft *Insurance Contracts*. Agenda paper 2G 'Scope: Financial guarantees' posted by the insurance project for the May 2010 board meeting discusses some similarities and differences between a derivative and a financial guarantee contract.

financial instruments project. Otherwise an entity might have to change its accounting for financial guarantee contracts twice—first, as a result of this project and again as a result of the insurance project. We think the Board should leave the requirements for financial guarantee contracts unchanged until the insurance project finalizes its proposals.

8. Furthermore, the Board has had a long-standing view that derivatives should be measured at fair value with all changes presented in the P&L. While we acknowledge that a financial guarantee contract does not meet the definition of a derivative (as discussed in footnote 3), we think that it has many similar characteristics. Therefore, we think it would be inconsistent with that long-standing view to present a portion of the fair value change of a loan commitment or financial guarantee contract in OCI.

Question 1
Does the Board agree that the tentative decision in paragraph 1 should **not** apply to loan commitments and financial guarantee contracts designated under the FVO? If not, what would the Board like to do and why?