Project	**Fair value option for financial liabilities**
Topic	**How to determine the effects of changes in a liability's credit risk**

Background

Existing requirements

1. If an entity designates a financial liability as at fair value through profit or loss (FVO), paragraph 10 of IFRS 7 *Financial Instruments: Disclosures* requires the entity to disclose the amount of the change, during the period and cumulatively, in the fair value that is attributable to changes in the liability's credit risk. Paragraph B4 of IFRS 7 provides a default method for calculating that amount. That default method attributes all changes in fair value, other than changes in a benchmark interest rate, to changes in the credit risk of the liability. Paragraphs IG7-IG11 set out an example of how that default method could be applied in practice. However, IFRS 7 permits entities to use a different method if it provides a more faithful representation of the effects of changes in liabilities' credit risk.

2. For the purposes of those disclosures, IFRS 7 defines a liability's *credit risk* as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'.

The proposals in the exposure draft

3. For all liabilities designated under the FVO, the exposure draft *Fair Value Option for Financial Liabilities* (ED) proposes that the effects of changes in the

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liability's credit risk would not affect profit or loss (P&L). Instead those amounts would be presented in other comprehensive income (OCI).

4. For the purposes of determining the amount of change in fair value of a liability that is attributable to changes in its credit risk, the ED proposes using the application guidance in IFRS 7. Question 8 in the ED asked respondents whether they agreed.

Purpose of this paper

5. **This paper asks the Board whether it wants to confirm the proposals in the ED to use the guidance in IFRS 7 for determining the amount of change in fair value of a liability that is attributable to changes in its credit risk.**

6. Agenda paper 5A asks the Board how it wants to address the effects of changes in the credit risk of liabilities designated under the FVO (eg present those amounts in OCI or present those amounts separately in P&L). This paper is relevant regardless of which alternative in agenda paper 5A the Board decides to pursue (unless the Board decides to do nothing and retain the guidance in IAS 39 (as described in paragraph 10(c) of agenda paper 5A)).

Feedback received

General feedback

7. As discussed in agenda paper 5A, most respondents (and most participants in the Board's outreach programme, including almost all users) supported the proposals in the ED. Those respondents agreed that the effects of changes in the liability's credit risk should not affect P&L but instead should be presented in OCI.

8. Furthermore, those respondents agreed that the guidance in IFRS 7 for measuring the effects of changes in a liability's credit risk is appropriate and operational. They noted that determining the effects of changes in liabilities'

credit risk can be complex so it is necessary to allow some flexibility in how it is measured. They acknowledged that the default method described in IFRS 7 is imprecise (because it captures all fair value changes above the change in a benchmark rate) but said that it is a reasonable proxy in many cases. Moreover, they noted that IFRS 7 allows an entity to use a different method if it more faithfully represents the effects of changes in the liability's credit risk.

9. However some respondents (including those who supported the Board's proposals in the ED) asked for some clarification on particular items. Those comments generally fell into two categories:

   (a) What does *changes in a liability's credit risk* mean? [For simplicity, this paper refers to that notion as 'changes in own credit risk']

   (b) How do you measure the effects of changes in own credit risk?

10. Those two categories of comments are described in more detail below in paragraphs 12-18. We think it is very important to consider those categories separately because they are different issues. The first relates to understanding what own credit risk is, while the second relates to measuring that amount. An entity may understand the meaning of own credit risk but have trouble measuring changes in it. Also, if an entity determines that a particular liability does not have any own credit risk, there is nothing to measure.

11. A few respondents did not agree with the proposals in the ED because they thought that the measurement guidance in IFRS 7 is inappropriate. This view is described in more detail in paragraph 18.

What exactly does changes in own credit risk *mean?*

12. This section focuses solely on feedback received regarding what changes in own credit risk means. It ignores the complexities inherent in measuring that amount—those complexities are described in the next section of this paper.

13. Some respondents expressed concern that the meaning of own credit risk is not consistently interpreted in practice. Those respondents urged the Board to

provide additional application guidance to more clearly explain what they mean. For example, respondents asked for clarification on the following topics:

(a) The difference between the **credit risk of the entity** and the **credit risk of the liability**— eg some respondents asked why the proposals (and IFRS 7) focus on the credit risk of the liability rather than the credit risk of the entity.

(b) The difference between **own credit risk** and **asset-specific performance risk**—eg some respondents asked whether liabilities issued by a consolidated special purpose entity (SPE) have own credit risk or asset-specific performance risk if those liabilities only 'pass through' to investors the cash flows of specified (legally isolated) assets. Similarly, some respondents asked whether liabilities with unit-linking features have credit risk.[1]

How do you measure the effects of changes in own credit risk?

14. This section focuses on feedback received regarding how to **measure** the effects of changes in own credit risk. In other words, this feedback assumes that the entity knows what *own credit risk* is—and is now trying measure the effects of its changes. Moreover, this section assumes that the liability has own credit risk—ie if the entity determines that a particular liability does not have own credit risk, there is nothing to measure.

15. As noted above in paragraph 8, most respondents agreed with the Board's proposals that the guidance in IFRS 7 is appropriate and operational—and provides an appropriate level of flexibility. Those respondents said that the guidance in IFRS 7 is a pragmatic approach that acknowledges the difficulty in isolating the effects of changes in a liability's credit risk.

[1] We note that paragraph 10 of IFRS 7 says that for contracts with unit-linking features, changes in the performance of the related internal or external fund are not changes in the liability's credit risk.

16. However, some respondents said that additional measurement guidance is needed. They noted that while the current level of guidance in IFRS 7 might be appropriate because it applies only to disclosures, the ED proposes elevating this information to the face of the financial statements (and profit or loss will be affected). Therefore, there is an increased need for more robust measurement guidance to ensure consistency and comparability.

17. For example, some respondents said that the Board should state more explicitly that methods **other than** the default method are acceptable—and, in some cases, **required**—if they result in more faithfully representative information. Also, some noted that the Board should be more prescriptive about what other measurement methods are acceptable (and when they should be used).

18. As mentioned in paragraph 11, a few respondents did not agree with the proposals in the ED. Those respondents said that the default method in IFRS 7 does not result in a precise enough measure of the effects of changes in own credit risk—and, therefore, should not be permitted. Many of those respondents generally agreed with the FASB's proposal, which would require an entity to measure significant changes in the fair value of liabilities resulting from changes in the **entity's credit standing**, which explicitly excludes the effects of changes in the price of credit.

FASB's proposals

19. Paragraph 94 of the FASB's exposure draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB ED) set out proposals related to liabilities' credit risk:

> An entity shall present separately on the face of the statement of comprehensive income the amount of significant changes in the fair value of its financial liabilities arising from changes in the entity's own credit standing during the period, excluding changes related to changes in the price of credit. Significant changes in fair value arising from changes in the entity's credit standing, excluding changes in the price of credit, shall be presented separately for financial liabilities for which all changes in fair value are recognized in net

income and for financial liabilities for which qualifying changes in fair value are recognized in other comprehensive income.

20. Paragraph 97 of the FASB ED proposes related disclosures, which would require an entity to disclose both (a) qualitative information about the reasons for changes in fair value attributable to changes in the entity's credit standing and (b) how the gains and losses attributable to changes in the entity's credit standing were determined.

21. In paragraph B2 of Appendix B the FASB acknowledges that there may be several different methods to determine the change in fair value attributable to a change in an entity's credit standing—and notes that it is not proposing to prescribe a method for determining that change. However, Appendix B of the FASB ED sets out **possible** methods for measuring changes in an entity's credit standing. The FASB asked questions on its proposals related to credit risk (see questions 32-34 and 36 in the FASB ED).

22. The appendix to this agenda paper sets out excerpts from the basis for conclusions and Appendix B of the FASB's proposals.

Staff analysis and recommendation

23. Consistent with the majority of respondents, we think the Board should confirm the proposals in the ED to maintain the guidance in IFRS 7 for measuring own credit risk.

24. However we think that that guidance should be clarified and enhanced, as discussed below, with additional guidance to address some of the questions and concerns raised by respondents.

What exactly does changes in own credit risk *mean?*

25. As noted at the beginning of this paper, IFRS 7 defines credit risk as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'.

26. Based on the feedback received from constituents, we do not think it is necessary to change the definition of credit risk in IFRS 7. However, we recommend that the Board add some explanatory text. For example, we think the Board should clarify that:

    (a) **A liability's own credit risk looks to the reporting entity's performance risk associated with that particular liability**. In other words, a liability's credit risk refers to the risk that the reporting entity will fail to perform on that particular liability.

    For example, if an entity issues a collateralized liability and a non-collateralized liability, the credit risk of those two liabilities will be different even though they are issued by the same entity. The own credit risk on the collateralized liability will be less than the own credit risk on the non-collateralized liability (and own credit risk may be zero for some collateralized liabilities). A similar analysis would apply to senior debt and subordinated debt.

    (b) **Own credit risk is different from asset-specific performance risk**. Asset-specific performance risk is **not** related to the performance risk (ie the creditworthiness) of the reporting entity—but rather is related to the performance risk of a single asset or a specified group of assets. Sometimes a liability does not have any own credit risk but rather only has asset-specific performance risk. Sometimes a liability can have both own credit risk and asset-specific performance risk. The distinction is probably easiest to illustrate with examples:

    If a liability has a unit-linking feature whereby the amount due to investors is contractually calculated based on the performance of the related assets, the effect of that unit-linking feature on the fair value of the liability is **not** own credit risk, it is asset-specific performance risk. That is because the effect of the unit linking feature has nothing to do with the creditworthiness of the reporting entity (ie the risk that the reporting entity will not perform). [The last sentence of paragraph

10(a) in IFRS 7 is clear that the effects of the unit-linking feature is not own credit risk.] However, the liability would have own credit risk (in addition to asset-specific performance risk) if the related assets are not ring-fenced solely for the benefit of the investors in the unit-linked liability. This is because the issuer might default on the unit-linked liability even if the related assets are performing well (ie the issuer might use the cash flows from the related assets to satisfy another of its liabilities).

A second example is a liability issued by a consolidated SPE. Assume that the SPE is legally isolated from the consolidated group such that the assets in the SPE are ring-fenced solely for the benefit of its investors, the SPE enters into this one transaction only, and the consolidated group does not owe any amounts to the investors if the SPE's assets do not generate cash flows. From the consolidated group's perspective, the issued liabilities have asset-specific performance risk, but do not have any own credit risk. That is because the risk of the liabilities' non-performance has nothing to do with the group's creditworthiness (ie the risk that the group will not perform) but rather depends solely on the performance of the ring-fenced assets in the SPE.

How do you measure the effects of changes in a liability's credit risk?

27. As noted earlier in this paper, while most respondents agreed that the guidance in IFRS 7 for measuring the effects of changes in own credit risk is appropriate, a few respondents did not agree with the proposals in the ED. Those respondents said that the default method in IFRS 7 does not result in a precise enough measure of the effects of changes in own credit risk—and, therefore, should not be permitted. However, the respondents who said that the default method was not precise enough did not suggest a better methodology (other than some who referred to the FASB's measurement methodologies).

28. We agree that the default method described in IFRS 7 provides an imprecise estimate of the effects of changes in own credit. This is not a new criticism. In the basis for conclusions on IFRS 7, the Board said that the default method would provide a reasonable proxy for changes in a liability's own credit risk, in particular when such changes are large, and would provide users with information with which to understand the effects of such changes.

29. During the Board's outreach programme, it has received a consistent message from those entities who are currently determining the effects of changes in own credit (ie for disclosure purposes)—that determining the effects of changes in own credit risk is difficult and there needs to be some flexibility in how entities are permitted to calculate it.

30. Furthermore, in the user questionnaire, the Board specifically asked users whether the default method in IFRS 7 was appropriate. Most users responded that it is an appropriate method and noted the difficulty in determining the amount more precisely. Many users noted that the default method provides sufficient information so they can detect early warning signs of possible future financial difficulties and other trends in the entity's creditworthiness.

31. Therefore, we recommend that the Board confirm the proposals in the ED to use the guidance in IFRS 7 but we suggest that the Board add some additional application guidance:

    (a) An entity is permitted to use a method other than the default method if the entity believes it more faithfully represents the effects of changes in own credit risk. This is consistent with the guidance in paragraph 10(a)(ii) of IFRS 7 but some preparers said that it was not clear enough and, in practice, some view the default method as the only acceptable methodology. We suggest the Board clearly state that a more precise method is acceptable.

        Some may prefer that an entity is required (rather than permitted) to use a more precise method if one is available. However, we do not recommend that requirement unless the default method clearly does not

faithfully represent the effects of changes in own credit risk (see (b) below). IFRS 7 allows entities flexibility to choose between the default method and other methods—and the Board has received significant support from users and others for retaining the flexibility in IFRS 7. Also, we think that entities might interpret such a requirement to mean that they must search for a more precise methodology. As long as the default method is a reasonable proxy, we do not think the benefits of performing such a search exceed the costs. Finally, if an entity has a more precise methodology, we think it likely will use it — ie we think the risk is low that an entity will choose to ignore a methodology that more faithfully represents the effects of changes in own credit risk because, as discussed in footnote 1 of AP 5A, the default method would give rise to 'measurement mismatches'.

Other methods could include the measurement methods set out in Appendix B of the FASB ED, if the entity determines that those methodologies faithfully represent the effects of changes in own credit risk. As noted earlier in this paper, some respondents said that the FASB's measurement approach (ie to explicitly exclude the effects of changes in the price of credit) is a more precise and representational faithful methodology to determine changes in own credit risk. If that is the case, IFRS 7 would not prohibit an entity from using them.

However many of the entities that are currently determining the effects of changes in own credit (ie those who use the FVO for liabilities and must prepare the disclosures summarized in paragraph 1 of this paper), said that the FASB's proposals are not operational because it is not possible in many cases to separate changes in the price of credit from changes in the entity's creditworthiness. Also, at least one respondent said that Method 1 in the FASB's ED (ie looking solely to changes in the entity's credit rating) is inappropriate because changes in credit ratings do not accurately reflect changes in own credit risk—that is, the market's perception of an entity's own credit risk can change but the

entity's credit rating might not change (or might not change on a timely basis).

(b) In some cases, the default method clearly does not faithfully represent the effects of changes in own credit risk and, in those circumstances, is prohibited if a more precise method is identified. For example, for a unit-linked liability that has own credit risk, the default method would attribute changes in the value of the related assets to changes in own credit risk, which is incorrect. In such cases, an entity would be required to use another methodology.

(c) Entities should disclose more detailed information about the methodologies used to determine the effects of changes in own credit risk—eg a description of the methodology, the assumption used, and why that methodology is appropriate. [While some qualitative information is currently required by paragraph 11 of IFRS 7, some of the users who responded to the user questionnaire said those disclosures should be more robust.]

Question 1
Does the Board agree with our recommendation in paragraphs 23-24 that it should maintain the guidance in IFRS 7 for measuring own credit risk – with additional guidance to address some of the questions and concerns raised by respondents? If not, what does the Board want to do instead and why?

APPENDIX A—relevant sections of the FASB's basis for conclusions

Changes in an Entity's Own Credit Standing

BC160 Concerns of some of the Board's constituents about including the effect of changes in an entity's own credit risk in measuring the financial performance of financial liabilities were discussed in paragraphs BC112 and BC113. The Board decided that an entity should present on the face of the statement of comprehensive income significant changes in fair value of a financial liability that are attributable to changes in the entity's own credit standing (excluding the change in the price of credit), disaggregated according to whether changes in the fair value of the liability are recognized in net income or in other comprehensive income.

BC161 The Board believes that requiring separate presentation of significant changes in fair value attributable to changes in the entity's own credit standing (excluding the change in the price of credit) would address differing needs of different financial statement users and would provide financial statement users with the ability to include or exclude those amounts when they are analyzing financial statements of different entities.

BC162 The Board considered whether any entities should be required to separately present all changes in fair value attributable to a change in an entity's own credit standing (that is, the portion of the discount rate that is not the benchmark/risk-free interest rate). In FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (included in Subtopic 825- 10), the Board decided that for financial liabilities for which the fair value option has been elected with fair values that have been significantly affected during the reporting period by changes in instrument-specific credit risk, an entity should disclose all of the following:

(d) The estimated amount of gains and losses from fair value changes recognized in net income that are attributable to changes in the instrument-specific credit risk

(e) Qualitative information about the reasons for those changes

(f) How the gains and losses attributable to changes in instruments pecific credit risk were determined.

However, the Board decided not to provide guidance about when a change in instrument-specific credit risk is considered significant or detailed computational guidance about how to determine the approximation of the amount of the liability's fair value change attributable to the change in instrument-specific credit risk. The Board understands that, in practice, changes in instrument-specific credit risk are generally determined on the basis of changes in the reporting entity's own credit spreads or credit default swap spreads. However, the approach can vary depending on the nature of the liability.

BC163 IFRS 7, *Financial Instruments: Disclosures*, requires an entity to disclose for all liabilities measured at fair value the amount of change (during the period and cumulatively) in fair value that is attributable to changes in the credit risk of the liability. IFRS 7 indicates that the change in fair value attributable to credit risk can be determined in either of two ways:

(a) As the amount of change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk

(b) Using an alternative the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Under IFRS 7, changes in fair value other than changes related to a change in the benchmark rate are generally attributed to a change in the credit risk.

BC164 The Board believes that the change in fair value attributable to the change in an entity's credit spread does not accurately reflect the change in an entity's own credit because it also measures the change in the price of credit, which affects not just the individual entity, but also other entities in the industry and the economy. Thus, the Board decided that an entity should present separately on

the face of the statement of comprehensive income significant changes in fair value of a financial liability that are attributable to changes in the entity's own credit standing, excluding the price of credit. The Board believes such information would be meaningful to users of the financial statements because an entity would be required to present changes in fair value related to changes in its credit risk only when there has been a change in the entity's own credit standing. Changes in the price of credit solely related to changes in market conditions would not be presented.

BC165 The Board recognizes that there may be several different methods to determine the change in fair value attributable to a change in an entity's own credit standing excluding the change in the price of credit and the proposed guidance does not prescribe a method for determining that change.

APPENDIX B —relevant sections of the FASB's appendix B

Appendix B: Possible Methods for Measuring Changes in an Entity's Credit Standing

B1 To address concerns of some of the Board's constituents about including the effect of changes in an entity's own credit risk in measuring its financial performance, the Board decided that an entity should separately present the effect of these changes on the face of the statement of comprehensive income. To provide meaningful information to users, the Board considered whether to require an entity to measure the effect of changes in an entity's own credit risk by determining the change in fair value attributable to a change in the entity's own credit spread (that is, the portion of the discount rate that is not the benchmark/risk-free interest rate), which generally is consistent with current practice for complying with similar requirements under Subtopic 825-10 and IFRS 7. However, the Board believes that the change in fair value attributable to the change in an entity's credit spread does not accurately reflect the change in the entity's own credit alone because it also measures the change in the price of credit, which affects not just the individual entity, but also other entities in the industry and the economy. Thus, the Board decided that an entity should present separately on the face of the statement of comprehensive income significant changes in fair value of a financial liability that are attributable to changes in the entity's credit standing, excluding the change in the price of credit. Such information would be meaningful to users of the financial statements because an entity would be required to present changes in fair value related to changes in its credit risk only when there has been a change in the entity's credit standing. Changes in the price of credit solely due to changes in market conditions would not be presented separately.

B2 The Board recognizes that there may be several different methods to determine the change in fair value attributable to a change in an entity's credit standing, excluding the change in the price of credit, and the proposed guidance does not prescribe a method for determining that change. This appendix describes two

methods that could be used to determine the change in fair value attributable to a change in an entity's credit standing, excluding the change in the price of credit. The Board requests that constituents review this appendix in considering Questions 32–34 and 36 in the summary.

Method 1

B3 Under Method 1, if there has been no change in an entity's credit rating from the beginning to the end of the period, the entity would assume that there has been no change in fair value for the period attributable to a change in the entity's credit standing, excluding the change in the price of credit. If a financial liability is not rated, the entity would estimate what the financial liability's rating would have been at the beginning and end of the period based on the basis of market information.

B4 If an entity experiences a credit rating change from one period to another (or estimates that it would have experienced a rating change had it been rated), the entity would measure the change in the fair value of its liabilities attributable to a change in the entity's credit standing, excluding the price of credit, by calculating the difference in the change in the reported fair values of the entity's liabilities (which are based on the entity's actual discount rates and credit ratings at the beginning and end of the period) and estimated changes in its fair value based on measures of what its discount rate would have been at the end of the period without a change in credit rating.

Method 2

B5 Under Method 2, the change in the fair value of the financial liability attributable to a change in the entity's credit standing, excluding a change in the price of credit, would not be based on whether an entity has had a change in credit rating. Instead, an entity would isolate the portion of the fair value changes of its liabilities related to the change in the price of credit and deduct that amount from the overall change in fair value. An entity would estimate the change in the price of credit by looking to entities in the industry with the same credit standing. Those entities may or may not have debt instruments with the

same credit rating as the entity for a number of reasons, including delays in changes in credit ratings and the fact that not all debt instruments are rated.

B6 The Example illustrates the application of the methods described above.

[We have omitted the examples from this appendix.]