Project **Financial Instruments: Hedge Accounting**

Topic **Hedge accounting: hedges of credit risk using credit derivatives**

Introduction

Background

1. In the Board's deliberations for the exposure draft *Hedge Accounting* (the ED), the Board discussed accounting for hedges of credit risk using credit derivatives. The Board did not propose any changes in the ED, however it asked a question in relation to this issue. Question 15 of the ED's invitation to comment relates to this issue.

2. The purpose of this paper is to ask the Board the following questions:

   a) Question 1—Whether the Board wants to specifically address hedges of credit risk using credit derivatives?

   b) Question 2—Whether for hedges of credit risk the Board wants to introduce an exception to the separately identifiable and reliably measurable criteria for risk components?

   c) Question 3—Whether the Board wants to provide another alternative to hedge accounting for hedges of credit risk using credit derivatives instead?

3. The staff recommendations are as follows:

a) Question 1—the staff recommend that the Board should address hedges of credit risk using credit derivatives.

b) Question 2—the staff recommend that the Board does *not* introduce an exception to the general criteria for risk components for hedges of credit risk.

c) Question 3—the staff recommend that the Board permit alternative 3[1] as discussed in the Basis for Conclusions (the BC) as an alternative to hedge accounting.

Proposal in the ED

4. The ED discussed credit risk using credit derivatives in paragraphs IN45 to IN47 and asked a question (question 15) but did not propose any changes. Paragraphs BC219-BC246 of the BC set out the alternatives that the Board considered and provided the rationale for not proposing any changes on this issue.

5. The Board noted that this is a significant issue for many of our constituents. Financial institutions frequently use credit derivatives (eg credit default swaps (CDSs)) to manage their exposure to credit risk from loans and loan commitments. However, most financial institutions do not currently apply hedge accounting due to the operational difficulty in isolating and measuring the credit risk component of a financial item as a risk component that meets the eligibility criteria. As a result, the accounting outcome under IFRSs is a mismatch of gains and losses of the loans and loan commitments (measured at amortised cost and generally unrecognised, respectively) versus the credit default swaps (measured at fair value through profit or loss), which creates profit or loss volatility that is artificial.

[1] With a slight adaptation for loan commitments(see paragraph 57).

6. The Board noted that hedge accounting for credit risk is typically not achieved because it is operationally difficult (if not impossible) to isolate and measure the credit risk as a component that meets the eligibility criteria for hedged items. Therefore the Board therefore explored three possible alternative approaches to hedge accounting of credit risk for (subject to certain qualification criteria) for loans and loan commitments:

   a) **alternative 1:** permit:

      (i) electing fair value through profit or loss (FVTPL) *only at initial* recognition;

      (ii) designation of a component of nominal amounts for FVTPL; and

      (iii) discontinuation of FVTPL accounting.

   b) **alternative 2:** permit:

      (i) electing FVTPL at initial recognition *or subsequently* (if subsequently, the difference between the carrying amount and fair value is recognised immediately in *profit or loss*);

      (ii) designation of a component of nominal amounts for FVTPL; and

      (iii) discontinuation of FVTPL accounting.

   c) **alternative 3:** permit:

      (i) electing FVTPL at initial recognition *or subsequently* (if subsequently, the difference between the carrying amount and fair value is *amortised or deferred*);

      (ii) designation of a component of nominal amounts for FVTPL; and

      (iii) discontinuation of FVTPL accounting.

7. The Board discussed that the alternatives to hedge accounting could be subject to the following qualification criteria:

a) that the borrower (or the holder of the loan commitment) matches the reference entity of the credit derivative (ie match of name); and

b) the seniority of the financial instrument matches that of the instrument that can be delivered in accordance with the credit derivative[2].

The qualification criteria are set with a view to accommodate economic hedges of credit risk that would qualify for hedge accounting but for the fact that the risk component cannot be reliably measured. The qualification criteria considered were consistent with regulatory requirements and risk management practice of financial institutions.

8. The Board also considered that elective FVTPL would also be available for loan commitments that fall outside the scope of IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*[3].

9. However, in its deliberations leading up to the ED the Board concluded that these alternatives are too complex and hence did not propose any changes in the ED in relation to hedges of credit risk using credit derivatives. However, given the importance of the issue the Board decided to ask a question about the alternatives to allow further discussion in the redeliberations.

Feedback from comment letters and outreach activities

10. Many respondents are of the view that the Board should consider how to accommodate hedges of credit risk using credit derivatives under IFRSs. Respondents commented that hedges of credit risk using credit derivatives is becoming an increasingly significant practice issue in the application of IFRSs. They noted that this issue is just as significant as other issues that have been

[2] Paragraphs BC227 and BC228 of the BC.
[3] Financial instruments for which credit risk is managed include loan commitments that are accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

addressed in the ED (eg the time value of options, hedges of aggregated exposures and risk components of non-financial items). They further noted that financial reporting under IFRSs should allow entities to reflect the effects of such activities in the financial statements consistent with the overall hedge accounting objective to better reflect risk management activities.

11. Respondents commented that IFRSs today fail to represent the effect of credit risk management activities and distort the financial performance of financial institutions. They noted that because of the accounting mismatch between loans and loan commitments and the related credit derivatives, the profit or loss under IFRSs is significantly more volatile for financial institutions that hedge their credit risk exposures than for financial institutions that do not hedge.

12. Many respondents noted that the objective of hedge accounting is not met if IFRSs do not provide a way to account for hedges of credit risk so that financial statements can reflect the credit risk management activities of financial institutions.

13. Most users commented that the Board should address this issue. Many users also noted that the financial statements currently reflect accounting-driven volatility when credit risk is hedged and do not align with these risk management activities.

14. Participants in the outreach provided the same feedback. Most are also of the view that this is an important practice issue that the Board should address.

The solution?

15. However the feedback was mixed on *how* the Board should address or resolve this issue. Many are of the view that it is difficult to reliably measure credit risk as a risk component for the purposes of hedge accounting. However, some suggest that for some types of instruments the credit risk component of financial instruments can be reliably measured based on credit default swap (CDS) prices subject to certain adjustments.

16. Many agreed that the alternatives set out in the BC were too complex although some respondents support elective FVTPL as an alternative to hedge accounting. Of the three FVTPL alternatives, most respondents support alternative 3.

17. Respondents who supported elective FVTPL think that it is operational and believe that it is no more complex than the other possible approaches, eg identifying risk components. Most preferred alternative 3 of the three alternatives as it aligns most closely with the dynamic credit risk management approach of many financial institutions. Some users support elective FVTPL as they think that the benefits of providing a better depiction of the economics of the risk management activities outweigh the complexity.

18. The various suggestions made by respondents to the Board on how to address this issue can be broadly summarised as follows:

    a) **Risk components:** apply the general criteria for risk components (assuming credit risk would qualify for designation as a risk component).

    b) Exception to the general risk component criteria: provide an exception by:

        (i) using the measurement method in IFRS 7 *Financial Instruments: Disclosures*; or

        (ii) permitting 'residual risks' as an eligible hedged item.

    c) Alternatives to hedge accounting: consider other alternatives to hedge accounting:

        (i) elective FVTPL (as discussed in the BC)—adopt alternative 3 set out in the BC;

        (ii) apply financial guarantee contract accounting; or

        (iii) apply the accounting for time value of options.

Staff analysis of the feedback

Risk components

19. Some respondents are of the view that practice should be allowed to develop based on the general risk component criteria without providing any specific exception to the general risk component criteria. They are of the view that addressing credit risk specifically would be 'rules based' and hence inconsistent to principle-based standard setting. These respondents think that the onus should be on entities to prove that they have separately identified and measured reliably the credit risk component. These respondents think that by acknowledging in the ED that it is operationally difficult (if not impossible) to isolate and measure the credit risk component of a financial item that meets the eligibility criteria for hedged items[4], the Board is specifically prohibiting designating credit risk as an eligible risk component.

20. The staff note that under IFRSs today, risk components of financial items are already eligible hedged items if they meet the separately identifiable and reliably measurable criteria. For hedges of credit risk, the accounting mismatch and hence the artificial profit or loss volatility results from financial institutions not being able to achieve hedge accounting mainly for the following reasons:

    a) failing the hedge effectiveness eligibility criteria (ie falling outside the 80-125 per cent range); and

    b) the criteria that the risk is separately identifiable and reliably measurable—many of these financial products for which credit exposure are managed are complex and can contain multiple embedded options making isolating and measuring the credit risk component operationally complex (see paragraphs 21 to 35 below).

[4] Paragraph IN45 and BC220 of the ED.

Measuring the credit risk component

21. A few respondents commented that financial institutions have sophisticated models for pricing credit risk and as a result a credit risk component should qualify for hedge accounting in the same way as a refining spread or the crude oil component of jet fuel might qualify for hedge accounting. They argue that judgments, adjustments and assumptions could be made to CDS pricing to determine a measure for the credit risk component—just as judgment, adjustments and assumptions would be made in identifying the crude oil component.

22. Some respondents also commented that they do not understand why CDSs cannot be accepted for pricing credit in the same way that LIBOR is used for pricing of interest rate risk. They noted that for hedges of interest rate risk, counterparty credit risk and differences in the derivative versus cash market also exist between the hedged item and the hedging instrument.

23. The staff consider that the comparison to the crude oil or crack spread component of jet fuel fails to appropriately consider the differences in facts and circumstances. For an analysis of identifying risk components in the context of crude oil and refined oil products refer to agenda paper 3A of this meeting. For CDSs and the loan or loan commitments there are various mismatches and differences arising from terms and conditions of the respective instruments and the nature of credit risk. Adjustments for these differences would be required for an entity to arrive at a fair value measurement of 'pure' credit for the loan or loan commitments for which credit risk is managed. The staff note that the more mismatches and adjustments or assumptions are required the less reliable the measurement typically becomes.

Adjustments using CDS prices

24. The staff note that compared to other risk components, CDSs can behave differently from the credit risk component. In other words, there are more

differences between the risk exposures of the financial derivative (ie CDSs) that is designated as the hedging instrument and that of the hedged (credit) risk component than for many other risk components.

25. The staff note that recently there have been discussions about whether voluntary debt restructurings constitute a credit event under the standard ISDA CDS contract. Whether an event constitutes a credit event is determined by a committee consisting of eight international banks, four hedge funds and a bond fund. The fair value of the affected bonds has decreased and markets have taken a 'hair cut' on the bonds. However, the uncertainty about any pay-out under CDSs depending on how the debt crisis will develop and what measures might be considered a credit event is a factor that affects CDSs in a different way than the actual underlying debt. It is an additional factor for CDSs that is not present in the value of the debt as such. Hence, there could be scenarios where for example an impairment loss on a loan might not be compensated by a pay-out from a CDS. Also, market liquidity and the behaviour of speculators trying to close positions and taking gains affect the CDS and the debt market in different ways.

26. The staff note another example could be where a financial institution enters into a CDS to hedge the credit exposure from a loan commitment. The reference entity defaults while the loan commitment remains undrawn or only partly drawn. In this scenario, the financial institution receives compensation without incurring a credit loss (ie a gain from being overhedged).

27. The staff also note that upon a credit event, the protection buyer receives the notional principal less the fair value of the reference entity's obligation. Hence the compensation received for credit depends on the fair value of the reference instrument. The staff note that for a fixed rate loan, the fair value of the reference instrument is also affected by changes in interest rates. In other words, on settlement of the CDS, the entity also receives or pays compensation for the fair value changes attributable to interest rate risk—and not just credit risk of the reference entity. Hence, due to the way CDSs are settled, interest rate risk and

credit risk are *inextricably linked*. This reflects that credit risk is an 'overlay' risk that is affected by all other value changes because they determine what is lost in case of a default.

28. The staff note that in the April meeting, the Board confirmed its proposal in the ED that a layer component of a contract that includes a prepayment option is *not* eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. It noted that if the prepayment option's fair value changed in response to the hedged risk a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how hedge effectiveness would be measured).

29. The staff think that similarly credit risk is not a risk that can be separately identified using CDS pricing as the fair value of the CDSs also includes changes attributable to interest rates and not just credit (because of the nature of credit risk as an overlay risk—see paragraph 27).

30. The staff learnt that in the models developed to measure changes in credit risk in practice, the change in CDS prices are discounted using the interest rate at inception of the hedge (ie that interest rate is kept constant). The staff note that the hedge accounting requirement is to compare the fair value changes in the hedged risk against the fair value changes of the hedging instrument and hence a *current* discount rate should be applied.

31. Hence, because of the different risk characteristics of the CDS compared to the credit exposure the staff consider that credit risk cannot be separately identified and reliably measured from CDS pricing.

Isolating credit risk component from the loans and loan commitments

32. The staff note that loans and loan commitments for which credit exposures are managed can contain one or several of the following options:

    a) prepayment;

b) liquidity;

c) term-out and drawdown;

d) currency;

e) multiple borrower;

f) grid pricing.

The existence of these options impacts the measurement of the fair value of the credit risk component of the loan/loan commitments.

33. To obtain a measure of a credit risk component such that it is an eligible risk component that is separately identifiable and reliably measurable, entities would be required to evaluate how the effects of the embedded options modify the credit risk exposure. Hence, isolating the credit component can be quite difficult for financial products that contain multiple embedded options.

34. Some suggest that these options can be ignored if immaterial or that the Board could allow for simplification. For example:

a) assume a standardised 'hair cut' of x% for all prepayment options;

b) assume that the credit risk exposure for loan commitments would be 100% of the committed amount.

However, while possibly not significant, ignoring these features would still result in merely an *approximation* of the credit risk component. That means that some ineffectiveness would not be measured and recognised. Also, this means it would be an exception to (instead of an application of) the general risk component criteria.

35. Hence, the staff note that measuring the risk component is often more difficult than for other risk components. Adjustments would be required for the multiple options that that are often part of the hedged financial products.

36. Some respondents noted that the Board should not specifically prohibit hedges of credit risk from being eligible for hedge accounting because the structural

differences between the CDS and a debt instrument noted by the Board may disappear over time as the market structure for CDSs develops, or more sophisticated models of adjusting for these structural differences may develop in the future that would then enable entities to measure the credit risk component of a financial item as a component that meets the eligibility criteria for hedged items.

37. The staff note although it may be the case that in the future markets may evolve, hedging credit risk using credit derivatives under IFRSs is currently a significant practice issue. The staff note that if the Board removes the comment that it is difficult to isolate and measure credit risk, based on the feedback received it seems highly likely that some entities would draw the wrong conclusion and consider that as an 'endorsement' of designating credit risk as a hedged item on a risk components basis. Hence, it is more appropriate that a different and more timely solution to eliminate the accounting mismatch and profit or loss volatility is needed so that financial statements under IFRSs can provide more relevant and useful information.

38. In addition, the staff are sceptical that evolution of the markets would resolve the issue of the inextricable link between credit risk and other risks resulting from the nature of credit risk as an overlay risk (see paragraph 27). This is an issue arising from the hedged item and hence cannot be addressed by the evolution of the market for hedging instruments.

Exception to the general risk component criteria

39. Many respondents acknowledge the difficulty in meeting the general risk component criteria for credit risk exposures but believe that it is important to find a solution for hedges of credit risk. Some respondents suggest that the Board consider providing an *exception* to the general risk component criteria for credit risk.

Risk components using the method in IFRS 7

40. Some respondents suggest the Board consider an approach that would provide a reasonable approximation of the credit risk as an exception to the general risk component criteria. These respondents suggest that the Board consider the guidance in IFRS 7[5] and IFRS 9 for measurement of the entity's own credit on the entity's financial liabilities at fair value through profit or loss. They think that the Board should provide the same 'relief' for measuring the credit risk component for the purposes of hedge accounting as for the measurement of 'own credit' for financial liabilities measured at fair value through profit or loss.

41. The staff note that in finalising the requirement for the fair value option for financial liabilities under IFRS 9, the Board retained the default method in the application guidance in IFRS 7[6] to determine the effects of changes in the liability's credit risk. The Board received comments that determining the effects of changes in a liability's credit risk can be complex, and therefore it was necessary to allow some flexibility in how it is measured. Respondents, like the Board, acknowledged that the default method is imprecise but consider the result a reasonable proxy in many cases. Moreover, the staff note that respondents did acknowledge that the IFRS 7 method does *not* isolate changes in a liability's credit risk from other changes in fair value (eg general changes in the price of credit or changes in liquidity risk); those respondents said that it is often very difficult or impossible to separate those items[7].

42. The staff note that applying the IFRS 7 method could be just as complex as applying the general risk component criteria for some of these financial instruments for which the credit risk exposure is managed.

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[5] IFRS 7.B4.
[6] The IFRS 7 method has been incorporated into IFRS 9.B5.7.16-B5.7.20.
[7] IFRS 9.BC5.62.

43. The staff note that the IFRS 7 method involves the use of observed market price at the beginning and end of the period in determining the change in the effects of credit. It requires entities to deduct any changes in market conditions from changes in the fair value of the instrument. Any residual amount is deemed to be attributable to changes in credit. The staff learnt that the loans and loan commitments for which the credit risk is hedged very often have no observable market price, and complex modelling would be involved to arrive at a market price. To apply the IFRS 7 method, valuations for parts of the instrument would then be deducted and analysed for changes in market conditions to arrive at a credit risk component.

44. Furthermore, the staff note that the loans and loan commitments for which the credit exposure is managed often have embedded options (see paragraph 32) and the fair value of these options depends on both market and non-market conditions (eg the exercise of prepayment options could be due to changes in interest rate (market condition) while loans are typically refinanced (exercise of the prepayment option) well in advance of the scheduled maturity despite interest rate movements[8]). Hence isolating the changes for market conditions on these embedded options could involve significant judgment and can become extremely complex.

45. The staff learnt that for the IFRS 7 method to be operational it would also require many of the same simplifications that some commentators suggested for the general risk component criteria (eg using a standardised haircut for prepayment and term out options, and ignoring immaterial options) (see paragraph 34).

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[8] The staff learnt that the borrowers typically seek to maintain long-term debt or liquidity lines and will rarely allow maturities of loan commitments to fall below 12 months. Many borrowers will seek to refinance 5 year loan commitments on an annual basis to show a relatively constant 5-year liquidity commitment.

46. The staff think that for exchange traded bonds for which market prices are readily observable and for which several embedded options typically do not exist, IFRS 7 might be an approximation or proxy for the credit risk component in some circumstances.

47. However, for loans and loan commitments that are not actively traded, the IFRS 7 method can become a complicated 'circular' pricing exercise and would very likely result in a rough approximation or imprecise measurement of the credit risk component.

48. However, the staff further note that the Board had acknowledged the shortcomings of the approach used for IFRS 7 and IFRS 9 and that it is only a proxy for measuring credit risk. Hence, the Board had actively sought to limit the application of this approach by retaining the bifurcation requirement for financial liabilities even though bifurcation of financial assets was eliminated. Hence, the approach is only applicable to financial liabilities designated as at fair value through profit or loss.

'Residual risks' as an eligible hedged item

49. A few respondents suggest that the Board considers permitting 'residual risks' as an eligible hedged item. Under this approach, the changes in cash flows or fair value of an item that is **not** attributable to a specific risk or risks (that meet/s the separately identifiable and reliably measurable criteria) could be designated as an eligible hedged item (eg an entity could designate the fair value changes of a loan attributable to all risks other than interest rate risk).

50. The staff note that this approach has the advantage of not requiring an entity to *directly* measure credit risk. However, the staff note that this approach also has similar complexity to the IFRS 7 method for some financial instruments where there are multiple embedded options. Determining the fair value changes attributable to a specific risk (eg interest rate risk) could be complex. Also, the

issue regarding the inextricable link between credit risk and other risks resulting from the nature of credit risk as an overlay risk (see paragraph 27) would remain.

51. The staff further note that under this approach, the hedge effectiveness assessment under the new hedge accounting requirements would not be met as it would be difficult to establish and demonstrate a direct economic relationship between the 'residual' risk and the hedging instrument (CDSs) which gives rise to offset—a requirement to qualify for hedge accounting.

Alternatives to hedge accounting

Elective fair value through profit or loss

52. In the Board's deliberations for the ED, the Board discussed alternatives to hedge accounting as a possible solution to address this issue. But the Board concluded that the elective FVTPL alternatives discussed were too complex.

53. Some large international financial institutions commented that they do not think that elective FVTPL would add unnecessary complexity. They think that elective FVTPL alternatives discussed by the Board in the deliberations would be the most operational and efficient approach to address and meet the ED's objective to reflect their risk management activities. Some respondents commented that elective FVTPL may be less burdensome to implement than hedge accounting in some circumstances.

54. Of the three alternatives, most respondents think that alternative 3 best reflects the effects of an active and flexible risk management strategy. Many respondents consider that alternative 3 is the one that mostly aligns accounting with the dynamic approach under which the credit risk is typically managed in many of these financial institutions. Some respondents commented that alternative 3 is better than the current IFRS 9 fair value option if hedge accounting cannot be achieved. It provides more useful information about the effectiveness of credit risk mitigation strategies undertaken by banks in their risk management of credit

exposure using credit derivatives, especially when compared to the fair value option.

55. Some respondents noted that alternative 2 is less complex than alternative 3. However, they agreed with the Board's conclusion that the profit or loss impact when the financial asset is remeasured to fair value does not provide useful information as it does not reflect any credit related event and will be counter-intuitive to investors. Respondents noted that under alternative 2 the entity would take an immediate loss at the inception of the economic hedge creating an accounting disincentive for entities to use this alternative in practice.

56. Some respondents noted that the elective FVTPL alternatives would create profit or loss volatility due to changes in interest rates for fixed rate instruments. The staff note that one of the benefits of elective FVTPL is that the entire fair value change of the instrument is recognised in profit or loss hence avoiding the need to identify and separately measure credit risk.

57. A few respondents noted that the differentiation of the accounting treatment of the measurement change adjustment (MCA) for loan and loan commitments under alternative 3 creates operational complexity. Alternative 3 proposes that the MCA be amortised for loans and deferred for loan commitments that fall within the scope of IAS 37. The staff note that the differential treatment aligns with the accounting for loans at amortised cost and the accounting for loan commitments under IAS 37. Respondents noted that some loan commitments are drawn occasionally, and it can be administratively burdensome when there is a different accounting approach between drawn and undrawn loans. This would require tracking of MCA amortisation when the loan is drawn and ceasing amortisation when the loan is repaid. Hence, these respondents suggested the accounting for MCA should be aligned. They noted that amortisation of the MCA for both loans and loan commitments would be the more operational approach.

58. The staff is of the view that elective FVTPL is less operationally complex than the credit risk component and the IFRS 7 method as entities would not be required to identify and isolate the credit risk component. The staff further note that because the fair value changes from the loan or the loan commitments and the credit derivative are both taken to profit or loss, any 'ineffectiveness' or mismatch of economic gain or loss between the loans/loan commitments and the CDS would be immediately recognised in profit or loss. The staff note that to further operationalise the approach, the Board could consider aligning the accounting of the MCA for loans and loan commitments. The staff also note that disclosures as discussed by the Board in its deliberations[9] would also provide transparency to this approach and useful information for users more generally.

Financial guarantee contract

59. Some respondents argue that credit derivatives are used for risk management purposes as a protection—a guarantee against the default of a counterparty and hence an alternative would be to treat them as a financial guarantee contract.

60. The staff note that credit derivatives such as CDSs typically do not meet the definition of a financial guarantee contract under IAS 39 or IFRS 9. A financial guarantee contract is defined as:

> …a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument[10].

61. In a standardised CDS contract the credit events that trigger payment under CDSs (eg bankruptcy, repudiation/moratorium, restructuring) may not directly relate to the failure to pay on that particular debt instrument. In other words, the specified

[9] BC244 and 245 of the ED.
[10] IAS 39.9.

payments received may not be the result of the debtor failing to make payment on that particular debt instrument in accordance with the original or modified terms.

62. Furthermore, the staff note that to meet the definition of a financial guarantee contract, it must be a precondition for payment that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due[11]. CDSs do not require the holder to be exposed to the underlying reference financial instrument as a precondition for entering into a CDS contract (ie an entity can hold a 'naked' position). Hence a typical CDS does not meet the definition of a financial guarantee contract under IAS 39 or IFRS 9.

63. The definition of a financial guarantee contract would have to be broadened in order for CDSs to meet the definition of a financial guarantee contract. The staff note that accounting for CDSs as financial guarantee contracts would mean that CDSs would not be measured at fair value but at cost—ie applying accrual accounting to a derivative financial instrument.

Time value of options

64. Some respondents consider that the premium paid on CDSs is similar to buying protection under an insurance contract and, accordingly, the premium should be amortised to profit or loss. These respondents propose that the Board could consider applying the ED's proposed accounting treatment for the time value of options to CDSs.

65. The staff note that under the Board's tentatively confirmed decision on the accounting for time value of options, when an entity designates only the intrinsic value of the option as the hedging instrument, the time value of the option at inception is deferred in other comprehensive income (OCI) and subsequent fair

[11] IAS 39.AG4(b)

value changes for the time value of the option are recognised in OCI. For a situation like hedging credit risk the time value would be amortised to profit or loss (ie like for a *time period* related hedged item).

66. Respondents who support this approach argue that from a risk management perspective, changes in the fair value of the derivative during the period are irrelevant, as long as the issuer (of the debt) is solvent. If there is no credit event the fair value of the CDS on maturity will be zero. Hence, interim fair value changes could be recognised in OCI like for the time value of options.

67. The staff note that a difference between ('normal') options and CDSs is that for options the time value paid is known from the beginning (hence the amount to be amortised or deferred is known) whereas for a CDS the premium is contingent on the occurrence of a credit event and hence the total premium ultimately paid is not known at the outset. This is because the premium is paid over time—but only until a credit event occurs. The staff note that for this approach to be operational, the contingent nature of the premium would have to be ignored so that the amortisation of the CDS premium in profit or loss can be based on the assumption that no credit event occurs—even though that risk is reflected in the fair value of the CDS. This is in substance 'pay as you go' accounting for the CDS premium (ie recognise it in profit or loss on an accrual basis[12]).

68. The staff note that in order to apply the same accounting to CDSs, it would require splitting the fair value of the CDS into an intrinsic value and time value. A question arises whether the CDS would only have time value (and hence *no* intrinsic value) until a credit event occurs. In other words before a credit event occurs, should the entire fair value of the CDS be deemed to be its time value?

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[12] An alternative to 'pay as you go' accounting is to require capitalisation of the present value of the maximum cumulative premium (ie the premium to be paid under the contract assuming no default occurs) as an asset and recognising a corresponding liability. The amortisation expense of the asset and the unwinding of the present value of the liability would be recognised in profit or loss.

69. However, the staff think that the entire fair value of the CDS is not attributable to time value before a credit event. The staff note that hedged items such as bonds or loans have 'intrinsic' value but no equivalent to time value. In an effective economic hedge, the changes in the 'intrinsic' value in the hedged item would offset the changes in the intrinsic value of the hedging instrument. During times of financial difficulty (but before a credit event(eg actual default)) the fair value of the loan would have decreased due to deterioration of credit. The fair value of the CDS would increase because of the higher risk of default. Hence, the increase in fair value of the CDS includes some intrinsic value element although it would be difficult to isolate and separately quantify it.

70. The staff further note that if the entire fair value on a CDS is treated as time value before default, there could be a mismatch when an entity recognises an impairment loss on the loan or loan commitment before default (as all fair value changes from the CDS would still be recognised in OCI). One solution would be to recycle from OCI to profit or loss the amount of impairment loss from the loan or loan commitment and hence simply deem the amount of the impairment loss to be the intrinsic value of the CDS. This means it raises the same issue as other *approximations* discussed earlier in this paper (see paragraph 34).

71. The staff further note that most of the CDSs taken out are standardised 5 year CDSs or have maturities longer than the credit exposure. Under the proposed accounting for the time value of options an entity is required to determine aligned time value if the option is not fully aligned with the hedged item[13]. Hence, if the accounting for time value of options is applied to CDSs an entity would similarly be required to compute a separate aligned CDS valuation for the hedged credit exposure in many cases due to the misalignment in maturity between the credit

[13] An entity determines the aligned time value using the valuation of the option that would have critical terms that perfectly match the hedged item.

exposure and the CDS. This would add to the effort that this alternative would entail.

72. The staff also note that any mismatch of economic gains or losses from the hedge is not recognised under this approach. The loan and loan commitments are recognised at amortised cost and unrecognised, respectively, and the fair value changes from the CDS would not be recognised in profit or loss (only the premium paid). The profit or loss recognition for the CDS under this approach would be the same as accrual accounting while assuming perfect hedge effectiveness.

73. The staff note that the same qualification criteria discussed by the Board in the BC for elective FVTPL could also apply to this alternative.

74. The staff consider that this approach is less transparent than alternative 3 of elective FVTPL.

Staff recommendations and questions

75. 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. The staff further note that as the credit derivatives market develops, using credit derivatives to manage credit exposures is likely to increase.

76. The staff consider that it is difficult to measure credit risk in a way that meets the general criteria for risk components under hedge accounting. The financial instruments for which credit risk exposures are managed often have many multiple embedded options that could modify the instrument's exposure to credit risk for which complex valuation adjustments would be required. Furthermore, the fair value of the hedging instrument (CDS) is also exposed to other risks (ie interest rate risk) (see paragraphs 27 to 29) and does not solely relate to credit risk.

Hence, the many adjustments and assumptions required to measure a credit risk component cannot appropriately address the issue of separately identifying the credit risk component.

77. The staff also note that many respondents including 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.

78. The staff recommend that the Board address this issue specifically so that IFRSs can better reflect the economic substance of the credit risk management strategies. The staff consider that the objective of hedge accounting to represent in the financial statements the effect of an entity's risk management activities is not met if a solution is not found to address the profit or loss volatility from the accounting 'mismatch' of gains and losses of the loans and loan commitments versus those of the CDSs.

Question 1
Does the Board agree with the staff recommendation that the Board should address hedges of credit risk using credit derivatives? If the Board does not agree, why?

Exception to the general risk component criteria

79. The staff consider that providing an exception to the risk component criteria is not the most efficient solution as an argument could also be made for other risks that do not meet the separately identifiable and reliably measurable criteria (eg inflation risk).

80. The staff further note that in some cases the methods suggested can be just as complex as trying to apply the risk component approach (without any

concession). These methods also lead to the consequence that not all hedge ineffectiveness might be captured in profit or loss.

81. Hence, the staff do not recommend that the Board introduce an exception to the general criteria for risk components.

Question 2
Does the Board agree with the staff recommendation to not introduce an exception to the general criteria for risk components for hedges of credit risk? If the Board does not agree, what does the Board prefer instead and why?

Alternatives to hedge accounting

82. The staff consider that this issue could be most efficiently and clearly addressed by providing an alternative to hedge accounting.

Financial guarantee contract

83. One advantage of broadening the definition of a financial guarantee contract to accommodate hedges of credit risk is its simplicity.

84. However, the staff do not recommend this approach. Following this approach means in effect applying accrual accounting to a derivative financial instrument. The staff considers that it is important and relevant information that derivative financial instruments are measured at fair value.

Time value of options

85. The staff do not recommend the Board applying the accounting for time value of options to credit derivatives as a way to accommodate hedges of credit risk.

86. To follow this approach, assumptions would have to be made on what is considered to be time value and intrinsic value of a CDS. This would require

ignoring a key characteristic of CDS contracts—the contingent nature of the premiums paid on the CDS. It would also require determining the 'intrinsic' value of the CDS, which could only be an approximation.

87. The staff further note that under this approach any mismatch of economic gains or losses (ie economic hedge ineffectiveness) between the loan and loan commitments versus the CDSs would not be fully recognised in profit or loss.

Elective FVTPL

88. The staff consider that alternative 3 of elective FVTPL provides the most efficient solution to address this long standing issue and facilitates some degree of alignment with credit risk management.

89. The staff notes that alternative 3 avoids the need to identify and separate credit risk. Alternative 3 is operationally simpler than the IFRS 7 method and the 'residual' method.

90. In particular, the staff consider that alternative 3 of elective FVTPL provides the greatest transparency about credit risk management activities. Any economic mismatch of gains or losses from the loans and loan commitments versus the credit derivatives is recognised in profit or loss. The disclosure of the MCA adjustments also provides useful information about when the financial institution engages in active credit risk management.

91. The staff consider that alternative 3 aligns most closely with the ED's overall objective of improving the quality of information as it provides an alternative for financial institutions to reflect their active credit risk management activities.

92. Hence, the staff recommend alternative 3 of elective FVTPL as it would produce the most meaningful (ie transparent and relevant) information for users and in the staff's view would improve the quality of financial reporting. To further operationalise this alternative, the staff recommend the Board aligns the accounting of the MCA for loans and loan commitments (see paragraph 57).

Question 3
Does the Board agree with the staff recommendation in paragraph 92 above to permit alternative 3 of elective FVTPL with alignment of the accounting for MCA for loans and loan commitments? If the Board does not agree, what does the Board prefer instead and why?

Appendix A

A1. This appendix provides extracts from the Basis for Conclusions (the BC), IFRS 9 *Financial Instruments* and the addendum of agenda paper 21B from the 21 October 2010 IASB meeting.

A2. Extracts of the BC (paragraphs BC 219 to BC246):

Hedging credit risk using credit derivatives

BC219 Many financial institutions frequently use credit derivatives to manage their credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer the risk of credit loss on a loan or a loan commitment to a third party. This might also reduce the regulatory capital requirement for the loan or loan commitment while at the same time allowing the financial institution to retain nominal ownership of the loan and to preserve the relationship with the client. Credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (eg a facility for a particular client) or the bank's overall lending portfolio.

BC220 However, financial institutions that manage credit risk using credit derivatives generally do not achieve hedge accounting because it is operationally difficult (if not impossible) to isolate and measure the credit risk of a financial item as a component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, it is operationally difficult to isolate and measure the change in fair value that is attributable solely to credit risk.

BC221 Some believe that credit default swap prices are the best measure of the credit risk component of a financial asset. However, the Board noted that using credit default swap pricing to measure the credit risk component of a financial instrument (eg a bond) might be conceptually flawed, at least because of the following structural differences between a credit default swap and a debt instrument:

(a) funding—a credit default swap is a synthetic instrument and does not require funding, whereas a debt instrument is a cash instrument that requires initial cash outlay;

(b) coupon accrual on default—a defaulted debt instrument does not pay the coupon accruals between the last coupon date and the date of default whereas a credit default swap protection buyer pays the accrued premium until the date of default;

(c) counterparty credit risk—a protection buyer of a credit default swap has the risk that the protection seller will default on the credit default swap contract; and

(d) defined credit event—events that trigger the payout of the credit default swap may not necessarily be a default.

BC222 Other aspects that give rise to differences between the value of a credit default swap and the credit risk inherent in the reference obligation are:

(a) features such as 'cheapest to deliver' options;

(b) differences in liquidity between the credit default swap and debt markets;

(c) the effect of auction processes when credit default swaps are settled as a result of a credit event; and

(d) the interpretation of the 'restructuring' credit event (and any related uncertainty about that interpretation).

BC223 When the requirements for hedge accounting are not met, IFRS 9 and IAS 39 permit an entity to designate as at fair value through profit or loss, at initial recognition, financial instruments that are within the scope of the standard if doing so eliminates or significantly reduces an 'accounting mismatch'. However, the fair value option is only available at initial recognition, is irrevocable and an entity must designate the financial item in its entirety (ie for its full nominal amount). Because of the various optional features and the drawdown behavioural pattern of the loans and loan commitments, credit portfolio managers engage in a flexible and active risk management

strategy. Credit portfolio managers most often hedge less than 100 per cent of a loan or loan commitment. They might also hedge longer periods than the contractual maturity of the loan or the loan commitment. Furthermore, the fair value option is available only to instruments that are within the scope of IAS 39. Most of the loan commitments for which credit risk is managed fall within the scope of IAS 37 rather than IAS 39. Consequently, most financial institutions do not (and often cannot) elect to apply the fair value option because of its restrictions and scope.

BC224 As a result, financial institutions that use credit default swaps to hedge credit risk of their loan portfolios measure their loan portfolios at amortised cost and do not recognise most loan commitments (ie those that meet the scope exception of IAS 39). The changes in fair value of the credit default swaps are recognised in profit or loss every period (as for a trading book). The accounting outcome is a 'mismatch' of gains and losses of the loans and loan commitments versus those of the credit default swaps, which creates volatility in profit or loss. During the Board's outreach programme, many users pointed out that that outcome does not reflect the economic substance of the credit risk management strategy of financial institutions.

BC225 In the exposure draft, the Board proposes that a risk component should be separately identifiable and reliably measurable (see paragraph 18) in order to qualify as a hedged item. As mentioned before, measuring the credit risk component of a loan or a loan commitment is complex. Consequently, to accommodate hedge accounting for hedges of credit risk, a different hedge accounting requirement specifically for this type of risk component would have to be developed, or the proposed hedge accounting requirements would have to be significantly modified (eg in relation to eligible hedged items and effectiveness testing).

BC226 The Board considered three alternative approaches to address situations in which credit risk is hedged by credit derivatives. These alternatives would, subject to qualification criteria, permit an entity with regard to the hedged credit exposure (eg a bond, loan or loan commitment):

(a) alternative 1:

(i) to elect fair value through profit or loss only at initial recognition;

(ii) to designate a component of nominal amounts; and

(iii) to discontinue fair value through profit or loss accounting.

(b) alternative 2:

(i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and fair value is recognised immediately in profit or loss);

(ii) to designate a component of nominal amounts; and

(iii) to discontinue of fair value through profit or loss accounting.

(c) alternative 3:

(i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and fair value is amortised or deferred);

(ii) to designate a component of nominal amounts; and

(iii) to discontinue fair value through profit or loss accounting.

BC227 The fair value through profit or loss election would be available for a financial instrument that is managed in such a way that an economic relationship with credit 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. However, this would also apply to loan commitments that fall outside the scope of IAS 39 and IFRS 9 if additional qualification criteria are met. The Board considered the following qualifying criteria for electing fair value through profit or loss:

(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 in accordance with the credit derivative).

BC228 The qualification criteria above are set with a view to accommodating 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 qualification criteria above are also consistent with regulatory requirements and the risk management strategy underlying the current business practice of financial institutions.

BC229 For discontinuation, the Board considered the following criteria:

(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 because of, for example:

(i) improvements in the credit quality of the borrower; or

(ii) changes to capital requirements imposed on the financial institution.

BC230 Given the rationale for electing fair value through profit or loss, an entity would typically discontinue accounting at fair value through profit or loss if the discontinuation 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). The Board noted that in the circumstances when the discontinuation criteria apply, the financial instrument, if fair value through profit or loss accounting had not already been elected, would not qualify (any more) for that election. Hence, the Board considered it would be

logical to make discontinuation of fair value through profit or loss mandatory (rather than optional) if the discontinuation criteria are fulfilled.

BC231 Alternative 1 permits electing fair value through profit or loss 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. Fair value through profit or loss can be discontinued if the qualification criteria are met. Loan commitments that fall outside the scope of IFRS 9 could also be eligible in accordance with this alternative if the qualification criteria are met. In accordance with alternative 1, at the date of discontinuation of fair value through profit or loss the fair value of the financial instrument will be its deemed cost. For loan commitments outside the scope of IFRS 9 the measurement and recognition criteria of IAS 37 would apply.

BC232 Alternative 1 permits an election for a nominal component. The Board noted that when IAS 39 was issued there were concerns that allowing the designation of a component of nominal amounts could provide an incentive for earnings management. This was the reason why IAS 39 prohibits the designation of such a component. However, the Board noted that:

(a) for the purpose of hedging credit risk, the business model is about holding the loan (or loan commitment). This is because:

(i) investment-grade bank loans are largely illiquid instruments and are therefore 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 the credit standing of the facility provider is crucial for the line of credit).

(iii) these instruments 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 within the scope of IFRS 9, the accounting mismatch arises only for instruments that are not classified as fair value through profit or loss. 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 of collecting contractual cash flows. The Board addressed the issue of earnings management 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, because of the business model (see (a) above), the sale of loan commitments is 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 and therefore mandatory classification as at fair value through profit or loss applies. Consequently, the considerations above that apply to loans also apply to loan commitments (assuming that equivalent disclosure of information would be required).

BC233 The Board noted that 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 the initial recognition of that exposure) this alternative is not aligned with the credit risk management strategy and therefore would not reflect its effect. An advantage of alternative 1 is that it is less complex than the other alternatives that the Board considered. By not permitting the election of fair value through profit or loss after initial recognition (or inception of a loan commitment), the difference at later points in time between the carrying amount and the fair value of the financial instrument will not arise.

BC234 In addition to the election of fair value through profit or loss at initial recognition in accordance with alternative 1, alternative 2 also permits that election after initial recognition. This means that the election is available again for an exposure for which fair value through profit or loss was elected previously (which logically cannot apply if the election is restricted to initial recognition). An example is a volatile longer-term exposure that was

previously deteriorating and was 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.

BC235 The Board noted that when the financial instrument is elected for measurement as fair value through profit or loss after initial recognition, a difference could arise between its carrying amount and fair value. This difference is a result of the change in the measurement basis (eg from amortised cost to fair value for a loan). The Board considers this type of difference a measurement change adjustment. Alternative 2 proposes to recognise the measurement change adjustment in profit or loss immediately. At the date of discontinuation of fair value through profit or loss accounting, the fair value will be the deemed cost (as in alternative 1). If the financial instrument is elected again after a previous discontinuation, the measurement change adjustment at that date is also recognised immediately in profit or loss.

BC236 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 significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives.

BC237 A disadvantage of alternative 2 is that it is more complex than alternative 1. Furthermore, it might appear susceptible to earnings management. An entity can decide at what time to elect fair value through profit or loss accounting 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. The accounting impact of immediately recognising the measurement change adjustment in profit or loss may also deter an entity from electing fair value through profit or loss accounting. 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, it will

immediately recognise a loss if it elects fair value through profit or loss accounting.

BC238 On the other hand, the advantage of recognising the measurement change adjustment immediately in profit or loss is that it is operationally simpler than alternative 3. Alternative 3 provides the same eligibility of fair value through profit or loss accounting and its discontinuation as alternative 2. Consequently, it also facilitates an accounting outcome that reflects the credit risk management strategy of financial institutions.

BC239 An important difference between alternatives 2 and 3 is the treatment of the measurement change adjustment (ie the difference that could arise between the carrying amount and fair value of the financial instrument when fair value through profit or loss accounting is elected after initial recognition of the credit exposure). Alternative 3 proposes that the measurement change adjustment should be amortised for loans and deferred for loan commitments that fall within the scope of IAS 37.

BC240 More specifically, alternative 3 proposes the following in relation to the measurement change adjustment:

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

(i) the measurement change adjustment is amortised over the life of the instrument;

(ii) when the measurement change adjustment plus the fair value is greater than the carrying amount if the loan had been continued to be measured at amortised cost, the amount above amortised cost is recognised as an impairment (to the extent of the unamortised measurement change adjustment); and

(iii) any unamortised measurement change adjustment at the date of discontinuation is added to the fair value of the financial instrument as its new deemed cost.

(b) for loan commitments within the scope of IAS 37, the measurement change adjustment is deferred until the earlier of:

(i) the discontinuation of fair value through profit or loss accounting; and

(ii) recognition of a provision in accordance with IAS 37 (ie when the 'probable' threshold is met).

BC241 As in 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 credit exposures and the credit derivatives. An advantage of alternative 3 over 2 is that it would be less susceptible to earnings management and would not deter the election of fair value through profit or loss in scenarios after initial recognition of the exposure when the fair value of the exposure has already declined.

BC242 However, a disadvantage of alternative 3 is that it is the most complex of the alternatives. The Board noted that the measurement change adjustment in accordance with alternative 3 would have presentation implications. The measurement change adjustment could be presented in the statement of financial position in the following ways:

(a) as an integral part of the carrying amount of the exposure (ie it could be added to the fair value of the loan): this results in a mixed amount that is neither fair value nor amortised cost.

(b) presentation as a separate line item next to the line item that includes the credit exposure: this results in additional line items in the balance sheet (statement of financial position) and may easily be confused as a hedging adjustment.

(c) in other comprehensive income.

BC243 The periodic charge for the amortisation of the measurement change adjustment for loans could be presented in the statement of comprehensive income as:

(a) (part of) interest revenue: however, the Board noted that the financial instrument that the amortisation relates to would no longer be measured at amortised cost (given the election to apply fair value through profit or loss accounting)

and hence this presentation would be inconsistent with requirements regarding interest revenue recognition.

(b) other gains or losses.

BC244 The Board noted that disclosures could provide transparency on the measurement change adjustment. The Board considered a reconciliation of changes in the measurement change adjustment balance during the period that would include, for example, the following reconciling items:

(a) additions as a result of electing fair value through profit or loss accounting;

(b) releases:

(i) amortisation

(ii) impairment

(iii) discontinuation

(iv) transfers to allowance account for credit losses; and

(c) the effect of foreign exchange rate changes.

BC245 The Board also considered a reconciliation of the nominal amount and the fair value of the credit derivatives that have been used to manage the credit exposure of a financial instrument that qualified and was elected for fair value through profit or loss accounting.

BC246 However, in the light of the complexities that the three alternatives that the Board considered would introduce, the Board proposes not to allow elective fair value accounting for part of the nominal amount of hedged credit exposures (such as loans and loan commitments).

A3. Extracts of IFRS 9 (paragraphs B5.7.16 to B5.7.20):

Determining the effects of changes in credit risk

B5.7.16 For the purposes of applying the requirement in paragraph 5.7.7(a), an entity shall determine the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability either:

(a) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see paragraphs B5.7.17 and B5.7.18); or

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

B5.7.17 Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates.

B5.7.18 If the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, the amount in paragraph B5.7.16(a) can be estimated as follows:

(a) First, the entity computes the liability's internal rate of return at the start of the period using the fair value of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.

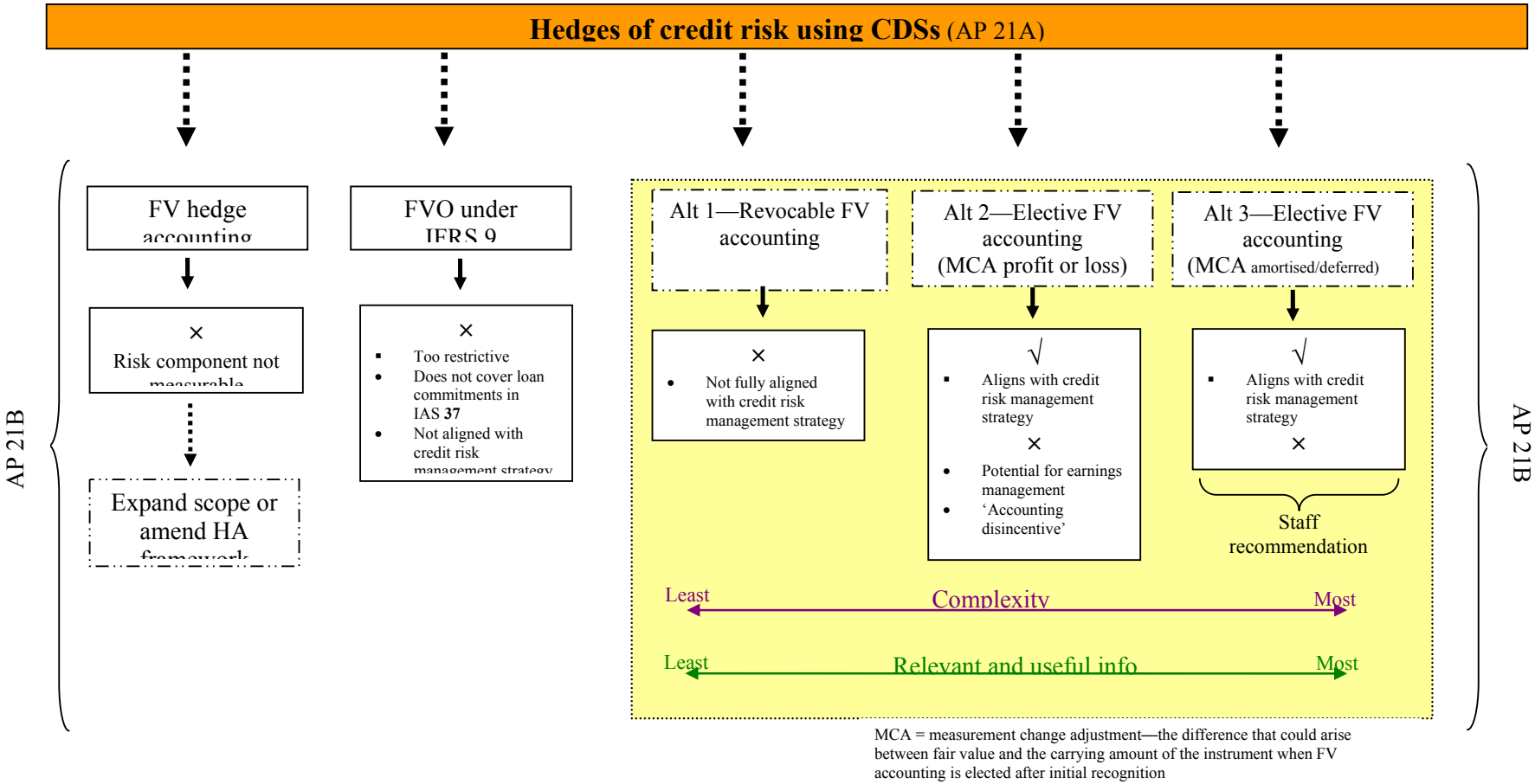
(b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).

(c) The difference between the fair value of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).

B5.7.19 The example in paragraph B5.7.18 assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in observed (benchmark) interest rates are not significant. This method would not be appropriate if changes in fair value arising from other factors are significant. In those cases, an entity is required to use an alternative method that more faithfully measures the effects of changes in the liability's credit risk (see paragraph B5.7.16(a)). For example, if the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).

B5.7.20 As with all estimates of fair value, an entity's measurement method for determining the portion of the change in the liability's fair value that is attributable to changes in its credit risk must make maximum use of market inputs.

A4. Addendum of agenda paper 21B from the 21 October 2010 IASB meeting:



MCA = measurement change adjustment—the difference that could arise between fair value and the carrying amount of the instrument when FV accounting is elected after initial recognition