

STAFF PAPER

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IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Relief to accelerate application of own credit requirements		
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Background

1. In October 2010 the IASB published IFRS 9 (2010) that addressed the concerns about presenting changes in a liability's credit risk in profit or loss ('own credit'¹). Essentially that document requires that when a financial liability is designated as at fair value through profit or loss under the fair value option (FVO), the change in the fair value of the liability that is attributable to changes in the issuer's own credit should be recognised in other comprehensive income (OCI)². IFRS 9 further requires that amounts presented in OCI will not subsequently be transferred (recycled) to profit or loss. This change in IFRS 9 has received strong support from our constituents.
2. When the Board first proposed including the own credit requirements in IFRS 9 some respondents suggested that it should in fact be incorporated in IAS 39 *Financial Instruments: Recognition and Measurement*. At the time the Board decided that it was inappropriate to amend IAS 39 given the active project to replace it with IFRS 9. In response to the exposure draft *Mandatory Effective Date of IFRS 9*, published in August 2011, that proposed deferring the

¹ 'Own credit' refers to the risk that the issuer will fail to perform on that particular liability and does not necessarily relate to the creditworthiness of the issuer.

² If the presentation of changes in the liability's credit risk would create or enlarge an accounting mismatch, IFRS 9 (2010) requires the gains or losses on that liability to be presented in profit or loss. However, the circumstances in which this is the case is expected to be rare.

mandatory effective date of IFRS 9 to 2015, the majority of respondents continued to support IFRS 9 as a considerable improvement over IAS 39 and urged the Board to finalise the Standard as soon as possible. However, as an interim solution some respondents recommended the Board incorporate the requirements for the presentation of own credit in IAS 39. They argued that this would improve the quality of, and help restore user confidence in, financial reporting.

3. The scope of that ED was limited to the proposal to delay the mandatory effective date of IFRS 9 and the final amendment had to be published before 1 January 2012 (the start of the comparative period if the effective date remained 1 January 2013). It was therefore decided not to consider this recommendation as part of those deliberations.
4. Since then requests for the Board to accelerate the application of the own credit requirements have intensified. The reasons for this are outlined in more detail below. The own credit issue was not included in the scope of the limited amendments to IFRS 9 that the Board has been considering to date. However, as the Board intends to publish an exposure draft proposing limited amendments to the classification and measurement (C&M) requirements of IFRS 9 before the end of the year, the staff believe that it is timely for the Board to reconsider whether application of the own credit requirements should be accelerated.

Why should acceleration be considered?

5. IFRS 9 (2010) is structured to include the IFRS 9 (2009) requirements for C&M of financial assets - so an entity cannot early apply the C&M model for financial liabilities without also early applying the C&M requirements for financial assets.
6. However, as a result of the Board's decision in November 2011 to re-open IFRS 9 to consider limited amendments to the classification and measurement requirements for financial assets, entities that have not already applied the C&M

requirements are unlikely to consider early applying IFRS 9 before the limited amendments are finalised. This is particularly true of banks due to the extent of change that may arise as a result of any changes to the C&M model - and it is banks who most commonly have liabilities measured at fair value under the fair value option (FVO) and thus are the most vocal in requesting urgent change to the treatment of own credit.

7. In July 2012, the Board tentatively decided that in order to improve comparability for users of financial statements, once the limited amendments to IFRS 9 and the impairment projects are finalised, entities will no longer be permitted to early apply previous versions of IFRS 9³. Entities wishing to apply the amended C&M model will therefore have to wait until IFRS 9, including impairment, is finalised (and the necessary impairment systems implemented) before being able to apply the classification and measurement phase, effectively making the own credit requirements dependent on the implementation of an expected loss impairment model. This could be 2015 or even later depending on the mandatory effective date determined for impairment.
8. Markets continue to be volatile and own credit gains or losses remain significant, accentuating concern about the usefulness of reporting gains when an entity is experiencing own credit deterioration.
9. In September 2012, the FASB considered a similar request from some of its constituents to accelerate the exposure and finalisation of its tentative decision regarding the presentation of changes in fair value attributable to changes in own credit risk. However, the FASB rejected the request primarily due to concerns about inserting another short-term project in the overall intensive financial instruments project and the low probability that a decision could be reached in time for year-end reporting.

³ Those entities which applied a previous version of IFRS 9 prior to the publication of the complete version of IFRS 9 would be permitted to continue applying that version until the mandatory effective date of IFRS 9

10. As a result of the decision to re-open IFRS 9 and the subsequent tentative decision to eliminate the phased implementation of IFRS 9, the staff thinks there is a stronger case for making the own credit requirements available separately than there was in the past.

Purpose of this agenda paper

11. The purpose of this agenda paper is to provide the Board with a staff analysis of possible approaches to accelerate the application of the own credit presentation requirements (paragraphs 15 - 41), a concluding summary (paragraphs 42 – 44) and a question to the Board.

Possible approaches

12. The following possible approaches to address the concerns summarised in the preceding section have been identified:
- (a) **Approach A:** Amend IAS 39 to incorporate the requirements for the presentation of own credit gains or losses on financial liabilities designated at fair value through profit or loss (FVPL) under the FVO (set out in paragraphs 15 - 23);
 - (b) **Approach B:** Modify the early application guidance in IFRS 9 (2010) and later versions of IFRS 9 to permit the early application of only the own credit requirements (set out in paragraphs 24 – 31);
 - (c) **Approach C:** Once IFRS 9 is finalised, permit the early application of only the own credit requirements (set out in paragraphs 32 - 38);
 - (d) **Approach D:** Do not accelerate the application of the own credit requirements (set out in paragraphs 39 - 41).
13. Approaches A to C would all have a similar outcome – the difference is in the steps to achieve the outcome and the likely time to completion. Approaches A

to C also share the disadvantage of reducing comparability between entities during the period leading up to the mandatory effective date

14. The staff is not making a recommendation to the Board.

Staff analysis of possible approaches

Approach A: Amend IAS 39

15. Approach A entails 'duplicating' the requirements currently in IFRS 9 for the presentation of own credit gains or losses for financial liabilities designated at FVPL under the FVO in IAS 39 which will enable entities to accelerate the application of the own credit requirements independent of the completion of IFRS 9. This would have the effect of decoupling the change from the IFRS 9 timeline.
16. This is consistent with the recommendations made by a number of constituents over time as described above. These constituents are of the opinion that this would be a significant step towards enhancing the quality and reputation of IFRS.
17. However, IFRS 9 prohibits the recycling of own credit gains or losses accumulated in OCI. Incorporating the presentation requirements for own credit in IAS 39 will require the incorporation of the prohibition on recycling as well. Upon initial application of IFRS 9, any accumulated amounts attributable to liabilities that are de-designated under the FVO will remain in OCI⁴.
18. Furthermore, incorporating the IFRS 9 requirements into IAS 39 will not be straight-forward and will require care to ensure there are no unintended consequences as a result of the amendment. The amendments have not been structured to fit into IAS 39 - they were designed for IFRS 9. Time will be

⁴ IFRS 9 currently requires liabilities to be de-designated under the FVO if an accounting mismatch no longer exists due to the C&M requirements and allows an entity to de-designate its previous FVO elections when the entire C&M is first applied.

needed to incorporate these requirements into the structure of IAS 39.

Approaches B and C would not require this additional work to be undertaken. It is also not clear that all our constituents would agree with the proposed amendment. Some at least may share the Board's previously expressed view that we should not be amending IAS 39 at the same time as we work on IFRS9.

19. This approach is also inconsistent with the Board's consistent message that we are replacing IAS 39 and therefore no longer making changes to it.

Nature and timing of the amendment

20. The own credit requirements were previously exposed. But they were exposed in the context of IFRS 9 and not IAS 39. Any change to IFRSs must be made in accordance with due process and the staff believe that a separate exposure draft would need to be published in order to amend IAS 39. Also, when previously exposed, the draft only considered transition for the situations where either IFRS 9 was being newly applied to both assets and liabilities simultaneously or where IFRS 9 had already been applied to financial assets. If IAS 39 was modified per Approach A, transition requirements are needed for when an entity first applies the own credit requirements in accordance with IAS 39 and subsequently applies the IFRS 9 C&M model.
21. It would also be necessary to consider what additional transition requirements need to be included in IFRS 9 for situations when an entity has a liability designated under the FVO in accordance with IAS 39 that it is required to de-designate or decides to de-designate on transition to the full classification and measurement model in IFRS 9. This could arise for example when an accounting mismatch no longer exists because the measurement of a financial asset has been changed by IFRS 9. The new approach would also introduce another combination of financial instrument accounting (own credit in conjunction with the IAS 39 classification and measurement model) that was not previously exposed for comment. The Board's agenda is already filled to capacity by the current work plan. In order to publish an exposure draft on the proposed amendment to IAS 39 staff resources would be diverted from the

delivery of the remainder of the IFRS 9 projects. We are already working to capacity to complete general hedge accounting, to prepare exposure drafts on classification and measurement and impairment and to progress accounting for macro hedging.

22. Due process for an exposure draft is likely to result in the final amendment not being published until the middle of 2013. For jurisdictions subject to endorsement these requirements will be subject to endorsement (which process would be in addition to any endorsement of IFRS 9) which can take considerable time.
23. The staff is not supportive of this approach as it has been previously decided not to amend IAS 39 but to replace it in its entirety. The only circumstance that has changed since then is the expected timing for the completion of IFRS 9 – we are no less committed to replacing IAS 39 than before. The staff therefore think that it is better to find a solution to make the own credit requirements available for early application by amending IFRS 9. As discussed in the preceding paragraph, the staff also consider it unlikely that an amendment to IAS 39 could be finalised in time for 2012 year-end reporting and question whether there will be any meaningful timing benefit compared to the other approaches.

Approach B: Modify IFRS 9 (2010) and the final version of IFRS 9

24. Approach B will accelerate the application of the IFRS 9 own credit requirements by modifying the existing transition requirements of IFRS 9 (2010) to permit an entity to early apply only the own credit requirements. So an entity would be able to elect to apply the own credit requirements without otherwise changing the classification and measurement of financial instruments. The net effect would be identical to Approach A.
25. Such a modification can easily be achieved. Only a minor change would be required to IFRS 9, so this approach would minimise any distraction from the overall IFRS 9 project. The staff think that the change could be simply achieved by modifying the effective date paragraphs of IFRS 9 (2010) to permit

an entity that has not already applied IFRS 9 (2009) to early apply paragraphs 5.7.7 – 5.7.9 of IFRS 9 (2010) without the need to early apply any of the other requirements of IFRS 9 (2009) or IFRS 9 (2010). If an entity elects to early apply these paragraphs, it will also be required to early apply paragraph 10A of IFRS 7, which will result in modifications to IFRS 7 as well.

26. The benefit of this approach is that entities can apply only the selected paragraphs without impacting any decisions that would be made once the remaining phases in IFRS 9 are finalised. Taking this approach a jurisdiction that only wants to adopt the own credit solution could adopt (or endorse as relevant) IFRS 9 and activate only the effective date paragraph relevant to own credit. This enables a jurisdiction not ready to adopt IFRS 9 in full to make the own credit requirements available. Prior to the mandatory date of IFRS 9 if a jurisdiction took this approach it would not contradict IFRS 9 as published by the IASB as that would also allow entities only to adopt the changes related to own credit (draft wording for the proposed amendment is included in Appendix A).
27. However, this approach further entrenches the phased application of IFRS 9, something which, at the July 2012 meeting, the Board has tentatively agreed to eliminate once IFRS 9 is finalised. At that meeting the Board decided that once IFRS 9 is finalised (i.e. general hedge accounting, the amendments to classification and measurement and the impairment phases are complete) only one version of IFRS 9 will be in place that combines all phases.
28. It should be noted that this modification will have a limited lifespan unless the same early application relief is provided in the final version of IFRS 9. Including early application relief in IFRS 9 (2010) without carrying it forward to IFRS 9 once finalised will put entities that were not able to make use of the relief in IFRS 9 (2010) at a disadvantage. This could happen for example, if a jurisdiction only adopts IFRS 9 when complete. Therefore, if the Board vote in favour of this approach, it will also need to consider voting in favour of Approach C.

Nature and timing of modification

29. This approach will require a separate exposure draft to be published which carries with it time and resource constraints. These changes could be exposed along with the exposure draft on limited amendments to classification and measurement which is expected to be published before the end of this year. A longer comment period would be required for this document than for one that was unique to own credit (such as an exposure draft under Approach A above). However, this would not significantly impact the time period before an entity is able to apply the own credit requirements.
30. Making another amendment to IFRS 9 to deal with own credit may lead to confusion and uncertainty amongst constituents about the Board's commitment to finalise the remaining phases of IFRS 9. It may be viewed as incongruous that we need to amend IFRS 9 (2010) in anticipation of it having an extended life prior to the completion of IFRS 9 in total as suggested in Approach C below.
31. The staff is not in favour of this approach as the modification is expected to have an extremely short lifespan, especially if IFRS 9 is completed in the near future. If the proposed modification is exposed along with the limited amendments to C&M it could be finalised in the first half of 2013. According to the current work plan, IFRS 9 is expected to be completed in total by the end of 2013. The period during which the own credit requirements would be available before IFRS 9 (2010) is replaced with the final version of IFRS 9 will be very short. It is therefore questionable whether it makes sense to expect constituents to incorporate and/or endorse two versions of IFRS 9 in a short time frame.

Approach C: Include early application relief in the final version of IFRS 9

32. Approach C is similar to Approaches A and B in that it permits an entity to early adopt only the own credit requirements with no other changes being made to the classification and measurement of financial instruments. In form it is closest to Approach B with the difference being that Approach C will only include the early application relief in the final version of IFRS 9 rather than also being published as a separate amendment of just IFRS 9 (2010).
33. Although the effect of this approach is identical to Approach B, Approach C is superior to Approach B in that it will be available as part of the whole package of IFRS 9. If a jurisdiction only wants to adopt IFRS 9 when fully complete this approach is more appropriate than Approach B. A disadvantage of this approach is that, similar to Approach B, it will be inconsistent with the Board's previous tentative decision to eliminate the phased implementation of IFRS 9. It would mean that until the mandatory effective date of IFRS 9, entities could elect only to change their accounting for own credit while continuing to otherwise account for their financial instruments in accordance with IAS 39.
34. Furthermore, the early application relief will only be available once the remaining phases of IFRS 9 have been finalised and the document published. However, it is not expected that the time difference between completion of Approach B and Approach C would be significantly different. Given that the own credit effect on the financial statements is already required to be disclosed under IFRS 7 and analysts are already able to adjust for the own credit effect, the staff question whether this time difference is sufficiently material to warrant Approaches A or B relative to Approach C.

Nature and timing of modification

35. Incorporating the proposed early application relief into the upcoming exposure draft on the limited revisions to the classification and measurement phase will require minimal effort and can be done without distracting the staff and Boards' attention from its other priorities.

36. It would also mean that on finalising the proposals post exposure these changes could be incorporated into the publication of a single document – the final version of IFRS 9.
37. Some staff recommend that the Board reconsiders its July tentative decision and using the approach outlined as Approach C, makes an amendment such that entities are able to early adopt the own credit requirements in IFRS 9 in advance of being required to adopt other phases of IFRS 9 and favour this approach to ensure that the changes occur in the most efficient manner possible. In particular, the staff think that making the application of the own credit requirements dependent on the implementation of an expected loss impairment model will inappropriately defer an improvement in accounting for own credit.
38. Furthermore those favouring this approach believe that the proposed early application relief can be included in the forthcoming exposure draft on the limited revisions to IFRS 9 without distracting the Board and constituent's focus away from the overall objective. This will ensure that the staff's efforts can be directed to completing IFRS 9 rather than modifying old versions of IFRS 9.

Approach D: Do not accelerate the application of own credit requirements

39. This approach will not require any action to be taken to accelerate the application of the own credit requirements. Entities can apply the own credit requirements by applying IFRS 9(2010) (existing C&M), IFRS 9 including general hedge accounting when published or following the completion of IFRS 9, by applying all phases of the IFRS 9 project.
40. Some staff are in favour of this approach as they believe that amending either IAS 39 or IFRS 9 will reduce comparability and further entrench the phased application of IFRS 9 which is contrary to the very strong message from the Board in July that phasing should be stopped sooner rather than later. All the other approaches discussed in this paper would result in some entities effectively continuing to apply the classification and measurement model in IAS 39 in conjunction with the own credit requirements in IFRS 9.

41. They also note that paragraph 10 of IFRS 7 already requires disclosure of the changes in own credit, during the period and cumulatively, for financial liabilities designated as at fair value through profit or loss in accordance with IAS 39. Preparers also often provide non-GAAP information which adjust for the changes in own credit risk. Although this is not an ideal situation, it is a process that is fairly well understood by both preparers and users alike with no-one ending up being uninformed or confused.

Summary and question to the Board

42. The staff have differing views, with some favouring Approach C and others favouring approach D.
43. In summary, those that favour Approach C believe that an improvement in the accounting for own credit gains or losses should not be dependent on the completion of IFRS 9, and in particular on the implementation of an expected loss impairment model, and that an entity should be able to apply these requirements in advance of being required to adopt other phases of IFRS 9.
44. Others that favour Approach D believe that permitting an entity to early apply the own credit requirements without having to apply the other requirements of IFRS 9 will reduce comparability and further entrench the phased application of IFRS 9. As IFRS 7 already requires the disclosure of own credit gains or losses in accordance with IAS 39 and preparers are routinely adjusting for the effects of own credit – a process that is well understood by preparers, there is no pervasive reason to make any amendments.

Question to the Board

Which approach does the Board support and why?

Appendix A: Approach B - Draft wording of amendment to IFRS 9 (2010)

IFRS 9 (2010) Financial Instruments

Chapter 7 Effective date and transition

7.1 Effective date

7.1.1 An entity shall apply this IFRS for annual periods beginning on or after 1 January 2015. Earlier application is permitted (but also see paragraph 7.3.2). However, if an entity elects to apply this IFRS early and has not already applied IFRS 9 issued in 2009, it must apply all of the requirements in this IFRS at the same time (but see also paragraph 7.3.2). If an entity applies this IFRS in its financial statements for a period beginning before 1 January 2015, it shall disclose that fact and at the same time apply the amendments in Appendix C

7.1.1A Despite the requirement in paragraph 7.1.1, an entity may elect to early apply paragraphs 5.7.1(c), 5.7.7 – 5.7.9, 7.2.12 and B5.7.5 – B5.7.20 without having to early apply the other requirements of this IFRS. When entity has elected to early apply these paragraphs, it shall apply paragraph 10A of IFRS 7 from the same date. An entity that has elected to early apply these requirements shall continue to apply the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* until the entity elects to early apply all the requirements of this IFRS or the occurrence of the mandatory effective date as specified in paragraph 7.1.1.