IFRS Accounting

# Staff paper

Agenda reference: 3

**IFRS® Interpretations Committee meeting**

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| Date | **March 2023** |
| Project | **Guarantee over a Derivative Contract** |
| Topic | **Initial consideration** |
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## Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about whether, applying IFRS 9 *Financial Instruments*, an entity accounts for a guarantee over a derivative contract as a financial guarantee contract or a derivative. Specifically, the submission asked about the accounting for the guarantee by the entity writing the guarantee (the issuer).

2. The objective of this paper is:

   (a) to provide the Committee with a summary of the matter;

   (b) to present our analysis; and

   (c) to ask the Committee whether it agrees with our recommendation not to add a standard-setting project to the work plan.

## Structure of the paper

3. This paper includes:

   (a) summary of the submission;

   (b) findings from information request;

   (c) staff analysis; and

   (d) staff recommendation.

4. There are two appendices to the paper:

   (a) Appendix A — Suggested wording for the tentative agenda decision; and

(b) Appendix B — Submission.

## Summary of the submission

5. The submission describes a fact pattern in which an entity (Entity C) provides a guarantee over a derivative contract between two counterparties—Entity A and Entity B—which promises to reimburse, in full or in part, one of the counterparties (Entity A) for the actual loss suffered in the event of a default by the other counterparty (Entity B).

6. According to the terms of the derivative contract, the derivative is immediately terminated in the event of a default by either counterparty and a fixed close-out amount is calculated, and become payable immediately, based on a valuation of the remaining contractual cash flows of the derivative prior to default.

7. With regards to the guarantee, the maximum amount of reimbursement provided under the guarantee is not specified and will fluctuate based on the changes in the fair value of the derivative contract. Reimbursement under the guarantee will be provided only if the derivative contract is a financial asset for Entity A and Entity B has failed to make payment of the close-out amount when due in full or in part. In other words, it is only from that point, that the issuer of the guarantee (Entity C) can determine its exposure under the guarantee.

8. The submitter asks whether such a guarantee over a derivative contract meets the definition of a financial guarantee contract, or that of a derivative, as defined in Appendix A to IFRS 9.

9. A financial guarantee contract is defined in Appendix A to IFRS 9 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. A derivative is defined in Appendix A to IFRS 9 as:

> A financial instrument or other contract within the scope of this Standard with all three of the following characteristics.
>
> a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit

index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c) it is settled at a future date.

11. If the issuer's rights and obligations under the guarantee meet the definition of financial guarantee contract, the entity may elect to apply either IFRS 9 or IFRS 17, based on the requirements in paragraph 2.1(e) of IFRS 9. On the other hand, if the guarantee described in the fact pattern does not meet the definition of a financial guarantee contract, the submitter also seeks clarification on whether it should be accounted for as a derivative in the scope of IFRS 9.

12. The submitter outlines various views as summarised below:

(a) View A—the guarantee meets the definition of a financial guarantee contract. This is because the fact pattern is to reimburse the actual loss when the specified debtor (Entity B) fails to make payments when due. The fact that the fixed close-out amount is not determinable until a default occurs does not preclude the guarantee from being a financial guarantee contract. This is because when a default occurs, the amount will be determined, similar to that of a debt instrument such as a loan. Therefore, such a guarantee meets the definition of a financial guarantee contract;

(b) View B—the guarantee does not meet the definition of a financial guarantee contract. This is because the definition of a financial guarantee contract refers to a debt instrument, which normally refers to a non-derivative financial instrument. In the fact pattern described in the submission, the close-out amount is not a specified payment and varies based on the changes in the fair value of the derivative. The submitter further identified two related views;

(i) View B1—The guarantee meets the definition of a derivative because the fair value of guarantee changes in response to the change in interest rates, the initial investment is relatively small, and settlement happens in future; and

(ii) View B2—The guarantee does not meet the definition of a derivative because the guarantee only arises in the event of Entity B failing to pay Entity A the fixed close-out amount when due, which is a non-financial variable specific to a party of the contract (Entity A). Therefore, it does not meet the definition of a derivative.

13. Appendix B to this paper reproduces the submission, which provides further details and rationales about the alternative views identified by the submitter.

## Findings from information request

14. We sent an information request to members of the International Forum of Accounting Standard-Setters, securities regulators and large accounting firms. We also made the submission available on our website.

15. The request asked:

a) whether the fact pattern described in the submission is common or widespread;

b) if it is common, whether the amounts involved has a material effect on the issuing entity's financial statements; and

c) whether respondents observed material diversity in how entities apply the relevant IFRS Accounting Standards, and if so, whether such diversity is only in particular jurisdictions or industries.

16. We received 19 responses—ten from national standard-setters, five from large accounting firms, two from securities regulators, one from an organisation representing a group of securities regulators, and one from a financial institution. The views received represent informal opinions and do not necessarily reflect the official views of those respondents or their organisations.

17. All respondents said that the writing of a guarantee over a derivative, as described in the submission, is not common or widespread. However, two accounting firms said there are limited situations in which the fact pattern described in the submission have occurred in the banking or insurance industry in some jurisdictions. One standard-setter also mentioned that such transaction might become more common in their jurisdiction in the future.

18. In addition, some standard-setters and accounting firms shared how they would theoretically apply the requirements in IFRS 9 for such a guarantee over a derivative contract if they had such transactions. A few of these respondents (including both standard-setters and accounting firms) noted that there could be potential diversity in practice as a result of different views expressed by different accounting firms.

19. However, almost all respondents said that there are no material effects on financial statements given such a fact pattern is not common. Only one respondent (an accounting firm) said such transactions could have a material effect to the entities concerned, similar to the effects seen during the financial crisis when similar transactions were executed by banks. However, this respondent did not provide any information on whether the outcomes of the potential diversity in practice described in paragraph 18, would be expected to have a material effect on the amounts that entities report.

## Staff analysis

### *Should the Committee add a standard-setting project to the work plan?*

20. Paragraph 5.16 of the *Due Process Handbook* sets out the criteria the Committee considers when determining whether to add a standard-setting project to the work plan. One criterion, included in sub-paragraph 5.16(a), is that 'the matter has widespread effect and has, or is expected to have, a material effect on those affected'.

21. As explained above, the findings from the information request described in paragraph 14–19 indicate that the fact pattern described in the submission is not common, and therefore we have not obtained evidence that the use of a guarantee over a derivative contract is widespread in practice or is expected to have a material effect on those affected.

22. Even though the findings from the information request indicated that there could be potential diversity in practice if transactions such as those described in the request become more widespread, we note that similar questions about whether a guarantee contract meets the definition of a financial guarantee contract as defined in IFRS 9, could arise in other circumstances. In our view, the alternative views described in paragraph 12 of the paper, focus on whether the guarantee is written over a 'debt instrument' as referenced in the definition of a financial guarantee contract. Therefore, any potential standard-setting project to eliminate

diversity in practice would extend beyond the fact pattern described in the request and could result in significant unintended consequences when applying the requirements for financial guarantee contracts more generally. We therefore think that the matter described in the request is, in isolation, too narrow for the IASB or the Committee to address in a cost-effective manner.

## Staff recommendation

23. Based on our assessment of the work plan criteria in paragraphs 5.16 of the *Due Process Handbook* (as discussed in paragraphs 20–22), we recommend that the Committee does not add a standard-setting project to the workplan. We recommend the Committee instead publishes a tentative agenda decision that explains its reasons for not adding a standard-setting project.

24. Appendix A to this paper suggests wording for the tentative agenda decision.

| Question for the Committee |
|---|
| 1. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan?<br>2. Does the Committee have any comments on the wording of the tentative agenda decision suggested in Appendix A to this paper? |

## Appendix A — Suggested wording for the tentative agenda decision

**Guarantee over a Derivative Contract (IFRS 9 *Financial Instruments*)**

The Committee received a request about whether, applying IFRS 9 *Financial Instruments*, a guarantee over a derivative contract is accounted for as a financial guarantee contract or a derivative, by the entity writing the guarantee (the issuer).

The request described a guarantee to be written over a derivative contract, to reimburse the actual losses that one of the derivative counterparties incurs, up to the close-out amount calculated based on a valuation of the remaining contractual cash flows of the derivative prior to default, in the event that the other counterparty of the derivative contract fails to make a payment of the close-out amount when due in full or in part.

**Findings**

Evidence gathered by the Committee [to date] indicated that the matter described in the request is not widespread, and that when the matter does arise, the amounts involved are not material.

**Conclusion**

Based on the evidence it gathered, the Committee concluded that the matter described in the request does not have widespread effects and does not have (and is not expected to have) a material effect on those affected.

The Committee also noted that even though the findings from the information request indicated that there could be potential diversity in practice if transactions such as those described in the request became more widespread, similar questions about whether a guarantee contract meets the definition of a financial guarantee contract as defined in IFRS 9, could arise in other circumstances. The Committee considered that the question asked in the request requires analysis of whether the guarantee is written over a 'debt instrument' as referenced in the definition of a financial guarantee contract.

Therefore, any potential standard-setting project to eliminate diversity in practice would extend beyond the fact pattern described in the request and could result in significant unintended consequences when applying the requirements for financial guarantee contracts more generally. The Committee therefore concluded that the matter described in the request is, in isolation, too narrow for the IASB or the Committee to address in a cost-effective manner.

Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

## Appendix B – Submission

B1. We have reproduced the submission below. We have deleted details that would identify the submitter of this request.

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**Suggested agenda item: Accounting for a guarantee over a derivative contract - IFRS 9 *Financial Instruments***

It has come to our attention that there are diverse views on whether a guarantee over a derivative contract should be accounted for as a financial guarantee contract or as a derivative financial instrument under IFRS 9. We are seeking clarification by the Committee of the issue detailed below.

**<u>Background</u>**

A financial guarantee contract ("FGC") is defined in Appendix A to IFRS 9 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."

A derivative is defined in Appendix A to IFRS 9 as follows.

> "A financial instrument or other contract within the scope of this Standard with all three of the following characteristics.
>
> (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
>
> (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
>
> (c) It is settled at a future date."

This submission considers whether a guarantee over a derivative contract meets the definition of an FGC or that of a derivative, as defined in Appendix A to IFRS 9. We have used the following fact pattern to illustrate the issue.

**Fact pattern**

Entity A has entered into a derivative contract for two years with Entity B under which Entity A pays a fixed rate of 5% per annum to Entity B and receives LIBOR + 4% per annum over a specified notional amount. The contract meets the definition of a derivative financial instrument in IFRS 9 and is measured by Entity A at fair value through profit or loss.

Entity C writes a guarantee to Entity A over the derivative contract for the same two years in exchange for a premium.

Entity A, Entity B and Entity C are unrelated to each other.

Under the derivative contract, the amounts due by Entity A under the pay leg and the amounts due to Entity A under the receive leg are net settled on a quarterly basis in arrears. In the event of a default of either counterparty, the derivative is immediately terminated, and a fixed close-out amount is determined in accordance with the terms of the derivative contract and is based on a valuation of the remaining contractual cash flows of the derivative prior to default. Once determined the fixed close-out amount is due and payable and does not accrue interest.

The guarantee written by Entity C requires Entity C to reimburse Entity A for the loss it incurs up to the close-out amount in the event that (i) the close-out amount is payable by Entity B to Entity A (i.e. it is an asset for Entity A), and (ii) Entity B fails to make payment of that amount when due in full or in part. The guarantee does not reimburse Entity A for any other losses. It is also a condition of the guarantee that Entity A be party to the derivative for the whole term of the guarantee and a pay-out under the guarantee will only be made in respect of losses actually suffered by Entity A due to non-payment of the fixed close-out amount by Entity B.

**Question:**

Does the guarantee contract written by Entity C meet the definition of a financial guarantee contract? If the definition of a financial guarantee is not met, is the guarantee contract a derivative in the scope of IFRS 9?

**View A—Yes, the guarantee meets the definition of an FGC**

The guarantee issued by Entity C covers a single payment (the fixed close-out amount) once that payment is currently due and payable by Entity B and so it covers a 'specified debtor' as required by the definition of a financial guarantee contract.

The guarantee only covers the credit risk of Entity B in relation to default on the fixed close-out amount. Entity C cannot be required to make a payment to Entity A under the contract in respect of payments that are not currently due and payable. Although IFRS does not define a debt instrument, given that the amount that the guarantee protects is a financial asset (i.e., right to a fixed amount of cash), the characteristics of the amount guaranteed are consistent with a debt instrument. In other words, the guarantee is provided for a debt instrument only and it only reimburses Entity A if it suffers a credit loss due to Entity B failing to make payment when due in accordance with the terms of that debt instrument.

Proponents of this view consider that the fact the fixed close-out amount is not known until a default occurs under the derivative contract is not relevant to the assessment of whether the guarantee meets the definition of an FGC because at the point of default the amount will be known and fixed. Proponents also note that if the close-out amount was not fixed because it accrued interest after the close-out amount was initially determined, this would nevertheless be a debt instrument consistent with the fact that both fixed and variable rate loans are debt instruments.

**View B—No, the guarantee does not meet the definition of an FGC**

The definition of an FGC refers to a debt instrument. Although IFRS 9 does not define the term "debt instrument" in relation to an FGC, this term normally refers to non-derivative financial instruments such as loans and trade receivables.

In addition, the close-out amount, which Entity C guarantees, is not a specified payment. Instead it depends on the valuation of the derivative contract at the date of default which is not known when the guarantee is entered into.

Accordingly, the guarantee contract does not meet the definition of an FGC when the guarantee is entered into.

If View B applies, then the second question of whether it is a derivative in the scope of IFRS 9 is also relevant.

**View B1—It meets the definition of a derivative in the scope of IFRS 9**

Because the close-out amount depends on financial risk arising from the guaranteed derivative, the guarantee exposes the writer to financial risk and therefore the contract meets part (a) of the definition of a derivative.

Furthermore the initial net investment is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and the contract is settled at a future date, therefore parts (b) and (c) of the definition of a derivative are met.

Consequently the guarantee contract meets the definition of a derivative.

**View B2—It does not meet the definition of a derivative in the scope of IFRS 9**

The guarantee only protects the holder from the actual credit loss incurred on the close-out amount. The credit loss only arises in the event of Entity B failing to pay Entity A the fixed close-out amount when due.

Failure to pay is a non-financial variable. This is confirmed by IFRS 4 paragraph B18(g) & IFRS 17 paragraph B29 which explain that an FGC meets the definition of an insurance contract. An insurance contract is defined in Appendix A of IFRS 4 and IFRS 17 as "[a] contract under which one party (the insurer) accepts significant *insurance risk* from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder." (emphasis added). Therefore, for an FGC to meet the definition of an insurance contract, the underlying risk of the FGC, being failure to pay of the debtor, must meet the definition of insurance risk. Given insurance risk is defined in IFRS 4 and IFRS 17 Appendix A as a "[r]isk, *other than financial risk*, transferred from the holder of a contract to the issuer" (emphasis added), it follows that failure to pay is not a financial risk (i.e. it is a non-financial variable).

Because a payment is only made under the guarantee if Entity A suffers a credit loss under the derivative contract it is party to, the non-financial variable is specific to Entity A (i.e. specific to a party to the guarantee contract).

Therefore, the underlying risk of the guarantee over the close-out amount is a non-financial variable specific to a party to the contract and consequently it does not meet part (a) of the definition of a derivative which scopes out such non-financial variables from the definition of a derivative. The guarantee contract is therefore not accounted for as a derivative contract.

Under this view it is expected that the guarantee contract would meet the full definition of an insurance contract, however, this analysis is outside the scope of this submission.

**Reasons for the Committee to address the issue**

Currently, we are aware of divergent views on this matter. The issue is not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee's agenda.

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