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Financial instruments

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IASB’s work on financial instruments

- Financial Instruments (replacement of IAS 39):
  - Phase I: Classification and measurement
  - Phase II: Amortised cost and impairment
  - Phase III: Hedge accounting
- Financial instruments with characteristics of equity
- Derecognition
- Offsetting

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Classification and measurement

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Overview of classification model
– *for financial assets only*

Business model test

Contractual cash flow characteristics

›

Amortised cost (one impairment method)

›

FVO for accounting mismatch (option)

Reclassification required when business model changes

All other instruments:
- Equities
- Derivatives
- Some hybrid contracts
- …

›

Fair Value (No impairment)

›

Equities: OCI presentation available (alternative)

Amortised cost – An entity's business model

Business model

- objective of holding instruments to collect or pay contractual cash flows rather than to sell prior to contractual maturity to realise fair value changes
- not an instrument by instrument approach to classification
- Assess contractual terms of instruments within such a business model

No 'tainting' rules for assets at amortised cost

- gains or losses from derecognising such items to be presented separately with additional disclosures

Amortised cost
– Contractual cash flow characteristics

Contractual cash flow characteristics › **Contractual terms that give rise to solely payments of**

- **Principal**
- **Interest**

Interest =
Consideration for
•time value of money
•credit risk

Additional changes from exposure draft:

- Structured debt – look through
- Distressed debt
- Non-recourse debt

Amendments to embedded derivatives (applicable only to financial assets)

Hybrid contracts

Financial host

No separation – part of classification

<u>Non</u>-financial host

IAS 39 guidance retained

Equity investments—OCI alternative

Alternative presentation of fair value changes in other comprehensive income (OCI)

Scope

- investments in equity instruments not held for trading

Features

- alternative available instrument by instrument
- **dividends recognised in P&L**
- no recycling, impairment or change in presentation

Fair value option (FVO) for financial assets*

Fair value option available, if…

Accounting mismatch

~~Managed on fair value basis~~

Not managed to collect contractual cash flows = FV

~~Embedded derivative(s)~~

Hybrid contracts with financial host classified in entirety

*Circumstances when FVO available unchanged for financial liabilities

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Financial liabilities—background

Feedback on June 2009 ED:

- Financial liabilities ‘not broken’
- Financial liabilities less urgent
- Need to address ‘own credit’

Excluded financial liabilities from the scope of IFRS 9 for 2009 year ends

To
seek input on best
way to address
‘own credit’

‘Own credit’?

- What is ‘own credit’?
  - fair value changes in liability arising from changes in the issuer’s credit quality
- How is it measured?
  - often measured as change in margin over a benchmark interest rate
- What is the concern?
  - Gain when credit quality deteriorates, loss when credit quality improves
  - Reporting such gains and losses is not useful
    - Board’s Request for Information on measurement of liabilities
    - ED on classification and measurement

FVO and own credit—targeted change

To address 'own credit risk' :

- Retain IAS 39 measurement requirements for financial liabilities:
  - held for trading ➔ fair value through P&L
  - hybrid liabilities ➔ bifurcation requirements in IAS 39
  - 'vanilla' liabilities ➔ amortised cost
  - maintain FVO (with current eligibility conditions)

  BUT
- Separate out 'own credit risk' for FVO
- 'Own credit risk' portion would be separated in a manner similar to that previously used in IFRS 7 for disclosure (IFRS 7 B4)

FVO and own credit—targeted change

Profit or Loss (liabilities under FVO)	
Change in FV attributable to all factors except 'own credit risk'	(X)
Profit	XXX

Mandatory for all liabilities under the FVO *unless* this would create or enlarge an accounting mismatch

Financial liability on statement of financial position at (full) fair value

Statement of Comprehensive Income (liabilities under FVO)	
Other Comprehensive Income:	
Change in FV attributable to 'own credit'*	X

* Not recycled

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Amortised cost and impairment

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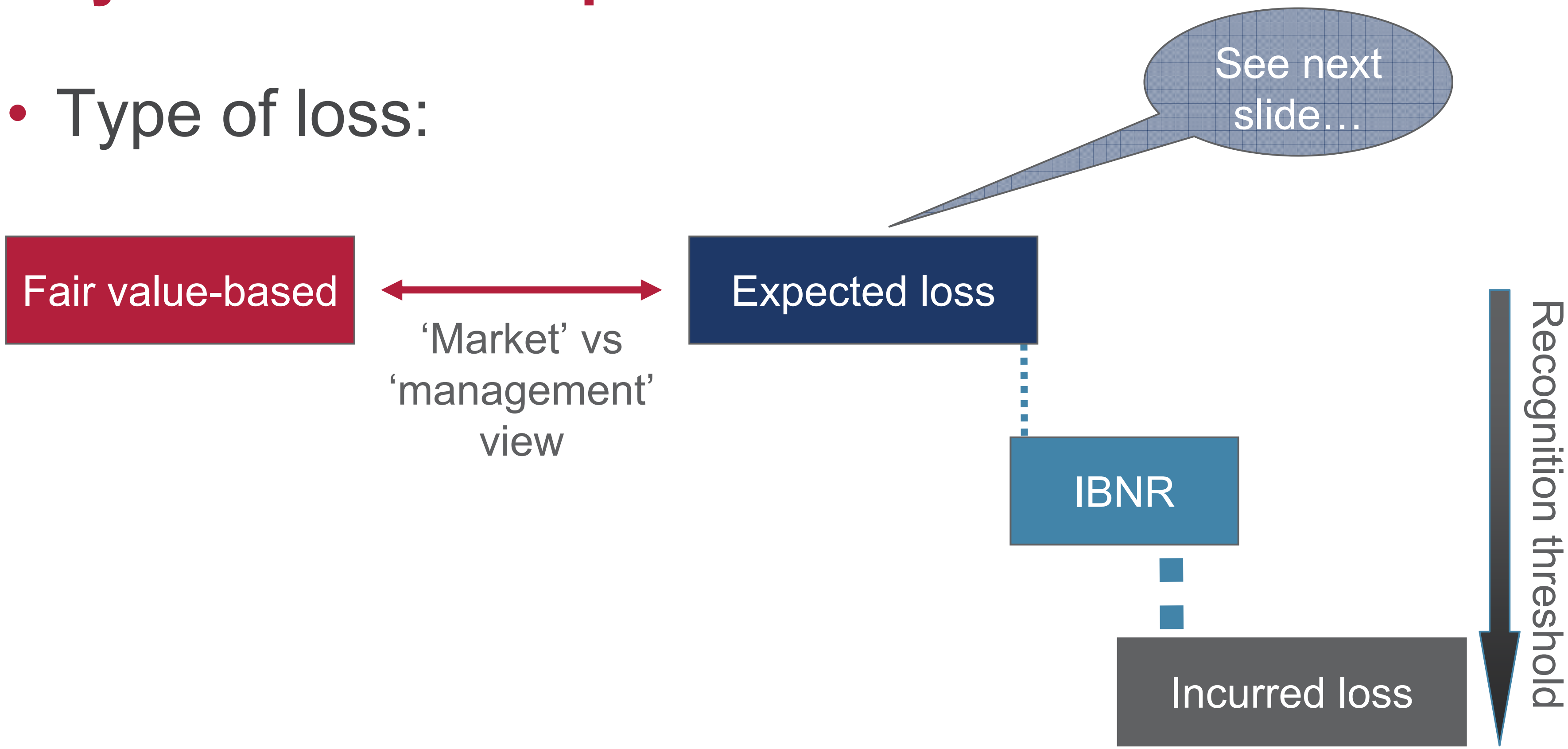
Alternative impairment models

Key features of impairment models

- Type of loss:



Overview—expected loss considerations

ISSUE	◄ TO BE CONSIDERED ►			
Which expected losses?	Over the life or shorter?	All EL or only ‘more-likely-than-not’ to occur (for single instruments)		Through-the-cycle or not
When are initial loss expectations recognised?	◄ Allocate over life ►			Upfront (likely be same treatment for changes in estimates)
	Integrated in EIR	Separately as an annuity	Separately straight-line	
How are changes in loss estimates treated?	Full catch-up to profit or loss in period of change	Partial catch-up to profit or loss	No catch-up (adjust prospectively)	Combination based on good/bad book
Allowance account floor?	No floor	Floor (eg ‘incurred’ losses)		

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Discussions of alternative models

	EBF	Partial catch-up	BCBS	FASB
EL input	Lifetime EL (best estimate)			Lifetime EL ('frozen' outlook)
Initial EL	Over life (reset linear)	Over life (variations)	Over life (adjusted EIR)	Upfront (day 1 loss)
Changes in EL estimate	No catch-up (linear–fully prospective)	Partial catch-up (life-to-date, time proportional)	Full catch-up *or* EIR reset (↔ situation)	Full catch-up
Ceiling / floor	Ceiling: EL_t Floor: bad book	Ceiling: N/A Floor: bad book *[+ target good book LLA]*	Ceiling: A/C_0 Floor: EL of 'upcoming period'	Ceiling: A/C_0 Floor: N/A

Outlook…

Approach for re-deliberations (the ‘game plan’…)

- First develop an impairment model for *open portfolios*
  - Basic architecture
  - Details
- Ascertain whether that approach ‘fits all’…
  - Single instruments
  - Short-term trade receivables
  - Variable-rate instruments
  - Loan commitments
  - Other instruments
- Revisit presentation and disclosure

Outlook… (cont'd)

Topics to be considered in finalising the project…

- Probability weighting of possible outcomes
  - Expected loss = expected value?
- How does the impairment model fit into amortised cost?
  - 'Cost plus' vs present value notion
- Extent of guidance
  - Application guidance
  - Implementation guidance
  - Illustrative examples
- Scope: off balance sheet credit exposures…

Next steps and timeline

IASB	2009	2010	2011		
	Q4		Q1	Q2	H2
Impairment	ED	~~ED?~~	ED?	IFRS	

Re-exposure…?

FASB comment deadline: **30 Sept 2010** …?

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Hedge accounting

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Timeline

	2010		2011		
	Q3	Q4	Q1	Q2	H2
Hedge accounting		ED		IFRS	

Introduction

- The Board is considering hedge accounting **comprehensively**
- Overall approach:
  - Use existing architecture
  - Address specific problem areas
  - Use clear and explicit principles
  - Identify any exceptions clearly

Hedge Accounting—broad direction

- Simplify hedge accounting
- Consider application to portfolios

This project will not look at hedge accounting for hedges of net investments in foreign operations

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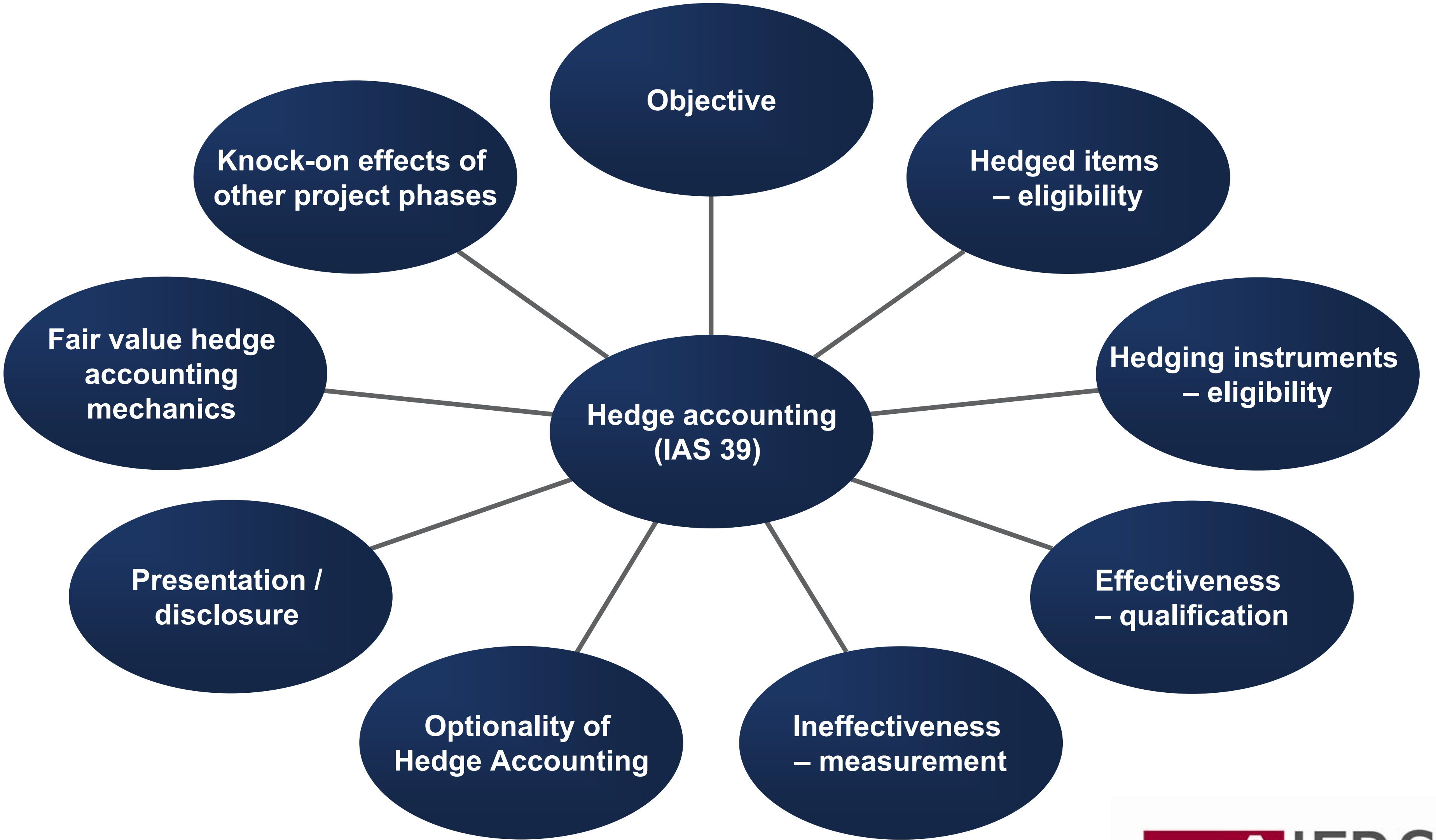
Components of the hedge accounting model

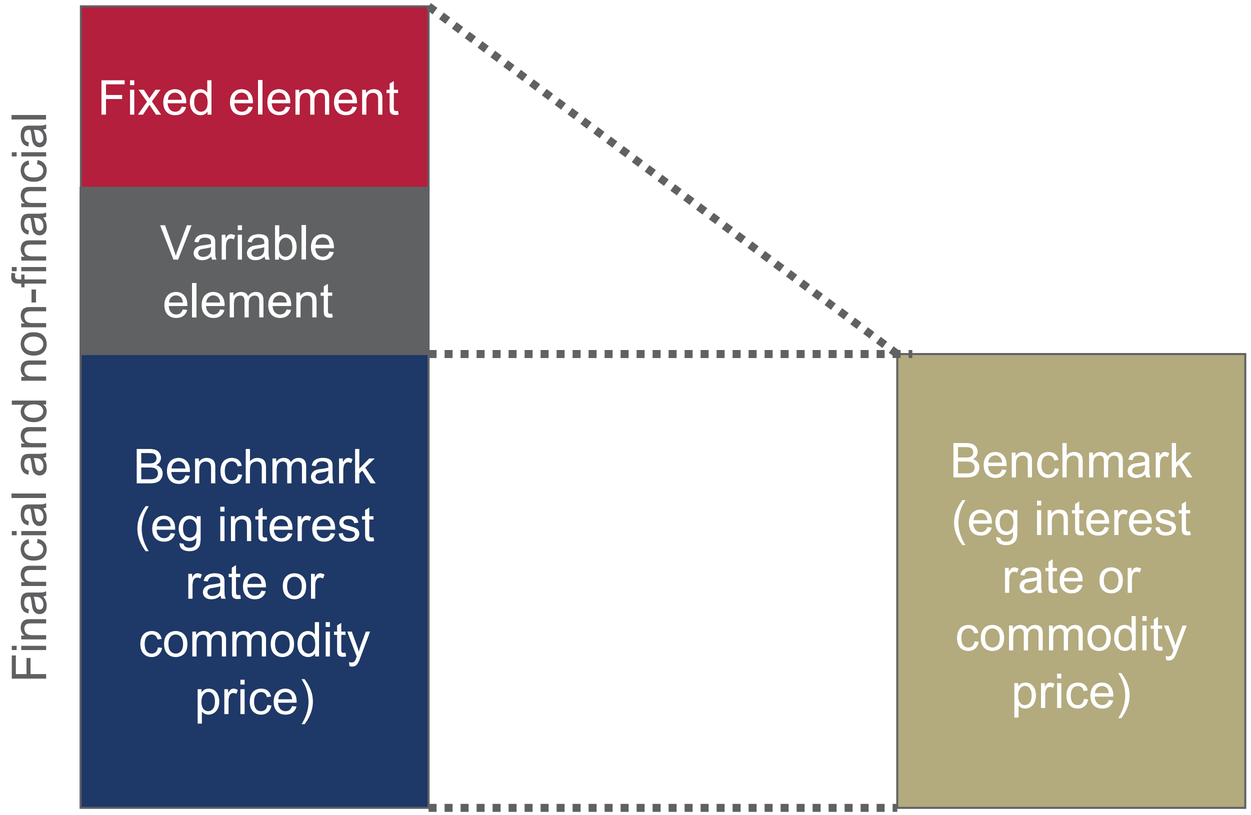


Objective

Risk management objective:
Seeks to link
risk management and
financial reporting
(top down)

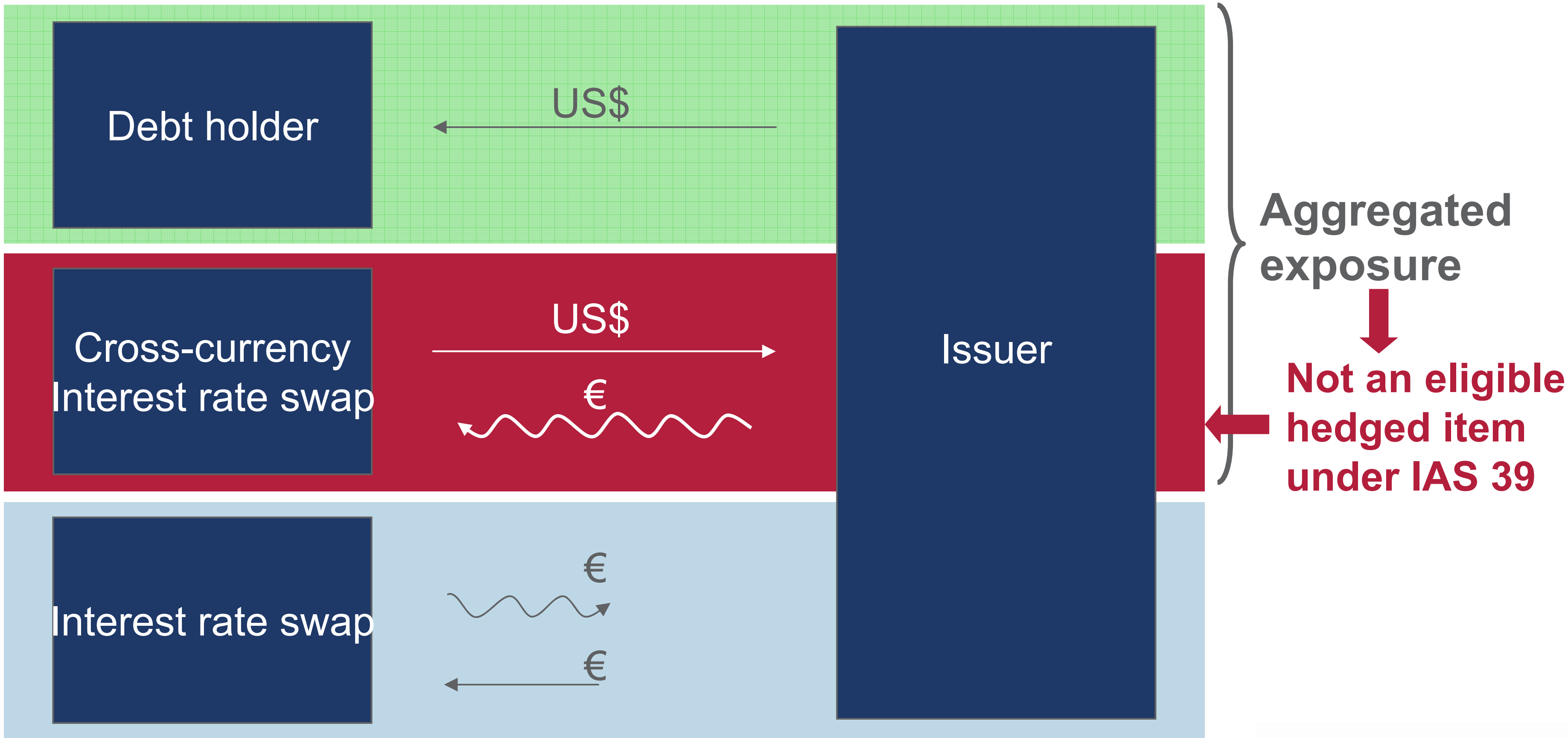
Accounting objective:
Seeks to manage
timing of recognition
of gains or losses
(bottom up)

Hedged items: risk components



Hedged items: aggregated exposures

Aggregated exposure—combination of: (a) another exposure and (b) a derivative



Hedged items: groups and net positions

- Proposals:
  - Net positions as eligible hedged items:
    - Conditions:
      - Consistent with risk management
      - Items identified on a gross basis
    - √ Fair value hedges
    - √ Cash flow hedges:
      - →Only if offsetting cash flows affect profit or loss (in their entirety) in the same period

Hedged items: groups and net positions continued

- Proposals:
  - Change in fair value of individual hedged items need not be proportional to that of the group
  - Permit layer approach (eg bottom layer) to identifying hedged items from a group
  - Separate line item presentation of hedging instrument gains or losses for net position hedges if group has offsetting risks
    - For example sales and purchases hedged for FX risk or interest revenue and expense

Hedging instruments: time value of options

Fair value of option

Time value

→ Reflects probability of being in the money in the future

→ Always ≥ 0 (for option holder)

Intrinsic value

→ Value of being in the money

→ Is 0 if option is at or out of the money

Option: time value continued

- Proposals:
  - Time value of an option—treatment reflects view as purchased protection ('insurance') and depends on the type of hedged item:
    - **transaction related**: eg forecast purchase of a commodity

      → defer cumulative change of option's time value in OCI (recycled similarly to cash flow hedges)
    - **time period related**: eg hedging existing inventory

      → amortise option's time value over the life of the option

Treatment as a cost of hedging reflects economics

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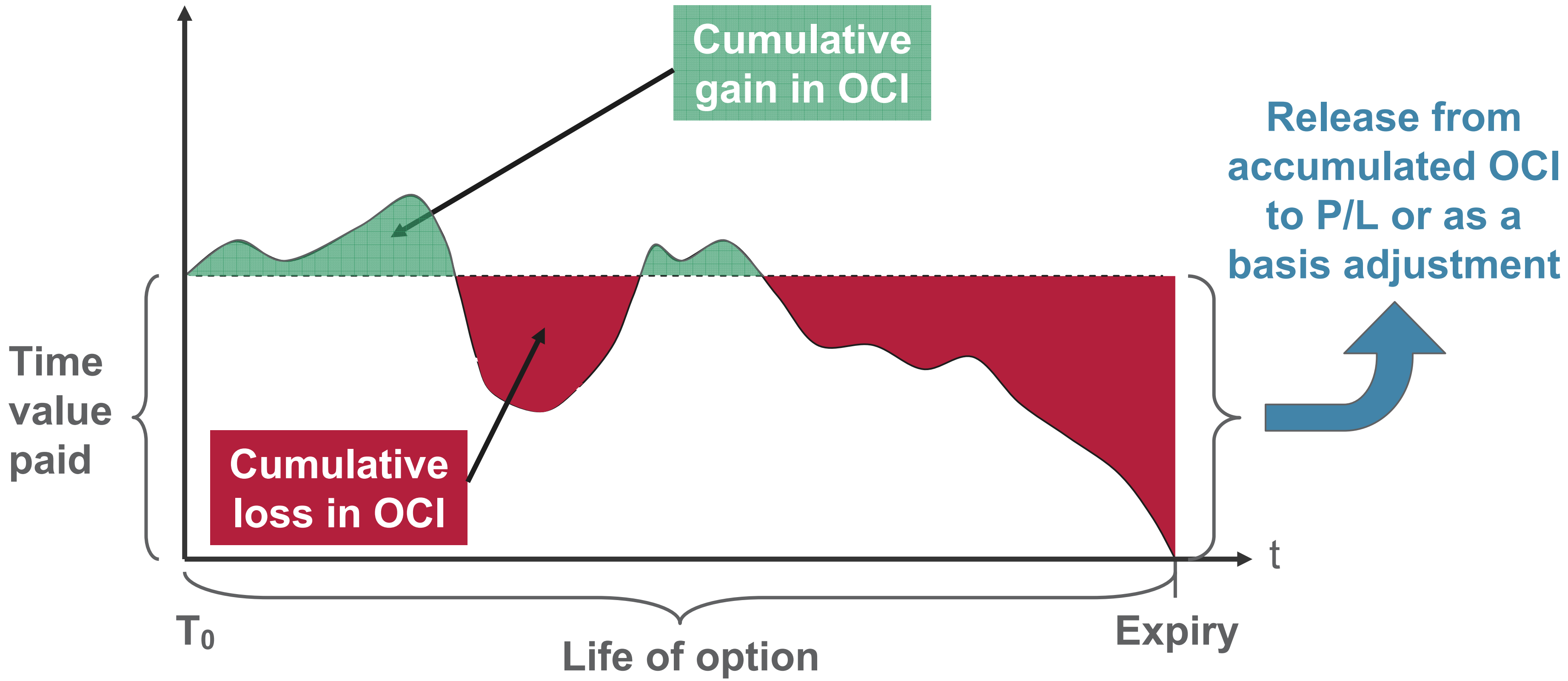
Option: time value continued

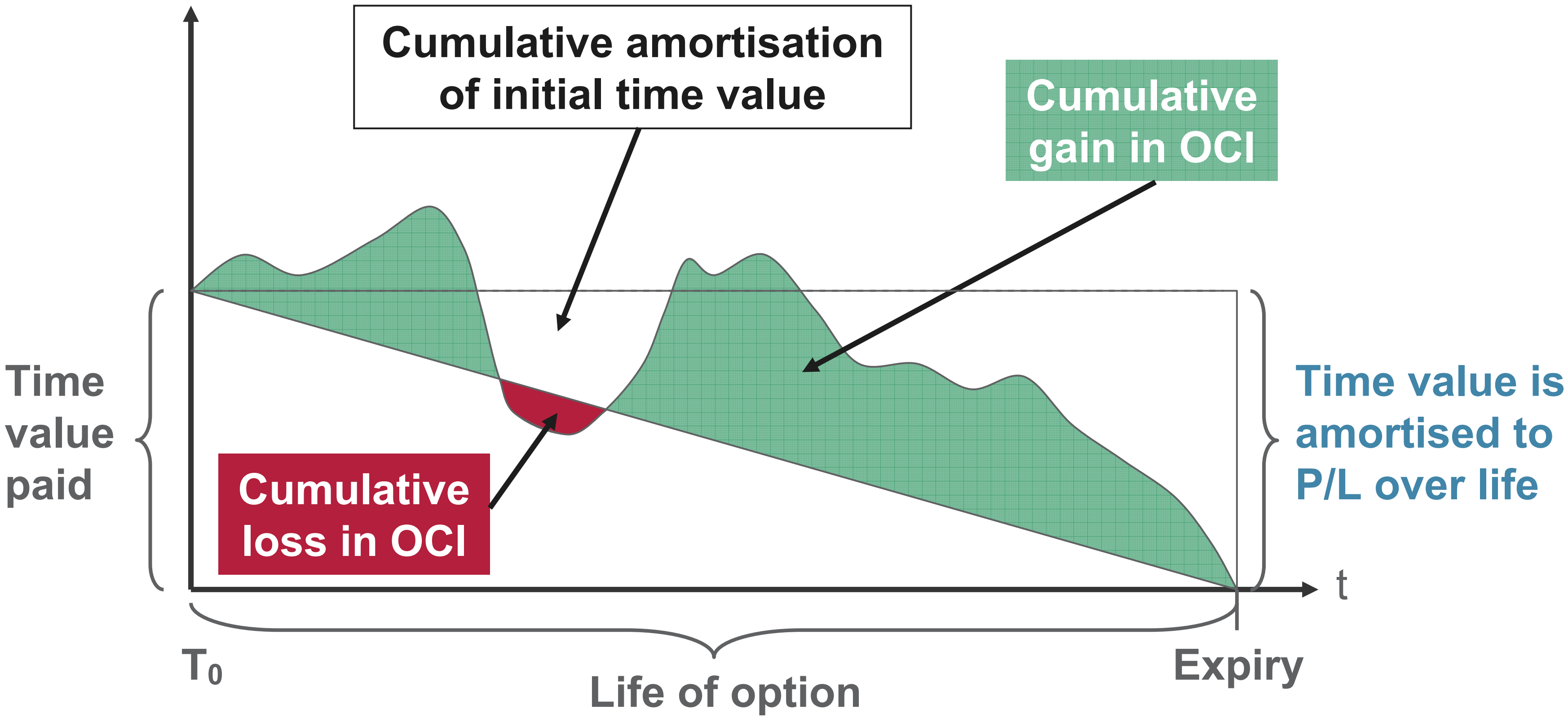
Accounting if the hedged item is transaction related



Treatment as a cost of hedging reflects economics

Option: time value continued

Accounting if the hedged item is time period related



Treatment as a cost of hedging reflects economics

Hedge effectiveness

Hedge effectiveness

Hedge effectiveness requirements (qualifying criteria):

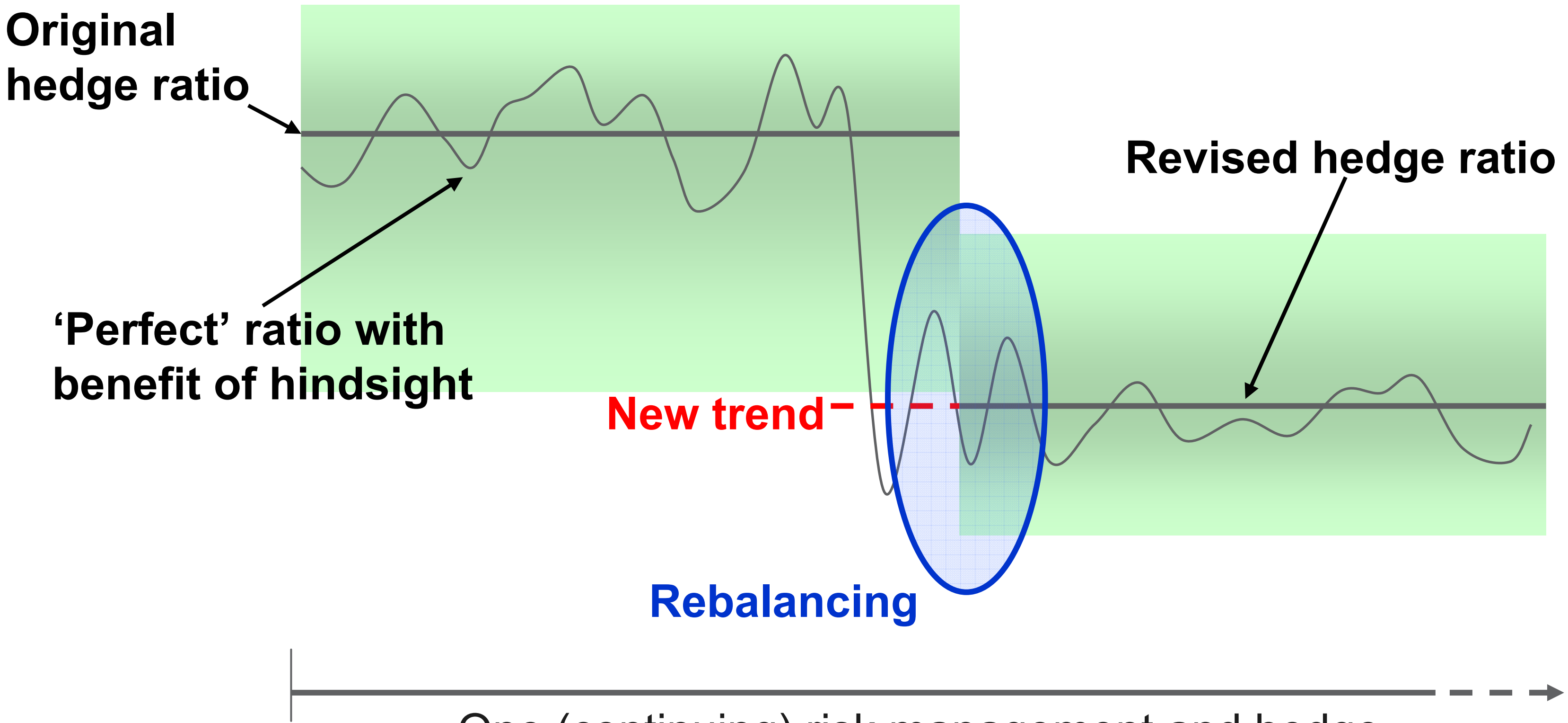
1. Objective of effectiveness assessment is met
2. More than accidental offset

Measuring and recognising hedge ineffectiveness

Effectiveness assessment

- Proposals:
  - **Type of approach**: objective-based
    - → no bright-line (ie no 80%-125% or other range)
    - → rebalancing of the hedge ratio can become necessary
  - **Method of assessment**: purpose-driven
    - → depends on characteristics of the hedging relationship and the potential sources of ineffectiveness
      - qualitative versus quantitative assessment
      - method might need to change as circumstances change
  - **Direction**: forward looking
    - → at inception and on an ongoing basis

Effectiveness assessment



One (continuing) risk management and hedge accounting relationship

Effectiveness assessment continued

- Proposals:
  - **Objective** of hedge effectiveness assessment
    - Hedging relationship should produce an **unbiased result** and **minimise *expected* hedge ineffectiveness**

    ⇒Risk management determines the 'optimal' hedge ratio

      → ie no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item such that they would produce a biased result

      → this does not mean that a hedging relationship has to be expected to be perfectly effective

Discontinuation and rebalancing

- Proposals:
  - **Mandatory discontinuation**
    - When hedging relationship ceases to meet the qualifying criteria
  - **Discontinuation and restart**
    - Change in the risk management objective
  - **Adjusting a continuing hedging relationship** ‘Rebalancing’
    - Risk management objective remains the same but fail (or are about to fail) objective of hedge effectiveness assessment
  - **Revocation of designation prohibited**
    - When all the qualifying criteria are still met (including the risk management objective)

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Rebalancing

- Proposals:
  - **Rebalancing**
    - response to changes in the relationship between hedging instrument and hedged item

      → evaluate whether changes in the extent of offset are:
      - fluctuations around the hedge ratio versus
      - an indication that the relationship between hedging instrument and hedged item changes
    - Continuation of the existing hedging relationship

      → different implications depending on whether hedging instrument or hedged item is adjusted
    - Update documentation

Hedge accounting mechanics

	Cash flow hedge accounting	Fair value hedge accounting
Ways to account today		
Proposals to change the way we account for hedges today…	•Unchanged	•Cumulative gain or loss on the hedged item attributable to the hedged risk as a separate line item in the balance sheet •Hedged item's carrying amount not changed •The fair value changes for hedging instruments and hedged items are taken to other comprehensive income and any ineffectiveness is transferred immediately to profit or loss

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Other presentation issues

- Proposals:
  - **'Basis adjustments'**
    - Mandatory
    - Direct transfer from cash flow hedge reserve to asset (or liability)

      $\Rightarrow$No distortion of OCI when hedged item is adjusted
  - **Hedges of FX risk of firm commitments**
    - Hedge-by-hedge choice (FVH or CFH) retained

Knock-on effects of other project phases

- Proposals:
  - **Embedded derivatives**
    - embedded derivatives are eligible hedging instruments only if separated from their host contract
      - ⇒no longer available under IFRS 9 for asset host contracts
  - **Equity investments for which the OCI presentation alternative is elected**
    - hedge accounting is not available for instruments designated at fair value through OCI
  - **Impairment**
    - interaction of expected loss model with ‘highly probable’

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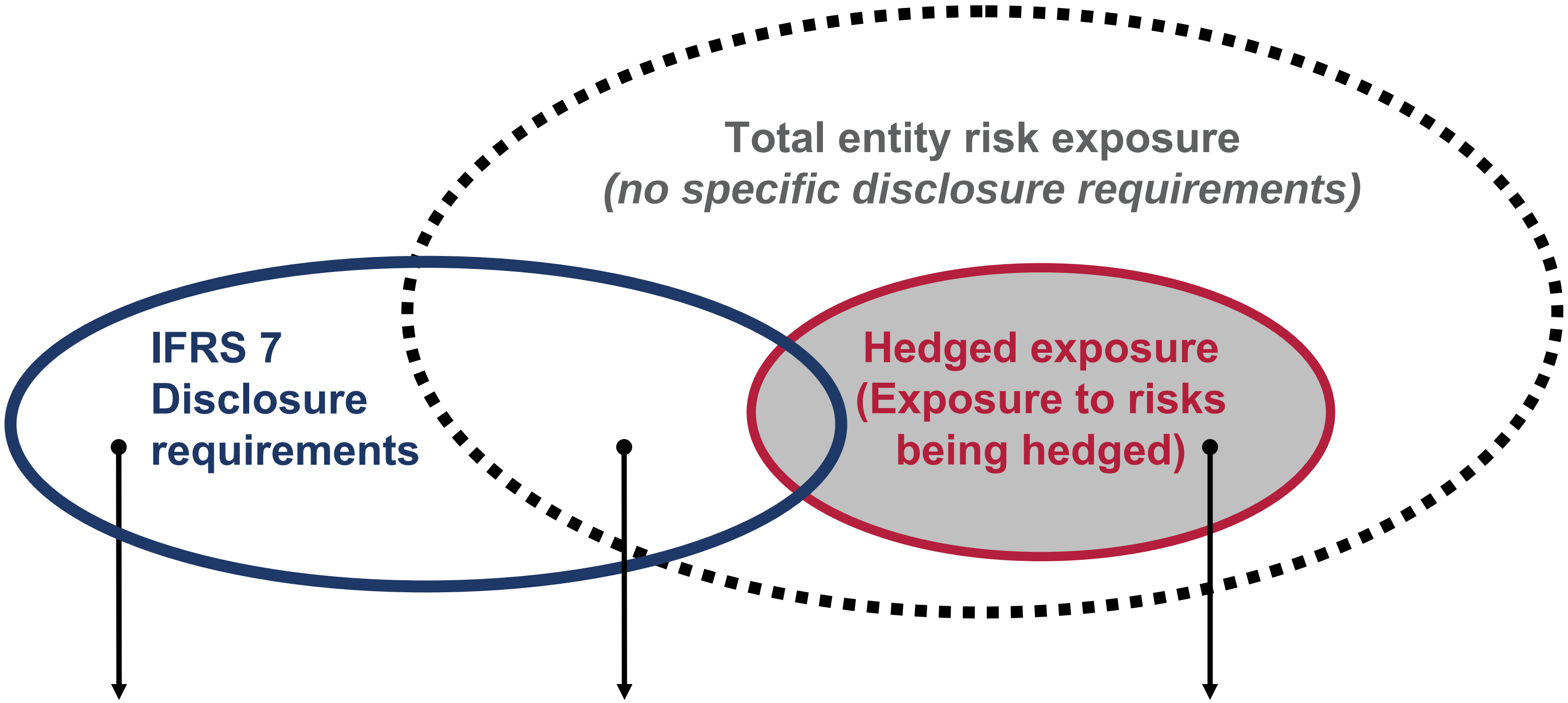
Disclosures: scope

Proposed scope for hedge accounting disclosures



Significance of financial instruments for financial position and performance

Nature and extent of risks arising from financial instruments

Entity's exposure attributable to the hedged risk

Disclosures: type and extent

- **Proposals:**
  - **Risk management strategy**
    - How risks arise, are being managed and extent of exposures being managed
  - **Effect of hedging on future periods**
    - Quantitative information about extent of exposures being *managed*
    - Amount of exposure being *hedged*
    - Effect of hedging (eg rates or prices locked in)
  - **Effect of hedge accounting on primary financial statements**
    - Tables with an overview of balance sheet items (including accumulated OCI) and amounts in P/L and OCI
  - **Disclosure required by type of risk**
  - **Information from other documents can be incorporated by reference**

Transition and effective date

- Proposals:
  - Transition requirements
    - Prospective application of new hedge accounting model to *all* hedging relationships
    - Hedging relationships that qualified under IAS 39 and qualify under the new model will be treated as *continuing* hedging relationships
    - No restatement of comparatives
  - Effective date
    - Annual periods beginning on or after 1 January 2013 with earlier application permitted
    - all existing IFRS 9 requirements must be adopted at the same time (or already have been adopted)

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Next steps…

- Exposure draft expected in Q4 2010
- Continued outreach
- IFRS in Q2 of 2011

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Financial instruments with characteristics of equity

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Project status

- IASB and FASB discussed how to proceed with the project in October 2010
  - The boards acknowledged currently no sufficient capacity to deliberate the project issues

  $\Rightarrow$ No exposure draft in the near term as originally planned.
- Next Steps:
  - The boards will return to this project when they have the requisite capacity (expected to be after June 2011)

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Derecognition

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Derecognition Disclosures
Amendments to IFRS 7

- Converge the disclosures on transfers of financial assets
- Similar to those in ED *Derecognition - Proposed amendments to IAS 39 and IFRS 7* (published March 2009)
- Final standard was issued in October 2010.

Disclosures: Objectives

On-balance sheet disclosures

To help understand the relationship between financial assets that are not derecognised and associated liabilities

Off-balance sheet disclosures

To help evaluate the nature of and risks from continuing involvement in derecognised financial assets

Users' concern!

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Offsetting

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Differences between IFRS and US GAAP

	IFRS	US GAAP
Number of counterparties	Two or more	Only two
Ability to set-off?	Unconditional	Conditional
Intent to set-off?	Required (to either net settle or settle simultaneously)	Not required for the following: • Some derivatives • Some derivatives & cash collateral • Some repos and reverse repos
Is offsetting required when criteria are met?	Required	Permitted
Risk exposure presented	Cash flows	Credit risk

Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

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