Office of the Superintendent of Financial Institutions Canada | Bureau du surintendant des institutions financières Canada

Guideline

Subject: **Derivatives Disclosure**

Category: **Accounting**

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This guideline provides federally regulated financial institutions with application guidance to Section 3861, Financial Instruments - Disclosure and Presentation, in the Handbook of the Canadian Institute of Chartered Accountants (CICA) and outlines additional disclosure requirements.

Introduction

Section 3861 provides disclosure requirements relating to all financial instruments. OSFI supports this type of comprehensive disclosure.

This guideline supplements the guidance contained in the discussion paragraphs of Section 3861 and provides institutions with guidance in applying the disclosure requirements to derivative financial instruments. It also includes further disclosure requirements for derivative financial instruments as well as disclosure requirements for derivative non-financial instruments such as commodities contracts. In addition, it requires banks, trust and loan companies and life insurance companies to disclose certain derivatives related amounts that are reported to OSFI in accordance with the capital requirements guidelines, and all institutions to disclose information about revenue relating to derivative and other instruments held for trading purposes as defined in paragraph 19(f)(i) of Section 3855. This guideline outlines minimum disclosure requirements and institutions are encouraged to make additional disclosures that they consider to be appropriate.

The annexes to this guideline summarize the information that should be presented in the institution's annual report, or OSFI annual return for institutions that do not produce annual reports, to conform with the requirements of this guideline, and illustrate how disclosures relating to derivative instruments could be integrated with the disclosures of all other financial instruments.

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CICA Disclosure Requirements

The recommendations of Section 3861 are presented below in italics followed by the OSFI application guidance.

The following disclosures should be made either in the body of the financial statements or in the accompanying notes. Institutions that do not produce annual financial statements should make these disclosures in their OSFI annual return.

Terms and conditions

.43 For each class of financial assets, financial liabilities and equity instruments, both recognized and unrecognized, an entity should disclose information about the extent and nature of the financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows.

The notional amounts and other information about the extent and nature of all derivative instruments should be disclosed, including those instruments that are excluded from the reports to OSFI for capital adequacy purposes. The remaining term to maturity of all derivative instruments should be disclosed, as a minimum, for the following three time bands: 1 year or less, over 1 year through 5 years, and over 5 years.

Notional amounts and other information about the extent and nature of derivative financial instruments should be disclosed by class (e.g., interest rate contract or foreign exchange contract) and by type (e.g., forwards, futures, swaps, and options). Interest rate cross currency swaps should be included under foreign exchange contracts.

The notional amounts of over-the-counter (OTC) derivative instruments should be disclosed separately from the notional amounts of those derivative instruments that are exchange traded.

The notional amounts and other information about the extent and nature of derivative instruments held for trading purposes should be disclosed separately from the information relating to derivative instruments that are held for other than trading purposes.

The notional amounts of other derivative instruments held for trading purposes should be disclosed and presented with the notional amounts of derivative financial instruments held for trading purposes.

An explanation should be provided of the criteria used by the institution to distinguish between trading activities and other than trading activities.[1] The distinction between derivative instruments held for trading purposes and derivative instruments held for other than trading purposes should be made on a transaction by transaction basis. Institutions should classify as "held for trading purposes" those derivative instruments that are used to hedge instruments held for trading purposes.

Interest rate risk

.49 *For each class of financial assets and financial liabilities, both recognized and unrecognized, an entity should disclose information about its exposure to interest rate risk, including:*

(a) contractual repricing or maturity dates, whichever dates are earlier; and

(b) effective interest rates, when applicable.

OSFI is not proposing any specific application guidance for derivative instruments with reference to this recommendation.

Credit risk

.58 *For each class of financial assets, both recognized and unrecognized, an entity should disclose information about its exposure to credit risk, including:*

(a) the amount that best represents its maximum credit risk exposure at the balance sheet date, without taking account of the fair value of any collateral, in the event other parties fail to perform their obligations under financial instruments; and

(b) significant concentrations of credit risk.

The maximum credit risk exposure is the current replacement cost of all outstanding derivative contracts that have a recognized positive value (obtained by marking to market those contracts).

The maximum credit risk exposure of all derivative instruments should be disclosed, including those instruments that are excluded from the reports to OSFI for capital adequacy purposes.

The maximum credit risk exposure should be disclosed by class of derivative instrument. Further categorization within each class of derivative financial instrument by type is encouraged but not required.

[1] Regardless of the accounting designation as “held for trading” (Fair Value Option) under section 3855.19(f)(ii), trading and other than trading activities described within this guideline are based on the definition found in OSFI’s Capital Adequacy Requirements for Banks, Trust & Loan Companies and Cooperatives; Minimum Continuing and Capital Surplus Requirements for Life Insurance Companies; Test of Adequacy of Assets in Canada and Margin Requirements for Foreign Life Insurance Companies; and Minimum Capital Test for Property & Casualty Insurance Companies.

The maximum credit risk exposure should be disclosed after taking into consideration the impact of offsetting contracts with a given counterparty in accordance with Section 3861, (i.e., where the institution has a legally enforceable right to set off the contracts and it intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously). The conditions that will need to be met to satisfy the first criterion (legally enforceable right) will be included in OSFI's capital requirements guidelines.

In making the disclosures outlined in paragraph 63 of Section 3861, institutions should show the impact on the maximum credit risk exposure of recognizing master netting agreements where there is no intention of settling on a net basis or of realizing the asset and settling the liability simultaneously as an adjustment to the total maximum credit risk exposure of the derivative instruments. Institutions should explain the extent and nature of such master netting agreements and their role in credit risk management.

Fair value

.69 Except as set out in paragraphs 3861.70-.71, for each class of financial assets and financial liabilities, an entity should disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with the corresponding carrying amount in the balance sheet.

.70 When it is not practicable within constraints of timeliness or cost to measure reliably the fair values of:

(a) investments in equity instruments that do not have quoted market prices in an active market and are not classified as held for trading;

(b) financial assets or financial liabilities transferred or originated in a related party transaction that are classified as held-to-maturity investments, loans or receivables, or financial liabilities other than ones held for trading; or

(c) actuarial liabilities of life insurance enterprises in accordance with Accounting Guideline AcG-8, Actuarial Liabilities of Life Insurance Enterprises - Disclosure*;*

the information about fair value in paragraphs 3861.69 and 3861.72 is not required to be disclosed.

.71 When paragraph 3861.70 applies, information should be provided to help users of financial statements in making their own judgments about the extent of possible differences between the carrying amount of such financial assets and financial liabilities and their fair value, including:

(a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;

(b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be reliably measured;

(c) information about the market for instruments; and

(d) when financial assets whose fair value previously could not be reliably measured are sold, disclosure of that fact, together with the carrying amount of such financial assets at the time of sale and the amount of gain or loss recognized.

.72 *An entity should disclose the following:*

(a) the methods and significant assumptions applied in determining fair values of financial assets and financial liabilities separately for classes of financial assets and financial liabilities (paragraph 3861.40 provides guidance for determining classes of financial instruments).

(b) whether fair values of financial assets and financial liabilities are determined directly, in full or in part, by reference to published price quotations in an active market, or are estimated using a valuation technique (see Financial Instruments – Recognition and Measurement, paragraphs 3855.A41-.A61).

(c) whether its financial statements include financial instruments measured at fair values that are determined, in full or in part, using a valuation technique based on assumptions that are not supported by observable market prices or rates. If changing any such assumption to a reasonably possible alternative would result in a significantly different fair value, the entity should state this fact and disclose the effect on the fair value of those reasonably possible alternative assumptions. For this purpose, significance should be judged with respect to net income and total assets or total liabilities.

(d) the total amount of the change in fair value recognized in net income during the period that was estimated using a valuation technique based on assumptions that are not supported by observable market prices or rates.

The fair value should be disclosed by class of derivative instrument. Further categorization within each class of derivative financial instrument by type is encouraged but not required.

The fair value of derivative instruments held for trading purposes should be disclosed separately from the fair value of derivative instruments held for other than trading purposes.

The fair value of the derivative instruments that are in a favourable or receivable position should be shown separately from the fair value of those that are in an unfavourable or payable position.

The fair value of derivative instruments, irrespective of whether held for trading or other than trading purposes, should be disclosed after taking into consideration the impact of offsetting contracts in accordance with Section 3861.

In order to provide fair value disclosures on a basis consistent with the disclosures outlined in paragraph 63 of Section 3861 for maximum credit risk exposure, institutions should show the impact on the fair value of recognizing master netting agreements where there is no intention of settling on a net basis or of realizing the asset and settling the liability simultaneously as an adjustment to the total fair value of the derivative instruments.

The fair value of recognized financial assets, such as debt and equity securities, held for trading purposes, should be disclosed in a manner that provides readers of the financial statements, or OSFI annual return for financial institutions that do not produce annual financial statements, with an integrated portrayal of the fair value of recognized financial assets held for trading purposes and the fair value of derivatives held for trading purposes.

Institutions are encouraged, but not required, to disclose average fair value information for all derivative instruments and recognized financial assets held for trading purposes, as well as the basis for determining average fair value (e.g., daily, weekly or monthly). Disclosure of average fair value would be presented on a basis consistent with period-end fair value information.

Impairment not recognized in net income

.78 When objective evidence of impairment exists for certain financial assets, but an impairment loss is not recognized in net income because the decline in recoverable amount (in the case of financial assets measured at cost) or fair value (in the case of all other financial assets) is not other than temporary, an entity should disclose:

(a) the information that the entity considered (both positive and negative) in reaching the conclusion that the decline in recoverable amount (in the case of financial assets measured at cost) or fair value (in the case of all other financial assets) is not other than temporary;

(b) for financial assets measured at cost or amortized cost, the carrying amount and fair value of either the individual assets or appropriate groupings of those individual assets; and

(c) for available-for-sale financial assets measured at fair value, the amount of the cumulative loss related to the asset in accumulated other comprehensive income.

OSFI is not proposing any specific application guidance for derivative instruments with reference to this recommendation.

Other Disclosures

The following disclosures should be made in either the notes to the financial statements or in the MD&A section of the annual report. Institutions that do not prepare an annual report should make these disclosures either in the notes to the financial statements or in a supplementary management report. Institutions that do not produce annual financial statements should make these disclosures in the notes to the OSFI annual return.

OSFI expects the following information to be disclosed for all derivative instruments:

(a) an explanation of the nature and extent of the institution's use of derivative instruments;
(b) the business purposes that they serve;
(c) the risks associated with them; and
(d) information about management's policies for controlling the risks.

In disclosing information about management's policies for controlling risks, information should be included about management's policies on matters such as hedging risk exposures, avoidance of undue concentrations of risk and requirements for collateral to mitigate credit risks.

The following additional disclosures are not addressed by Section 3861, but are required by this guideline:

(a) Banks, authorized foreign banks in respect of their business in Canada – foreign bank branches (FBBs), trust and loan companies and life insurance companies should disclose the positive replacement cost, credit equivalent amount and the risk-weighted equivalent by class of derivative instrument. Further categorization within each class of derivative financial instrument by type is encouraged but not required. The credit equivalent amount is the positive replacement cost plus an amount representing the potential future credit exposure as outlined in OSFI's capital requirements guidelines. Institutions should provide an explanation of these disclosures and indicate how the amounts are calculated.

Banks, FBBs, and trust and loan companies should calculate the positive replacement cost, the credit equivalent amount and the risk-weighted equivalent in accordance with the Capital Adequacy Requirements Guidelines.

Life insurance companies should calculate the positive replacement cost and the credit equivalent amount in accordance with the MCCSR Guideline. Life insurance companies should calculate the risk-weighted equivalent by multiplying the credit equivalent amount by a risk-weighted factor. This risk-weighted factor is determined by dividing the counterparty factor by 8%.

(b) The revenue from trading activities for derivative instruments and recognized financial assets held for trading purposes[2] should be disclosed. Revenue from trading activities consists of two components: (i) net gains or losses (whether realized or unrealized); and (ii) net interest income or net interest expense. Each component should be disclosed separately.

An institution should disclose revenue from trading activities relating to interest rate contracts, foreign exchange contracts, equities, commodities and other contracts, and recognized financial assets held for trading purposes, or based on the method by which it manages and internally reports its trading business (e.g., by product, type of risk, etc.).

It is recognized that it may not be possible for readers of the financial statements or OSFI annual return to reconcile the disclosure of revenue from trading activities to specific line items reported in the income statement.

[2] Per CICA Handbook section 3855.19(f) (i)

Annex A - Disclosure of Notional Amounts

Below is a summary of the information that should be disclosed relating to notional amounts for each class and type of derivative instrument and an illustration of how these disclosures could be integrated with the disclosures relating to other instruments.

A. Recognized Financial Assets - Balance Sheet Amount

Assets to be classified in accordance with industry practice

B. Recognized Financial Instruments

Derivative Instruments - Notional Amount

Interest Rate Contracts[3,4,5]

Forward rate agreements
Futures contracts
Swap contracts
Options purchased
Options written

Foreign Exchange Contracts[3,4,5]

Foreign exchange spot and forward contracts
Futures contracts
Swaps contracts
Options purchased
Options written

Other Derivative Contracts[3,4,5,6]

Equities, commodities, credit derivatives and other

C. Unrecognized Financial Instruments

Credit Instruments - Contract Amount

Credit instruments to be classified in accordance with industry practice

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3 Total of notional amounts for each type of derivative instrument should be broken down between (a) those held for trading purposes as defined in paragraph 19(f)(i) of Section 3855, and (b) those held for other than trading purposes

4 Total of notional amounts for each type of derivative instrument should be broken down between OTC and exchange traded derivatives.

5 Total of notional amounts for each type of derivative instrument should be broken down by remaining term to maturity.

6 Disclosures relating to Other Derivative Contracts are not required to be made by type.

Annex B - Disclosure of Maximum Credit Risk Exposure

Below is a summary of the information that should be disclosed relating to the maximum credit risk exposure for derivative instruments. However, disclosure of derivative financial instruments by type is encouraged but not required.

Derivative Instruments

Interest Rate Contracts

Forward rate agreements
Futures contracts
Swap contracts
Options purchased

Foreign Exchange Contracts

Foreign exchange spot and forward contracts
Futures contracts
Swaps contracts
Options purchased

Other Derivative Contracts

Equities, commodities, credit derivatives and other

Total

Less: Adjustment for master netting agreements[7]

Net

[7] In making the disclosures outlined in paragraph 63 of Section 3861, this adjustment is made to show the impact on total maximum credit risk exposure of recognizing master netting agreements where there is no intention of settling on a net basis or of realizing the asset and settling the liability simultaneously.

Annex C - Disclosure of Fair Value

Below is a summary of the information that should be disclosed relating to fair value of derivative instruments and an illustration of how these disclosures could be integrated with the disclosures relating to other instruments. However, disclosure of derivative financial instruments by type is encouraged but not required.

A. Recognized Financial Assets
Assets to be classified in accordance with industry practice

B. Recognized Financial Liabilities
Liabilities to be classified in accordance with industry practice

C. Recognized Financial Instruments
Derivative Instruments

Interest Rate Contracts [8,9]
Forward rate agreements
Futures contracts
Swap contracts
Options purchased
Options written

Foreign Exchange Contracts [8,9]
Foreign exchange spot and forward contracts
Futures contracts
Swaps contracts
Options purchased
Options written

Other Derivative Contracts [8,9]
Equities, commodities, credit derivatives and other

Total Fair Value

Less: Adjustment for master netting agreements[10]

D. Unrecognized Financial Instruments

Credit Instruments
Credit instruments to be classified in accordance with industry practice

Net Fair Value

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8 The fair value of recognized financial assets and derivative instruments should be broken down between (a) those held for trading purposes as defined in paragraph 19(f)(i) of Section 3855, and (b) those held for other than trading purposes.

9 The fair value of derivative instruments should be broken down between those in a favourable/receivable position and those in an unfavourable/payable position.

10 In order to provide fair value disclosures on a basis consistent with the disclosures outlined in paragraph 63 of Section 3861 for maximum credit risk exposure, this adjustment is made to show the impact of recognizing master netting agreements where there is no intention of settling on a net basis or of realizing the asset and settling the liability simultaneously.

Annex D - Disclosure of Positive Replacement Cost, Credit Equivalent Amount and Risk-Weighted Equivalent

Below is a summary of the information that should be disclosed relating to the positive replacement cost, the credit equivalent amount and the risk-weighted equivalent for derivative instruments. However, disclosure of derivative financial instruments by type is encouraged but not required.

Derivative Instruments

<u>Interest Rate Contracts</u>

Forward rate agreements
Futures contracts
Swap contracts
Options purchased

<u>Foreign Exchange Contracts</u>

Foreign exchange spot and forward contracts
Futures contracts
Swaps contracts
Options purchased

<u>Other Derivative Contracts</u>

Equities, commodities, credit derivatives and other

Total

Annex E - Disclosure of Revenue from Trading Activities

Below is a summary of the type of information that could be disclosed relating to revenue from trading activities as defined in paragraph 19(f)(i) of Section 3855 for derivative instruments and recognized financial assets held for trading purposes. An institution may, however, disclose revenue from trading activities based on the method by which it manages and internally reports its trading business (e.g., by product, type of risk, etc.).

Interest Rate Contracts (including recognized debt securities)

Foreign Exchange Contracts

Equities, Commodities, Credit Derivatives and Other Contracts (including recognized equity securities)

Total

- END -