Guideline Impact Analysis Statement

D-10 Accounting for Financial Instruments Designated as Fair Value Option

February 2007

I. Background

The Canadian Accounting Standards Board (AcSB) included an option in the new Financial Instruments standards that permits entities to fair value any financial asset or financial liability at initial recognition. Fair value changes will impact income. While this option ("Fair Value Option") is generally consistent with the original standard developed by the International Accounting Standards Board (IASB), it did not include a subsequent IASB Amendment.

The IASB amended its Financial Instruments Standard because of concerns by financial institution supervisors and the European Central Bank regarding the use of the Fair Value Option. The IASB Amendment limits the use of the Fair Value Option to situations where the Fair Value Option provides more relevant information because:

(1) it eliminates or significantly reduces an accounting mismatch, or

(2) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management strategy.

In addition, when a financial contract contains one or more embedded derivatives that significantly modify the cash flows of the host contract, the entity may designate the entire contract at fair value.

The U.S. currently does not have the Fair Value Option, but the Financial Accounting Standards Board (FASB) has issued an exposure draft that did not include the IASB Amendment. The U.S. federal financial institutions regulatory agencies have recommended to the FASB that the IASB Amendment be added to the proposed standard. FASB will be issuing a final standard in first quarter 2007.

Institutions in other countries applying International Financial Reporting Standards use the Fair Value Option only to a limited extent. However, some Canadian financial institutions have indicated an intention to use the Fair Value Option widely. This heightens the need for OSFI to ensure financial institutions maintain the quality of regulatory capital and reliability of regulatory reporting. OSFI has particular concerns related to:

- the reliability of fair values when observable market prices are not available; and
- the lack of a requirement for a documented risk management strategy as a prerequisite to using the Fair Value Option.

The Basel Committee on Banking Supervision[1] has developed Supervisory Guidance to clarify supervisory expectations on the use of the Fair Value Option. The Basel guidance encourages strong internal controls and risk management practices for the use of the Fair Value Option and emphasizes that standards should be higher for non-traded instruments. For illiquid instruments where component risk prices cannot be observed, the paper cautions for "appropriate valuation approaches." The Basel guidance states that gains and losses should be reversed from Tier 1 capital for regulatory purposes if risk management and control practices fall short of supervisory expectations resulting in unreliable fair values.

The IASB Amendment and the Supervisory Guidance encourage strong internal controls and accept valuations that are "reliable or based on appropriate valuation approaches."

OSFI issued Guideline D-10 in June 2006 to address the concerns noted above. The Guideline was issued to coincide with institutions' implementation of the Financial Instruments standards for fiscal 2007.

II. Problem Identification

Subsequent to the issuance of Guideline D-10, financial institutions raised some issues in respect of the accounting for loans with the intent of reselling for profit. Under the previous Canadian accounting standards, and consistent with current International standards, these types of loans would simply be designated as held for trading, without use of the fair value option. A similar practice is also generally followed when applying US standards. Under Canada's new financial instruments standard, these loans can only be designated as held for trading if the Fair Value Option is used. However, under the June 2006 version of Guideline D-10, these loans would not qualify to use the Fair Value Option and would essentially create a different accounting treatment compared to that of previous Canadian and current US and international GAAP.

III. Objectives

A key condition of D-10 was that the Fair Value Option was to be used to reduce risk. However, these loans were originated or acquired for trading purposes. OSFI did not intend to impact loans that would have previously qualified for inclusion in the trading book because they were intended for short term resale for profit.

IV. Options and Assessment

OSFI undertook consultations with a number of financial institutions to address the situation in which certain loans with intention for reselling for profit should qualify for use of the Fair Value Option.

[1] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States.

These consultations led to the identification of four situations where these types of loans could use the Fair Value Option when certain conditions are met.

OSFI has identified two alternatives for amending the Fair Value Option.

Option 1: Exempt all loans designated with intent of reselling for profit from Guideline D-10**.**

This option has the advantage of requiring few resources by either OSFI or financial institutions to implement.

However, this option would not encourage good risk management practices for less liquid loans whose market value could be subject to significant volatility. These loans should be subject to D-10 to ensure that robust risk management practices continue to apply where the Fair Value Option is used.

Option 2: Create additional guidance for certain loans to be exempt from some of the requirements of Guideline D-10

While this option creates additional guidance, it eliminates OSFI's concerns that certain loans would be removed from the application of D-10. This option would ensure loans with intent of reselling for profit are not subjected to D-10. Given that the criteria for use of the Fair Value Option for certain loans are explicit, the burden for financial institutions to use this option is minimal.

V. Consultations

Subsequent to the issuance of Guideline D-10 in June 2006, OSFI undertook consultations with a number of financial institutions to consider options for addressing the problem. A consensus was reached with respect to the need to amend Guideline D-10 to permit the use of the Fair Value Option for certain loans with the intent of reselling for profit that met specific conditions.

VI. Recommendations

OSFI believes the amended guidance is an appropriate way to address the issue of loans with the intent of reselling for profit.

VII. Implementation

OSFI will issue immediately an amended Guideline D-10 given the new accounting standards for financial instruments are required to be implemented for fiscal year 2007.