HM Treasury

Financial Reporting Advisory Board Paper

IFRS 9 FReM adaptation for financial guarantees

Issue:	HM Treasury requests that the FRAB agrees to an adaptation of IFRS 9 for the 2021-22 FReM.
Impact on guidance:	The 2021-22 FReM will be updated to include the adaptation.
IAS/IFRS adaptation or interpretations for the public-sector context?	Yes – the 2021-22 FReM will introduce a new adaptation for the public-sector context for IFRS 9.
Impact on WGA?	Changes will be made in department level accounts.
IPSAS compliant?	N/A – FReM specific adaptation
Impact on Estimates/budgetary regime?	Accounting changes may have a knock-on effect on budgets, but these would be minimal, and the implementation of the adaptation will not cause any new misalignments.
Alignment with National Accounts	Yes, for standardised guarantees. Other financial guarantees are not reflected in the National Accounts.
Recommendation:	That FRAB notes the proposed adaptation to IFRS 9 in the 2021-22 FReM and agrees their publication.
Timing:	The updated Manuals will be published in December 2021.

DETAIL

Background

1. The transaction price of a financial guarantee would usually, in an active competitive market, represent the fair value of that guarantee.

2. To fulfil policy objectives, central government entities may issue financial guarantees at nil or non-market rates or in circumstances where no market exits.

3. In these instances, the transaction price charged for the financial guarantee may not fully represent fair value.

4. For financial guarantees offered at below fair value **in active markets**, the IFRS 9 standard provides guidance on how to measure such financial guarantees to reflect their fair value. Below are the relevant excerpts of IFRS 9 that set out how to obtain a fair value measurement for such guarantees (5.1 to B5.1.2A section (a)).

5. For financial guarantees issued where no active market and no observable equivalents exists, IFRS 9 dictates the uses of the final excerpt below, B5.1.2A section (b). Financial guarantees issued in these circumstances and a proposed adaptation to this section of IFRS 9 are the subject of this paper.

5.1 Initial measurement

5.1.1 Except for trade receivables within the scope of paragraph 5.1.3, **at initial recognition, an entity shall measure a** financial asset or **financial liability at its fair value** plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.

5.1.1A However, if the fair value of the financial asset or **financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph B5.1.2A.**

B5.1.2A
The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received, see also IFRS 13). **If an entity determines that the fair value at initial recognition differs from the transaction price** as mentioned in paragraph 5.1.1A, **the entity shall account for that instrument at that date as follows:**

(a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (i.e. a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

(b) in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

Amendments to IFRS

6. B5.1.2A section (b) prevents users of IFRS, such as some financial institutions/banks, from recognising large day one gains on financial instruments.

7. However, some central government entities may issue financial guarantees where no active market exists and at nominal or nil transaction value to support economic policy objectives. In this instance, they are prevented from recognising day one losses when applying the Standard as written.

8. In such accounts, the nominal or nil transaction value would be recognised as a liability for the period in which the loans were issued. Any adjustment to fair value these guarantees on the balance sheet would be deferred to a subsequent reporting period. This results in an understatement of liabilities in the entities' accounts, and by extension, the WGA.

9. An example to demonstrate the issue is set out below:

> **Example**
>
> A government entity issued financial guarantees to banks to provide 10-year COVID support loans to private businesses during 2020-21. The loans were offered resulting in approximately £100 billion of lending. For these guarantees the government charged a nil or nominal fee.
>
> No active market exists or observable equivalents to determine fair value of these guarantees.
>
> Applying IFRS 9, per B5.1.2A section (b), would result in the nominal or nil amount charged for these guarantees being recognised as a liability on the entity's balance sheet for the year ending March 2021.
>
> Given the exceptional circumstances caused by the global COVID pandemic it is expected a significant proportion of these guarantees will be called on.
>
> As such, by applying B5.1.2A section (b) as written and deferring any adjustment in carrying value of the guarantees, users of the financial statements may misunderstand the extent of the entity's present obligation and the expected outflows in respected of the guarantees.

10. It is HM Treasury's view that preventing central government departments from recognising losses at recognition when issuing financial guarantees where no active market exists is an unintended consequence of IFRS 9, B5.1.2A section (b) and therefore proposes the following adaption be published in the 2021-22 FReM onwards.

11. The adaptation seeks to use a lifetime expected credit loss model for measurement on initial recognition in those instances where there is no active market or observable equivalent for financial guarantees that are issued below fair value. It allows recognition from day 1, overriding the Standard's requirement to defer (B5.1.2A paragraph (b)).

Proposed Amendment

IFRS 9 *Financial Instruments*	
Adaptations	Where an entity issues a financial guarantee below fair value and where no active market or observable equivalent exists such that it would follow B5.1.2A section (b), then it should instead measure the financial guarantees at initial recognition, and at reporting period end, at an amount equal to lifetime expected credit loss (ECL) in accordance with the requirements of IFRS 9. Initial measurement and subsequent measurement are to be recognised through profit and loss. For the purpose of applying Interpretation (4)[1] of the FReM's interpretation of IFRS 9, and for the purpose of determining suitable disclosures under IFRS 7, the department shall apply them as if ECL were Fair Value. In the case of Interpretation (4), if it can be evidenced that the intrinsic rate cannot be reliably determined, then the HM Treasury Financial Instrument rate should be used.

12. ECL is, per the standard, an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. By allowing government entities to apply Lifetime ECL at recognition they can present an immediate loss, recognised though profit and loss, and thus a more faithfully, true and fair view of the liability.

13. The FReM interpretation allows entities to present the true liability on the balance sheet by measuring the financial guarantees at initial recognition, and at reporting period end, at an amount equal to lifetime expected credit loss (ECL) in accordance with the requirements of IFRS 9. This is to align as closely as possible to IFRS 9, as per section 5.5 Impairment of the Standard: an entity will use Lifetime ECL if the credit risk on a financial instrument has increased significantly since initial recognition (5.5.3).

14. Given the adaptation's override of initial recognition, the use of Lifetime ECL is stated in the adaption.

15. Below are the relevant excerpts of IFRS 9 regarding the initial use of Lifetime ECL which demonstrate how the adaptation has been written to interlace with the standard.

[1] Interpretation (4) for the 2021-22 FReM:
Where future cash flows are discounted to measure fair value, entities should use the higher of the rate intrinsic to the financial instrument and the real financial instrument discount rate set by HM Treasury (promulgated in Public Expenditure System (PES) papers) as applied to the flows expressed in current prices.

5.5 Impairment

5.5.3 Subject to paragraphs 5.5.13–5.5.16, **at each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the *lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition.**

5.5.4 The objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking.

5.5.5 Subject to paragraphs 5.5.13–5.5.16, if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to *12-month expected credit losses*.

5.5.6 For loan commitments and financial guarantee contracts, the date that the entity becomes a party to the irrevocable commitment shall be considered to be the date of initial recognition for the purposes of applying the impairment requirements.

5.5.7 If an entity has measured the loss allowance for a financial instrument at an amount equal to lifetime expected credit losses in the previous reporting period, but determines at the current reporting date that paragraph 5.5.3 is no longer met, the entity shall measure the loss allowance at an amount equal to 12-month expected credit losses at the current reporting date.

5.5.9 At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition.

5.5.10 At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition.

Recommendation

16. The Board is requested to agree the proposed adaptation to IFRS 9 for publication in the 2021-21 FReM.

HM Treasury
24th June 2021