18th November 2021

Financial Reporting Advisory Board Paper

IFRS 9 *Financial Instruments*: 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 departmental level accounts and consolidated into WGA from 21-22.
IPSAS compliant?	FReM specific adaptation. More closely aligned to IPSAS 41
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. This paper sets out the justification for the IFRS 9 FReM adaptation proposed at the 144th Financial Reporting Advisory Board, (paper FRAB 144 (04)) on 21st June 2021.
2. On 21st June 2021 the Board agreed with HM Treasury's intent to present a true and fair, and transparent accounting treatment. However, discussion highlighted that the justification for the proposed adaptation needed to be set out more fully before a decision could be made on including the adaption in the next publication of the Government Financial Reporting Manual (FReM) (as an in year update) in December 2021 (for the year ending 31st March 2022).
3. The proposed adaptation seeks to addressed two issues:
    - The first is to prescribe the measurement basis (expected credit losses) for certain policy driven financial guarantees, where otherwise applying fair value measurement would present significant scope for inconsistent treatment.

- The second is to override the need to defer the difference between fair value and the transaction price, which in the case of policy driven guarantees charged at significantly below fair value, the deferral results in understating the liability position of the entity.

4. The proposed adaptation:

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.

Mandating Expected Credit Losses

5. The adaptation proposes a departure from applying IFRS 13 *Fair Value Measurement* as written and instead, proposes to initially value the financial guarantee using Expected Credit Loss (ECL). ECL is the method used for subsequent valuation (s5.5) of financial guarantees under IFRS 9.
6. The extract below from the IFRS 13 sets out the objective in Fair Value measurement. Put simply, the adaptation looks to tackle situations where market transactions would not take place (not merely that they could not be observed) because the government is entering into financial guarantees for certain specific policy reasons – potentially precisely because there is no market. In such situations there is significant scope for divergent assumptions, especially market participant-based assumptions about risk. To provide consistency of treatment and clarity of approach, the adaptation mandates the use of Lifetime ECL.

IFRS 13 - Objective

[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.

2. Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same—**to estimate the price at which an *orderly transaction* to sell the asset or to transfer the liability would take place between *market participants* at the measurement date under current market conditions** (i.e. an *exit price* at the measurement date from the perspective of a market participant that holds the asset or owes the liability)

3. When a price for an identical asset or liability is not observable, an entity measures fair value using another **valuation technique that maximises the use of relevant *observable inputs* and minimises the use of *unobservable inputs***. Because fair value is a market-based measurement, it is **measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk**. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

7. Entities, applying IFRS as adapted per the FReM, are required to value financial assets and liabilities per IFRS 13 *Fair Value* valuation techniques using the established fair value hierarchy.
8. In the specific scenarios where the adaptation would apply there is no active market or observable equivalents to supply complete level 1 inputs.

72. To increase consistency and comparability in fair value measurements and related disclosures, this IFRS establishes **a fair value hierarchy** that categorises into three levels (see paragraphs 76–90) the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (*Level 3 inputs*)

73. In some cases, the inputs used to measure the fair value of an asset or a liability might be categorised within different levels of the fair value hierarchy. In those cases, the fair value measurement is **categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement**. Assessing the significance of a particular input to the entire measurement requires judgement, taking into account factors specific to the asset or liability. Adjustments to arrive at measurements based on fair value, such as costs to sell when measuring fair value less costs to sell, shall not be taken into account when determining the level of the fair value hierarchy within which a fair value measurement is categorised

9. Thus, in attempting to obtain a measure of fair value for financial guarantees entities will, in these scenarios, be required to use unobservable inputs (Level 3 inputs). Per para 73 (IFRS 13) this results in the categorisation of the whole valuation to be Level 3 in its entirety.

75. If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within Level 3 of the fair value hierarchy.

10. Under the Standard, for scenarios in the scope of the proposed adaptation, there would be little, if any, market activity for similar financial guarantees at the measurement date and thus it is these unobservable inputs that would be used to measure fair value per para 87, IFRS 13.

Level 3 inputs

86. Level 3 inputs are unobservable inputs for the asset or liability.

87. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, **if any, market activity for the asset or liability at the measurement date**. However, the fair value measurement objective remains the same, i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

88. Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. **A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability.** For example, it might be necessary to include a risk adjustment when there is significant measurement uncertainty (e.g. when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability, or similar assets or liabilities, and the entity has determined that the transaction price or quoted price does not represent fair value, as described in paragraphs B37–B47).

89. An entity shall develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, an entity may begin with its own data, but it shall adjust those data if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (e.g. an entity-specific synergy). **An entity need not undertake exhaustive efforts to obtain information about market participant assumptions**. However, an entity shall take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement.

11. As per para 87, the entity will use unobservable inputs and, as stated in para 89, these inputs will be developed using the best information available in the circumstances

including the entity's own data. But the entity need not undergo exhaustive efforts in generating such data.

12. As per para 61, the entity will use valuation techniques that are appropriate for the circumstances and maximise the use of relevant observable inputs for which sufficient data is available to measure fair value. Three valuation techniques are identified, and of these only one could reasonably be considered to apply to scenarios in scope of the adaptation.

Valuation techniques

61. An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

62. The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. Three widely used valuation techniques are the market approach, the *cost approach* and the **income approach**. The main aspects of those approaches are summarised in paragraphs B5–B11. **An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value.**

13. Of the most widely used valuation techniques, for the purpose of financial guarantees, the market approach would be preferable for providing the most comparable data (sections B5 -B7). It provides a source of level 1 inputs for similar guarantees available on the active market although in different circumstances.

Market approach

B5. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business

14. However, in this scenario, where an entity has provided a financial guarantee where no active market or observable equivalent exist, the market approach lacks sufficient relevant information to be viable. Similarly, the cost approach is not appropriate in the context of a financial guarantee.

Cost approach

B8. The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

15. The income approach, in conjunction with the market approach for any existing observable equivalents, is typically the only viable route to estimate fair value for a financial guarantee in the scenario where no active market or observable equivalent exists.

Income approach

B10. The income approach converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

Those valuation techniques include, for example, the following:

(a) **present value techniques (see paragraphs B12–B30);**
(b) option pricing models, such as the Black-Scholes-Merton formula or a binomial model (i.e. a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option; and
(c) the multi-period excess earnings method, which is used to measure the fair value of some intangible assets.

16. The income approach hypothetically provides a method of taking an equivalent financial guarantee, issued in an active market, and adjusting components to reflect the situation of the government entity's policy driven guarantee. The present value measurement would estimate all future cash flows for the financial guarantee, adapting for possible variations in amount and timings as well as the time value of money and risk.
17. However, the technique would also incorporate other factors that market participants would consider in the circumstances. By implication, this means trying to take into account circumstances that, in essence, mean market participants are not willing to enter into the transaction. This creates challenges in developing assumptions that can be mutually agreed by preparers and auditors and creates scope for inconsistent reporting between entities.

The components of a present value measurement

B13. Present value (i.e. an application of the income approach) is a tool used to link future amounts (e.g. cash flows or values) to a present amount using a discount rate. A fair value measurement of an asset or a liability using a present value technique captures all the following elements from the perspective of market participants at the measurement date:

(a) an estimate of future cash flows for the asset or liability being measured.
(b) expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows.
(c) the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (i.e. a risk-free interest rate).
(d) **the price for bearing the uncertainty inherent in the cash flows (i.e. a *risk premium*).**
(e) **other factors that market participants would take into account in the circumstances**.
(f) for a liability, the non-performance risk relating to that liability, including the entity's (i.e. the obligor's) own credit risk.

18. The proposed drafting of the adaptation seeks to anchor itself within the concepts and terms already used within IFRS 9. It avoids seeking to define a new sub-category of non-market guarantees or develop a non-IFRS based measurement basis. Rather it identifies the sub-category of guarantees as defined in the standard (those falling into B5.1.2A section (b), where the transaction price is below fair value) and specifies the measurement technique to be applied (Lifetime ECL) to underpin comparable and faithful reporting.
19. The UK public sector has adopted International Financial Reporting Standards (IFRS) and this proposed adaptation is grounded within those standards. As a comparison, below sets out how IPSAS has both identified and chosen to address the issue of valuing financial guarantees issued by the public sector under the same conditions as this adaptation.

IPSAS 41

20. In 2018, the International Public Standards Board (IPSASB) replaced IPSAS 29 *Financial Instruments: Recognition and Measurement* with IPSAS 41 *Financial Instruments*. This updated standard is based on IFRS *9 Financial Instruments* and was developed as part of IPSASB's project to improve financial reporting for financial instruments, by addressing weaknesses in, and reducing the complexity of, the existing requirements.
21. IPSAS 41, further to IFRS 9, provides guidance for non-exchange transactions i.e. a financial instrument issued for nil or nominal value in return.

Equity Instruments Arising from Non-Exchange Transactions

AG128. In the public sector, equity investment can be used as a way for an entity to provide financing or subsidized funding to another public sector entity. In such a transaction, there is generally a lack of an active market for such investments (i.e., the equity instrument is unquoted), and there are no or minimal future cash flow expectations from the investment besides a potential redemption by the issuing entity. Cash is provided by the investing entity to the investee generally to further the investee's economic or social objectives. Examples of such investments could include membership shares in a development bank, or equity investment in another public sector entity that provides certain social programs or services (e.g., shelters, subsidized housing, small business assistance...etc.)

AG129.At initial recognition of such transactions, an entity shall analyse the substance of the arrangement and assess whether the intention at the outset is the provision or receipt of resources by way of a non-exchange transaction. To the extent that the transaction, or component of the transaction, is a non-exchange transaction, any assets or revenues arising from the transaction are accounted for in accordance with IPSAS 23. **The entity providing the resources shall recognize the amount as an expense in surplus or deficit at initial recognition.**

AG130. To the extent an equity instrument arises from the transaction, or component of the transaction, that is within the scope of this Standard, it is to be recognized initially at fair value in accordance with paragraph 57. The equity instrument is to be measured subsequently in accordance with paragraphs 61–63. **If the instrument does not have an active market, the entity shall consider valuation techniques and inputs in AG149–AG155) in determining its fair value.**

22. IPSAS 41 contains the same valuation techniques contained in IFRS 9 as well as providing guidance for valuation techniques when there is no active market. It concludes, that in the specific circumstances covered by the IFRS 9 adaptation proposed by this paper, an entity should follow AG136

AG136. If no reliable measure of fair value can be determined, either by direct observation of an active market or through another valuation technique**, an entity is required to measure the financial guarantee contract at the amount of the loss allowance determined in accordance with paragraphs 73 to 93.**

Where paragraphs 73 to 93 cover recognition to measurement of **Expected Credit Losses**.

Deferral of loss

23. IFRS 9 states a financial asset or liability shall be initially measured at fair value as set out in para 5.1.1.In cases, such as set out above, where the transaction price can be evidenced to depart from fair value then 5.1.1A of IFRS 9 states the entity will apply B5.1.2A.

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.**

24. B5.1.2A recognises the transaction price is usually the best evidence of a financial instrument's fair value at recognition but prescribes the approach to dealing with a scenario where the two are not one and the same.

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.

25. B5.1.2A provides two routes for an entity to account for a financial asset or liability where the transaction price does not represent fair value at initial recognition.
26. Part (a) applies to transactions that have an observable equivalent in an active market, with a quoted price for an identical asset or liability or can be based on valuation techniques that use only Level 1 inputs.
27. It states this observable equivalent represents fair value of the financial asset or liability in question and that the difference between this observable fair value and the actual transaction price is to be recognised as a gain or loss.
28. As set out by the proposed adaptation, the scenarios in question are where an entity issues a financial guarantee below fair value and where no active market or observable equivalent exists, so part (a) would not apply.
29. Part (b), applicable in all other cases, requires the difference to be deferred until a change in a factor that market participants would consider when pricing the asset or liability.
30. By following the Standard as written, an entity would record only the transaction value on their balance sheet at initial recognition. In the absence of the adaptation government entities could report guarantees with very material expected credit losses as low value liabilities that are reflective of the low transaction price.
31. Section B5.1.2A is not explicit on how the deferred difference should be recognised. It can be inferred from IAS 39 that straight line amortisation is appropriate (although not in all cases – IAS 39.BC222(v)(ii)) leaving deferral until the instrument's fair value can be determined using market observable inputs or realised through settlement[2].
32. In the context of an inherently high-risk financial guarantee (evidenced by the policy objective of providing a service where other market participants have deemed the risk too high or uncertain) amortisation is inappropriate and deferral until the instrument's fair value is known is potentially open ended (given the challenge in fair value measurement for such guarantees).
33. Realising the value via settlement, i.e. when a guarantee is called, is an accurate and Standard compliant change in factor. However, this option alone is inappropriate as it would leave only the transaction price (potentially a nil or nominal value) on the balance sheet until the guarantee is called.
34. These problems support the case for overriding section B5.1.2.A's requirement to defer recognition and using Lifetime ECL to measure the value of the guarantee at initial recognition.
35. The adaptation is written to be as sympathetic to the existing Standard as possible. To achieve its objective, it departs from the letter of the Standard but not the spirit. The purpose of mandating the use of Lifetime ECL for initial and subsequent measurement achieves these goals and knits the adaptation's change and knock-on effects back into the normal application of IFRS 9, as instructed by section 5.5.3, with minimal deviation.

[2] As recommended by IFRS 9 for banks – illustrative disclosures, PwC.

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*.

36. By overriding section B5.1.2A's requirement to defer recognition, this adaptation removes individual preparer's judgment for determining a change in factor and ensures all financial guarantees in these circumstances are brought fully on balance sheet, at recognition, in a consistent way across central government, increasing transparency and comparability for the users of the accounts.
37. To again draw a comparison with similar accounting standards that address the same issues as this adaptation, IPSAS 41, Initial Measurement of Financial Assets and Financial Liabilities (paragraphs 57-59), refers users to AG117.

AG117. The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price. If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 58, the entity shall account for that instrument at that date as follows:

(a) At the measurement required by paragraph 57 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 recognize 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 57, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognize 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.

The requirements of this paragraph do not apply to concessionary loans or equity instruments arising from non-exchange transactions as outlined in paragraphs AG118 to AG130.

38. This is a direct copy of IFRS 9 B5.1.2A with exception of the last line. This last line, that states the requirements of the paragraph do not apply to non-

exchange, i.e. nil/nominal consideration, transactions as outlined in AG118 to AG130. As shown above in AG128 – 130 "The entity providing the resource shall recognise the amount as an expense in surplus or deficit *(profit or loss)* at initial recognition" (Exc AG129).

Scope of application beyond financial guarantees

39. This adaptation is focussed on financial guarantees only. Prima facie, this is the area that has proved most problematic in applying IFRS 9 as set out above. However, considering the feedback from the Board and the value in consistent reporting of transactions with similar economic substance the Treasury is exploring whether the scope of the adaptation should go beyond financial guarantees. Discussions have begun with preparers and the NAO about their practical experience in other cases. At present there is no clear emerging case for a widened scope. A firmer conclusion will require further consultation and investigation and need to consider any parallels with the implementation of IFRS 17 *Insurance Contracts*.

Questions: Does the Board agree:

- to the proposed adaptation,
- that it is included in the FReM for publication in December 2021 (applicable to financial years ended 31 March 2022 onwards),
- that any expansion of scope of the adaptation will be a future Board decision, in light of further consultation and investigation (including implications for implementation of IFRS 17).

HM Treasury
18TH November 2021