OSFI RELEASES DRAFT GUIDELINE ON APPLICATION OF IFRS 9 TO FINANCIAL INSTRUMENTS AND DISCLOSURE OBLIGATIONS

Posted on April 1, 2016

Categories: Insights, Publications

On March 10, 2016, the Office of the Superintendent of Financial Institutions (OSFI) published a draft of its forthcoming guideline (**Draft Guideline**), IFRS 9 *Financial Instruments and Disclosures*, regarding the application of International Financial Reporting Standard 9 – Financial Instruments (**IFRS 9**) to Federally Regulated Entities (**FREs**)[1].

Background

In July 2014, the International Accounting Standards Board (**IASB**) finalized IFRS 9, which will replace International Accounting Standard 39 in annual periods beginning on or after January 1, 2018 subject to the early adoption exception for Domestic Systemically Important Banks (**D-SIBs**). Pursuant to this exception, D-SIBs should adopt IFRS 9 for the annual period beginning on November 1, 2017[2].

Notable developments in IFRS 9 include the adoption of a logical model for classification and measurement; a single, forward-looking 'expected loss' impairment model; and a revised approach to hedge accounting.

On December 18, 2015, the Basel Committee on Banking Supervision (**BCBS**) responded to the release of IFRS 9 by issuing guidelines on the implementation of the expected credit losses (**ECL**) framework, as detailed in Guidance on Credit Risk and Accounting for Expected Credit Losses (**Credit Risk Guideline**).[3]

The Draft Guideline

The proposals in the Draft Guideline are tailored to the size and complexity of individual FREs. For example, D-SIBs are subject to additional requirements when applying IFRS 9's ECL framework.

If adopted, the Draft Guideline will replace and consolidate the following guidelines:

- C-1 Impairment – Sound Credit Risk Assessment and Valuation of Financial Instruments at Amortized Cost;
- C-5 Collective Allowance – Sound Credit Risk Assessment and Valuation Practices for Financial Instruments at Amortized Cost;

- D-1, D-1A, D-1B Annual Disclosures;
- D-6 Derivatives Disclosure; and
- D-10 Accounting for Financial Instruments Designated as Fair Value Option.

The Draft Guideline is divided into three chapters: (i) Fair Value Option, (ii) Impairment Guidelines and (iii) Disclosures. These chapters will be reviewed in turn.

Chapter One: Fair Value Option

IFRS 9 permits designating a financial asset or liability at fair value through profit or loss upon initial recognition (**Fair Value Option**).

FREs who exercise this option must satisfy the following requirements:

1. comply with the criteria set forth in IFRS 9;
2. have appropriate risk management procedures in place at all times;
3. only apply this option where there is a reliable basis for estimating fair value; and
4. if requested, provide additional supporting documentation to OSFI.

The Fair Value Option should not be exercised in respect of loans to individuals or companies whose annual gross revenue does not exceed $62.5 million. Of further note, the aforementioned requirements do not apply to life insurance enterprises' loans if they are classified as Fair Value through Other Comprehensive Income in accordance with IFRS 9.

Chapter Two: Impairment Guidelines

With respect to impairment, the Draft Guideline substantially adopts the framework outlined in BCBS's Credit Risk Guideline. Specific guidance is provided to (i) Internal Ratings Based Deposit-Taking Institutions (**IRB-DTIs**) and (ii) Standardized Deposit-Taking Institutions (**Standardized DTIs**), each of which will be examined in turn.

Internal Ratings Based Deposit-Taking Institutions

Section 2.1 of the Draft Guideline applies to IRB-DTIs and advances OSFI's interpretation of IFRS 9's ECL framework and how it should apply to FREs. To this end, the Draft Guideline sets out guiding principles and recommended practices.

OSFI recommends banks estimate ECL in respect of all lending exposures. OSFI further expects that application of the assessment and measurement mechanisms outlined in IFRS 9's ECL framework will be grounded in a robust and disciplined approach.

A proportional approach is permitted, provided it is commensurate with the size, complexity and economic significance of the FRE and its activities. To this end, the Draft Guideline sets out eleven principles to consider when accounting for ECLs.

While FREs are afforded substantial discretion when applying the guiding principles, they must ultimately satisfy OSFI that adequate procedures are in place, and OSFI will periodically review banks to ensure sound credit risk practices have been adopted. OSFI will also consider credit risk practices when assessing a bank's capital adequacy.

Standardized Deposit-Taking Institutions

Section 2.2 discusses the implementation of IFRS 9's ECL framework as it relates to Standardized DTIs. Note that application of this section is limited to Standardized DTIs that are engaged in the business of lending. A Standardized DTI that determines it is not in the business of lending must notify OSFI and state the basis for this conclusion.

The regulatory burden applicable to Standardized DTIs is substantially reduced relative to IRB-DTIs. The overwhelming majority of guidance provided in the preceding section does not apply to Standardized DTIs.

Structural similarities remain, however. All deposit taking institutions (**DTIs**) are encouraged to exercise discretion and adopt prudent measures commensurate with their impairment obligations under the Draft Guideline.

Furthermore, DTIs must pre-notify OSFI of any material changes to their ECL methodology or level.

Chapter Three: Disclosures

Chapter Three of the Draft Guideline specifies the disclosure obligations applicable to life insurance enterprises, property & casualty (P&C) insurance enterprises and derivatives transactions applicable to all FREs.

Annual Disclosures for Life Insurance Enterprises

OSFI expects life insurance enterprises to include the disclosures required by the Draft Guideline and IFRS 9 in their annual OSFI return or by way of a supplementary management report appended thereto.

The annual return should further disclose an aggregate statement of financial position value and the fair value of investments. Life insurance enterprises should also identify significant risks to their business, including, among others, policy liabilities; delineate the responsibilities of senior management in this regard; and discuss risk management strategies.

Annual Disclosures for Property & Casualty Insurance Enterprises

In addition to complying with the life insurance enterprise disclosure obligations discussed above, P&C insurance enterprises must also include information on reinsurance transactions in the notes to their financial statements.

Derivatives Disclosures

The Draft Guideline maintains OSFI's existing derivatives disclosure regime, save for removing disclosures that are now covered by IFRS and BCBS's Pillar 3.

Next Steps

OSFI has invited industry to comment on the Draft Guideline by May 6, 2016. Comments may be provided directly to OSFI via email to: Renée Chen, Director, Accounting Policy Division (Renee.Chen@osfi-bsif.gc.ca) or through industry associations.

The final guideline will apply to FREs with annual periods beginning on or after January 1, 2018, subject to the early adoption exception applicable to D-SIBs, in which case IFRS 9 should be adopted for the period commencing November 1, 2017.

We invite market participants to discuss their questions and concerns with our legal team and are available to assist those wishing to submit comments.

By Pat Forgione, Darcy Ammerman, Sean Brandreth, Matthew Burns Student-at-Law

[1]FREs include, among other entities, a bank to which the Bank Act applies; a body corporate to which the Trust and Loan Companies Act applies; an association to which the *Cooperative Credit Associations Act* applies; and an insurance company or a fraternal benefit society incorporated, formed or continued under the *Insurance Companies Act*.[ps2id id='1' target=''/]

[2]Canada, Office of the Superintendent of Financial Institutions, Early adoption of IFRS 9 Financial Instruments for Domestic Systemically Important Banks – Advisory. For more information, please see our previous bulletin on this topic.[ps2id id='2' target=''/]

[3]Basel Committee on Banking Supervision, *Guidance on Credit Risk and Accounting for Expected Credit Losses*.[ps2id id='3' target=''/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.