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

Guideline

Subject: **Accounting for Financial Instruments Designated as Fair Value Option**

Category: **Accounting**

No: **D-10** **Date:** **June 2006**
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Introduction

This Guideline provides application guidance to banks, foreign bank branches, bank holding companies, federally regulated trust & loan companies, cooperative credit associations, life insurance companies & fraternal benefit societies, property and casualty insurance companies, and insurance holding companies (collectively referred to as "Federally Regulated Entities" or "FREs") applying the fair value option in International Accounting Standard 39 *Financial Instruments: Recognition and Measurement* as issued by the International Accounting Standards Board (IASB) that allows entities to designate a financial asset or financial liability at fair value through profit or loss upon initial recognition. This option is referred to as the "Fair Value Option."

Canadian legislation governing FREs allow OSFI to specify accounting principles. OSFI's ability to make specifications is addressed in *International Standard on Auditing 210* and the equivalent *Canadian Auditing Standard 210*. Given that using the Fair Value Option is a choice, OSFI believes that the specifications made in this Guideline will not impair an FRE's ability to obtain an audit opinion that states that the financial statements are in accordance with International Financial Reporting Standards as issued by the IASB. OSFI believes this Guideline is essential in maintaining the integrity of regulatory capital when applying the Fair Value Option.[1]

[1] The capital treatment of these financial instruments designated as Fair Value Option should continue to comply with OSFI's capital guidelines for determining capital adequacy.

Table of Contents

Page

I. Basel Committee on Banking Supervision's Supervisory Guidance on the Fair Value Option

OSFI expects all institutions using the Fair Value Option to meet the supervisory expectations set out in Principles 1 – 4 of the Basel Committee's *Supervisory guidance on the use of the fair value option for financial instruments by banks*.[2] OSFI intends to follow principles 5-7 in assessing risk management, controls and capital adequacy related to all institutions' use of the Fair Value Option.

II. International Accounting Standard (IAS) 39 Guidance on the Fair Value Option

OSFI understands that institutions using the Fair Value Option will apply IAS 39, as amended from time to time, including IAS 39.9 "Definitions of four categories of financial instruments – *A financial asset or financial liability at fair value through profit or loss"* paragraph (b).

> **IAS 39.9 (b)**
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> *Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either*
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> *(i)* *it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or*
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> *(ii)* *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 or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24* Related party Disclosures *(as revised in 2003)), for example the entity's board of directors and chief executive officer.*

For IAS 39.9(b)(i), institutions may apply the Fair Value Option under this criterion if: (a) consistent with a documented risk management strategy, it eliminates or significantly reduces[3] the measurement or recognition inconsistency of measuring financial assets or liabilities together on a different basis[4], and (b) the fair values are reliable at inception and throughout the life of the instrument.

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[2] Link: www.bis.org/publ/bcbs127.pdf

[3] "Significantly reduce" is to be determined by the institution and subject to internal and external audit review. OSFI does not expect institutions to use effectiveness tests similar to those required for hedge accounting in their assessment of whether the "significantly reduce" criterion is met.

[4] An institution may satisfy this requirement by a documented and implemented strategy which may include, but is not limited to, the following strategies to eliminate or significantly reduce risk:
(i) asset liability matching in duration and amount;
(ii) assets which are approximately matched in amount to the liabilities and have a higher (or lower) duration within a documented range;

For IAS 39.9(b)(ii), institutions may apply the Fair Value Option under this criterion if: (a) the institution has a documented risk management strategy to manage the group of financial instruments together on a fair value basis and can demonstrate that significant financial risks are eliminated or significantly reduced,[3] and (b) the fair values are reliable at inception and throughout the life of the instrument.

IAS 39.48A: Reliable Fair Values for the Fair Value Option

OSFI expects institutions to follow the criteria in IAS 39 paragraph 48A and all additional guidance provided by the IASB including the final report of the Expert Advisory Panel *Measuring and disclosing the fair value of financial instruments in markets that are no longer active.*[5]

Using the Fair Value Option for Loans and Receivables

Generally, the Fair Value Option should **not** be used for loans and mortgages to companies having annual gross revenue below $62.5 million, for loans and mortgages to individuals, or for portfolios made up of such loans and mortgages.

(iii) assets which are less than the liabilities but have a higher duration within a documented range; or
(iv) assets which exceed the liabilities but have a lower duration within a documented range.

[5] This paper was issued in October 2008 and can be found at the following link: http://www.iasb.org/NR/rdonlyres/0E37D59C-1C74-4D61-A984-8FAC61915010/0/IASB_Expert_Advisory_Panel_October_2008.pdf