STAFF PAPER

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Project	**Transition Resource Group for Impairment of Financial Instruments**		
Paper topic	Collateral and other credit enhancements and the measurement of expected credit losses		
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Introduction

1. We have received a submission about the inclusion of cash inflows from collateral and other credit enhancements, such as insurance and financial guarantee contracts, in the measurement of expected credit losses. In particular, the submitter asks what is meant by credit enhancements that are 'part of the contractual terms' to determine which cash flows should be included in the measurement of expected credit losses.

2. This paper:

   (a) sets out the relevant accounting requirements in IFRS 9 *Financial Instruments* (2014) and IFRS 7 *Financial Instruments: Disclosures*;

   (b) summarises the potential implementation issue raised by the submitter; and

   (c) asks the members of the Transition Resource Group for Impairment of Financial Instruments ('the ITG') for their views on the issue identified.

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Accounting requirements

3. Paragraph B5.5.28 of IFRS 9 explains that expected credit losses are a probability-weighted estimate of credit losses (ie the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between:

   (a) the cash flows that are due to an entity in accordance with the contract; and

   (b) the cash flows that the entity expects to receive.

4. This is consistent with the definition of credit loss in Appendix A of IFRS 9. In addition, the definition of credit loss refers to the inclusion of cash flows from the sale of collateral and other credit enhancements as follows:

   > The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. ...

5. Further guidance about cash flows from collateral and other credit enhancements in the measurement of expected credit losses is given in paragraph B5.5.55. This refers to the inclusion of cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity:

   > **B5.5.55** For the purposes of measuring expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other

> credit enhancements that are part of the contractual terms and are not recognised separately by the entity. The estimate of expected cash shortfalls on a collateralised financial instrument reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral, irrespective of whether foreclosure is probable (ie the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Consequently, any cash flows that are expected from the realisation of the collateral beyond the contractual maturity of the contract should be included in this analysis. Any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument unless it meets the relevant recognition criteria for an asset in this or other Standards.

6. In addition, paragraph 35K of IFRS 7 requires disclosures with the objective of enabling users of financial statements to understand the effect of collateral and other credit enhancements on the amounts arising from expected credit losses. In particular, paragraphs 35K(a) and 35K(b)(iii) require an entity to disclose, by class of financial instrument:

> (a) the amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with IAS 32).
>
> (b) a narrative description of collateral held as security and other credit enhancements, including:
>
> > …
> >
> > (iii) information about financial instruments for which an entity has not recognised a loss allowance because of the collateral.

…

Potential implementation issue identified

7. The submitter notes that paragraph B5.5.55 of IFRS 9 requires the inclusion of cash flows from collateral and other credit enhancements, such as insurance contracts and financial guarantee contracts, in the measurement of expected credit losses *if the credit enhancement is part of the contractual terms and not recognised separately by the entity*.

8. The submitter asks what is meant by 'part of the contractual terms' in the context of the inclusion of cash flows from collateral and other credit enhancements in the measurement of expected credit losses.

9. In particular, the submitter asks whether the credit enhancement must be an explicit term of the related asset's contract to be taken into account in the measurement of expected credit loss, or whether other credit enhancements that are not recognised separately can also be taken into account.

10. The submitter supplies a few examples of credit enhancements as follows:

    (a) The contract contains a cross-reference to another document that refers to the credit enhancement, for example the loan amortisation schedule to the loan contract incorporates the insurance premium payable by the obligor.

    (b) Credit enhancements required by local laws and regulations that govern the contract, that are not specifically in the contract itself. For example, in some jurisdictions legislation requires that lenders must take out financial guarantee contracts that contain little or no down payment in respect of certain loans.

    (c) Credit enhancements, such as financial guarantee contracts or credit default insurance policies, entered into at the same time and in contemplation of the lending arrangement, that cannot be assigned independently from the credit exposure it covers. For example, a lender may not extend credit to a subsidiary without a financial guarantee from its parent.

(d) Credit enhancements, such as parent-sub guarantees, in which the guarantee is obtained by the lender sometime after the advance of the credit exposure and that cannot be assigned by the lender to a third party without a simultaneous transfer of the credit exposure to the same third party.

11. The submitter notes that economically and from a risk management perspective, a lender would not consider a loss to have occurred if it was expected to be covered by the credit enhancement.

12. The submitter also comments that, in their experience, at present many, if not most, banks account for credit enhancements, such as those mentioned in paragraph 10, as part of their IAS 39 *Financial Instruments: Recognition and Measurement* incurred loss impairment. However, because IFRS 9 does not contain the same requirements as IAS 39 in respect of the inclusion of cash flows from credit enhancements in the measurement of impairment, the submitter notes that there could be a change in practice on transition to IFRS 9.

Review of accounting requirements

13. In this section we look at relevant requirements from IFRS about which cash flows should be taken into account in the measurement of expected credit losses.

14. As noted in paragraph 5 and highlighted by the submitter, paragraph B5.5.55 of IFRS 9 notes that for the purpose of measuring expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity.

Integral to the contractual terms

15. We observe that this guidance should be read within the context of the definition of credit losses. As noted in paragraph 4, credit loss is defined in IFRS 9 as the difference between:

(a) all contractual cash flows that are due to an entity in accordance with the contract; and

(b) all the cash flows that the entity expects to receive.

16. The definition provides further guidance that the cash flows that the entity expects to receive should include cash flows from the sale of collateral held or other credit enhancements that are *integral* to the contractual terms.

17. The term 'integral to the contractual terms' is not defined in IFRS 9. However we observe that it is not limited to the explicit terms in the contract of the financial asset being assessed for impairment and, within this context, the definition of credit losses is broader. The use of the term 'integral' is consistent with its use in the definition of effective interest rate in Appendix A of IFRS 9. This definition includes the statement that the calculation of the effective interest rate includes 'all fees and points paid or received between parties to the contract that are an *integral* part of the effective interest rate (see paragraphs B5.4.1-B5.4.3), transaction costs, and all other premiums or discounts'. We observe that it may be consistent, therefore, to treat cash flows from financial guarantees, for example, as integral to the contractual terms of the guaranteed financial asset when measuring expected credit losses, which would better reflect the economic perspective of cash shortfalls.

Recognised separately

18. However, as noted in paragraph B5.5.55 of IFRS 9, credit enhancements that are recognised *separately* by the entity are not included in the measurement of expected credit losses. This is to avoid double counting. For example, cash inflows from a credit default swap that is accounted for as a derivative would not be included in the measurement of expected credit losses of the underlying financial asset. The credit default swap is a separate contract and is accounted for separately as a derivative that is measured at fair value through profit or loss.

19. Consequently, expected cash flows from credit enhancements that are integral to the contractual terms of the financial asset *and* are not accounted for separately should be taken into account when measuring expected credit losses.

Disclosure

20. We would like to note that as outlined in paragraph 6 of this paper, IFRS 7 requires disclosures that enable users of the financial statements to understand the effect of collateral and other credit enhancements on the amounts arising from expected credit losses. More specifically such disclosures require information about:

(a) the entity's maximum exposure to credit risk *without* taking into account any collateral held or other credit enhancements; and

(b) financial instruments for which an entity has not recognised a loss allowance because of collateral.

Question for ITG members
What are your views on the issue discussed in this paper?