



STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	Credit enhancement in the measurement of expected credit losses (IFRS 9)		
Paper topic	Initial Consideration		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the effect of a credit enhancement on the measurement of expected credit losses (ECL) when applying the impairment requirements of IFRS 9 *Financial Instruments*. Paragraph B5.5.55 of IFRS 9 requires the inclusion of cash flows expected from collateral and other credit enhancements in the measurement of ECL if the credit enhancements are part of the contractual terms and are not recognised separately by the entity.
2. The submitter asked whether the cash flows expected from a financial guarantee contract or any other credit enhancement that is integral to the contractual terms of a loan can be included in the measurement of ECL if the credit enhancement would otherwise be required to be separately recognised.
3. The objective of this paper is to:
 - (a) provide the Committee with a summary of the matter;
 - (b) present our research and analysis; and
 - (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

4. This paper includes:
 - (a) background information (paragraphs 6–10);
 - (b) staff analysis and assessment against the Committee’s agenda criteria (paragraphs 11–19); and
 - (c) staff recommendation (paragraphs 20).
5. There are two appendices to this paper:
 - (a) Appendix A—Proposed wording of the tentative agenda decision; and
 - (b) Appendix B—Submission.

Background information

6. In December 2015, the Transition Resource Group for Impairment of Financial Instruments (ITG) discussed the inclusion of cash inflows from collateral and other credit enhancements in the measurement of ECL, and what is meant by credit enhancements that are ‘part of the contractual terms’ ([Agenda Paper 5](#)).
7. The ITG noted that the definition of credit loss in IFRS 9 states that when estimating cash flows, an entity shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. Consequently, the ITG observed that credit enhancements included in the measurement of ECL should not be limited to those that are explicitly part of the contractual terms. However, ITG members also noted that an entity:
 - (a) would be required to apply its judgement in assessing what is meant by ‘integral to the contractual terms’ and, in making that assessment, an entity should consider all relevant facts and circumstances; and
 - (b) must not include cash flows from credit enhancements in the measurement of ECL if the credit enhancement is accounted for separately. ITG members noted that this was particularly important in order to avoid double counting.

8. The request submitted to the Committee describes a fact pattern in which a bank originates a loan with a borrower. The loan agreement does not explicitly refer to the fact that the bank will obtain a third-party guarantee in connection with this loan. However, at the origination date, in accordance with its business practices the bank mitigates its credit risk in respect of the loan by obtaining a financial guarantee from a third party for which it pays a fee to the guarantor.
9. The submitter raised the question of whether the cash flows expected from a financial guarantee contract or any other credit enhancement that is integral to the contractual terms of a loan can be included in the measurement of ECL if the credit enhancement would otherwise be required to be recognised separately in accordance with IFRS Standards.
10. The submitter has observed the following views:
 - (a) View 1 – Yes. Credit enhancements are included in the measurement of ECL and are not recognised separately because they are integral. Proponents of this view say the requirement/condition in paragraph B5.5.55 of IFRS 9 relating to separate recognition can be ignored if a credit enhancement is integral to the contractual terms.
 - (b) View 2 – No. Credit enhancements cannot be included in the measurement of ECL as it is a separately recognised financial instrument. Under this view, a credit enhancement cannot be included in the measurement of ECL if it is required to be recognised separately, even if it is integral to the contractual terms.
 - (c) View 3 – Accounting policy choice.

Summary of our research and analysis

Outreach

11. We decided not to perform outreach on this request for two reasons:
 - (a) We are aware through informal research and information provided by the submitter that the fact pattern is widespread. Banks in many jurisdictions
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obtain financial guarantee contracts from third parties in accordance with their business practices even when the loan agreements do not explicitly refer to the guarantees. The ITG also discussed an inter-related issue (see paragraphs 6-7 of this paper) about the effect of a credit enhancement on the measurement of ECL. This indicates that the use of credit enhancements is widespread.

- (b) Because the matter relates to the application of IFRS 9 and this is the first year in which IFRS 9 is in effect, we considered it to be urgent in nature and thus proceeded to bring it to the Committee's November 2018 meeting.

Staff analysis

12. Paragraph B5.5.55 of IFRS 9 states (*emphasis added*):

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.

13. Consequently, the staff are of the view that for the cash flows expected from a credit enhancement to be included in the measurement of ECL, the credit enhancement is required to be both:
 - (a) part of the contractual terms; and
 - (b) not recognised separately by the entity.

(a) Part of the contractual terms
14. The ITG specifically discussed whether a credit enhancement must be an explicit term of the related asset's contract in order for it to be 'part of the contractual terms' (see paragraphs 6-7 of this paper). The ITG observed that credit enhancements included in the measurement of ECL should not be limited to those that are explicitly part of the contractual terms. Entities should use judgement in assessing whether a credit enhancement is integral to the contractual terms, taking into account all relevant facts and circumstances.

(b) Not recognised separately

15. Applying paragraph B5.5.55 of IFRS 9, the cash flows expected from a credit enhancement are included in the measurement of ECL only if the credit enhancement is not recognised separately. The ITG discussion therefore focused on credit enhancements that an entity does not recognise separately, ie does not account for separately. The ITG noted that this was particularly important.
16. Therefore in our view an entity determines whether it is required to recognise a credit enhancement separately. Even if the credit enhancement is judged to be integral to the contractual terms, an entity cannot decide to not recognise it separately if separate recognition is required applying IFRS Standards. If the credit enhancement is for example in the form of a credit default swap, an entity is required to account for it separately as a derivative measured at fair value through profit or loss if it meets the relevant recognition requirements in IFRS 9. In this case the entity would not include in the measurement of ECL the cash flows expected from the credit default swap.
17. Consequently, for all credit enhancements including financial guarantee contracts held, an entity applies the applicable IFRS Standard to determine whether it is

required to recognise the credit enhancement separately. If that is the case, then the entity cannot include the cash flows expected from the credit enhancement in the measurement of ECL.

Staff conclusion

18. An entity includes the cash flows expected from a credit enhancement in the measurement of ECL only if both the requirements in paragraph 13 of this paper are met. Therefore, if a credit enhancement is required to be recognised separately by IFRS Standards, an entity cannot include the cash flows expected from it in the measurement of ECL, even if the credit enhancement is judged to be integral to the contractual terms of the loan. Similarly, if a credit enhancement is judged to be non-integral to the contractual terms, then an entity cannot include the cash flows expected from it in the measurement of ECL, even if the credit enhancement is not required to be recognised separately.

Question 1 for the Committee

Does the Committee agree with our analysis of the requirements in IFRS 9 outlined in paragraphs 12-18 of the paper?

Should the Committee add this matter to its standard-setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?¹

19. Based on our analysis, we think the requirements in IFRS 9 provide an adequate basis for an entity to determine whether to include the cash flows expected from a credit enhancement in the measurement of ECL in the fact pattern described in the submission.

¹ Paragraph 5.16(b) of the *Due Process Handbook*

Staff recommendation

20. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraph 19 of this paper), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing an agenda decision that explains how an entity applies the requirements in IFRS 9 to the fact pattern described in the submission.

Questions 2 and 3 for the Committee

2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda?
3. Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

Appendix A—Proposed wording of the tentative agenda decision

Credit enhancement in the measurement of expected credit losses (IFRS 9)

The Committee received a request about the effect of a credit enhancement on the measurement of expected credit losses (ECL) when applying the impairment requirements in IFRS 9. The request asked whether the cash flows expected from a financial guarantee contract or any other credit enhancement that is integral to the contractual terms of a loan can be included in the measurement of ECL if the credit enhancement is otherwise required to be recognised separately applying IFRS Standards.

Paragraph B5.55 of IFRS 9 requires the inclusion of cash flows expected from collateral and other credit enhancements in the measurement of ECL if the credit enhancements are part of the contractual terms and are not recognised separately by the entity.

Accordingly, the Committee observed that for the cash flows expected from a credit enhancement to be included in the measurement of ECL, the credit enhancement is both:

- (a) required to be part of the contractual terms; and
- (b) not required to be recognised separately by the entity.

The Committee concluded that, if a credit enhancement is required to be recognised separately by IFRS Standards, an entity cannot include the cash flows expected from it in the measurement of ECL even if the credit enhancement is judged to be integral to the contractual terms of the loan. An entity applies the applicable IFRS Standard to determine whether it is required to recognise a credit enhancement separately.

The Committee concluded that the requirements in existing IFRS Standards provide an adequate basis for an entity to determine whether to include the cash flows expected from a credit enhancement in the measurement of ECL in the fact pattern described in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B—Submission

A1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

Suggested agenda item: Determining whether a credit enhancement that is integral to the contractual terms of a loan can be included in the measurement of expected credit losses (ECL) if it would otherwise be required to be separately recognised

It has come to our attention that there are diverse views on the assessment of whether a financial guarantee purchased at the time a loan is granted can be included in the measurement of ECL if it is integral to the contractual terms of that loan, even though the financial guarantee would otherwise be required to be recognised separately.

Background

For the purposes of measuring expected credit losses, the estimate of expected cash shortfalls reflects the cash flows expected from collateral and other credit enhancements (e.g. financial guarantee contracts and insurance contracts over loan assets) that are part of the contractual terms and are not recognised separately by the entity. [IFRS 9:B5.5.55]

Appendix A of IFRS 9 defines credit loss as 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, discounted by the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). It specifies that 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. [IFRS 9: Appendix A]

At its December 2015 meeting, the Transition Resource Group for Impairment of Financial Instruments (ITG) noted that it is not necessary for a credit enhancement to be explicitly stated in the terms of the contract for which expected credit losses are being measured, but it is necessary for the credit enhancement to be “integral to those contractual terms”. There is no specific guidance in IFRS explaining what is “integral to the contractual terms” and, therefore, judgement will be required, considering all relevant facts and circumstances, to determine whether a credit enhancement meets this criterion.

A typical transaction in which the need to assess whether a financial guarantee can be included in the measurement of ECL is the following:

A bank originates a loan with a borrower. The loan agreement does not explicitly refer to the fact that the bank will obtain a third party guarantee in connection with this loan. However, at the origination date, in accordance with its business practices, the bank mitigates its credit risk in respect of the loan by obtaining a financial guarantee from a third party for which it pays a fee to the guarantor.

Question –Can a financial guarantee contract or any other credit enhancement that is integral to the contractual terms of a loan be included in the measurement of ECL if it would otherwise be required to be separately recognised?

View 1 – Yes, credit enhancements are included in the measurement of ECL and are not recognised separately because they are integral

Proponents of this view argue that the requirement/condition in B5.5.55 relating to separate recognition can be ignored if a credit enhancement is integral to the contractual terms.

They believe that in assessing whether a financial guarantee is integral to the contractual terms of the loan, the lender would not solely look at the terms of the loan contract. It would also consider whether the financial guarantee is integral to the management of its asset. If the bank has a business practice of obtaining financial guarantees for particular loans, such that these financial guarantees are obtained at inception of the loans (allowing for administrative time lag) proponents of this view would conclude that the financial guarantee is integral to the contractual terms of the loan. They further note that the expectation that a financial guarantee will be obtained may influence the pricing of the loan so is similar to transaction costs which are netted against the asset on initial recognition.

View 2 - No, credit enhancements cannot be included in the measurement of ECL as it is a recognised separately financial instrument.

Under this view, a credit enhancement cannot be included in the measurement of ECL if it is required to be recognised separately, even if it is integral to the contractual terms.

Proponents of this view believe that the assessment of whether a financial guarantee is integral to the contractual terms of the loan does not extend to considering whether the financial guarantee is integral to the management of the asset. Indeed, the definition of credit loss

requires a link between the guarantee and the contractual terms of the loan. A lender merely choosing to purchase a financial guarantee at the point of origination of a loan where the guarantee is not anticipated in the loan agreement does not provide a sufficient link between the guarantee and the contractual terms of the loan and is not integral to the loan.

In the situation illustrated above, the bank is not compelled to enter into the guarantee, nor has a right under the loan agreement to require the borrower to provide the bank with a guarantee from a specified guarantor (for example, that may be the case when a lender has the right to demand a guarantee from a parent in respect of a lending to a subsidiary) as there is no reference to a guarantee in the contractual terms of the loan.

View 3 – Accounting Policy.

Proponents of this view believe that views 1 and 2 are both valid interpretations of the assessment of whether a financial guarantee is integral to the contractual terms of a loan. Accordingly, the bank is required to adopt an accounting policy that has to be applied consistently to similar guarantee arrangements either to treat the financial guarantee as integral to the guaranteed loan, or to recognise the financial guarantee separately from the loan.

Reasons for the Committee to address the issue

Currently, we believe that there are divergent views on this matter in a number of different jurisdictions. The issue is not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee's agenda.