
Project	Financial Instruments: Replacement of IAS 39
Topic	Hedge accounting: hedges of credit risk using credit derivatives

Introduction

Background

1. Many financial institutions today frequently use credit derivatives to manage their credit risk exposures arising from their lending activities. During the course of its outreach activities, the staff have received overwhelming feedback from both preparers and users that IFRSs today do not appropriately reflect the economic outcome of the credit risk management activities of financial institutions.

Purpose

2. The purpose of this paper is to provide to the Board:
 - (a) a description of how financial institutions manage credit exposures arising from their lending activities; and
 - (b) an analysis of the accounting implications.
3. This paper does not contain a staff recommendation nor ask the Board for decisions. Agenda paper 21B contains:
 - (a) the alternatives for how the Board could proceed;
 - (b) the staff recommendation; and
 - (c) a question to the Board.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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Managing credit risk exposure of loans and loan commitments

4. This section of the paper describes:
 - (a) the relevant features of the products for which credit risk exposure is commonly managed; and
 - (b) how they are managed.
5. Hedges of credit risk exposure allow financial institutions to transfer the risk of credit loss on a loan¹ or a loan commitment to a third party. It also reduces the regulatory capital requirement for the loan while at the same time allowing the financial institution to retain nominal ownership of the loan and preserve the relationship with the client. Credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (eg a facility for a particular client) or the bank's lending portfolio.

Loan commitments

6. The staff learnt that the credit risk exposure for which credit risk is hedged by financial institutions is largely in the form of undrawn loan commitments rather than funded loans. (Borrowers for which credit risk protection is available in the market usually have direct access to the corporate bond markets and short term commercial papers, which often provide cheaper forms of financing).
7. The staff learnt that the borrower usually avoids drawing on its loan commitments, to refrain from sending signals to the market that it is obliged to rely on bank financing. Hence, the staff learnt that for loan commitments, draw rates of loan commitments rarely exceed 5-10% of the nominal amount, and most of them remain undrawn. However, once the credit quality of the borrower deteriorates, drawings often increase and are frequently drawn up to 100% at the time of default. Hence, when the credit quality of the borrower starts to

¹ In this paper references to 'loan' are used in a generic way, ie they include instruments such as bonds, etc.

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deteriorate, credit portfolio managers typically regard the loan commitments as having the risk equivalent to that of a drawn loan.

Loans

8. The loans for which credit exposure is managed commonly contain at least the following optional features:
 - (a) prepayment options—loans are normally prepayable at any time without penalty;
 - (b) liquidity options—undrawn loan commitments may be drawn at any time (usually with very short notice periods); and
 - (c) term-out and drawdown options—the borrower may extend the term of the loan up to a defined maximum number of years.
9. For loans with extension options, the staff learnt that financial institutions typically manage the credit exposure of extendible loans based on the maximum extendible maturity. For example a 1-year revolving loan with a one year extension option will normally be treated as a 2 year risk position.
10. Loans and facilities are typically refinanced well in advance of their scheduled maturity as borrowers typically seek to maintain long-term debt or liquidity lines (given these are used as back-up facilities). Borrowers will rarely allow maturities of the loan commitments to fall below 12 months. For example, a borrower might seek to refinance eg a 5-year loan or facility on an annual basis to show a relatively constant 6 year liquidity commitment facility. Prepayment options are often exercised by borrowers during periods of tightening of the market interest rate spread because cheaper funding is available.

Managing credit risk exposure

11. Due to the different option features of the loans and facilities, credit portfolio managers typically engage in an active and flexible risk management approach. For example, credit risk protection is taken out when it is anticipated that the

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credit quality of a specific borrower will deteriorate. Credit portfolio managers rarely hedge 100% of the nominal amount of loan from origination and for the contractual maturity of the loan and loan commitments. Rather they commonly hedge credit risk depending on the circumstances from time to time and only for a proportion of the loan or loan commitments.

12. To manage the credit risk exposure of these financial products, managers typically use credit default swaps (CDSs).
13. A credit default swap enables credit portfolio managers to transfer the credit risk of a specific borrower to a third party. A set premium is paid periodically to a third party in return for a set payment amount should there be a credit event (eg bankruptcy)—ie in return for a credit-event contingent payment. Hence, the CDS acts economically like a credit insurance policy on the loan or loan commitment that compensates the protection buyer (the financial institution in this case) from a credit loss.
14. We learnt that the CDSs for hedging purposes are typically kept and managed in the bank's books separately from trading CDSs.

Regulatory requirements

15. To obtain regulatory capital benefits from the CDS hedges, the CDS terms need to match the name of the borrower and the seniority of the loan. Hence, each CDS is specifically linked to an individual loan. The regulatory relief from holding CDSs also relates to their maturity. If the remaining maturity of the CDS exceeds that of the credit exposure it gets full recognition for relief whereas otherwise there is a reduction in the extent of the relief (based on a formulaic approach). Also, the credit quality of the counterparty to the CDS is required to be sufficiently high and/or the CDS is required to be fully collateralised (so the credit risk on the CDS is minimal).

Example 1

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In 2010 Bank ABC has three undrawn loan commitments of €100M each to company XYZ. Total exposure is €300M. The loan commitments expire in 2 year (LC A), 4 years (LC B) and 6 years (LC C), respectively. All of these commitments are cancellable by company XYZ at any time and without financial penalty.

Bank ABC purchases a CDS to hedge €75M of credit exposure to company XYZ. The remaining maturity on the hedge is 4 years and 2 months.

Bank ABC applies the CDS as an economic hedge of 75% of the 4-year loan commitment (LC B).

In 2011, company XYZ refinances the now 1-year (LC A) and 3-year (LC B) loan commitments and replaces them with new 5-year and 7-year loan commitments.

Bank ABC now applies the CDS as an economic hedge of the 5 year (LC C) loan commitment.

Staff analysis of the issue

16. This section of the paper provides an analysis of the accounting implications for financial institutions that use credit derivatives to manage the credit exposure arising from their lending activities. The staff note that portfolio credit managers manage all credit exposures irrespective of whether they are (already) a balance sheet position or (still) only a commitment to lend (off balance sheet item).
17. Under IFRSs the financial products for which credit risk is managed by credit portfolio managers fall into the following three types of instruments:
 - (a) loans;
 - (b) loan commitments that meet the scope exception in IAS 39; and
 - (c) loan commitments to lend at below market interest rates.
18. The accounting is summarised in the following table:

TABLE I

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	Subsequent measurement	Eligible for FV hedge accounting?	Fair value option (FVO)
Loans	Amortised cost	× Credit risk component not measurable	× Too restrictive
Loan commitments that meet the scope exception in IFRS 9/IAS 39	IAS 37 ²	× Credit risk component not measurable	× Not in the of scope of IFRS 9/ IAS 39
Loan commitments to lend at below market interest rates	Higher of IAS 37; and FV less cumulative amortisation in accordance with IAS 18 ³	× Credit risk component not measurable	× Too restrictive

19. CDSs that credit portfolio managers use as ‘hedging instruments’ are derivatives and are accounted for at fair value through profit or loss.

Fair value hedge accounting

20. Under IAS 39 today, an entity can designate any risk component of a financial item as long as hedge effectiveness can be measured. Any ineffectiveness is recognised in profit or loss⁴.
21. In May 2010, the Board tentatively decided that a *contractually specified* risk component should be eligible for designation as the hedged item in a hedging relationship, irrespective of whether it is the component of a financial or a non-financial item⁵. The Board will deliberate further on whether non-contractually specified risk components should be eligible for designation as the hedged item for both financial and non-financial items.

² IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

³ IAS 18 *Revenue*.

⁴ IAS 39.81

⁵ See agenda paper 9D from the May 2010 IASB meeting.

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22. For hedging the credit risk component of a financial instrument, almost all constituents who commented on this issue do not consider the credit risk component to be measurable. The spread between the risk free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, it is operationally difficult to isolate and measure the changes in fair value that is only attributable to credit risk.
23. Some believe that CDS prices are the best measure of the credit risk component of a financial asset. However, the staff note (and most constituents who have commented on this issue agree) that using CDS pricing to measure the credit risk component of a financial instrument (eg bond) may be conceptually flawed due to at least the following structural differences between a CDS and a bond:
- (a) funding—a CDS is a synthetic instrument and does not require funding whereas a bond is a cash instrument that requires initial cash outlay;
 - (b) coupon accrual on default—a default bond does not pay the coupon accruals between the last coupon date and the date of default whereas a CDS protection buyer pays the accrued premium until the date of default;
 - (c) counter party credit risk—a protection buyer of a CDS has the risk that the protection seller will default on the CDS contract; and
 - (d) defined credit event—events that trigger the payout of the CDS may not necessarily be at default.⁶
24. Other aspects that also give rise to differences between the value of a CDS and the credit risk inherent in the reference bond are features like ‘cheapest to deliver options’, the effect of auction processes when CDSs are settled as a

⁶ In a CDS contract, a credit event triggers a settlement payment by the protection seller to the protection buyer. The definitions in a standardised CDS contract list six credit events: bankruptcy, obligation default, failure to pay, repudiation/moratorium, obligation acceleration and restructuring.

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result of credit event and the interpretation of the ‘restructuring’ credit event (and the related uncertainty about that interpretation).

Fair value option (FVO)

25. When the requirements for hedge accounting are not met, IFRS 9 and IAS 39 today permit an entity to designate, at initial recognition, financial instruments that are within the scope of the standard at fair value through profit or loss if doing so eliminates or significantly reduces an ‘accounting mismatch’⁷.
26. However, the FVO is *only* available at initial recognition and entities must designate 100% of the financial item⁸. Due to the various optional features and the drawdown behavioural pattern of the loans and loan commitments, credit portfolio managers engage in a flexible and active risk management strategy. Most often credit portfolio managers hedge less than 100% of a loan. They may also hedge longer than the contractual maturity of the loan or the loan commitment (for example, if the bank expects the loans to be extended or renewed—see paragraph 9—or as a consequence of the implicit incentives of the regulatory treatment, see paragraph 15).
27. The staff also note that the FVO is only available to instruments that are within the scope of IAS 39. Most of the loan commitments for which credit risk are managed fall into the scope of IAS 37 rather than IAS 39⁹.
28. The feedback from outreach activities indicates that only a very limited number of financial institutions elect to apply the FVO due to the restrictions around how the FVO is to be applied under IAS 39 today.

⁷ IFRS 9.4.5, IAS 39AG.4D-E.

⁸ IAS 39.AG4G.

⁹ Loan commitments meet the definition of a derivative but the Board decided to simplify the accounting for particular types of loan commitments and hence excluded them from the scope of IAS 39 (IAS 39.BC16).

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Summary of the overall accounting implications

29. In summary, financial institutions that manage credit risk using credit derivatives cannot apply hedge accounting because it is operationally impossible to isolate and measure the credit risk component of a financial item (see paragraphs 22 to 23).
30. Almost all financial institutions do not elect to apply the FVO due to its restrictions (ie designate at initial recognition and for the entirety of the financial instrument) because for most portfolio managers, their risk management strategy is responsive to the anticipated change in credit exposure of its lending portfolio and typically involves hedging credit risk depending on the circumstances from time to time to and often for less than 100% of a loan reflect the expected pattern of drawdown/ repayments and changes in credit quality. The FVO is also not available for most loan commitments for which credit exposure is managed.
31. As a result, financial institutions who use CDSs to hedge credit risk of their loan portfolios, present their loan portfolios at amortised cost and loan commitments (that meet the scope exception) are not recognised (see table I). The changes in fair value of the CDSs are presented in profit or loss every period—like a trading book. The accounting outcome is a ‘mismatch’ of gains and losses of the loans and loan commitments versus those of the CDSs that result in volatility in the income statement. That outcome does not reflect the economic substance of the credit risk management strategy of financial institutions.
32. Users also strongly agree that the current accounting under IFRSs regarding credit risk hedging strategies that use CDSs does not provide relevant and useful information. The profit or loss volatility does not reflect the economic effect of the CDS hedges, which is to provide protection against future credit losses. For example, there are phases where the gains from the CDSs precede the impairment losses on the credit exposure, while in other phases losses from the CDSs precede impairment reversals. There can also be scenarios where the gain

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or loss on the CDS is later than the related effect on the credit exposure. Users find these outcomes confusing and misleading.