

STAFF PAPER

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Project	Financial Instruments: Impairment		
Paper topic	Loan commitments and financial guarantee contracts		
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Paper Overview

Purpose of the paper

1. This papers considers
 - (a) whether to include within the scope of the proposed impairment model:
 - (i) IASB:
 1. loan commitments that are not accounted for at fair value through profit or loss; and
 2. financial guarantee contracts to which IFRS 9 *Financial Instruments* applies (and as defined in the standard) and that are not accounted for at fair value through profit or loss.
 - (ii) FASB:
 1. loan commitments that are not accounted for at FV-NI; and
 2. financial guarantee contracts that are not accounted for at FV-NI.
 - (b) how the impairment model would apply.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

Background

IFRSs

2. Off balance sheet commitments such as financial guarantees¹ and loan commitments give rise to expected credit losses.
3. Although loans² also give rise to expected credit losses, the accounting requirements are different. For loans measured at amortised cost entities are required to apply the impairment requirements in IAS 39 *Financial Instruments: Recognition and Measurement*, whereas IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* applies to loan commitments and financial guarantee contracts that are not accounted for at fair value through profit or loss. The requirements are not exactly the same.
4. In practice, loan commitments and financial guarantee contracts are often managed using the same credit risk management approach and information systems irrespective of whether the credit exposure is accounted for in accordance with IAS 39 or IAS 37. Constituents have urged the IASB to align the impairment requirements for all credit exposures irrespective of their type (ie whether loans, loan commitments or financial guarantee contracts).
5. The IASB asked for views on this suggestion in the supplementary document (SD): *Financial Instruments: Impairment*. Most respondents were supportive but some asked for clarification of some application matters.

US GAAP

6. US GAAP does not provide explicit impairment guidance for loan commitments and financial guarantee contracts. In practice, entities look to ASC 450-20-25 (formerly FAS 5) which requires the recognition of a loss when the loss is both probable and the amount can be reasonably estimated.

¹ In this agenda paper we will use the term financial guarantee contracts as defined narrowly in IFRSs.

² In this agenda paper references to ‘loans’ are in a broad sense, ie including all ‘funded’ or ‘cash’ instruments that would be in the scope of the new impairment model (eg also including bonds).

7. Given that, like loans, financial guarantee contracts and loan commitments give rise to expected credit losses, the question arises whether to include loan commitments and financial guarantee contracts within the scope of the proposed impairment model.

Staff recommendations:

- Issue 1: The proposed impairment model should apply to loan commitments and financial guarantee contracts to which IAS 37 applies / that are not accounted for at FV-NI in accordance with US GAAP.
- Issue 2: The proposed impairment model should apply to instruments that create a present legal obligation to extend credit. When estimating expected credit losses the maximum contractual period over which the entity is exposed to credit risk shall be considered.
- Issue 3: The usage behaviour shall be estimated over the lifetime of a loan commitment when estimating expected lifetime losses.
- Issue 4 (IASB only): The discount rate to be applied to discounting the expected credit losses arising from a loan commitment or a financial guarantee contract shall be the rate that reflects:
- (a) current market assessments of the time value of money (ie risk free rate); and
 - (b) the risks specific to the cash flows (but only if, and to the extent that, the risks are taken into account by adjusting the discount rate rather than by adjusting the cash shortfalls being discounted).
- Issue 5 (IASB only): *As part of the impairment project* the accounting for revenue arising from loan commitments or financial guarantee contracts shall not be changed.

Issue 6: The final requirements should state explicitly that expected credit losses of undrawn loan commitments or financial guarantee contracts should be reported separately as a liability.

How existing requirements differ from the proposed impairment model

8. For background about existing requirements and practices see Appendix A.
9. Expected credit losses of loan commitments and financial guarantee contracts are similar to those of loans. The only difference is that in the latter case the borrower has already drawn the loan whereas in the former case the creditor has not yet had a cash outflow (because the loan commitment is undrawn or because for a financial guarantee contract the guarantor does not provide funding but only loss reimbursement to the lender). However, existing requirements for recognising and measuring losses arising from some financial guarantee contracts and loan commitments are not consistent with the proposed impairment model. The timing of the recognition and the measurement of credit losses under IAS 37 and Topic 450 are different from those proposed in the three-bucket impairment model.
10. For example, for a loan commitment the timing of the recognition of a provision for credit losses under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and Topic 450 is driven by when a loss becomes *probable*.³
11. Under IAS 37, this results in different outcomes for situations in which an individual loan commitment exists compared to a group of similar commitments, because for such a group the probability of the loss is determined by considering the group as a whole.⁴ Hence, for a group of similar commitments, the probability criterion could be fulfilled from inception, whereas this is very unlikely for an individual loan commitment that cannot be grouped with other similar commitments.

³ See IAS 37.14(b), 23-24 and 66-68.

⁴ See IAS 37.24.

12. Hence, the *main* differences between existing IFRS and the three-bucket model are:
- (a) the timing of the loss recognition is affected by whether the recognition threshold is applied to a group of similar items or items that cannot be grouped in that way.
 - (b) for larger groups of loan commitments or financial guarantee contracts, IAS 37 in effect already requires an expected loss approach (to be applied from the date of entering into the contract)⁵—but the measurement of the liability is *always* based on lifetime expected loss (ie there is no limitation to a 12-month expected loss for any subset).
 - (c) in contrast, for individual loan commitments or financial guarantee contracts that cannot be grouped (eg ‘big ticket’ items), the probable threshold in IAS 37 means that expected losses are ignored until they become probable (which will typically occur only after inception of the loan commitment or financial guarantee contracts).
13. Unlike the difference described in paragraph 11 related to IFRS, as the staff understand practice in the U.S., there is no difference in the timing of loss recognition for a “group” as compared to an “individual item.” The main difference between practice under U.S. GAAP and the three-bucket model would be as follows:
- (a) Losses under existing U.S. GAAP are only recognized when deemed “probable”, as compared to the three-bucket model where a measured credit impairment is always present (be it a 12-month expected loss or a lifetime expected loss).
 - (b) The measurement of the credit impairment under the three bucket model would contemplate the entity’s full expectation about future

⁵ For groups of similar assets IAS 39 still requires that there are incurred losses before an impairment loss is recognised. That means even if statistical methods are used there must not be an impairment loss on initial recognition of the asset (IAS 39.AG92). Hence, also the IBNR (incurred but not reported) concept results in an impairment loss only *after* initial recognition of the assets.

events, as opposed to being limited to those events that have been “incurred.”

14. Including loan commitments and financial guarantee contracts within the scope of the three-bucket impairment model would result in a consistent recognition and measurement approach between U.S. GAAP and IFRS. Further it would result in a consistent approach irrespective of whether the estimate is made on an individual or a portfolio basis (which is a difference that exists today for IFRS).
15. In addition, including loan commitments within the scope of the three-bucket impairment model would eliminate purely accounting-driven effects from the change from IAS 37 to IAS 39 once a loan commitment is drawn and as a result a loan is advanced. That accounting-driven effect exists today because the ‘probable’ threshold in IAS 37 is not necessarily (exactly) the same as the ‘incurred’ indicators in IAS 39. In addition, an effect arises because the discount rate to be applied in IAS 37 is a current rate, while IAS 39 requires discounting an impairment loss at the effective interest rate (EIR).
16. In practice, off balance sheet items are typically managed under the same credit risk management approach and use the same systems as loans recognised on the balance sheet. That is, risk managers tend to assess and manage many exposures irrespective of whether they are recognised as loans on the balance sheet or are (still) only a commitment to lend or make payments to reimburse for a loss. That reflects that credit risk is typically managed on a ‘by-counterparty’ basis.

Feedback invited on this matter

17. Constituents have urged the IASB to align the impairment requirements for all credit exposures, irrespective of their type, and locate them in a single standard.
18. As a result, in the IASB-only section of the SD, the IASB invited constituents to comment on whether the proposed impairment requirements should apply to all loan commitments (that are not accounted for at fair value through profit or loss) and financial guarantee contracts to which IAS 39/IFRS 9 applies (and that are not accounted for at fair value through profit or loss).

19. Since the publication of the SD, the boards have further developed the impairment proposals, and have tentatively arrived at the three-bucket model. Consequently, the staff have performed some outreach on applying the three-bucket model to loan commitments and financial guarantee contracts.

Relevant questions in the SD

20. In January 2011 the boards published the SD, including the IASB-only Appendix Z. Appendix Z included the following questions:

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

21. Appendix Z also asked constituents to consider the proposed impairment requirements in the SD for financial guarantee contracts that are currently within the scope of IAS 39/IFRS 9.

Summary of feedback on the SD and from limited outreach

22. Most of the respondents that responded to questions 15Z and 16Z agreed with those proposals for the following reasons:
- (a) The accounting for impairment should be consistent across similar types of financial instruments.

- (b) It would eliminate a potential inconsistency between the measurement approach for losses under financial commitments and the losses that would be measured at origination of the loan when it is drawn under the commitment.
 - (c) Companies typically manage their credit risk for financial assets, loan commitments and financial guarantee contracts using the same approach.
23. Of the respondents that agreed with the proposals, some noted the following issues and suggested that clarifying guidance should be provided:
- (a) Whether recognition of expected losses for loan commitments should be limited to commitments that are irrevocable.
 - (b) The period that should be considered when estimating expected credit losses for revolving facilities.
 - (c) The complexity involved in estimating future draw downs.
 - (d) The discount rate to be applied.
 - (d) The accounting for the fees received for the financial commitment.
 - (e) Presentation.
24. Some respondents disagreed with the proposals stating that entities should not recognise impairment before they recognise the associated financial assets. Instead, entities should apply the onerous contract requirements of IAS 37 similarly as for other executory contracts.
25. The feedback received from our outreach on applying the three-bucket impairment model to loan commitments and financial guarantee contracts was similar to the comments summarised above.
26. The remainder of this paper analyses each of the issues raised by respondents separately:
- (a) Issue 1: whether to apply the impairment model to loan commitments and financial guarantee contracts (paragraphs 27-32);

- (b) Issue 2: whether the impairment model should be applied to revocable loan commitments and the period considered in estimating expected losses (paragraphs 33-69);
- (c) Issue 3 (IASB only): Estimating future draw downs (paragraphs 70-84);
- (d) Issue 4 (IASB only): The discount rate to be applied (paragraphs 85-92);
- (e) Issue 5: Accounting for commitment fees (paragraphs 93 -101);
- (f) Issue 6: Presentation (paragraphs 102 -103).

Issue 1: whether to apply the impairment model to loan commitments and financial guarantee contracts

27. Those constituents who did not support the proposal to apply the impairment model to all loan commitments were concerned that impairment would be recognised before an associated financial asset is recognised on the balance sheet and preferred that those instruments stay within the scope of currently applicable standards.
28. Among those, the IFRS constituents preferred to continue applying the onerous contract requirements of IAS 37 (see paragraph 24). However, the purpose of a provision for an onerous contract is (among others) to recognise an impairment for an asset that has not yet been recognised. IAS 37 requires recognition of a loss if the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.⁶ Thus, in IAS 37, the recognition of a loss therefore anticipates an asset impairment (ie loss recognition is not delayed until the financial asset is recognised).
29. In addition, as discussed in paragraphs 10–12, applying the onerous contract requirements of IAS 37 could result in delayed recognition of expected losses in many circumstances because the timing of the recognition of a provision for credit losses is driven by when a loss becomes *probable*.

⁶ See IAS 39.68.

30. More generally, applying the new impairment model to loan commitments would:
- (a) eliminate the purely accounting-driven effects of changing between the scope of two different standards when loan commitments get drawn; and
 - (b) achieve a consistent measurement for credit exposures irrespective of whether they are funded ones or not (ie align the accounting for loans, loan commitments and financial guarantee contracts).
31. Some US GAAP constituents supported continuing with current practice for loan commitments. The staff’s concern with the existing US practice, however, is that it continues to be based on the concept of recognizing a loss only when the loss is probable,⁷ and the measurement of the loss is based on the “incurred” notion under Topic 450.
32. For these reasons, and in light of the support of the majority of IFRS respondents, the staff recommend that the proposed impairment model should apply to loan commitments and financial guarantee contracts to which IAS 37 applies / that are not accounted for at FV-NI in accordance with US GAAP.

Question 1

Do the boards agree with the staff recommendation that the proposed impairment model should apply to loan commitments and financial guarantee contracts to which IAS 37 applies / that are not accounted for at FV-NI in accordance with US GAAP?

If not, why not? What would the boards like to do?

Issue 2: Type of loan commitment and time horizon for expected losses

33. Some respondents to the SD stated that it is unclear whether the scope of the proposed impairment model would include *only irrevocable* facilities or, alternatively, also revocable facilities.

⁷ Note that the ‘probable’ criterion in FAS 5 is not the same as in IAS 37 or IAS 39.

34. Some noted that the proposed impairment model should be limited to irrevocable facilities.
35. During our outreach, some constituents commented that both revocable and irrevocable facilities should be subject to the proposed impairment model because they do not distinguish between them from a credit risk management perspective.
36. In addition, some respondents to the SD requested guidance on what time horizon should be considered when estimating expected losses for revolving facilities with no maturity date but for which the issuer can cancel or reduce the committed amount at short notice.
37. The question of what facilities should be included within the scope of the impairment standard is intertwined with the question of what period should be considered when estimating expected losses. To be consistent, the period to be considered when estimating expected losses should follow naturally from the scope. Consequently, the following section addresses both questions together.
38. The boards could consider that the scope of loan commitments subject to the three-bucket impairment model and period to be considered for estimating expected losses is based on:

Alternative A: The contractual maturity approach

Alternative B: The behavioural maturity approach.

Alternative A—contractual maturity approach

- The proposed impairment model applies to instruments that create a present legal obligation to extend credit.
- The period to consider when estimating expected credit losses is the maximum *contractual* period over which the entity is exposed to credit risk.

39. Alternative A is consistent with the definition of a liability in the IFRS Conceptual Framework (and as further clarified in IAS 37) and FASB Concept Statement 6.
40. Alternative A is also consistent with the loan commitments that are captured in IAS 37 today.⁸
41. Under IFRSs, a liability arises if an entity has a present obligation. An entity has a present obligation only if it has a duty or responsibility to act or perform in a particular way as a result of past transactions or events (often referred to as the obligating event).⁹ The entity has an obligating event only if it has little, if any, discretion to avoid the outflows of resources to another party, for example when the entity entered into an irrevocable agreement to acquire an asset.¹⁰
42. Similarly, FASB Concepts Statement 6 defines liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”¹¹ It further defines that the three essential characteristics of a liability are:
- (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a

⁸ See IAS 37.14(a), 16-19 and 68.

⁹ Conceptual Framework 4.15, 4.18.

¹⁰ Conceptual Framework 4.16.

¹¹ Concepts Statement 6, paragraph 35.

specified or determinable date, on occurrence of a specified event, or on demand,

- (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and
 - (c) the transaction or other event obligating the entity has already happened.
43. While Alternative A is consistent with the conceptual framework/concept statements, it is inconsistent with credit risk management practices of some banks. Some banks do not distinguish between irrevocable and revocable facilities from a credit risk perspective because they tend not to cancel revocable facilities.
44. Alternative A would bring into the scope of the impairment model irrevocable loan commitments only. In other words, the proposed impairment model would apply to facilities that are not cancellable and to the end of the notice period (ie the irrevocable part) of a revocable facility.
45. By entering into an irrevocable loan commitment, the issuer has a present legal obligation to extend credit as a result of a past event. The issuer has no discretion to avoid having to advance the loan. By entering into the loan commitment, the issuer is therefore exposed to expected losses.
46. By entering into a revocable facility that can be cancelled after a specific notice period, the issuer has a present obligation to extend credit until the notice period lapses. While the issuer has discretion to cancel the facility by giving notice, it cannot prevent the drawdown of credit *before* the notice period lapses. Given that the entity has no discretion to avoid the draw down, it is exposed to expected losses.
47. In contrast, by entering into a revocable loan commitment that can be cancelled immediately without a notice period, the issuer does not have a present legal obligation to extend credit. In other words, those facilities are non-binding agreements. Consider, for example, a credit card product in which each transaction is specifically reviewed and approved at the point of sale and the cardholder's ability to spend can be cancelled immediately at the credit card

company's discretion at any time. The credit card company has no legal obligation to extend credit at any time and is not exposed to expected losses that are the result of an existing credit exposure until the loan is advanced.

Period to consider when estimating expected credit losses

48. It would be consistent with Alternative A to consider the contractual period over which the entity is exposed to credit risk when estimating expected losses; that is, the time period over which the entity has no discretion to avoid being exposed to credit risk.
49. For facilities with a fixed term contractual maturity, the term of the facility is the time period over which the entity is exposed to credit risk that it cannot avoid. Said in other words, in accordance with Alternative A the entity shall consider the period over which it is exposed to credit risk as a result of the contractual obligations existing at the reporting date.
50. Consider a 5 year corporate loan commitment with a 1 year repayment period for amounts drawn down before the expiry of the loan commitment. Both, the term for the undrawn loan commitment and the repayment term for amounts drawn before the loan commitment expires need to be considered at the reporting date when estimating expected credit losses. This is because Alternative A considers the credit risk resulting from the contractual obligations that exist at the reporting date.¹²
51. Other facilities, such as revolving credit card facilities, do not have a fixed term maturity, but the issuer can withdraw or reduce the committed amount by providing a notice period.
52. Under these type of facilities, each loan that is advanced has a set period of time, usually one, three or six months, after which the loan is contractually repayable. The entity has no discretion to avoid being exposed to expected losses over the

¹² Note that this is different to Alternative B which considers obligations beyond those existing at the reporting date.

notice period and repayment period. Thus, in accordance with Alternative A, the maximum contractual period (ie the notice period and repayment period) should be considered when estimating expected losses.

Alternative B—behavioural maturity approach:

- The proposed impairment model applies to instruments that *behave like* a present legal obligation to extend credit.
- The horizon to consider when estimating expected credit losses is based on the *behavioural* life of the instrument.

53. In contrast to Alternative A, the scope of loan commitments subject to the impairment model under Alternative B is not limited to irrevocable facilities or the irrevocable part of a revocable facility (ie the notice period).
54. Instead, under Alternative B, all revocable facilities are included within the scope based on their expected maturity (that is even if the expected behaviour extends beyond the maximum contractual maturity).
55. Those supporting Alternative B reason that, although issuers have the ability to avoid extending credit under a revocable facility (either with immediate effect or after a notice period, depending on the terms), they tend not to cancel these facilities for business relationship purposes or simply because borrowers with financial difficulty typically draw down most or all of their credit line *prior* to the bank identifying these difficulties. As a result they argue that these facilities behave like an irrevocable facility.
56. Those supporting Alternative B also reason that revocable facilities are a source of potentially significant leverage and should be included within the scope of the proposed impairment model.
57. Others believe that including revocable facilities within the scope of impairment creates an unrealistic measure of exposure that does not exist and will distort leverage ratios.

58. Alternative B is not consistent with the credit risk practices of some banks (eg banks that apply the Basel II foundation approach). Those banks differentiate between irrevocable and revocable facilities. Facilities that are uncommitted, that are unconditionally cancellable, or that effectively provide for automatic cancellation at any time by the bank without prior notice don't have expected losses for the unfunded portion of a loan commitment from a credit risk perspective. That is because a CCF (credit conversion factor)¹³ of 0% will be applied to those facilities.¹⁴
59. While Alternative B is consistent with the credit risk management of some banks (eg some banks that apply the Basel II advanced approach), it is not consistent with the definition of a liability in the IASB *Conceptual Framework* and CON 6 under US GAAP. An entity only has an obligation if it has a duty or responsibility to one or more other parties to act or perform in a particular way.¹⁵ The intention/business practice not to cancel a revocable facility does not create a duty or responsibility to another party to extend credit. Instead, the terms and conditions of the instrument provide the issuer with discretion—the issuer can avoid advancing the loan.
60. This concept is applied and further clarified in other IFRSs. For example, IAS 37 clarifies that an entity has no realistic alternative to settling an obligation when settlement is either legally enforceable, or when the entity creates a valid expectation in *other parties* that it would discharge the obligation/act in a particular way.¹⁶ In other words, economic compulsion does not give rise to an obligation.

¹³ The CCF is the percentage of the undrawn facility estimated to be converted into a loan (see also paragraph 71).

¹⁴ Basel Committee on Banking Supervision, *Internal Convergence of Capital Measurement and Capital Standards*, par. 312 and 314. An utilisation rate of 0% for those facilities is applied if the bank demonstrates that they actively monitor the financial condition of the borrower and that their internal control systems could cancel the facility upon evidence of deterioration in credit quality of the borrower.

¹⁵ *Conceptual Framework* 4.15, 4.18 (This concept is applied and further clarified in other IFRSs). CON 6, par 35.

¹⁶ IAS 37.10 and 17.

61. IAS 32 is also clear that a *contractual* financial obligation is necessary in order to meet the definition of a liability and that economic compulsion, by itself, does not result in an instrument being classified as a liability under IAS 32.¹⁷

Period to consider when estimating expected credit losses

62. It would be consistent with Alternative B to consider the time horizon over which the entity is exposed to credit risk, on the basis of behavioural assumptions.
63. Using behavioural assumptions for a revolving facility could therefore result in a behavioural maturity that is longer than the contractual maturity; for example because a certain percentage of loans or loan commitments in the portfolio have been rolled over into new loans in the past and that practice is expected to be continued.

Illustrative Examples

64. The following examples illustrate the difference between Alternative A and Alternative B.¹⁸

Example 1

At the reporting date (31.12.X0) Bank A has a loan commitment that can be cancelled after a three month notice period. The holder of the commitment defaults on 27 January X1. At the reporting date a liability shall be recognised and measured at three months' expected losses in accordance with Alternative A and Alternative B. Irrespective of whether or not Bank A cancels the loan commitment at the reporting date, Bank A has a present obligation to extend credit until the notice period of three months lapses and thus is exposed to credit risk over that period in accordance with Alternative A.

¹⁷ IAS 32.11 and IAS 32.13. See also IFRIC Update from March 2006.

¹⁸ For simplicity the examples do not consider any repayment period for amounts drawn down before the expiry of the loan commitment.

Example 2

At the reporting date (31.12. X0), Bank B has a loan commitment that can be cancelled after a one day notice period. The holder of the commitment defaults on 27 January X1. Bank B does not exercise its cancellation right at the reporting date. Bank B shall recognize a liability, measuring expected losses over the next day in accordance with Alternative A at the reporting date. Even though Bank B does not exercise its cancellation right, at the reporting date Bank B does not have a present legal obligation to extend credit beyond one day. In contrast, in accordance with Alternative B, Bank B shall recognize a liability, measuring expected losses taking into account the risk of default on the 27 January X1. This is because at the reporting date a contractual arrangement existed and because the expected behavior was that the cancellation right was not exercised (ie the loss relates to a facility that is a continuation of the one that existed at the reporting date—even though there was no legal obligation to continue it).

Example 3

Bank C does not have a loan commitment on the 31 December X0. Instead it issues a loan commitment on 5 January X1. The holder of the loan commitment defaults on 27 January X1. At the reporting date (31.December X0), Bank C does not recognize a liability in accordance with Approach A or Approach B. No contractual relationship exists on the reporting date.

Staff recommendation

65. Neither Alternative A nor Alternative B is consistent with credit risk management methods applied by *all* banks.
66. While Alternative A is consistent with the IFRS *Conceptual Framework* and IFRSs as well as with CON 6 under US GAAP, it is operationally more complex for banks that consider the behavioural life for credit risk management purposes (eg some banks that apply the advanced internal rating-based approach):

- (a) Those banks would need to consider a subset for accounting purposes only (those that create present legal obligations).
 - (b) An interaction might exist between the likelihood of a loss for an existing loan when a loan commitment is cancelled or the limit reduced. Similar to providing ‘fresh money’, not cancelling or not reducing the limit of a loan commitment can sometimes reduce losses or even avoid a default of other facilities. For such interactions, Alternative A would need to consider the effect on the existing (other) credit exposures that would arise from cancelling or reducing the limit of the loan commitment, which is complex.
67. In addition, the provision for financial reporting purposes would be lower than the provision for regulatory purposes. However, some think that the adequacy of the allowance balance should be the focus of prudential regulators rather than accounting standard setters.
68. Finally, feedback from IFRS constituents during our outreach indicated that banks generally support Alternative B.
69. Despite those complexities, the staff support Alternative A. We recommend that the boards should consider which loan commitments are in the scope of the proposed impairment model and period for estimating expected losses in a manner that is consistent with the Conceptual Framework/Concept Statements.

Question 2

Do the boards agree with the staff recommendation that

- a) the proposed impairment model should apply to instruments that create a present legal obligation to extend credit?
- b) the maximum contractual period over which the entity is exposed to credit risk shall be considered when estimating expected credit losses?

If not, why not? What would the boards like to do?

Issue 3: Estimating future draw downs

70. As noted in paragraph 9, expected credit losses of loan commitments are similar to those of loans. The only difference is that in the latter case, the borrower has already drawn down the loan whereas in the former case it has not. As a result, when estimating expected credit losses of loan commitments, additional uncertainty arises in respect to one of the input factors—the exposure at default.
71. To measure the exposure at default of loan commitments, the issuer needs to estimate the amount drawn down upon default. Said in other words, the issuer needs to estimate the part of the undrawn facility that will be converted into a loan (also often referred to as credit conversion factor (CCF) for credit risk management purposes, or utilisation rate).
72. Today, some banks model the CCF for the next 12-months, reflecting customer and product-specific characteristics based on historical loss data. Other banks apply a 12-month CCF that is provided by the regulator.
73. Respondents to the SD, and constituents during our outreach, noted that estimating future draw downs over the lifetime of the instrument will introduce additional complexities.
74. Additional complexity in estimating future draw downs (or the CCF) over the lifetime of loan commitments arise because of the uncertainty involved in estimating the usage behaviour over a longer period. Constituents are concerned they will be held to a standard which they would not be able to provide.
75. During our outreach, some constituents suggested the following alternatives to reduce the complexity of estimating CCFs over the lifetime of loan commitments—acknowledge that:
- (a) the 12 months' CCF is sufficient when estimating *lifetime* expected credit losses.
 - (b) a CCF based only on historical information is sufficient when estimating expected credit losses.

- (c) the CCF provided by the regulator could be applied when estimating expected lifetime losses.
76. The staff have considered, but do not support any of these alternatives.
77. While it would be less complex to use a 12-month CCF, it would not necessarily reflect the economic reality.
78. In addition, applying the 12-month CCF when estimating lifetime expected credit losses for instruments categorised in Bucket 2/3 is inconsistent with the proposed model.
79. While applying CCFs based solely on historical information would reduce the complexity it would be inconsistent with the information otherwise required to be used by the proposed impairment model. Consider, for example, credit card retail clients in a country that faces significant problems, including rapidly rising unemployment levels. Historical utilisation rates are unlikely a good indicator for future draw downs and would need to be adjusted when estimating expected credit losses.
80. The CCFs provided by the regulator are 12 months' CCFs, generally not forward looking nor specific to product types. Similar to the issues mentioned above, applying such a standardised parameter when estimating expected losses is inconsistent with the model.
81. The staff acknowledge the complexity involved in estimating CCFs over the lifetime of the instrument. But the estimate of CCFs over the lifetime is necessary to have a consistent expected loss model. Not having it would defeat the purpose of removing the arbitrage between on balance and off balance sheet exposures.
82. The staff do not think that the final standard can remove the complexities involved in estimating the CCF over the lifetime of the instrument.
83. As tentatively decided in April 2012, the final standard will clarify that the degree of detail necessary in forecasting estimated losses decreases as the forecast period increases which might address some of the concerns stated.

84. Given each alternative suggested in paragraph 75 would create an exception to the principles of estimating expected losses, the staff do not suggest providing relief when estimating CCFs over the lifetime of the instrument.

Question 3

Do the boards agree with the staff recommendation that the usage behaviour shall be estimated over the lifetime of a loan commitment when estimating expected lifetime losses?

If not, why not? What would the boards like to do?

Issue 4: The discount rate to be applied (IASB Only)

85. In the proposed impairment model, expected shortfalls of cash flows should be discounted at the EIR. In order to provide operational relief to entities, the IASB has tentatively decided to permit an entity to use a current discount rate between, and including, the risk-free rate and the IAS 39 EIR when discounting expected losses.
86. However, because a loan commitment or financial guarantee contract is unfunded, the effective interest method and hence an EIR are not applicable.¹⁹ Loan commitments and financial guarantee contracts are not instruments for lending but a commitment to lend in the future and a promise to reimburse credit loss, respectively. Hence, those instruments by themselves²⁰ do not give rise to the notion of interest (ie “charges for the use of cash or cash equivalents or amounts due to the entity”²¹). Instead, the cash flow profile of loan commitments and

¹⁹ Even though an internal rate of return can mathematically be calculated (but the outcomes can for example be a negative rate).

²⁰ If fees arising from loan commitments are attributed to a loan resulting from that commitment those fees become part of the EIR and hence interest revenue. However, in that case the unit of account is not limited to the loan commitment but includes a loan (ie a lending instrument) as well—see also the section on “Issue 5: The accounting for commitment fees” below.

²¹ See IAS 18 *Revenue*, paragraph 5(a).

financial guarantee contracts is that of derivatives. The fact that interest revenue does not apply is also reflected in the accounting for loan commitments and financial guarantee contracts in the scope of IFRS 9, for which revenue recognition does not use the effective interest method.

87. Consequently, the requirements regarding the discount rate for calculating the present value of the expected losses arising from loans cannot simply be extended to loan commitments and financial guarantee contracts.
88. Some respondents requested that similar guidance as in other IFRSs (for example IAS 37) should be provided in the final requirements to clarify that entities are required to use discount rates that reflect the time value of money and should be adjusted for risk only if that risk is not reflected in the cash flows being discounted.
89. The staff think that this concept from IAS 37 could similarly be applied to discounting the expected credit losses arising from loan commitments and financial guarantee contracts. Similarly to IAS 37, the entity would need to consider the risk that the actual shortfalls of cash flows might ultimately differ from those expected.²²
90. As a result, the discount rate to be applied to discounting the expected credit losses arising from a loan commitment or a financial guarantee contract would be the rate that reflects:
- (a) current market assessments of the time value of money (ie risk free rate); and
 - (b) the risks specific to the cash flows (but only if, and to the extent that, the risks are taken into account by adjusting the discount rate rather than by adjusting the cash shortfalls being discounted).
91. If the risk adjustment is included by adjusting the discount rate, the adjusted discount rate is lower than the risk-free rate.

²² IAS 37.45 and 47.

92. The staff recommend that for calculating the present value of the expected credit losses arising from a loan commitment or a financial guarantee contract the discount rate should be determined as set out in paragraph 90. In the staff's view that discount rate is appropriate because:

- (a) an EIR notion does not apply for those instruments; and
- (b) the expected credit losses need to be discounted to be consistent with the overall impairment model as well as for conceptual considerations (ie that the timing of a cash flow affects its present value).

Question 4

Does the IASB agree with the staff recommendation that the discount rate to be applied to discounting the expected credit losses arising from a loan commitment or a financial guarantee contract shall be the rate that reflects:

- (a) current market assessments of the time value of money (ie risk free rate); and
- (b) the risks specific to the cash flows (but only if, and to the extent that, the risks are taken into account by adjusting the discount rate rather than by adjusting the cash shortfalls being discounted)?

If not, why not? What would the IASB like to do?

Issue 5: The accounting for commitment fees (IASB Only)

93. Within the context of the FASB's financial instruments project, the FASB has tentatively decided that for loan commitments, revolving lines of credit and standby letters of credit not classified and measured at FV-NI, an entity would recognize any fees received in accordance with existing guidance in Subtopic 310-20. Under that guidance, if the likelihood is that exercise of the commitment is remote, any commitment fees received would be recognized as fee income over the commitment period. If the likelihood is that exercise is not remote, any commitment fees received would be deferred and recognized over the life of the funded loan as an adjustment of yield.

94. The current accounting under IFRSs requires an assessment of whether it is probable that the entity will draw down. If so, the commitment fee is deferred and recognised as an adjustment to the effective interest rate.²³ If draw down is not probable, the fee is recognised as revenue over the commitment period.²⁴
95. The interaction between the revenue recognition project and revenue from financial instruments is planned for the revenue recognition discussions at the October 2012 board meeting.
96. Consequently, the IASB staff think the IASB at this meeting should make the following decisions:
- (a) for revenue arising from financial guarantee contracts: whether that revenue should remain part of the revenue recognition requirements (like today under IFRSs)—that would mean that any changes to the requirements would be discussed as part of the revenue recognition project (not the impairment project).
 - (b) for revenue arising from loan commitments: whether:
 - (i) revenue recognition should depend on whether the loan commitment results in a loan (which would determine whether revenue recognition for commitment fees would be part of the effective interest method); and
 - (ii) if not included in the effective interest method, whether commitment fees should remain part of the revenue recognition requirements (see (a) above).

IFRSs

97. The staff consider that the impairment model relates only to determining one of the two amounts that are needed for the ‘higher of’ accounting for loan commitments and financial guarantee contracts that are in the scope of IFRS 9.²⁵ That is the credit loss aspect, for which IFRS 9 refers to IAS 37 (but not the

²³ IAS 18, IE14(a)(ii).

²⁴ IAS 18, IE14(b)(ii).

²⁵ See IFRS 9.4.2.1(c) and (d).

revenue aspect, for which IFRS 9 refers to IAS 18). The staff consider that the same applies to loan commitments outside the scope of IFRS 9: they comprise the same two aspects with the only difference being that for the revenue aspect IAS 18 applies ‘directly’ (ie without first being routed through initial measurement at fair value under IFRS 9).

98. Consequently, the staff consider that the changes to the impairment model do *not* imply changing revenue recognition. This applies even more so because the impairment model has the basic design of a ‘decoupled’ model that considers credit losses in isolation instead of integrating them into interest revenue recognition (ie the EIR).²⁶
99. For the revenue aspect of all loan commitments and financial guarantee contracts²⁷ the revenue recognition standard applies (which results in some commitment fees being included in the effective interest method). Therefore, the staff consider that revenue recognition for all fees that are not included in the effective interest method should remain like under existing IFRSs unless changes are made as part of the revenue recognition project (ie the impairment project is not the place to change that accounting).
100. The staff also consider that the changes to the impairment model do *not* imply changing the requirements of when for a loan commitment revenue recognition should depend on whether that loan commitment results in a loan.²⁸ That question is one about what type of fees should be included in the calculation of the EIR in order to appropriately represent interest revenue and expense on the basis of an internal rate of return concept, but not a question of how losses are recognised. This is reflected in the fact that the same issue applies to the commitment holder (ie the potential borrower), who applies the effective interest method to determine interest expense but whose accounting does not involve any impairment or

²⁶ The exception are some assets that are credit impaired on initial recognition (see Agenda Paper 5D of this meeting). However, that exception results in a different determination of the EIR, which is a notion that does not apply to loan commitments and financial guarantee contracts.

²⁷ Those within the scope of this paper, ie other than any accounted for at fair value through profit or loss or as insurance contracts.

²⁸ See paragraph 93.

accounting for credit losses. Consequently, in the staff's view the impairment project is not the place to change that accounting (if there was such an intention).

101. The staff therefore recommend that the accounting for revenue arising from loan commitments or financial guarantee contracts not be changed as part of the impairment project. The discussion of the interaction between the revenue recognition project and revenue from financial instruments (planned for the revenue recognition discussions at the October 2012 board meeting) will decide in which standard the requirements that are currently in IAS 18 will be in the future.²⁹

Question 5

Does the IASB agree with the staff recommendation that the accounting for revenue arising from loan commitments or financial guarantee contracts not be changed as part of the impairment project?

If not, why not? What would the board like to do?

Issue 6: Presentation

102. Some respondents asked for clarification on the presentation of expected credit losses of loan commitments and financial guarantees in the statement of financial position, because they represent a liability (for an onerous contract) instead of a reduction of the value of an asset that does not exist. Respondents asked the boards to address the matter in the final requirements.
103. The staff recommend that the final requirements state that expected credit losses of undrawn loan commitments or financial guarantee contracts should be reported separately as liabilities (eg provisions for undrawn loan commitments/financial

²⁹ This is a drafting issue but not one of changing the substance of the requirements—unless changes are made as part of the revenue recognition project (see paragraph 99).

guarantee contracts) and not reported as an allowance balance. The expected credit losses do not represent a reduction to the value of an asset.

Question 6

Do the boards agree with the staff recommendation that the final requirements should state explicitly that expected credit losses of undrawn loan commitments or financial guarantee contracts should be reported separately as a liability?

If not, why not? What would the boards like to do?

Appendix A: Background of existing requirements and practices

Financial guarantees in IFRSs

- A1. The term ‘financial guarantee’ is generally used to refer to contracts issued by a wide range of general business entities, insurance entities and other financial institutions. They may have various legal forms, such as guarantees, some types of letters of credit, credit default contracts or insurance contracts. Currently, IFRSs define a *financial guarantee contract* (‘FGC’) narrowly as “A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument”.³⁰
- A2. During the redeliberations of the exposure draft *Insurance Contracts*, the IASB has tentatively decided to retain the existing approach in IFRSs that:
- (a) permits an issuer of a financial guarantee contract to account for the contract as an insurance contract if the issuer had previously asserted that it regards the contract as an insurance contract; and
 - (b) requires an issuer to account for a financial guarantee contract in accordance with the financial instruments standards in all other cases.
- A3. Paragraph 47 of IAS 39 and paragraph 4.2.1 of IFRS 9 set out the subsequent measurement for financial guarantee contracts that are accounted for in accordance with the financial instruments standards. Unless accounted for at fair value through profit or loss, the financial guarantee contract shall be measured at the higher of:
- (c) the amount determined in accordance with IAS 37; and
 - (d) the amount initially recognised less cumulative amortisation in accordance with IAS 18, if appropriate.

³⁰ IFRS 9, Appendix A.

Loan commitments in IFRSs

- A4. The scope of IAS 39 (and thus IFRS 9) includes some loan commitments that are not accounted for at fair value through profit or loss (ie commitments to provide a loan at a below-market interest rate).
- A5. Paragraph 47 of IAS 39 and paragraph 4.2.1 of IFRS 9 set out the subsequent measurement for these loan commitments. They shall be measured at the higher of:
- (e) the amount determined in accordance with IAS 37; and
 - (f) the amount initially recognised less cumulative amortisation in accordance with IAS 18, if appropriate.
- A6. All other loan commitments that are not accounted for at fair value through profit or loss are excluded from the scope of IAS 39. Instead they are within the scope of IAS 37.

Financial guarantee contracts in US GAAP

- A7. Generally, Topic 460 *Guarantees* in the *FASB Accounting Standards Codification*® (formerly FIN 45) applies to financial guarantee contracts. This guidance requires an entity to recognise a liability at the inception of the guarantee. The liability is generally recognised at the fair value of the guarantee; however, Topic 460 requires a guarantor to recognise the higher of the fair value of the guarantee and the amount that would be recognised under ASC 450-20-25 (FAS 5) for the related contingent loss at inception.³¹
- A8. Topic 460 does not describe in detail the subsequent measurement for guarantees, but does state that the liability would typically be reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee.³² An entity may

³¹ ASC 460-10-30-2 and 460-10-30-3; it is noted that it would be unusual for the contingent liability amount under FAS 5 to exceed the fair value.

³² ASC 460-10-35-1

recognise the release from risk upon expiration or settlement, by a systematic and rational amortisation method, or as the fair value changes.³³

- A9. Because of the lack of subsequent measurement guidance provided in Topic 460, entities look to ASC 450-20 (FAS 5) and record a contingent obligation when it is probable that the entity will have to assume responsibility under the guarantee and the amount of the loss is reasonably estimable.
- A10. Currently, entities may record an accrual for credit loss on a financial instrument with off balance sheet risk that is not measured at fair value, including financial guarantees and financial standby letters of credit. This accrual is required to be recorded separately from a valuation account related to a recognised financial instrument.³⁴

Loan commitments in US GAAP

- A11. Under US GAAP, loan commitments are recognised as financial assets when the credit facility is drawn and accounted for at amortised cost.
- A12. A principle for recognising a general provision for an onerous contract comparable to the guidance in IAS 37 does not exist under US GAAP. Generally, recording losses on executory contracts is not permitted, unless specifically required.
- A13. US GAAP does not provide explicit impairment guidance for loan commitments, however ASC 450-20-25 (formerly FAS 5) requires the recognition of a loss when the loss is both probable and the amount can be reasonably estimated. The staff's understanding is that entities record impairment for probable losses on unfunded loan commitments under ASC 450-20-25, recognising the loss as a liability as opposed to part of a contra-asset allowance (such as the Allowance for Loan and Lease Losses (ALLL)).

³³ ASC 460-10-35-2

³⁴ ASC 825-10-35-1.

- A14. Although no formal regulatory guidance on the recognition of credit losses related to off balance sheet financial instruments has been issued, US banking regulatory agencies have published publicly-available materials that are used by institutions and examiners.
- A15. These regulatory sources provide some additional guidance about when the recognition of a loss is appropriate for unfunded portions of cancellable commitments. These sources indicate that for credit cards:
- a. If the entity has “an effective monitoring and control system [that] identifies deteriorating credits at an early stage and freezes, cancels, or reduces those lines in a timely manner,” then no liability is needed.³⁵
 - b. If it is probable the bank will fund the commitment, regardless of whether it is cancellable, then the unfunded portion of the commitment would need to be considered for impairment.³⁶
- A16. The staff understand that in practice many banks do not record a liability for loan commitments associated with their credit card portfolio. This policy is based on their ability and known practice of cancelling the commitments within a relatively short time frame.³⁷

³⁵ “Credit Card Activities Manual,” FDIC (http://www.fdic.gov/regulations/examinations/credit_card/ch12.html#sec9)

³⁶ “Bank Accounting Advisory Series,” OCC (<http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/BAAS.pdf>), Section 2C, Question 4.

³⁷ “Credit Card Activities Manual,” FDIC...