

STAFF PAPER

11–12 December 2013

REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Loan Commitments and Financial Guarantee Contracts		
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Introduction

Purpose of the paper

1. The Exposure Draft *Financial Instruments: Expected Credit Losses* (the ‘ED’) proposed that an entity should recognise a provision for expected credit losses (‘ECL’) that result from loan commitments and financial guarantee contracts when there is a present contractual obligation to extend credit¹. To measure the exposure at default of the loan commitments, the issuer needs to estimate the usage behaviour over the period during which a present legal obligation exists to extend credit.
2. In November 2013 the IASB discussed whether ECL for revolving credit facilities should consider the contractual ability to cancel the undrawn commitment or whether that contractual ability does not necessarily limit an entity’s exposure to credit losses to the contractual notice period². The IASB tentatively decided that for revolving credit facilities:

¹ The following are included in the scope of the ED: (a) loan commitments when there is a present contractual obligation to extend credit, except any loan commitments that are accounted for at fair value through profit or loss in accordance with IFRS 9; and (b) financial guarantee contracts within the scope of IFRS 9 that are not accounted for at fair value through profit or loss.

² Refer to Agenda paper 5A *Loan commitments and financial guarantee contracts*, which was discussed in November 2013 IASB meeting.

- (a) ECL, including those on the undrawn facility, should be estimated for the period over which an entity is exposed to credit risk and over which future drawdowns cannot be avoided;
 - (b) ECL on the undrawn facility should be discounted using the same effective interest rate, or an approximation thereof, used to discount the ECL on the drawn facility; and
 - (c) the provision for the ECL on the undrawn facility should be presented together with the loss allowance for ECL on the drawn facility if an entity cannot separately identify the ECL associated with the undrawn facility³.
3. On the basis of this tentative decision, ECL on other loan commitments and financial guarantee contracts will still be based on considering the contractual obligation to extend credit as proposed in the ED. However, the IASB asked the staff to perform further analysis to determine whether these tentative decisions should apply to a wider scope of loan commitments and financial guarantee contracts.
4. This Agenda Paper is a follow-up to the deliberations at the November 2013 meeting on Agenda Paper 5A and presents and analyses a number of examples to illustrate the application of the proposed requirements and the effect of the IASB's tentative decision for revolving credit facilities.

Feedback

5. As reported in November, the vast majority of respondents agreed that loan commitments and financial guarantee contracts should be within the scope of the proposals. They agreed that, conceptually, ECL should be estimated over the contractual period for which an entity is committed to extend credit. However, many proposed that ECL on revolving credit facilities should be measured over the behavioural, rather than contractual, life because they were concerned that using the contractual period:

³ The IASB also acknowledged the presentation could be simplified by allocating all ECL to the drawn balance and, to the extent that ECL exceed the drawn balance, present the remaining ECL as a provision.

- (a) would be contrary to how the exposures are managed from a credit risk management perspective and for regulatory purposes;
 - (b) might result in (or be perceived as resulting in) recognising allowances that are inconsistent with (ie less than) the actual credit risk exposures arising from those contracts; and
 - (c) will result in outcomes for which no actual loss experience exists on which to base the estimates. This is because they do not have information available to support the measurement of ECL on a contractual basis, because this is inconsistent with credit risk management and actual statistical information.
6. Concerns about the application of the proposed requirements to other types of loan commitments or financial guarantees were not raised in the comment letter responses. However, informal outreach revealed some types of loan commitments for which the proposed discount rate and presentation requirements raise similar concerns as for revolving credit facilities. These are considered in the next section.

Staff analysis

7. The purpose of this analysis is to consider whether there are loan commitments, other than revolving credit facilities, for which the ECL should be estimated over a period that extends beyond the maximum contractual period over which the entity is exposed to credit risk, and if this is the case, how the ECL should be measured. The staff analysis for revolving credit facilities focused on loan commitments that are unconditionally cancellable. This Agenda Paper focuses on the following examples:
- (a) Example 1: a fixed-period loan commitment; and
 - (b) Example 2: a loan commitment that is conditionally cancellable.
8. For each of the examples, the staff analysis considered the period over which ECL should be estimated, the discount rate that should be applied and the presentation of the loss allowance related to the drawn balance and the provision for the undrawn balance.

Example 1: a fixed period loan commitment

9. Bank X enters into a fixed period loan commitment with one of its customers. The maximum loan amount available is CU100,000 and accrues interest at 5 per cent per annum on the outstanding (ie drawn) amount. At any point during the contractual life, the customer can draw against the loan amount, either partially or in full. The contractual period on this instrument is 5 years from the date that the customer signed the loan agreement and the instalments to be repaid are increased as drawdowns are made.
10. The customer is permitted to prepay the outstanding loan amount at any time. However, this is not a revolving facility because the payments against the facility are based on a normal instalment method and cannot be withdrawn again once paid. At each reporting date the undrawn (available) balance is therefore calculated as the total facility granted less the gross amounts drawn to date (for example, if the customer drew down CU20,000 after six months and then repaid it fully six months later, the available amount for the remaining four years would be only CU80,000).
11. Until the customer has fully drawn the approved amount the facility consists of two components, the amount already drawn and the amount still to be drawn. Bank X does not distinguish between the drawn and undrawn amounts for credit risk management purposes and estimates ECL on the total facility level.

Period over which ECL should be estimated

12. The period over which Bank X is exposed to credit risk is the maximum contractual period over which it is committed to extend credit. In this example, Bank X does not have the unconditional right to withdraw the undrawn balance and the maximum period over which ECL should be estimated is the contractual period of 5 years. However, Bank X should take into consideration the right of the customer to prepay the outstanding amount when estimating ECL. In other words, Bank X should determine the behavioural life of similar instruments based on its past experience, but the behavioural life cannot exceed the contractual period.

Discount rate to be applied

13. For credit risk management purposes Bank X estimates the cash flows it does not expect to receive based on the total facility level and not separately for the drawn and undrawn components. In other words, there is only **one set of cash flows** from the customer, which relates to both components. The disconnect between the discount rate used for the drawn balance and the undrawn commitment (as required in the ED) is a complication that is inconsistent with this risk management view, because the measurement of ECL for the undrawn commitment will change when it is drawn, merely as a result of the difference in discount rate. Because the undrawn commitment relates directly to the drawn balance, the effective interest rate ('EIR') applied to the drawn balance already reflects an assessment of the time value of money (albeit a historic rather than a current assessment) and of the risks that are specific to the cash flows. Consequently, it would be simpler and arguably appropriate to apply only one discount rate when discounting the cash flows not expected to be received.

Presentation

14. In this example, the customer is not able to withdraw amounts already repaid. However, Bank X estimates ECL on a facility level, for which there is only one set of cash flows. It is therefore not able to distinguish the ECL related to the drawn amount from the ECL on the undrawn balance. Consequently, it would seem appropriate to present the provision for the ECL on the undrawn balance together with the loss allowance for ECL on the drawn amount.

Example 2: loan commitment that is conditionally cancellable

15. Bank X enters into a loan commitment with one of its corporate customers. The maximum loan amount available is CU100,000 and accrues interest at 5 per cent per annum on the outstanding amount. The contractual period on this instrument is 5 years. It is cancellable if the customer's leverage ratio exceeds a specified percentage.

Period over which ECL should be estimated

16. In this example, Bank X is contractually committed to make a specified amount available to a customer for a specified period of time at a particular interest rate. Although the loan commitment is cancellable in specific circumstances, unless Bank X has access to information that indicates that the customer has breached these conditions, it has to extend credit over the five-year period. The maximum period over which Bank X will estimate ECL on any undrawn balance is the contractual period.

Discount rate to be applied

17. Similarly as in Example 1 above, for credit risk management purposes, Bank X estimates the cash flows that it does not expect to receive based on the total facility level and not separately for the drawn and undrawn components. In other words, there is only **one set of cash flows** from the customer that relates to both components. Consequently, it would be simpler, and arguably appropriate, to apply only one discount rate when discounting the cash flows that are not expected to be received.

Presentation

18. As for Example 1, Bank X estimates ECL on a facility level, for which there is only one set of cash flows. It is therefore not able to distinguish the ECL related to the drawn amount from the ECL on the undrawn balance. Consequently, it would seem appropriate to present the provision for the ECL on the undrawn balance together with the loss allowance for ECL on the drawn amount.

Conclusion

19. In both examples the remaining life of the instrument is the remaining contractual period, or a shorter period (for example, as a result of prepayments), over which there is exposure to credit risk on the financial instrument, as defined in the ED. In other words, ECL should be estimated over the behavioural life but it cannot extend beyond the contractual period. This is different from revolving credit facilities, in which the contractual ability to demand repayment and cancel the undrawn commitment does not necessarily limit an entity's exposure to credit loss

to the contractual notice period (so the behavioural life can be longer than the contractually committed period).

Staff recommendation

20. For loan commitments and financial guarantee contracts in general, the staff still consider the contractual period over which an entity is committed to provide credit (or a shorter period considering prepayments) to be the correct conceptual outcome. This is because the loan commitment will expire at a specified date and if an entity decides to renew or extend the loan commitment, it will be a new instrument, which provides the opportunity to revise the terms and conditions (including the interest rate).
21. We therefore recommend confirming the proposed requirement that the **maximum** period over which ECL should be estimated for loan commitments and financial guarantee contracts, other than revolving credit facilities, is the contractual period over which the entity is committed to provide credit.
22. For the reasons set out in paragraphs 13 and 17, the staff recommend extending the tentative decision pertaining to the discount rate to be used for revolving credit facilities, to all loan commitments and financial guarantees unless the EIR cannot be determined. In that case, an entity should determine the discount rate as proposed in the ED⁴.
23. We also recommend extending the tentative decision pertaining to the presentation of the provision for ECL on revolving credit facilities to all loan commitments and financial guarantees. In other words, the provision for the ECL on the undrawn balance should be presented together with the loss allowance for ECL on the drawn amount if an entity cannot separately identify the ECL associated with the undrawn balance. To the extent that the ECL exceed the drawn amount, the ECL should be presented as a provision.

⁴ The ED proposed that an entity should use a discount rate that reflects the current market assessment of the time value of money and the risks that are 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 that are being discounted.

Question to the IASB

Does the IASB agree with the staff recommendation to:

- a) confirm the proposed requirement that the maximum period over which ECL should be estimated for loan commitments and financial guarantee contracts, other than revolving credit facilities, is the contractual period over which the entity is committed to provide credit?
- b) require the same discount rate to be applied when estimating ECL on the drawn amount and the undrawn balance, unless the EIR cannot be determined, in which case the discount rate should be determined as proposed in the ED?
- c) present the provision for the ECL on the undrawn balance together with the loss allowance for ECL on the drawn amount if an entity cannot separately identify the ECL associated with the undrawn balance?

If not, what would the IASB prefer and why?