STAFF PAPER

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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 that result from loan commitments and financial guarantee contracts when there is a present contractual obligation to extend credit[1]. 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. This Staff Paper discusses the feedback received, including from our outreach and the fieldwork, on the proposed requirements to estimate the expected credit losses (ECL) on loan commitments and financial guarantee contracts that are within the scope of the ED. In particular this Staff Paper discusses the following with regards to loan commitments:

   (a) whether there is a particular type of loan commitment for which ECL should be estimated over a period that extends beyond the maximum contractual period over which the entity is committed to extend credit;

   (b) the period over which to estimate the usage behaviour; and

[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.

(c) the discount rate to be used when measuring ECL on this type of loan commitment.

Background

3. During the deliberations that preceded the publication of the ED, the IASB considered whether to apply the proposed impairment model to loan commitments and financial guarantee contracts. A further question was to which types of loan commitments the proposed model should be applied and the time horizon over which the ECL should be estimated. The IASB considered two approaches[2]:

   (a) the contractual maturity approach; or

   (b) the behavioural maturity approach.

4. At the time, the IASB noted that the behavioural maturity approach was consistent with the credit risk management practices of some banks and would therefore be operationally less complex to apply than the contractual maturity approach. However, the IASB believed that although the contractual maturity approach was inconsistent with the credit risk management practices of some, it was consistent with the definition of a liability in the *Conceptual Framework*. The ED therefore proposed that a provision should be recognised for the ECL that result from loan commitments when there is a present contractual obligation to extend credit.

Proposals, reason for the proposals and a question asked in the ED

5. The ED proposed, for loan commitments and financial guarantee contracts that are within the scope of the ED, to estimate ECL:

   (a) for undrawn loan commitments, as the difference between:

      (i) the present value of the principal and interest cash flows due to the entity if the holder of the loan commitment draws down the loan; and

      (ii) the present value of the cash flows that the entity expects to receive if the loan is drawn down.

[2] See Agenda Paper 5E that was discussed in July 2012

(b) for financial guarantee contracts, the entity is only required to make payments in the event of a default by the debtor in accordance with the terms of the instrument guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party.

6. An entity should estimate ECL consistently with its expectations that the loan commitment will be drawn down. That is, it should consider the expected portion of the loan commitment that will be drawn down within 12 months of the reporting date when estimating 12-month ECL, and the expected portion of the loan commitment that will be drawn down over the remaining life of the loan commitment when estimating lifetime ECL.

7. The ED proposed that the remaining life of a loan commitment and financial guarantee contract should be the remaining contractual period, or shorter period, over which it is exposed to credit risk. The maximum period to consider when estimating the ECL is the maximum contractual period over which the entity is exposed to credit risk and not a longer period, even if that would be consistent with business practice.

8. For undrawn loan commitments and financial guarantee contracts, 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. However, if the risk-adjustment is included by adjusting the discount rate, the adjusted discount rate will be lower than the risk-free rate.

9. In addition, the ED proposed that provisions for ECL from financial guarantee contracts or loan commitments should be presented in a separate line item in the statement of financial position as a liability.

10. Relevant extracts from the Basis for Conclusions are as follows:

> BC129 …Expected credit losses of obligations to extend credit (off balance sheet exposures) are similar to those of loans and other on balance sheet exposures. 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. The recognition of a liability for expected credit losses is limited to loan commitments and financial guarantee contracts with a present contractual obligation to extend credit. Without a present contractual obligation to extend credit, an entity may withdraw its loan commitment before it extends credit. Consequently, the IASB concluded that a liability does not exist for loan commitments or for financial guarantee contracts where there is not present contractual obligation to extend credit.
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> …
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> BC136 The IASB noted that it would be inappropriate to recognise a loss allowance for loan commitments and financial guarantee contracts, because there is no corresponding asset with which to present that loss allowance. The IASB therefore decided to require that an entity must recognise the expected credit losses for such financial instruments as a provision in the statement of financial position.

Feedback

11. The vast majority of respondents agreed that loan commitments and financial guarantee contracts should be within the scope of the proposals because:

    (a) ECL on loan commitments and financial guarantee contracts are similar to those of loans;

    (b) in practice, loan commitments and financial guarantee contracts are often managed using the same credit risk management approach and information systems; and

    (c) a single impairment model for all credit exposures irrespective of their type (ie whether loans, loan commitments or financial guarantee contracts) removes the complexity currently caused by different impairment models in IFRS.

12. However, a few respondents supported continuing the current accounting prescribed by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for those loan commitments and financial guarantee contracts. They believed that the existing accounting treatment is appropriate.

13. Many of the respondents that supported including loan commitments within the scope of the proposed model proposed that ECL should be measured over the behavioural life of the product, rather than over the contractual life, as was proposed. Although some of them agreed that, conceptually, ECL should be recognised over the contractual period and not over a longer period, the majority of respondents were concerned that using the contractual period:

    (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) insufficient allowances for the 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.

14. This was of particular concern for revolving credit instruments, for example credit cards. Some respondents stated that in general the contractual cancellation period of those products is one day, but in practice credit is offered for a longer period based on the entity's business practice (for example, conducting an annual limit or facility review). Facilities are generally not immediately cancelled. Consequently, those respondents proposed that the ECL on such loan commitments should be estimated over the behavioural life as this would more faithfully represent their exposure to credit risk.

15. Other comments received on loan commitments and financial guarantee contracts included concerns about different discount rates for drawn and undrawn facilities.

Staff analysis

16. Based on the widespread support received for the proposed requirements for loan commitments and financial guarantee contracts in general and the fact that new arguments were not raised that caused prior analysis to be brought into question, we do not intend to discuss those aspects of the proposals again (thus those instruments would be included in the scope of the model, generally the ECL would be estimated considering the contractual obligations, discounting would be as proposed in the ED and the ECL would be presented as a liability for those items). Instead we are only considering whether there is a particular type of loan commitment 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.

Particular type of loan commitment

17. The majority of respondents that commented that estimating the ECL over the contractual period over which an entity is exposed to credit risk is not appropriate in all cases, specifically made the comment in the context of revolving credit facilities such as credit cards and overdraft facilities.

18. Revolving credit facilities allow the borrower the flexibility to decide how often they want to make withdrawals from the facility and at what time intervals. These facilities are drawn and repaid and then drawn again. They do not have a fixed term or repayment structure and are different from an instrument with fixed monthly payments (for example, a mortgage) because it lets borrowers use as much of the credit as is available and only pay interest on what they have used. Revolving facilities can have a life of many years with balances being drawn daily and repaid (fully or partially) at monthly or other intervals. Such facilities could be viewed as a combination of two financial instruments:

    (a) a loan commitment to make the undrawn portion of the facility available; and

    (b) a financial asset for the portion of the facility that has been drawn down.

Our proposals in effect would have distinguished those aspects of the financial instrument, with the proposed discount rate and presentation requirements differing for the drawn and undrawn components.

19. The fundamental difficulty in applying the proposals to the revolving facilities results from the flexibility to make withdrawals from the facility up to the approved credit limit and repay outstanding balances at any time either fully or partially. This results in borrowers moving regularly (sometimes even on a daily basis) between the drawn and undrawn portions of a facility.

20. Revolving facilities can be contractually withdrawn by the lender with little or no notice resulting in repayment of any drawn balance and cancellation of any undrawn commitment under the facility. In accordance with the proposals in the ED, there would essentially be no requirement to recognise a provision for ECL on the undrawn portion of those loan commitments because the exposure period would be treated as one day. This can be illustrated through the following example:

Example

> Bank X grants a customer a credit card with a limit of £1,000 and a one-day notice period after which Bank X has the ability to cancel is commitment. At the reporting date, the customer has an outstanding balance of £500. The undrawn commitment for the credit card is £500.
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> In accordance with the ED, Bank X will estimate the ECL on the outstanding balance of £500 at an amount equal to 12-month or lifetime ECL (depending on whether the financial instrument is in Stage 1 or 2 of the proposed model). However, for the undrawn commitment, Bank X will recognise no ECL because the contractual cancellation period is one day.

21. However, in practice lenders continue to extend credit under a revolving credit facility for a longer duration and only cancel the facility if an increase in credit risk has been observed. For such facilities, the contractual maturities are set for protective reasons and are not actively enforced in the normal day-to-day management of the revolving credit facility. Respondents also do not believe that,

in effect, commercially they have the right to cancel the undrawn commitment unless there has been an increase in credit risk. This is often the case for revolving facilities, such as credit cards that are managed on a portfolio basis. Therefore, economically, the contractual ability to demand repayment and cancel the undrawn commitment does not necessarily limit an entity's exposure to credit losses beyond the contractual notice period.

22. ECL on undrawn commitments pertaining to revolving credit facilities can be significant. Restricting the recognition of a provision for the ECL to the contractual notice period is arguably inconsistent with the notion of expected credit losses and would therefore not reflect actual loss experience over any meaningful period. It would also neither reflect the underlying economics of the lending transaction nor the way in which those facilities are managed for credit risk purposes.

23. In addition, from a practical perspective, estimating the probability or risk of default over the contractual cancellation period would be difficult as entities have very little, if any, experience on which to base the estimates. This is because the contractual right to cancel the undrawn commitment is not generally exercised since it might not be the most effective method of recovering outstanding balances and limiting impairment losses nor is it commercially realistic from a business perspective.

24. Furthermore, users of financial statements have stated repeatedly that information provided on a basis that is used for accounting purposes only and that does not reflect the underlying economics of the transaction or how those facilities are managed from a credit risk perspective is not relevant or useful information.

Period over which the ECL should be estimated

25. If it is accepted that for revolving credit facilities the ECL should be estimated over a period that extends beyond the contractual period over which an entity is committed to extend credit, the next question to be considered, is what that period should be.

26. Although revolving credit facilities typically have contractual terms which can be terminated at short notice, their behavioural lifetimes, will normally extend

significantly beyond such contractual periods. Even if the contractual cancellation period is enforced and the undrawn commitment is cancelled, the outstanding balance (drawn balance) is usually not immediately repayable. Repayment of the drawn balance could take several years and the entity will remain exposed to the credit risk over that entire period.

27. Respondents noted that for credit risk management purposes revolving facilities are managed and the ECL are estimated on a **facility level**. They do not estimate the ECL on the financial asset and the undrawn commitment separately. This is consistent with our understanding that from a credit risk perspective the concept of ECL is equally relevant to drawn and undrawn exposures.

Example (continuing from paragraph 20)

> When estimating ECL, Bank X estimates what it expects the outstanding balance on the facility would be if a default was to occur (ie exposure at default). Bank X determines the credit exposure at the point of default to be £800 which takes into consideration expected future drawdowns.

28. For credit risk management purposes the behavioural period over which the ECL are estimated reflects the period over which the entity is exposed to the credit risk on the revolving facility and applies equally to the financial asset component (the drawn balance) and the undrawn commitment. It has been suggested that the proposed model should consider ECL in this way.

29. Suggestions made by respondents on how to describe the behavioural life of a revolving credit facility, are noted below:

The period until the next decision to renew the facility:

30. This would reflect the operational practices of managing revolving credit facilities and treat the commitment to extend credit following the decision to renew as a new commitment, replacing the previous commitment.

31. Depending on the frequency of review procedures, the period until the next decision to renew the facility or not might be short, which would give rise to similar concerns as with the contractual period (ie still be considered inconsistent with the 'economic' exposure). Furthermore, this approach introduces a dependency on the operational procedures of the entity and may lead to changes in

the behavioural life and the ECL because of changes in the entity's operating procedures.

Period over which the balance is repaid

32. The period over which the balance is repaid will reflect the period over which an entity is exposed to the credit risk on the revolving facility. However, the repayment period might be difficult to determine for revolving credit facilities because it requires the allocation of payments received between existing drawdowns and new drawdowns.

33. Some respondents indicated that potential operational simplifications could be to assume a first-in-first out (FIFO) allocation or a proportionate allocation of payments. However, this is somewhat arbitrary and is unlikely to represent the period over which an entity is exposed to credit risk on those instruments.

Remaining behavioural life

34. This method would involve estimating the ECL over the period in which the entity expects the facility to remain open based on historical experience, regardless of drawdown or repayment behaviours.

35. Recognising the ECL over such a period would create a significant disconnection between the ECL recognised and the interest charged over time (ie the facility could be open but undrawn for extended periods of time) and is likely to exceed the contractual period significantly.

Fixed 12 month period

36. Some respondents suggested estimating the ECL over a 12 month period, regardless of the contractual or behavioural period. This period would be consistent with the period used for financial instruments in Stage 1 of the proposed model and facilitate comparability and understanding of loss allowances in practice. This would also be consistent with the period over which the ECL are estimated by some entities for regulatory reporting purposes.

37. Those respondents believed that it is not necessary to consider a period beyond 12 months because revolving credit facilities that have experienced a significant increase in credit risk and ultimately go on to default, normally progress to default

within 12 months. Furthermore, within each 12 month period, facilities would have been subjected to at least one, if not more, reviews and the decision to continue lending has, in effect, been renewed at each of these review points.

38. However, the IASB has already considered and rejected this approach as stated in the Basis for Conclusions of the ED:

> BC133 The IASB considered and rejected the following alternatives that were suggested for estimating future drawdowns:
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> (a) limiting the estimate of future drawdowns to the next 12 months. While it would be less complex to use an estimate over a 12-month time period, such a limit would be arbitrary and inconsistent with estimating lifetime expected credit losses….

Discount rate to be used

39. The ED proposed that the discount rate to be used to discount the ECL on financial assets could be any reasonable rate that is between (and including) the risk-free rate and the effective interest rate (EIR). However, at the October 2013 meeting, the IASB tentatively decided to require that the ECL for financial assets should be discounted at the effective interest rate or at an approximation thereof.

40. When determining the discount rate used to reflect the time value of money for the measurement of ECL on loan commitments and financial guarantees, the ED required the use of a discount rate that reflects the current market assessment of the time value of money and the risks that are specific to the expected cash flows. The reason for this is provided in the Basis for Conclusions of the ED:

> BC134 Because loan commitments and financial guarantee contracts are unfunded, the effective interest method and, hence, an effective interest rate, are not applicable. Loan commitments and financial guarantee contracts are a commitment to lend in the future and a promise to reimburse credit loss respectively. Hence, those financial instruments by themselves (before they are drawn down) do not give rise to the notion of interest. Instead, the

> cash flow profile of loan commitments and financial guarantee contracts is akin to that of derivatives. The fact that interest revenue does not apply is reflected in the accounting for loan commitments and financial guarantee contracts within the scope of IFRS 9. For those loan commitments and financial guarantee contracts, revenue recognition of the related fee income does not use the effective interest method. Consequently, the IASB cannot simply extend the requirements for the discount rate for measuring expected credit losses that arise from financial assets to the requirements for the discount rate for measuring expected credit losses that arise from loan commitments and financial guarantee contracts.

41. As discussed in paragraph 27, most respondents commented that the drawn balance and the undrawn commitment components of a revolving credit facility are managed and the ECL are estimated on a facility level and not separately for each component. In other words, there is only **one set of cash flows** from the borrower that relates to both components. Respondents said that a disconnection between the discount rate used for the drawn balance and the undrawn commitment seems an unnecessary complication since the measurement of ECL for the undrawn commitment will change when it is drawn merely as a result of the difference in discount rate. This is further complicated by the way in which borrowers move freely between the drawn and undrawn components for revolving facilities.

42. For credit risk management purposes a single discount rate is usually applied to the facility as a whole and then an allocation is made for the ECL relating to the drawn and undrawn components of the facility. Because the undrawn commitment relates directly to the drawn balance, the EIR applied to the drawn balance already reflects an assessment of the time value of money (albeit a historic rather than current assessment) and the risks that are specific to the cash flows. It could therefore be considered to represent a reasonably approximation of the discount rate proposed in the ED for financial assets.

43. Respondents generally agreed with the proposed requirement to present the ECL related to the undrawn component as a liability rather than a loss allowance and noted that they can make an allocation of the ECL on the facility as a whole between the drawn and undrawn components although this will require additional cost to be incurred to reconfigure the existing credit risk management systems.

Staff recommendation

44. 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 to be consistent with the *Conceptual Framework* and to be the correct conceptual outcome. We therefore recommend confirming the proposed requirement that an entity should recognise a provision for ECL that result from loan commitments and financial guarantee contracts when there is a present contractual obligation to extend credit subject to the exception described below.

45. However, we believe that for revolving credit facilities, 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.

46. We also question whether relevant and useful information will be provided to users of financial statements about an entity's exposure to credit risk on this type of facility and the way in which an entity is managing them from a credit risk perspective if the ECL are calculated based on considering the contractual period.

47. We acknowledge that a period that extends beyond the contractual period is not consistent with the definition of a liability in the *Conceptual Framework.* However, the staff believe that there may, arguably, be a constructive obligation to extend credit beyond the contractual cancellation period if an entity does not have the practical ability to withdraw a facility from a customer whose credit risk has not increased up to the point of the drawdown.

48. Although an entity might exercise its right to cancel the undrawn component of a revolving credit facility if the borrower's credit risk is unchanged, there is no rational reason for the entity to exercise that option for some borrowers but not others if there has been no change in their credit standing. Consequently, the

question is whether that right to cancel the undrawn component is genuine (has substance) if the entity would have to cancel all undrawn facilities. Paragraph 3.102 of the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* states that:

> …terms that have no commercial substance should be disregarded. A term has no commercial substance if it has no discernible effect on the economics of the contract. Terms that have no commercial substance could include, for example:
>
> (i) terms that bind neither party; and
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> (ii) rights (including options) that the holder will not have the practical ability to exercise….

49. In the staff's view, the question is which future drawdowns are considered to arise from an existing contractual obligation and thus result in a recognisable liability, as opposed to those drawdowns which result from a future contract and thus do not result in a recognisable liability. An analogy can be made to catastrophe and equalisation provisions: IFRS 4 *Insurance Contracts* prohibits the recognition of a liability of provisions for possible future claims under contracts that are not in existence at the reporting date.

50. However, the staff consider the ECL estimated over the behavioural life of a revolving credit facility may provide more relevant and useful information about an entity's exposure to credit risk on revolving credit facilities to users of financial statements. We also note that the difference in the reported ECL for these facilities could be significantly lower if the exposure is restricted to the contractual period and is inconsistent with an economic assessment of that exposure.

51. If the IASB wish to reconsider the proposals taking into account the conceptual issues and the economic situation, and thus to look beyond the contractual life, the staff believe that the behavioural life should represent the period over which an entity is exposed to credit risk and that faithfully reflect the economics of the transaction. In determining the behavioural life for revolving credit facilities, an entity could consider factors such as:

(a) historic information and experience about the period in which the entity expects the facility to remain open;

(b) the behaviour patterns of the customers as well as the entity itself; or

(c) the period over which the balance is repaid.

52. However, we do not consider it would be appropriate to mandate how a behavioural assessment should be made. Rather, consistent with other aspects of the model, the staff believe that it is more appropriate to establish an objective as suggested in paragraph 51.

53. Independent from the above, we recommend that the IASB clarify that for revolving credit facilities, the rate used to discount the drawn balance, ie EIR or an approximation thereof, is a reasonable approximation of the discount rate for loan commitments and financial guarantees as proposed in the ED.

54. We are not recommending any changes to the presentation requirements for the allocation of ECL on revolving credit facilities. We therefore recommend confirming the proposed requirement to present the ECL on the undrawn component of a revolving credit facility as a provision in the statement of financial position.

Questions to the IASB

1. Does the IASB agree with the staff recommendation to confirm the proposals that an entity should recognise a provision for ECL, that result from loan commitments and financial guarantee contracts (other than revolving credit facilities), when there is a present contractual obligation to extend credit?

2. If the IASB wish to reconsider the proposed requirements to recognise a provision for ECL that result from revolving credit facilities where there is a present contractual obligation to extend credit, does the IASB agree that:

(a) the ECL should be estimated over its behavioural life; and

(b) the behavioural life should represent the period over which an entity is exposed to credit risk and that faithfully reflect the economics of the transaction. In determining the behavioural life for revolving credit facilities, an entity could consider factors such as:

- historic information and experience about the period in which the entity expects the facility to remain open;
- the behaviour patterns of the customers as well as the entity itself; or
- the period over which the balance is repaid;

3. Regardless of the response to Questions 2, does the IASB agree with the staff recommendation to:

(a) clarify that for revolving credit facilities the rate used to discount the drawn balance, ie the EIR or an approximation thereof, is a reasonable approximation of the discount rate for loan commitments and financial guarantees as proposed in the ED; and

(b) confirm the requirement to present the ECL on the undrawn commitment component of a revolving credit facility as a provision in the statement of financial position?