STAFF PAPER

22 April 2015

ITG meeting

Project	**Transition Resource Group for Impairment of Financial Instruments**
Paper topic	Assessment of significant increase in credit risk for guaranteed debt instruments

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Introduction

1. We have received a submission about whether an entity should consider the ability to recover cash flows from a financial guarantee contract held when assessing whether there has been a significant increase in credit risk of the guaranteed financial asset. The circumstances specified in the submission state that the financial guarantee contract is integral to the contractual terms of the guaranteed debt instrument.

2. This paper:

   (a) provides background information, referring to the relevant impairment requirements in IFRS 9 *Financial Instruments* (2014);

   (b) summarises the potential implementation issue and considers alternative views put forward by the submitter; and

   (c) asks the members of the Transition Resource Group for Impairment of Financial Instruments ('ITG') for their views on the issue identified.

Background and accounting requirements

3. Appendix A of IFRS 9 defines a financial guarantee contract 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.

4. From the perspective of a holder of a financial guarantee contract, the financial guarantee contract is not within the scope of IFRS 9 (see paragraph 2.1(e) of IFRS 9).

5. Paragraph 5.5.9 of IFRS 9 states that:

> At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition. [emphasis added]

6. However, when *measuring* expected credit losses in respect of the guaranteed debt instruments, the definition of credit loss in Appendix A of IFRS 9 requires that 'the cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms'. Further guidance is given in paragraph B5.5.55 of IFRS 9, which states that:

> For the purposes of measuring expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral *and other credit enhancements that are part of the contractual terms and*

> *are not recognised separately by the entity***.** [emphasis added]

Determining significant increases in credit risk

7. As noted in paragraph 5.5.4 of IFRS 9, the objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition considering all reasonable and supportable information, including that which is forward looking. Accordingly, paragraph 5.5.9 of IFRS 9 requires an entity to assess, at each reporting date, whether the credit risk on a financial instrument has increased significantly since initial recognition.

8. As noted above, paragraph 5.5.9 explains that to make this assessment, an entity must assess the change in the risk of a default occurring.

9. IFRS 9 does not define default. Instead, paragraph B5.5.37 of IFRS 9 requires an entity to define default consistently with the definition used for internal credit risk management purposes for the relevant financial instrument and to consider qualitative indicators (for example, financial covenants) when appropriate.

10. IFRS 9 requires that the risk of default is considered to assess the change in credit risk of a financial instrument. In contrast, collateral is taken into account when measuring expected credit losses. In addition to paragraph 5.5.9, this distinction is also reflected in other relevant requirements in the Standard reproduced below:

> …An approach that does not include an explicit probability of default as an input per se, … ,can be consistent with the requirements in this Standard, provided that an entity is able to separate the changes in the risk of a default occurring from changes in other drivers of expected credit losses, such as collateral ... (paragraph B5.5.12 of IFRS 9)
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> The following non-exhaustive list of information may be relevant in assessing changes in credit risk:
>
> (j) significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, *which are expected to reduce the borrower's economic incentive to make*

> *scheduled contractual payments or to otherwise have an effect on the probability of a default occurring*. For example, if the value of collateral declines because house prices decline, borrowers in some jursidictions have a greater incentive to default on their mortgages.
>
> (l) significant changes, such as reductions in financial support from a parent entity or other affiliate or *an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments.* Credit quality enhancements or support include the consideration of the financial condition of the guarantor…(emphasis added) (paragraph B5.5.17)
>
> …Financial instruments are not considered to have low credit risk when they are regarded as having a low risk of loss simply because of the value of collateral and the financial instrument without that collateral would not be considered low credit risk. (paragraph B5.5.22 of IFRS 9)

This distinction is also reflected in illustrative examples to IFRS 9:

> ..Bank Z therefore needs to assess whether there has been a significant increase in credit risk since initial recognition…,irrespective of the value of the collateral it holds. (Example 3 in paragraph IE22 of IFRS 9)

The issue

11. The issue relates to guaranteed debt instruments with financial guarantee contracts that are integral to the contractual terms of the debt instrument. An example of such an instrument is a credit wrapped instrument.

12. The submitter notes that in such circumstances, the definition of credit loss in Appendix A and paragraph B5.5.55 of IFRS 9 require that measurement of the expected credit losses of the guaranteed debt instrument includes cash flows from the integral financial

guarantee contract. However, the submitter asks whether an entity should consider the ability to recover cash flows through the integral financial guarantee contract when assessing whether there has been a *significant increase in the credit risk* of the guaranteed debt instrument.

13. The submitter notes that if the financial guarantee contract is taken into account, and, for example, there has been a significant increase in the risk of the debtor defaulting, if the credit quality of the guarantor were considered, the entity may still assess that there has not been a significant increase in the credit risk of the financial instrument. This may be because the terms of the guarantee provide for prompt recovery from the guarantor in the case of non-payment by the debtor and there is no significant increase in the risk of the guarantor failing to pay under the guarantee.

Analysis

14. Paragraph 5.5.9 of IFRS 9 requires that credit risk be assessed by considering the change in the risk of a default occurring since initial recognition. Paragraphs B5.5.12, and B5.5.22 of IFRS 9 show that collateral is not taken into account when assessing credit risk. Example 3 of IFRS 9, about a highly collateralised financial asset, also states that the ability to reduce cash shortfalls through the enforcement of collateral does *not* reduce the risk of default occurring on the financial instrument. Furthermore, IFRS 9 often refers to collateral and other credit enhancements together. We note that excluding recoveries from integral financial guarantee contracts when assessing significant increases in credit risk would be consistent with the treatment of collateral.

15. Furthermore, paragraphs B5.5.17 of IFRS 9 refers to 'increased amounts of collateral or guarantees' and 'significant changes in the value of collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements' as information that may be relevant in assessing changes in credit risk. However, we note that that these requirement is included *to the extent that these factors influence the risk of the borrower defaulting* and do not indicate that the risk of default can be considered to be reduced by the ability to recover under the collateral or guarantee arrangements.

Question for the members of the ITG
What are your views on the issue presented above?