STAFF PAPER

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ITG meeting

Project	**Transition Resource Group for Impairment of Financial Instruments**
Paper topic	Measurement of expected credit losses for an issued financial guarantee contract

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Introduction

1. We have received a submission asking how an entity should measure expected credit losses of a financial guarantee contract that it has issued, in circumstances in which premiums are receivable from the holder of the financial guarantee contract over the life of the contract.

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

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

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. Paragraph 2.1(e) of IFRS 9 clarifies that an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract is within the scope of IFRS 9. However, if an issuer of financial guarantee contracts has previously explicitly asserted that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either IFRS 9 or IFRS 4 *Insurance Contracts* to such financial guarantee contracts.

5. Paragraphs 5.5.17–5.5.18 of IFRS 9 require that the measurement of expected credit losses should reflect an unbiased and probability-weighted amount that is determined by evaluating a range of outcomes. An entity need not necessarily identify every possible scenario, but it should consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.

6. Paragraph B5.5.28 of IFRS 9 further explains how to measure expected credit losses. It states that expected credit losses are a probability-weighted estimate of credit losses (ie the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive.

7. Paragraph B5.5.32 of IFRS 9 provides specific requirements for determining the 'cash shortfalls' when measuring the expected credit losses for financial guarantee contracts issued by an entity:

> For a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is 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.* If the asset

> is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee. [emphasis added]

8. Paragraph 4.2.1(c) of IFRS 9 requires that after the initial recognition of an issued financial guarantee contract at its fair value, the issuer shall subsequently measure the financial guarantee contract at the higher of:

   (a) the amount of the provision for expected credit losses; and

   (b) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers*.

The issue

9. The issue relates to financial guarantee contracts that are issued by an entity, under which the entity receives regular premiums from the holder of the guarantee over the life of the guarantee.

10. The question asked is whether the measurement of expected credit losses for financial guarantee contracts issued should consider future premium receipts due from the holder and, if so, how?

Review of the requirements in the Standard

11. Some argue that the requirements in paragraph B5.5.32 of IFRS 9 (see paragraph 7) is unclear as to whether future premium receipts should be included in the measurement of expected credit losses for financial guarantee contracts issued by an entity.

12. On the one hand, some argue that future premium receipts should be ignored because the phrase ‘any amounts that the entity expects to receive from the holder, debtor or any other party’ should be read in the context of its relationship to ‘the expected payments to reimburse the holder for a credit loss that it incurs’. They

argue that the ‘amounts’ to consider relate only to recoveries or reimbursements of claims for losses and do not include receipts of premiums.

13. Others think, however, that the wording any amounts that the entity expects to receive from the holder, the debtor or any other party refers to all such amounts, including future premium receipts from the holder.

14. As noted in paragraph 7, paragraph B5.5.32 of IFRS 9 states that the estimation of cash shortfalls for a financial guarantee contract should be consistent with the estimates of cash shortfalls for the asset subject to the guarantee. This could be read as implying that future premium receipts should be ignored because they are not included in the measurement of the cash shortfalls of the asset subject to the guarantee. However, ‘consistent’ does not mean identical cash shortfalls. It is possible for the estimate of cash shortfalls for a financial guarantee contract to be consistent with that for the guaranteed asset, while still taking into account other factors, such as premium receipts and other terms of the guarantee that may give rise to differences between the two estimates (for example, when settlement under a guarantee is deferred or if the guarantee is for less than the full amount or term of the guaranteed asset).

Interaction with subsequent measurement requirements for issued financial guarantee contracts

15. As noted in paragraph 8, paragraph 4.2.1(c) of IFRS 9 requires that financial guarantee contracts issued are measured at the higher of the amount of the provision for expected credit losses and the amount initially recognised under IFRS 9 less the cumulative amount of income recognised.

16. As noted in paragraph 5, expected credit losses are a probability-weighted estimate of cash shortfalls for future possible scenarios in which defaults occur.

17. It has been suggested that when measuring the provision for expected credit losses for such financial guarantee contracts, the future premium receipts are included in the probability-weighted cash shortfalls. That is, for each future possible scenario being considered, an entity estimates the *net* cash shortfalls. The net cash shortfalls for each scenario comprise of the net present value of:

(a) the expected cash outflows to reimburse the holder for the expected loss it incurs on the guaranteed asset; less

(b) expected future premium receipts.

18. However, if the expected future premium receipts exceed the expected cash outflows for a particular scenario, the amount of net cash shortfall included in the probability-weighted estimate of cash shortfalls for future possible scenarios is zero for that scenario. This is because there is no expected credit loss under that scenario.

19. However, such an approach does not reflect the fact that cash outflows under the guarantee depend upon the risk of default of the guaranteed financial asset, whereas the premiums to be received are subject to the risk of default by the holder of the guarantee.

20. Consequently, the expected credit losses for the cash outflows under the guarantee should be considered separately from the expected credit losses in respect of the future premiums receivable (the ‘gross’ approach). Under this approach, the provision for expected credit losses in respect of the expected cash outflows payable under the guarantee (less any reimbursements for those outflows) excludes future premium receipts.

21. We note that this approach results in the consistent measurement of expected credit losses for financial guarantee contracts irrespective of whether or not premiums are receivable over the life of the contract or as a single premium at the inception of the contract.

Question for the members of the ITG

What are your views on the issue presented above?