STAFF PAPER

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Project	**Transition Resource Group for Impairment of Financial Instruments**
Paper topic	Inclusion of cash flows expected from the sale on default of a loan in the measurement of expected credit losses

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Introduction

1. We have received a submission about the inclusion of cash inflows expected to be recovered through the sale of a financial asset after it is in default in the measurement of expected credit losses.

2. This paper:

   (a) sets out the relevant accounting requirements in IFRS 9 *Financial Instruments* (2014) and IFRS 7 *Financial Instruments: Disclosures*;

   (b) summarises the potential implementation issue raised by the submitter; and

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

Accounting requirements

3. Paragraph B5.5.28 of IFRS 9 explains 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:

(a) the cash flows that are due to an entity in accordance with the contract; and

(b) the cash flows that the entity expects to receive.

4. This is consistent with the definition of credit loss in Appendix A of IFRS 9:

> The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. 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. ...

5. Paragraph 35B of IFRS 7 describes the objectives of credit risk disclosures. More specifically, paragraph 35B(b) of IFRS 7 notes that credit risk disclosures shall provide qualitative and quantitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes. In addition, paragraph 35G(a)(i) of IFRS 7 specifically requires:

> An entity shall explain the inputs, assumptions and estimation techniques used to apply the requirements in Section 5.5 of IFRS 9. For this purpose an entity shall disclose:
>
> (a) the basis of inputs and assumptions and the estimation techniques used to:

(i) measure the12-month and lifetime expected credit losses;

…

Potential implementation issue identified

6. The submitter asks whether cash flows that are expected to be recovered through the sale of the loan to a third party on a default can be included in the measurement of expected credit losses.

7. The submitter notes that when measuring expected credit losses an entity estimates the amount and timing of the cash flows it expects to receive in a default scenario.

8. The submitter provides the following background information:

> In practice, the amounts due on a defaulted loan can be recovered in a variety of ways. For example, the amounts due can be recovered:
>
> - using the entity's internal collections personnel to recover cash directly from the borrower;
> - using an external collections agency who, for a fee, recovers cash directly from the borrower and passes this to the lender;
> - through seizing and selling any collateral (using the entity's own employees or using external agents)
> - through selling the asset to a third party (e.g. a specialist buyer of distressed debt).
>
> For some entities, a number of the above recovery methods may be used. For example, an entity may initially use its internal collections for loan assets that have missed up to six monthly payments. If amounts remain outstanding after six months of recovery action, the entity uses an external collections agency to continue recovery action for a further six months. If amounts remain outstanding after this period the entity sells the asset to a third party that specialises in buying distressed loans. The entity determines that selling the loan to a third party at this stage maximises its overall recovery of cash flows because the third party buyer is a specialist in recovering cash flows. Given this sequence of

recovery actions, if the entity were to assess the cash shortfall for a portfolio of assets it would estimate that a proportion of the cash flows recovered would arise from the sale of defaulted loans. This leads to the question of whether the sale of the loan itself can be considered an expected cash flow when measuring expected credit losses.

This question is relevant because the projected loan sale price, discounted by the effective interest rate from the point of the loan sale to the reporting date, can be significantly different from the cash flows the entity would otherwise expect to recover directly from the borrower discounted by the effective discount rate to the measurement date. Differences can arise due to:

- different expected cash flows used in calculating the loan sale price. For example, the debt recovery specialist may expect to recover higher cash flows than the lender could expect to recover.
- the discount rate used in calculating the loan sale price being different to the effective interest rate.

In some cases, it is specified in the contractual terms of the loan that the loan may be sold by the lender to a third party with no further consent required from the borrower.

9. The submitter considers two different scenarios:

   (a) Scenario 1: there is no contractual term that allows the lender to sell the financial asset to a third party; and

   (b) Scenario 2: there is a contractual term that allows the lender to sell the financial asset to a third party with no further consent required from the borrower.

10. For each scenario the submitter puts forward two views:

   (a) View 1: cash flows from the expected sale on the default of a loan asset *cannot* be included in the measurement of expected credit losses;

   (b) View 2: cash flows from the expected sale of the default of a loan asset *can* be included the measurement of expected credit losses.

Scenario 1: no contractual right to sell the financial asset

11. In support of View 1, the submitter refers to the definition of credit loss in IFRS 9 (reproduced in paragraph 4). This definition requires that:

> … An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. 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. …

12. The submitter notes that from this definition, in their view, it can be argued that the cash flows from the expected sale of the loan asset should not be included in the estimate of cash flows because the cash flows from the sale do not arise from a contractual term of the instrument. The cash flows from the sale of the financial asset arises from selling the right to contractual cash flows to a third party, not from enforcing the rights to receive cash flows from the borrower.

13. On the other hand, in support of View 2, the submitter argues that not including forecast cash flows from loan sales in the estimate of expected cash flows would be inconsistent with the amortised cost measurement basis that reflects a hold-to–collect business model. This is because the Standard envisages that sales due to an increase in the asset's credit risk are not inconsistent with a hold-to-collect business model. Paragraph B4.1.3A of IFRS 9 states that:

> The business model may be to hold assets to collect contractual cash flows *even if the entity sells financial assets when there is an increase in the assets' credit risk.* To determine whether there has been an increase in the assets' credit risk, the entity considers reasonable and supportable information, including forward-looking information. *Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a business model whose objective is to hold financial assets to collect contractual cash flows because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. Credit risk management activities that are aimed at minimising potential credit losses due to credit deterioration are integral to such a business model.* Selling a financial asset

> because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity may demonstrate in other ways that the sale occurred due to an increase in credit risk. [emphasis added]

14. The submitter notes that expected sales from defaulted loans are part of the credit risk management activities that are aimed at minimising potential credit losses due to credit deterioration.

Scenario 2: contractual right to sell the financial asset

15. Similar to the arguments for View 1 in Scenario 1, a supporting argument for View 1 is that the cash flows from the expected sale of the financial asset in the case of a default should not be included in the measurement of expected credit losses, because the cash flows do not arise from a cash flow from the borrower under the contractual terms of the instrument. Under this view, the right to sell the financial asset to a third party in the contractual terms is seen as representing a pre-agreed right to transfer the asset to a third party, instead of a contractual right to cash flows.

16. Similarly, the arguments in support of View 2 are the same as those for View 2 in Scenario 1 in paragraphs 13–14. In addition, the submitter notes that further support for View 2 is provided by the fact that cash flows from the sale of the financial asset to third parties is already contemplated in the contract.

Review of accounting requirements

17. As noted in paragraphs 3 and 4, expected credit losses are a probability-weighted estimate of credit losses, which are the present value of the cash shortfalls, being the difference between:

    (a) the contractual cash flows that are due to the entity; and

    (b) the cash flows that the entity expects to receive.

18. The key issue that arises therefore is whether the cash flows that the entity expects to receive in paragraph 17(b) are restricted to the cash flows from the borrower under the contractual terms or whether it can include cash flows from expected sales of the financial asset.

19. The requirement reproduced in paragraph 17(a) refers to the *contractual* cash flows *that are due to the entity*. The requirement in paragraph 17(b) refers to the cash flows that the entity expects to receive and, in accordance with the definition of a credit loss (see paragraph 4), 'an entity shall estimate cash flows by *considering all contractual terms* of the financial instrument' (emphasis added). We note that the definition of credit losses does not explicitly require expected cash flows to be derived solely from the contractual terms or solely from the borrower. Instead, it only requires an entity to *consider* all the contractual terms when determining the expected cash flows.

20. Paragraph 5.5.17(a) of IFRS 9 requires that when measuring expected credit losses an entity evaluates a range of possible outcomes. In considering possible scenarios in which recovery is not made in full from the borrower, consideration is given to other relevant sources of recovery such as recovering from collateral. As part of this evaluation, we note that a possible scenario in which a credit loss occurs could be that an entity expects to recover its cash flows, in the event that it is unable to recover directly from the borrower, through the sale of the financial asset. Such a sale may be expected to occur when an asset is in default, as highlighted by the submitter. Thus cash flows beyond those collected directly from the borrower may be considered when relevant to the recovery of cash flows in a credit loss scenario.

21. However, to be included in the measurement of expected credit losses, cash flows from sales of financial assets must be 'cash flows that the entity *expects* to receive'. If the entity *does not have an intention, or the ability*, to sell the financial instruments (or otherwise transfer the cash flows to achieve derecognition), then the resulting cash flows must not be included in the measurement of expected credit losses. For example, if the entity does not have the contractual right to sell (or otherwise transfer) the financial asset, even in a

recovery scenario, then such proceeds could not be included in the calculation of expected credit losses.

22. Accordingly, including estimated cash flows from expected sales of financial assets that are part of an entity's recovery processes, when considering possible credit loss scenarios in the measurement of expected credit losses, would be consistent with the definition of credit loss.

23. It is further noted that expected credit losses in IFRS 9 are based upon considering the collection of contractual cash flows—accordingly, the proceeds of the sale of the asset are only relevant in considering recovery scenarios. For example, in considering a 'non default' scenario, the cash flows from selling the asset cannot be considered as the cash flows collected in order to determine the expected credit losses.

24. It is also noted that the business model assessment in IFRS 9 (along with the assessment of contractual cash flows) determines how financial assets are measured and thus whether the asset is subject to the impairment requirements of IFRS 9. Although it is noted that the sale of assets due to credit deterioration is consistent with a hold-to-collect business model, it does not mean that it should be *assumed* that the sale of assets will occur within such a business model (or in the hold-to-collect-and-sell business model for financial assets measured at fair value through other comprehensive income). Cash flows from the sale of assets should only be considered in the determination of expected credit losses in the manner described in paragraphs 20-23, when they are actually expected in the context of considering scenarios in which a credit loss occurs.

25. Finally we note that to meet the objectives of the disclosure requirements outlined in paragraph 5, an entity should disclose the basis of inputs and assumptions and the estimation techniques used to measure expected credit losses.

Question for ITG members
What are your views on the issue discussed in this paper?