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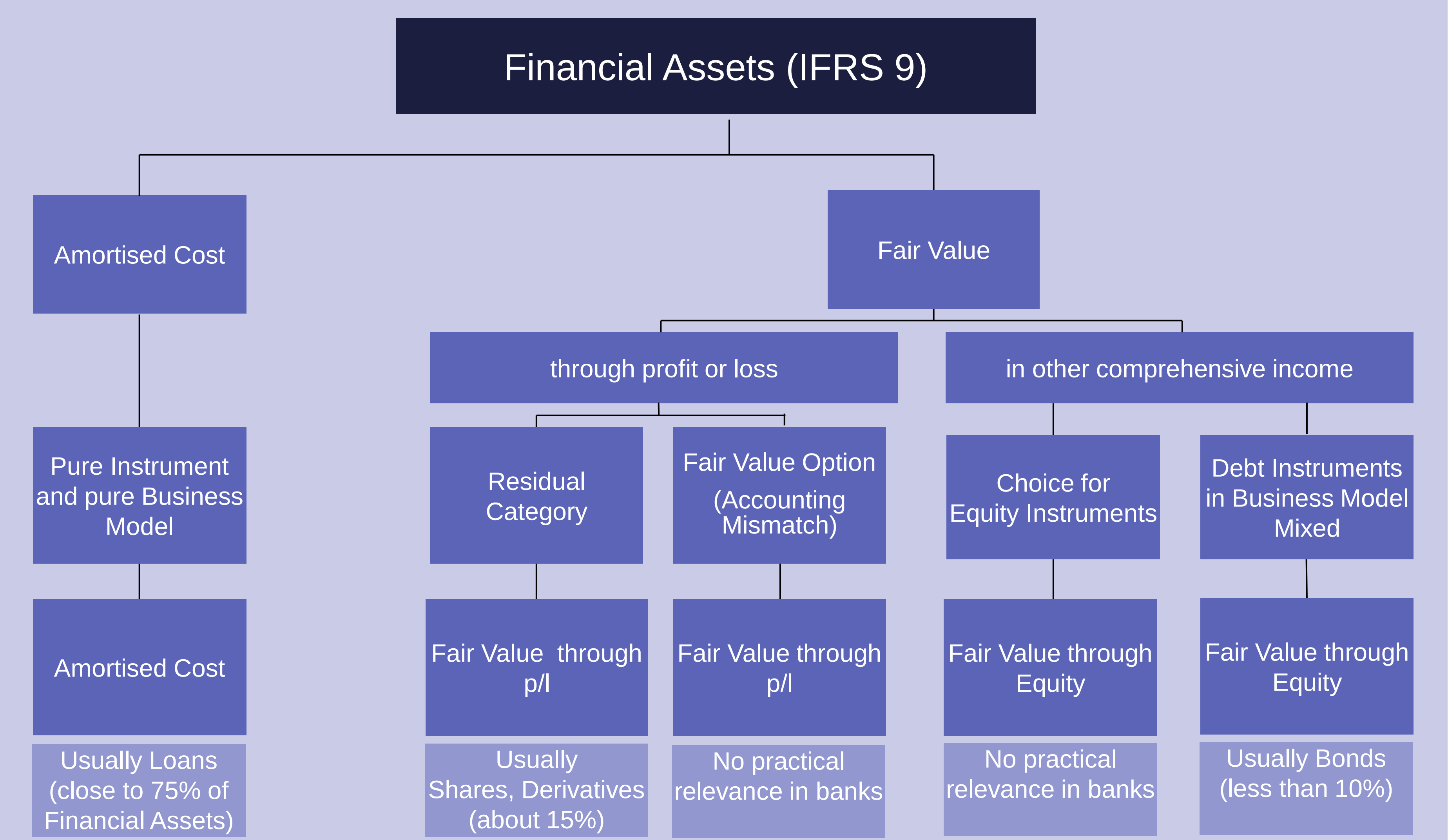
Default Risk Protection and Accounting Treatment of Financial Guarantees under IFRS

Prof. Dr. Edgar Löw

AGENDA

Preface – Financial Instruments under IFRS
(Recognition and Measurement)


Financial Assets (IFRS 9)
Amortised Cost
Fair Value
through profit or loss
in other comprehensive income
Pure Instrument and pure Business Model
Residual Category
Fair Value Option (Accounting Mismatch)
Choice for Equity Instruments
Debt Instruments in Business Model Mixed
Amortised Cost
Fair Value through p/l
Fair Value through p/l
Fair Value through Equity
Fair Value through Equity
Usually Loans (close to 75% of Financial Assets)
Usually Shares, Derivatives (about 15%)
No practical relevance in banks
No practical relevance in banks
Usually Bonds (less than 10%)

Debt Instruments – Loans and Bonds

Cash Flows Contractual terms of the asset give rise on specified dates to cash flows that are solely payments of principal and interest	**Business Model** Objective of the business model is to hold the financial asset to collect contractual cash flows	Amortised Cost	In practice Loans	Loan loss provision via Stages
Cash Flows Contractual terms of the asset give rise on specified dates to cash flows that are solely payments of principal and interest	**Business Model** Neither Held to collect nor Trading (Mixed Business Model like Treasury activity)	Fair Value through Equity	In practice Bonds	Loan loss provision via Stages

Qualification criteria for derivatives according to IFRS 9

Value marked to changes in a specific underlying*

Settlement at a future date

Insignificant or substantially reduced initial net investment compared with underlying

Measurement – At Fair Value through p/l (technical exception – Cash Flow Hedge

*Examples of underlyings in IFRS 9, Appendix A – interest rates, financial instrument prices, commodity prices, foreign exchange rates, indices of prices or rates, credit ratings or credit indices, or similar variables

AGENDA

Guarantees and impairments under IFRS

First Case

Government acts as direct protection providor

Bank receives direct protection via government

Question 1

Recognition

on

Balance

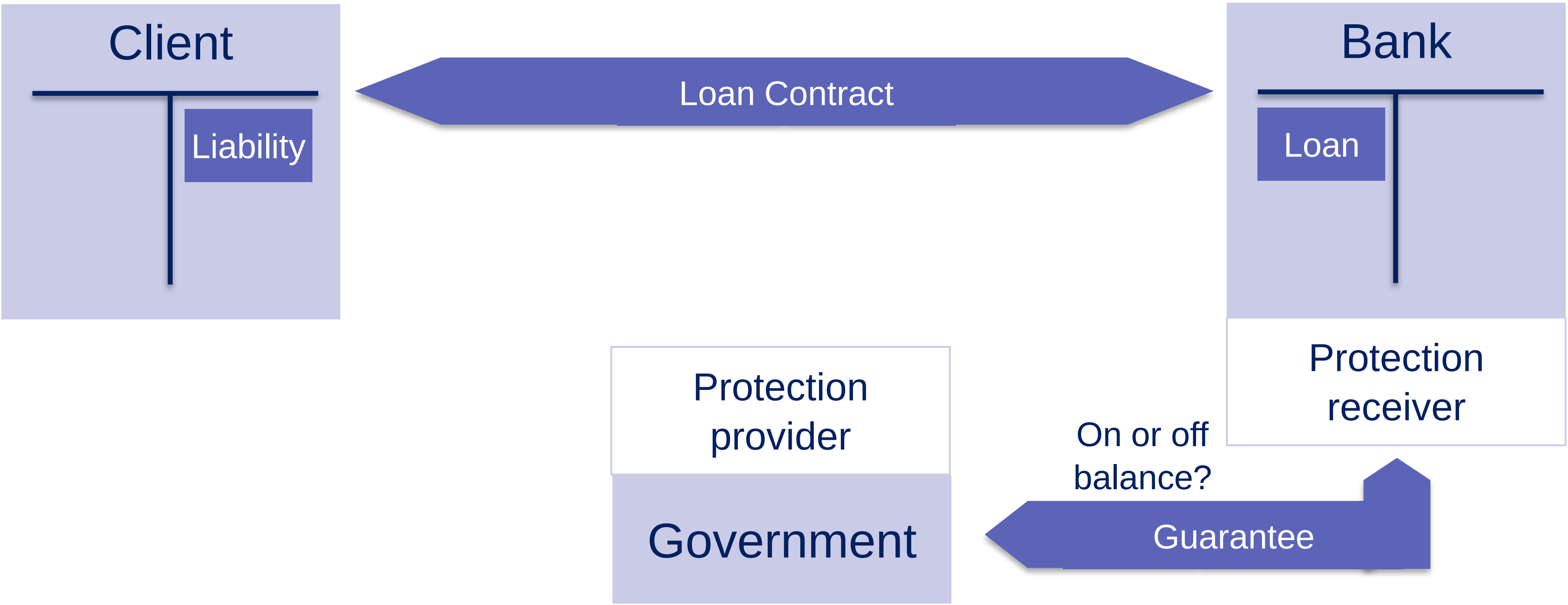
versus

Disclosure

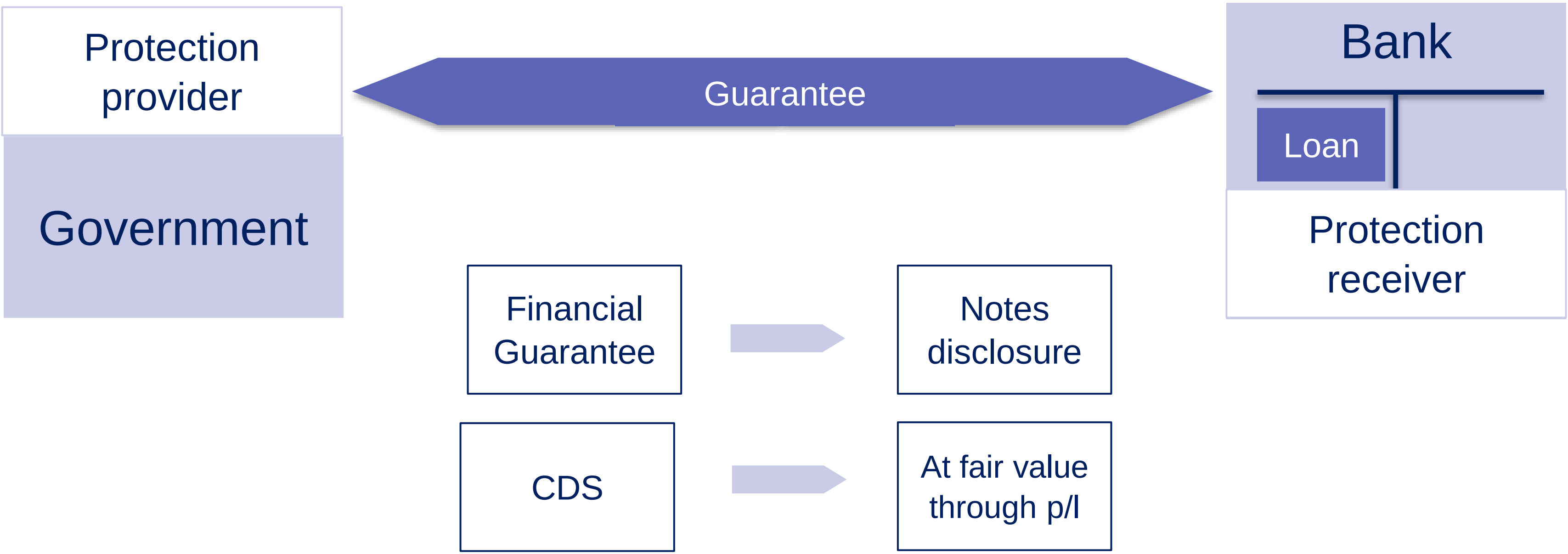
in the

Notes

Protection provider – protection receiver



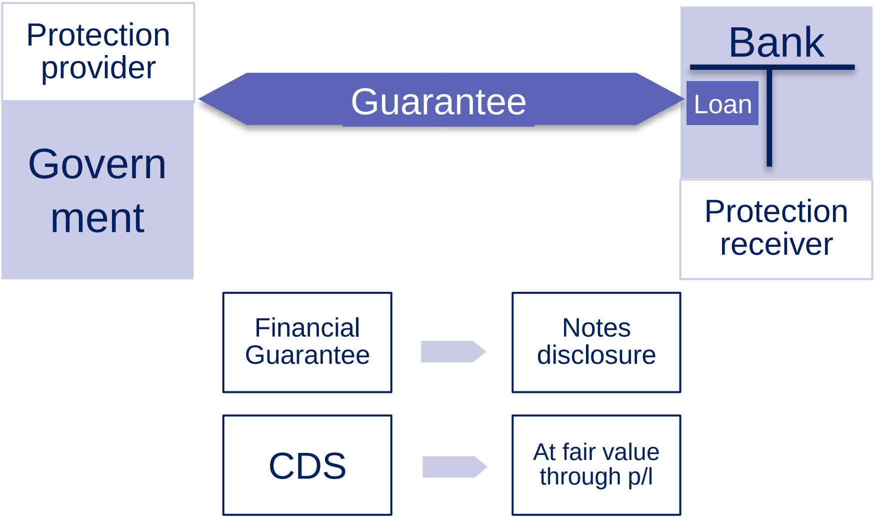
Protection provider – protection receiver



Protection provider – protection receiver

Financial guarantee contracts

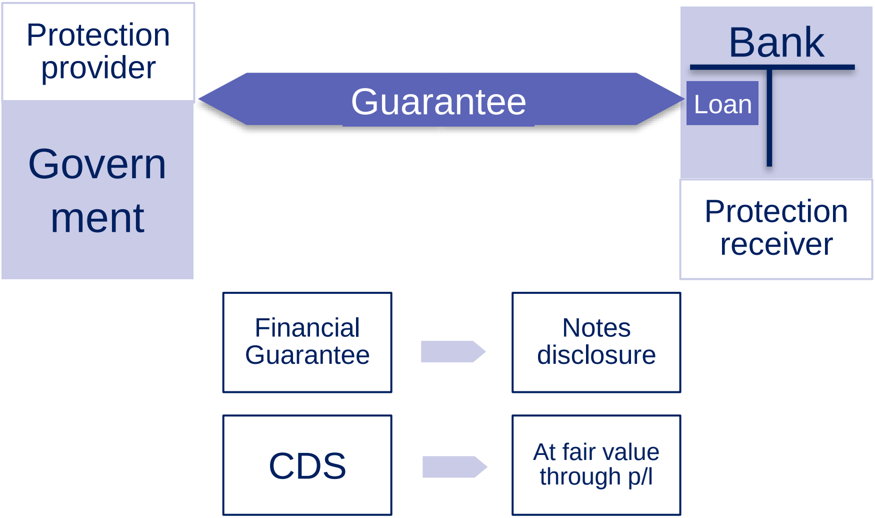
- Contract that
  - requires the issuer to make specified payments to reimburse the holder
  - for a loss it incurs
  - because a specified debtor *fails to make payment* when due
  - in accordance with the original or modified terms of a debt instrument
- Notes disclosure only (no p/l effect) (assumption for simplification – no fees)



Protection provider – protection receiver

Differences to credit derivatives (CDS)

- Derivative – payments do *not* require that the holder is exposed to, and has incurred a loss on the failure of the debtor to make payments on the guaranteed asset when due
- Derivatives in accordance with IFRS 9
- Measurement at fair value through p/l
- Example – credit default swap, requiring payments in response to changes in a specified credit rating or credit index



Second Case

Government uses own promotional or guarantee bank

Bank passes through loans provided by promotional bank to their clients

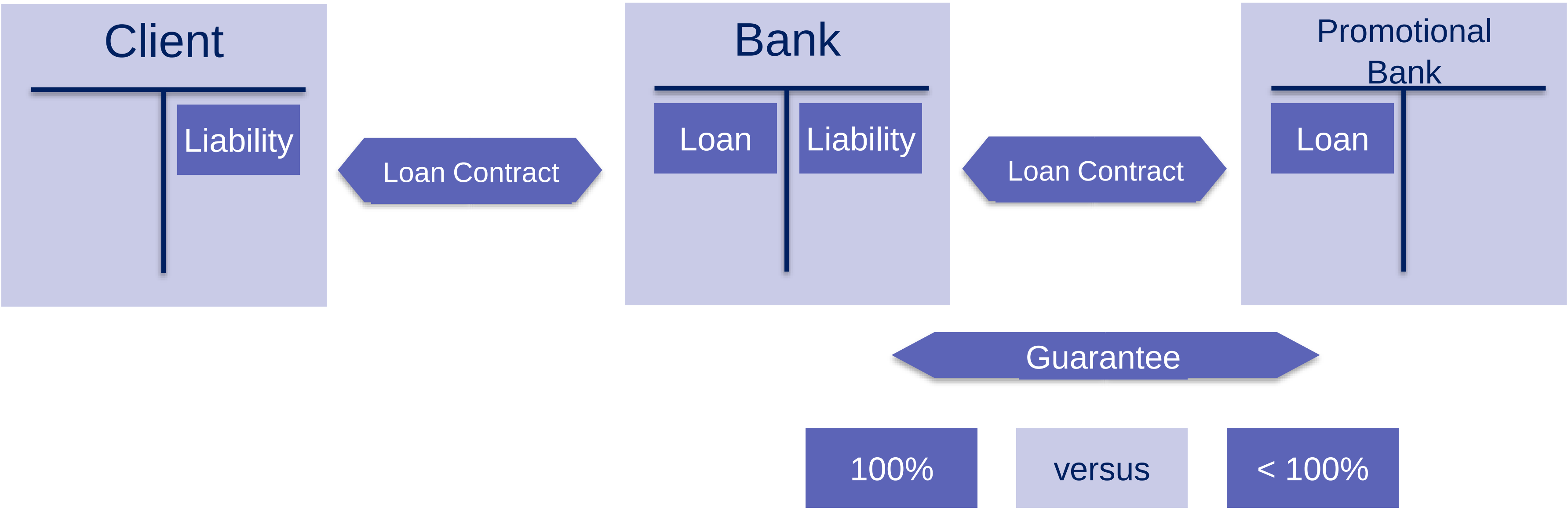
Question 2

Protection against default
100%
(economically no credit risk)

versus

Protection against default
< 100%
(still default risk)

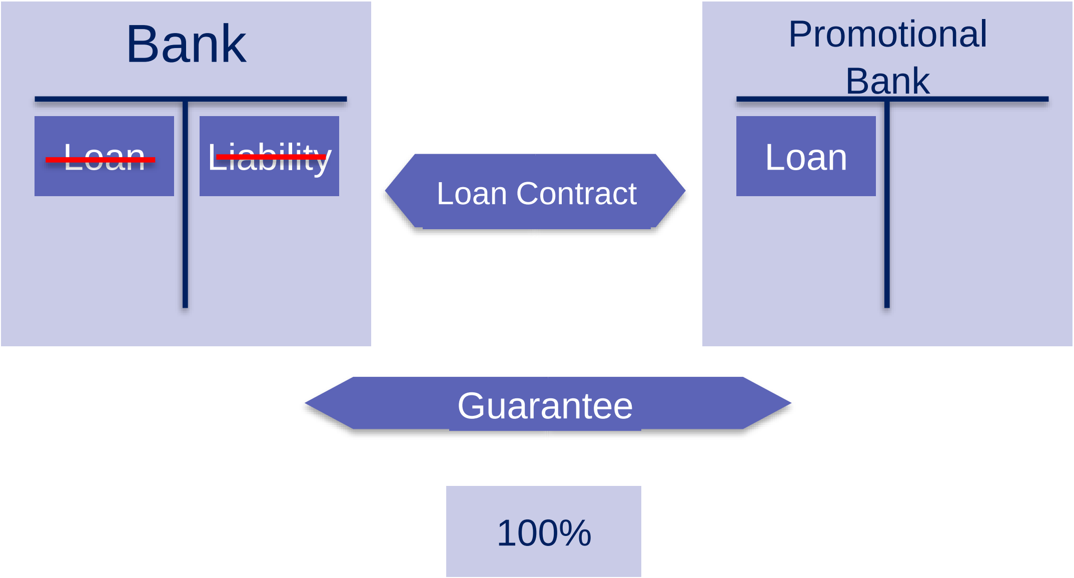
Loan contracts indirectly guaranteed via promotional bank



Loan contracts indirectly guaranteed via promotional bank

Guarantee – 100%

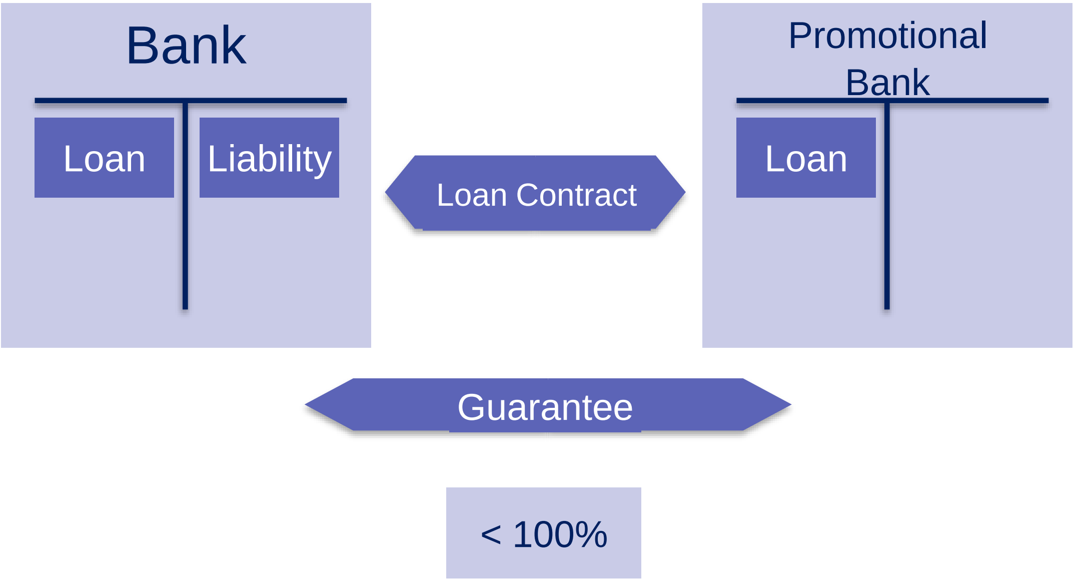
- Loan between Bank and Client maybe not a financial instrument (acting like a trustee with no own assets and no own liabilities)
- Transfer of almost all risks and rewards (to Promotional Bank)
  - Recognition and derecognition at the same moment in time
- Bank – no loan on balance



Loan contracts indirectly guaranteed via promotional bank

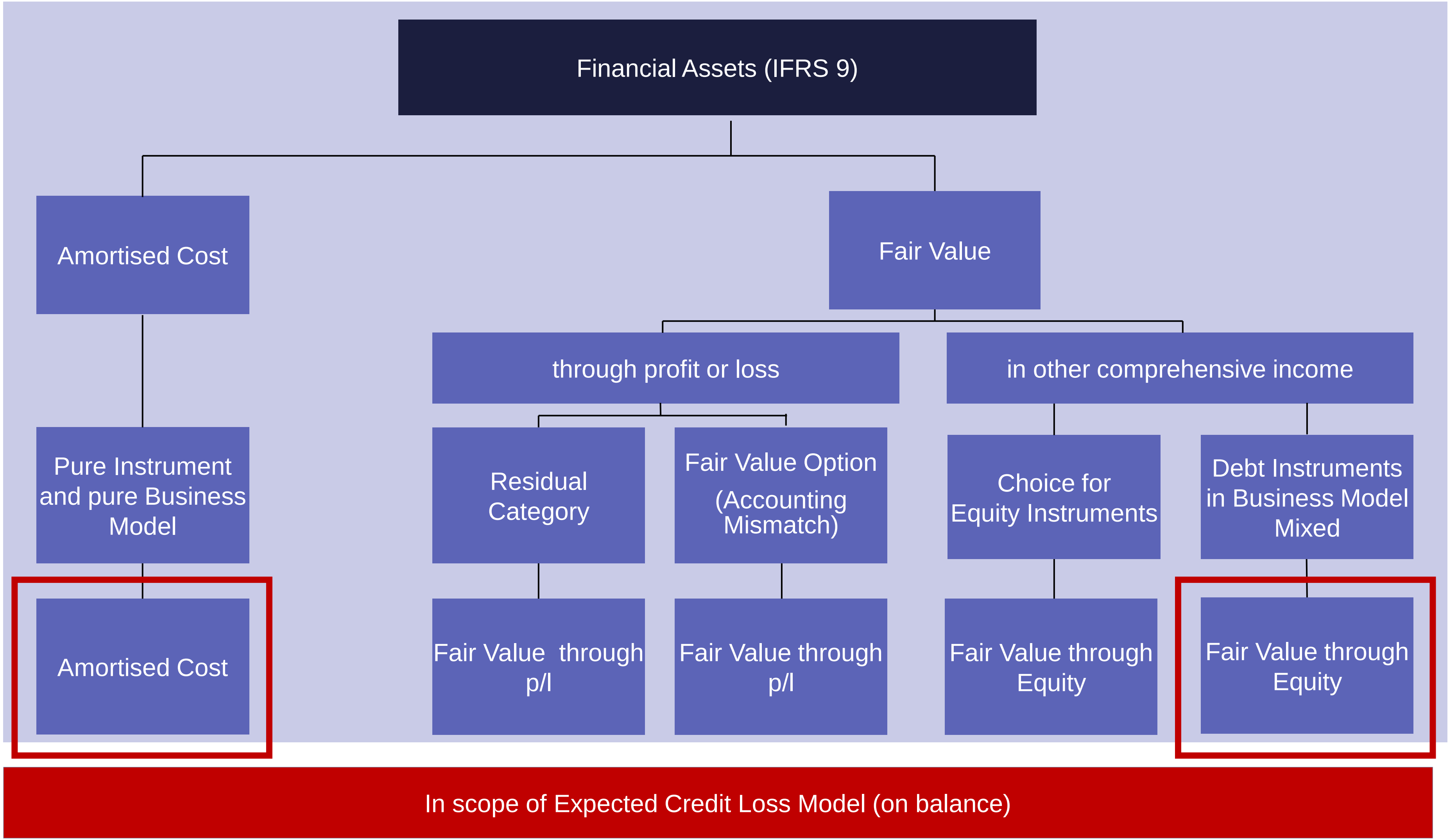
Guarantee – less 100%

- Loan between Bank and Client a financial instrument
- Recognition (on balance)
- Measurement – typically at amortised cost
- Impairment rules to be applied (Stage 1, Stage 2, Stage 3)



Third Case

Impairment on loans and application for financial guarantees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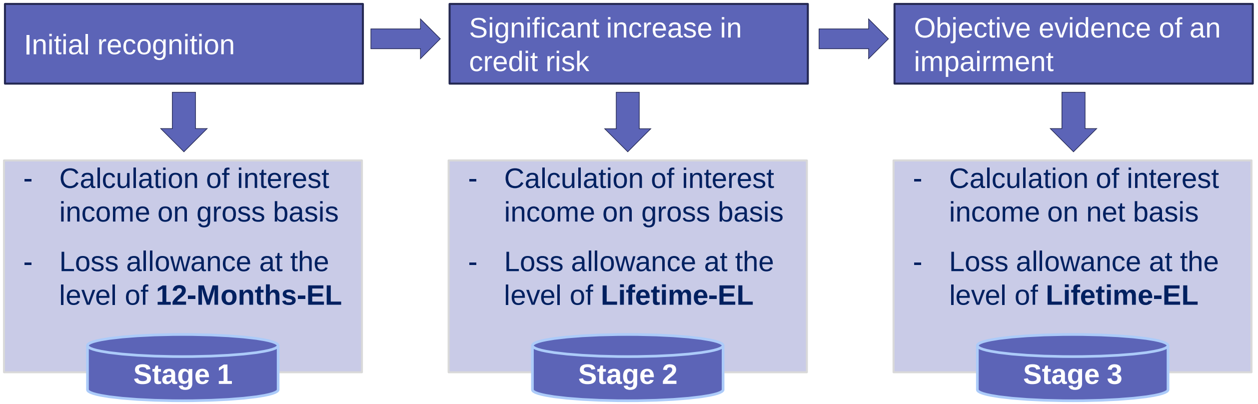
Fair Value through Equity
In scope of Expected Credit Loss Model (on balance)

Credit deterioration model

- Credit deterioration model – based on a *stage concept* in which each financial instrument to be assigned to one of three stages
- Assignment to stages depends on credit risk at reporting date
- Basically financial instruments that are not credit-impaired at initial recognition to be assigned to stage 1
  - Transfer to stage 2 if credit risk increases significantly (no impairment event)
  - Transfer to stage 3 if objective evidence of an impairment



Stage 1

12-month expected credit losses (IFRS 9.5.5.17(b))

- Proxy for adjusting interest rate for initial expected credit losses
- Expected shortfall in *all* contractual cash flows given probability of default occurring in next 12 months
- Not meaning
  - Expected cash shortfalls in the next 12 months
  - Credit losses on assets expected to default in next 12 months

Stage 2

Assessment of (significant) deterioration in credit quality – to be included (IFRS 9.5.5.17(a))

- Change in probability of default occurring compared with initial recognition
- Not change in expected losses (to be included in the estimation of future cash flows)
- Particular measurement methods not prescribed (nor is it necessary to explicitly include PD as input)
- Maturity to be included

Stage 3

Credit impaired financial asset (Appendix A, defined terms) – objective evidence after occurance of one or more of the following events

- Significant financial difficulty of the issuer or the borrower
- Breach of contract (default or past due event)
- Concessions of the lender due to financial difficutlies of the issuer or borrower
- Probability of bankruptcy or other financial reorganisation
- Disappearance of an active market for the asset (due to financial difficulties)
- Purchase or origination of a financial asset at a deep discount

Question 3

Debt Instruments and Impairment under IFRS 9 (protection buyer)

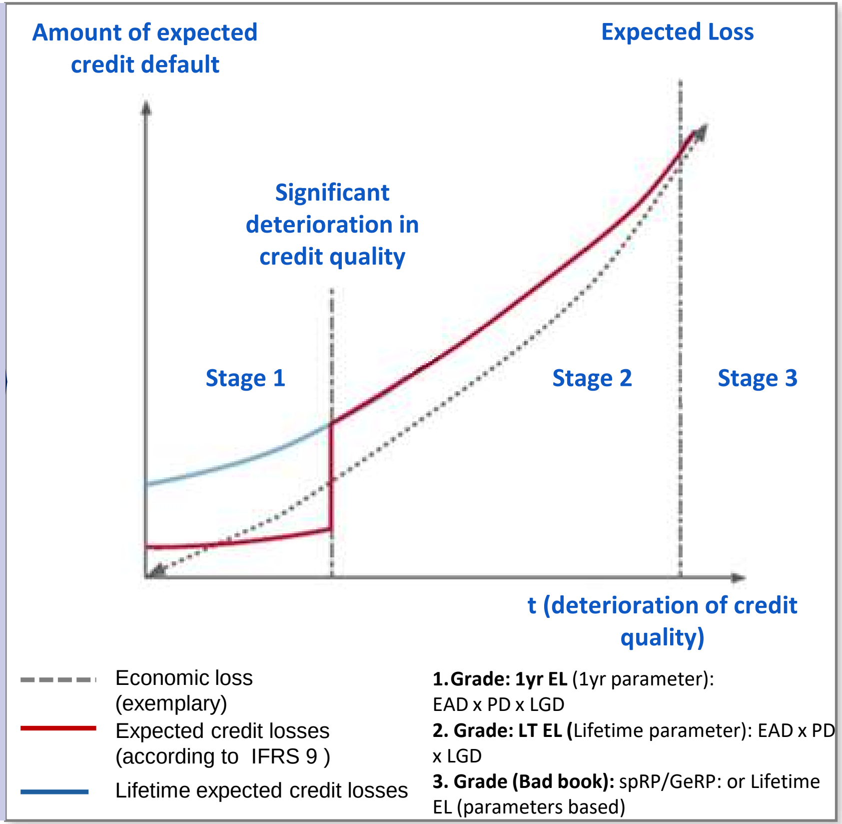
Comparison

Guarantee and Impairment under IFRS 9 (protection seller)

Significant deterioation in credit quality (stage 1 to stage 2)

Assessment of (significant) deterioration in credit quality – to be included by protection buyer (IFRS 9.5.5.17(a))

- Change in probability of default occurring compared with initial recognition
- No change in expected losses
  - Guarantee to be included in the calculation of the Loss given Default (LGD) only
- Possible outcome – although guarantee
  - Stage transfer from Stage 1 to Stage 2
  - Change from 12-month-loss (Stage 1) to lifetime expected loss (Stage 2)
  - Increasing loan loss povision (lifetime effect)



Consequences on p/l and summary

- Distinction between financial guarantee and derivative important due to p/l effect of value changes
- Only when a promotional bank is included and the bank is 100% protected against default risks (kind of a pass through arrangement) no recognition on balance possible (no loan)
- In all other cases guarantees not relevant for considering stage transfers in loans or bonds on the side of the protection buyer – only for estimating cash flows
  - Stage transfer to be considered (stage 2 or even stage 3 – deterioration in credit quality or default)
  - Stage transfer – loan loss provision increases due to changes from 12-month-loss to lifetime ECL
- Financial guarantees to be included in the system of loan loss reserves on the side of the protection seller (usually 12-month-loss but stage transfer possible)

Thank you very much for your kind attention

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