Educational material 9

APPLICATION OF IFRS STANDARDS IN LIGHT OF THE CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY

Issued financial guarantee contracts within the scope of IFRS 9 Financial Instruments

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Disclaimer

Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.

1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS that are relevant for entities considering how the pandemic affects their accounting for existing and new issued financial guarantee contracts within the scope of IFRS 9 Financial Instruments (IFRS 9), for financial periods ending after 31 December 2019. Therefore, this document summarizes the existing IFRS 9 requirements for issued financial guarantee contracts, (which is unchanged by the pandemic), but highlights the additional economic impact of COVID-19 may present, particularly for corporate entities that may not previously have attracted significant ECLs due to good standing specified debtors operating in fairly stable economic conditions.

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements.

This guidance does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

2. Financial Guarantee Contracts

A financial guarantee contract is 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 payments when due in accordance with the original or modified terms of a debt instrument. [IFRS 9 Financial Instruments (IFRS9) Appendix A].

Not all forms of credit enhancements meet the definition of a financial guarantee contract. Typical examples of credit enhancements are considered in this table:

Contract Type	Application of the financial guarantee contract (FGC) definition
A parent company guarantees a subsidiary's bank loan by agreeing to reimburse the bank for losses incurred if the subsidiary fails to pay.	These types of contracts would meet the FGC definition as it relates to a bank loan (debt instrument) of a specific debtor (the subsidiary). The issuer (the parent company) only reimburses the holder (the bank) for losses incurred as a result of the specified debtor (the subsidiary) failing to pay.
A parent company guarantees the general obligations of a subsidiary.	This type of contract would not meet the definition of a FGC as it is not specific in nature and may include obligations other than debt instruments.
A Credit Default Swap (CDS) that pays out in the event of a credit downgrade (which does not necessarily equate to an incurred loss).	This type of contracts would not meet the definition of the FGC as it reimburses the holder for losses that it may not incur. A CDS is a derivative and must be measured at fair value through profit or loss.

a. <u>Accounting considerations for an issuer of a financial guarantee contract:</u>

Initial recognition and measurement

An issued FGC is a financial liability and is initially recognised at fair value. If the FGC is issued to an unrelated party at arm's length, the initial fair value is likely to equal the premium received. If no premium is received (often the case in intragroup situations), the fair value must be determined using a different method that quantifies the economic benefit of the FGC to the holder.

For example, if an interest rate of 10% is charged with the benefit of a guarantee and a rate of 15% would be charged without it, the interest rate differential of 5% could be considered to represent the economic benefit of the FGC to the holder. The present value of this differential over the term of the guarantee could be a method to estimate the initial fair value of the FGC.

Subsequent Measurement

The FGC is measured at the higher of:

- The IFRS 9 expected credit loss (ECL) allowance, and
- The amount initially recognised (i.e. fair value) less any cumulative amount of income/ amortisation recognised. (IFRS 9 paragraph 4.2.1(c))

However, a FGC can be designated at fair value through profit or loss if there is an accounting mismatch or if the FGC is part of a portfolio of financial instruments that is managed and its performance is evaluated on a fair value basis.

Implications of applying the ECL model to FGCs

In terms of IFRS 9, a minimum of a 12-month ECL is required to be recognised at all times unless there has been a significant increase in credit risk of the holder in which case a lifetime ECL is required to be recognised. The IFRS 9 ECL allowance comprises a forward-looking probability weighted measure that must reflect the possibility of the loss event occurring (even if very unlikely). The loss event of a FGC is when the specified debtor fails to make payments when due in accordance with the original or modified terms of a debt instrument.

For example, even if there was only a 10% chance that the specified debtor will fail to make payments when due in terms of the original contract, this possibility must be factored into the ECL calculation. This means that when applying the 'higher of' test, the ECL allowance is likely to be larger than the amount initially recognised less any cumulative amortisation recognised. However, in cases where the underlying specified debtor is in a strong financial position or where the existence of collateral or other credit enhancements could either prevent or reduce the failure to make payments when due in terms of the original contract, the ECL allowance may not be very significant.

The economic impact of COVID-19 may present additional challenges, particularly for corporate entities with cross-company guarantee structures that may not previously have attracted significant ECLs due to good standing specified debtors operating in fairly stable economic conditions. Entities should consider whether COVID-19 is considered to be an adjusting or non-adjusting event (for further guidance refer to Educational Material 1 – Application of IFRS Standards in light of the Corona Virus Disease (COVID-19) Uncertainty – Events After the Reporting Period). In addition, entities should consider the following factors :

- The measurement of ECL must consider the impact of COVID-19 on the specified debtor in assessing the possibility of a credit loss occurring.
- Assess and track the underlying specified debtor's risk of default to identify a significant increase in credit risk.
- Incorporate reasonable and supportable information relating to the impact of COVID-19 that is available at the reporting date. This could include the impact of additional economic scenarios (for example the impact of a recession or downturn) or the impact of government economic relief measures where related to the specified debtor.

- Entities may need to reassess and update ECL estimates for changes in future economic conditions relative to historic experience given the severity of the economic impacts of COVID-19.

Disclosure

An entity is required to disclose the nature and extent of risks arising from financial instruments and how it manages those risks. In applying this disclosure requirement, entities may need to use judgment when considering the impact of COVID-19 on the risks arising from FGCs and how those risks are managed. In particular, some of the following specific disclosures may be applicable:

- the nature of the guarantee (i.e. the terms, history, loss events that would result in the guarantee being called on).
- the maximum potential liability under the guarantee.
- any provisions that might enable the issuer to recover any money paid out under the guarantee.
- the methods, assumptions and information used to measure FGCs and how updated forward-looking information has been incorporated as well as how the economic impact of COVID-19 was taken into account.
- Quantitative and qualitative information that enables evaluation of the amounts arising from FGCs.