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Why are financial guarantee contracts so popular yet so complex?

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Financial Guarantees

As interest rates continue to increase and the global economy steadily declines, companies must find smarter ways to structure their debt, both from third-party providers and group borrowings. Bianca Blanckenberg, Senior Manager for Financial Services at BDO South Africa shares some insight into the complexities of the measurement of risk and costs associated with issuing financial guarantee contracts (FGCs) and the financial reporting requirements.

With the introduction of IFRS 9, FGCs are now required to be measured and presented as disclosures in the financial statements of guarantors.

A financial guarantee contract (FGC) generally leads to preferential terms and conditions for the guaranteed entity. The stronger financial power of the guarantor ultimately leads to a credit rating enhancement of the guaranteed entity that may result in various benefits, such as a lower interest rate or access to larger facilities. This makes them an attractive option to explore.

Financial Guarantees under IFRS 9

IFRS 9 became effective on 1 January 2018 and defines an FGC 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 terms of a debt instrument. Often, entities don't know how to correctly account for the impact of the guarantees provided under these FGCs.

For example, an entity providing a guarantee to another entity is required by IFRS 9 to recognise a financial liability in their balance sheet to represent the guarantee obligation.

Accounting Treatment

Initial recognition & measurement requirements

At inception, the FGC liability is recognised and measured at fair value. If the guarantee is issued to an unrelated party on a commercial basis, not intra-group, the initial fair value is likely to equal the present value of the premium received over the life of the facility.

If no premium is received (which is often the case in intra-group situations), the fair value must be determined using a method that quantifies the economic benefit of the guarantee to the holder. As such, the fair value of an FGC is calculated as the present value of the difference between the net contractual cash flows required under a debt instrument, and the net contractual cash flows that would have been required without the guarantee.

The requirements for recognition and measurement introduces complexities as entities have to determine judgemental inputs such as the premium (i.e. cost) as well as the credit risk inputs of the borrower and guarantor for use in the fair valuation.

Subsequent measurement

At the end of each subsequent reporting period, FGC liability is measured at the higher rate of:

1 The IFRS 9 Expected Credit Loss ('ECL') allowance.

or

2 The amount initially recognised (i.e., fair value) less any cumulative amount of income/ amortisation recognised.

ECL is a crucial concept in accounting, especially under the framework of IFRS 9 for financial instruments. In simple terms, ECL represents the anticipated loss that a financial institution or entity expects to incur due to the possibility of a borrower defaulting on a financial obligation.

Under IFRS 9, the 12-month loss allowance shall be determined at each subsequent reporting period as the ECL. However, where there has been a significant increase in the credit risk ('SICR') i.e., that the specified party will default on the contract, the calculation is for lifetime ECL.

In addition, the IFRS 9 ECL allowance is a forward-looking probability weighted measure that must reflect the possibility of a loss occurring. It is important to note that the simplified impairment approach available for trade receivables cannot be used for FGCs.

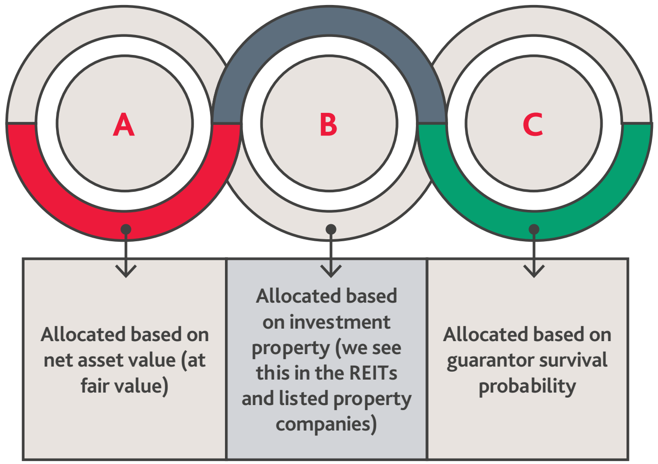
These subsequent measurement requirements involve additional judgemental assumptions of credit risk and an appropriate ECL methodology to be applied.

Allocation of FGC liability

The FGC liability shall be measured and recognised in the financial statements of the guarantor. Often, entities do not have an approach to accurately account for the impact of the FGC liability. For example, the measurement and allocation of the FGC liability where there are multiple guarantors involved.

Complexities in allocation of the FGC liability arise in the event that FGC states "jointly and severally liable" for guarantors within the same group. When IFRS 9 was first implemented, the approach followed by many entities was to recognise 100% of the FGC liability in each of the guarantors financial statements. However, for group scenarios, the industry has taken the approach to allocate the FGC liability against those entities where the likelihood to settle the obligation would be higher. The allocation is dependent on terms and conditions of the agreement as well as the nature and relationship of the entities within the group.

Allocation approaches include:



Any of the above allocation methods can be applied with the proviso that the total of all allocated ECLs should always be equal or more than the liabilities being guaranteed.

There was also a view that facts and circumstances play a role in the allocation, as you could have a case where it is clear that one entity in the group will be the one that the banks will call upon, and then to only raise the ECL in that entity's records.

One important comment that was raised is that regardless of the quantum of the ECL allocated to individual entities, all of them should still include the full amount guaranteed in their Maximum Exposure to Credit Risk Disclosure IFRS.

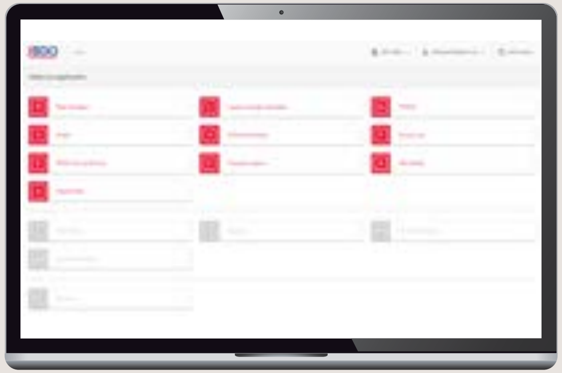
At BDO, we utilise these industry aligned guarantee allocation frameworks to ensure consistent and appropriate measurement and recognition of the FGC liability across guarantors.

Let BDO Technology simplify this for you

At BDO, we are on a journey of **digital transformation** to ensure that our clients and the broader BDO firm have access to industry leading technologies.

Powerful and innovative BDO CRS - Risk Suite enables our team to **efficiently rate** the **counterparty credit risk and measure financial instruments**, including the fair valuation and expected credit loss impairment. Third-party methodologies and data have been applied to ensure that our methodologies and models within BDO CRS - Risk Suite are aligned to the Basel II minimum requirements and can be applied across our clients.

BDO makes use of the BDO CRS - Risk Suite which is a total solution currently used within the South African lending environment and across our audit support engagements.



RISK SUITE OFFERINGS

Let's break down why these complexities arise and how BDO tackles them:

OFFERING

Financial guarantee liability valuation and disclosure:

- Initial and subsequent measurement.

BENEFITS FOR YOU

- Provide faster, more accurate valuations whilst reducing reliance on manual models.

TECHNOLOGY

- Rating System
- PD Term Structure
- Pricing Tool
- IFRS 9 Tool
- IFRS 9 Performing Tool

Step 1:

The first step would be to appropriately rate the credit risk of the counterparties involved. Using our Credit Rating Tools, we assess the credit risk of both the borrower and guarantor, providing us with essential ratings and inputs for the guarantee valuation.

Step 2:

Next, We use the Pricing Tool to determine the appropriate guarantee percentage spread. The valuation approach considers the pricing of a facility by a third-party market participant (Bank) with the impact of the guarantee providing enhanced credit in comparison to the same facility, without the impact of the guarantee support.

To do this, we price the debt instruments individually using both the borrower & guarantor's credit risk inputs.

We determine the spread by optimising the interest rate pricing of the borrower, with the World Bank pricing inputs, to achieve the same required return on capital.

The difference between the borrower optimised interest rate and the original interest rate is the guarantee spread which compensates for the risk mitigation of the guarantee.

This spread will be used in our IFRS 9 Performing tool to determine the initial fair value of the financial guarantee by present valuing the current cash flows by the optimised borrower interest rate.

The difference between the present valued amount and the outstanding balance at the initial recognition date is the day 1 fair value of the guarantee.

The tool provides an amortisation schedule for the term of the financial guarantee which can easily be extracted for financial reporting requirements.

An overview of the process performed on BDO CRS – Risk Suite for Step 2:

Step 3:

Leveraging our IFRS 9 Performing tool and the Scenario manager, we efficiently calculate Expected Credit Loss (ECL), ensuring consistency by pulling inputs from our Pricing Tool.

For future periods, the process remains the same for the determination of ECL to compare to the amortised guarantee value.

Step 4:

BDO Methodology and Approach

Our methodologies and models built within CRS are based on the principles of IFRS 13 fair value measurement and are aligned to industry practice. This process is elevated by the ease of scanning financial information of each counterparty into the platform, using OCR or upload templates. This information is then used to determine the credit risk inputs.

For the credit risk inputs, BDO utilise credit rating models within our technology such as Moody's RiskCalc SME and Large Corporate models. For the initial measurement, the approach is based on pricing the financial instrument with and without the guarantee impact, using the Pricing Tool and IFRS 9 Performing technology.

Initial measurement

To value the FGC on the underlying debt instruments, a market participant view has been taken. The market participant view allows us to determine the factors that the market would consider when valuing unlisted debt instruments. The fair value of the debt instruments consists of the fair value attributable to equity holders and the debt value incurred to fund the investment. The total fair value of the instrument equals the sum of these two parts:

Fair Value = Value of Equity + Value of Debt

The fair value of equity is determined by discounting the free cash flows at the assumed cost of equity rate. The debt/funding value of the portfolio is derived by subtracting the initial value of equity from the gross exposure of the portfolio. The initial value of equity is calculated by multiplying the risk-weighted assets (RWA) with the capitalisation rate:

Value of Debt = Gross Exposure - Initial Equity
= Gross Exposure - (RWA×Capitalisation Rate)

The approach above determined the initial fair value measurement of the FGC in line with IFRS 13 Fair Value Measurement.

Subsequent measurement

A summary of the BDO subsequent measurement approach to determine FGC liability:

Step 1: Amortised fair value: Fair value amount initially recognised less any cumulative amount of income/ amortisation recognised in line with IFRS 15.

Step 2: As at year-end, BDO performs the ECL calculation based on the following measures:

- Using independent credit risk measures determined within the CRS - Risk Suite.
- Facility terms and conditions.
- Determine stage of the loan – stage 1, 2 or 3.
- Calculate the ECL as either 12-month ECL or lifetime ECL depending on the stage of the loan.

Step 3: Compare the ECL to the amortised fair value of the FGC.

Step 4: Guarantor to recognise the higher of the two values as an FGC liability.

It is important to assess the terms and conditions within the contract as well as the number of guarantors. Where appropriate, BDO would perform an allocation of the fair value of the guarantee liability across the guarantor companies.

Conclusion

To recap, entities issuing FGCs are tasked with fair value calculations, credit risk analysis, ECL measurement and allocation challenges, all of which demand informed judgment and adherence to accounting standards.

The article has shed light on how BDO, through its industry-aligned guarantee allocation frameworks and cutting-edge technology like BDO CRS - Risk Suite, is equipped to simplify these complexities and ensure consistent and appropriate measurement and recognition of FGC liabilities across guarantors.

In an era of heightened measurement and reporting requirements for financial guarantees, choosing a partner with a deep understanding of best practices and incorporating our leading-edge technology is vital.

BDO provides an accurate and efficient solution that encompasses the entire financial reporting spectrum—recognition, measurement, and disclosure—for organisations of any size.

Explore the power of BDO CRS and simplify your financial guarantee journey today!

FOR A CLEAR PERSPECTIVE, PLEASE CONTACT:

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