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IFRS Developments

IASB and regulators highlight IFRS 9 ECL requirements during the coronavirus pandemic

What you need to know

- The IASB has published educational material on the measurement of ECLs during the pandemic that is broadly consistent with the guidance given by a number of regulators.
- It emphasises that IFRS 9 should not be applied mechanically and prior assumptions may no longer hold true in the current environment.
- Relief measures, such as payment holidays, will not automatically lead to loans being measured on the basis of lifetime losses and considerable judgement will be needed to measure ECLs at this time.

Introduction

The impact of the coronavirus pandemic is evolving rapidly. On 20 March 2020' we issued '*Applying IFRS, Accounting considerations of the coronavirus outbreak*'. Since then, a number of prudential and securities regulators, including the European Banking Authority (EBA), the European Central Bank (ECB), the European Securities and Market Authority (EMSA) and the Prudential Regulation Authority (PRA) in the UK (the 'regulators') have published guidance on the regulatory and accounting implications of the pandemic.

On 27 March 2020, the International Accounting Standards Board (the IASB or the Board) published a document for educational purposes, to help support the consistent application of accounting standards.[1] The Board indicates that they have engaged closely with the regulators named above to encourage entities to consider that guidance. Therefore, this publication considers the regulatory guidance in addition to the points made by the Board.

The Board emphasises that IFRS 9 *Financial Instruments* does not set bright lines or a mechanistic approach to determining when there is a significant increase in credit risk (SICR), nor does it dictate the exact basis on which entities should determine forward looking scenarios to measure expected credit losses (ECLs).

1. Use of reasonable and supportable information

Both the assessment of SICRs and the measurement of ECLs must be based on reasonable and supportable information that is available to an entity without undue cost or effort. The IASB acknowledges that it is likely to be difficult at this time to incorporate the specific effects of Covid-19 and government support measures on a reasonable and supportable basis. When it is not possible to reflect such information in the models, the Board expects post-model overlays or adjustments to be considered.

[1] *Accounting for expected credit losses applying IFRS 9 Financial Instruments in the light of current uncertainty resulting from the Covid-19 pandemic*, March 2020.

Building a better working world

How we see it

IFRS 9 highlights that "*The degree of judgment that is required to estimate expected credit losses depends on the availability of detailed information.*"[2] Moreover, the Basel Committee, in its 2015 guidance,[3] noted that for the world's largest banks, "*Consideration of forward-looking information is essential and should not be avoided on the basis that a bank considers the cost excessive or because there is uncertainty in formulating forward looking scenarios.*" This signals that a lack of data should not mean that the assessment of SICR and the calculation of ECLs will not be updated, as further analysed in the next sections.

2. Payment holidays and breaches of covenants

According to the Board, entities should not continue to apply their existing ECL methodology mechanically. For example, the extension of payment holidays to all borrowers in particular classes of financial instruments should not automatically result in all those instruments suffering an SICR. To assess SICRs, IFRS 9 requires that entities assess changes in the risk of default occurring over the expected life of a financial instrument.

Regulators refer to the 'flexibility' in IFRS 9 in determining when a significant increase in credit risk has occurred, considering both quantitative and qualitative indicators over the expected life of the instrument and embedding the effects of government programmes to support borrowers. Therefore, the grant of a payment moratorium, or a waiver of a breach of covenant, should not in itself be considered as an automatic trigger of SICR, with both ESMA and the PRA stressing the need to differentiate a temporary liquidity need from an SICR. The PRA also highlights that there may be very limited information available to make this determination at an individual borrower level. Furthermore, both ESMA and the PRA consider that the '30 days past due (DPD)' backstop SICR assumption might be rebutted in these circumstances.

The regulators consider that, when it is not practicable to assess staging on an individual basis, it may be necessary to apply a collective approach. ESMA refers to Illustrative Examples 38 and 39 in IFRS 9, which show how this might be done.

ESMA considers the accounting for modifications of contracts as result of the relief, observing that, in the absence of specific guidance in IFRS 9, entities must apply judgement in determining whether the modification is 'substantial', which would result in derecognition of the asset and the recognition of a new one. They conclude that, if the measure provides temporary relief to debtors and the net economic value of the loan is not significantly affected, the modification would be unlikely to be considered substantial.

How we see it

It is helpful that the IASB and the regulators have acknowledged that a temporary moratorium on payments, or a waiver of a breach of covenant, should not by itself be considered an SICR trigger in the current environment. This would also be the case if a moratorium results in a loss for the lender (e.g., if interest payments are reduced or waived), if it is provided irrespective of the borrowers' individual circumstances.

The same principle should apply to drawdowns on debt facilities to obtain liquid funds if they are usually considered as an indicator of SICR. We also agree that, for similar reasons, the 30 DPD backstop assumption may need to be rebutted in the current circumstances. When such events are automatic SICR triggers, some entities may need to consider adjusting their effects.

Lenders should distinguish between obligors whose long-term credit risk is unlikely to be significantly affected by the pandemic from those who may be more permanently impacted. However, as indicated by the PRA, this will be challenging for retail loans, as data is often not available to make this determination for individual borrowers.

For wholesale exposures, more information is generally available on individual obligors, although the SICR assessment will still be difficult. A lender may consider

[2] IFRS 9.B5.5.50.

[3] '*Guidance on Credit Risk and Accounting for Expected Credit Losses*', December 2015.

that borrowers in certain industries (e.g., airlines, tourism and hospitality) are exposed to a higher risk of business failure and, thus, an increased PD.

We agree that, when it is not practical to determine SICR on an individual basis, a collective approach to staging should be considered. This will also be challenging. The Illustrative Examples in IFRS 9 referred to by ESMA make use of historical information, which may not be relevant in the current circumstances. A possible method could be to transfer to stage 2 a portion of those customers who have been given a payment holiday or a waiver of a covenant breach, whose PD was already close to the level that would trigger an SICR. Any approach will require considerable judgement.

We agree that most modifications of contracts as a result of Covid-19 are unlikely to be viewed as substantial modifications. It follows that the effect of any waiver of interest or capital (measured using the original effective interest rate of the loan) must be recorded as an expense in profit or loss as soon as it is granted.

3. Considering forward looking information

The IASB expects that, in assessing forecast conditions, entities should give consideration both to the effects of Covid-19 and the significant government support measures being undertaken. It also warns that a number of the assumptions and linkages underlying the way ECLs have been implemented to date may no longer hold in the current environment. However, the Board still expects changes in economic conditions to be reflected in the macroeconomic scenarios and in their weightings and, when the effects of Covid-19 cannot be reflected in the models, post-model overlays or adjustments will need to be considered. The Board also highlights that the environment is subject to rapid change and updated facts and circumstances should be monitored.

The PRA indicates that, given the limited time to reassess the relationship between credit risk and economic variables, greater reliance should be placed on overlays and the governance around them. The PRA warns, however, of the danger of double counting. All regulators highlight the need to assess not only the nature of the economic shock due to the pandemic, but also the impact of economic support and relief measures. Given the challenges of preparing detailed forecasts far into the future, they recommend giving due weight to established long-term economic trends when estimating ECLs in the longer term. The PRA suggests that, in many cases, this will involve a shortening of the forecast period and a much quicker return to the long-term historical trend. The ECB has indicated that it will provide banks with central macroeconomic scenarios to support their ECL calculations.

How we see it

While the IASB and the regulators are right to emphasise the effects of government programmes, doing so will be challenging. The government interventions vary by country, they are currently evolving and the details are often not yet clear. Also, assessing the impact on different classes of borrowers will not be easy. It is helpful that some regulators provide views on forecasts and this, together with the views of other economists, should help banks construct a range of unbiased outcomes. However, one of the main unknowns is how long the effects of Covid-19 will last and the speed with which economies will return to normal.

It will normally be necessary to add overlays, as the IASB and regulators rightly warn that ECL models are based on relationships between macroeconomic indicators and ECLs which may not hold in these circumstances over the short term. It will be important, as highlighted by regulators not to 'double count' ECLs.

Entities should also consider whether their models incorporate the effects of triggers such as payment holidays, breaches of covenants, DPD or increases in drawdowns, in calculating ECLs. If they decide this is so, overlays may be needed to unwind the effects.

Any estimates as at Q1 2020 will be provisional and will need to be revised in Q2, as events unfold and further information becomes available on the level of disruption created by the coronavirus outbreak in the longer term.

4. Impact of government guarantees

While collateral does not affect the SICR assessment, ESMA highlights that the impact of public guarantees of issuers' exposures on ECL measurement will depend on whether they are considered an integral part of the contractual terms of a loan and whether they are recognised separately by the issuer.[4] In December 2015, the Transition Resource Group observed that credit enhancements included in the measurement of ECLs should not be limited to those that are explicitly part of the contractual terms. Guarantees have not normally been considered integral to a loan if they were not anticipated when the loan was originally granted. However, ESMA considers they will be "*when a public guarantee is provided in conjunction with broadly applicable ex-lege debt moratoria or economic support and relief measures*".

How we see it

Assessing whether a public guarantee is integral to the contractual terms of a financial asset will require judgement. Whilst we think that the ESMA view is helpful, an assessment of individual facts and circumstances may be necessary, and conclusions may vary depending on the type of government guarantee offered. Even if a guarantee does not qualify as' integral', it will often be possible to record the benefit of a guarantee as a reimbursement right, by analogy to IAS 37.

5. Transparency and disclosures

The Board highlights how, in the current environment, IFRS 9 and the associated disclosures can provide much needed transparency to users of financial statements. ESMA stresses the importance of disclosure of the judgements made on how the effect of the pandemic and related support measures have been factored into the assessment of SICRs and the measurement of ECLs, as well as the principal risks and uncertainties that an entity faces in the current circumstances. ESMA also reminds entities that, given the magnitude of the impact, sufficient disclosure should be provided in the interim financial statements on events and transactions since the end of the previous year.

How we see it

Given the level of judgement involved in applying IFRS 9 in the current circumstances, transparent disclosures will be critical. Also, lenders will be expected to provide more information on their exposures by sector and region. To the extent that entities have the legal and regulatory flexibility to do so, it is likely that some of the disclosures normally given at Q1 and not related to credit risk will be reduced, to focus on the information of particular concern to users at this time.

[4] IFRS 9.B5.5.55.

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