The Impact of COVID-19 on IFRS9 and the Definition of Default: Fintegral's Opinion

COVID-19: IFRS9 and Definition of Default

Background and recent impact

Governments and regulatory bodies have taken extraordinary measures to mitigate the adverse economic impact of COVID-19. These measures, which allow banks to grant payment moratoriums and use governments guarantees, have implications for how banks should deal with IFRS9 models and handle Definition of Default.

IFRS9

Overview of the Expected Credit Loss model

- The IFRS9 Expected Credit Loss (ECL) model categorises loans in 3 stages of impairment. The highest quality instruments are assigned to Stage 1, where an ECL is calculated accounting for default events over the next 12 months. Interest revenue is calculated based on the instrument's gross carrying amount.
- If the credit risk increases significantly, the instrument is transferred to Stage 2, where the ECL is calculated across the instrument's entire expected lifetime. Interest revenue is calculated as per Stage 1.
- Where the Financial instrument is impaired (Stage 3), ECL is calculated as per Stage 2, and interest revenue is calculated based on amortised cost.

Covid-19 Impact

- The recognition and measurement of impairment losses under IFRS9 is increasingly a subject of debate. Specifically, there is uncertainty as to how differentiate cases where the credit risk of a financial instrument has increased significantly versus a debtor experiencing temporary liquidity issues.
- In addition, given the current context of high uncertainty with limited and unreliable information, the use macroeconomic forecasts could lead to excessive procyclical assumptions in the IFRS9 model and result in inappropriate levels of ECLs.

Definition of Default

Overview of the Definition of Default

- Under the EU Capital Requirements Regulation (CRR), the capital framework allocates higher capital requirements to financial instruments that are flagged as in default.
- The regulatory definition of forbearance is designed to identify when credit institutions offer specific measures to help a specific borrower who is experiencing, or is likely to experience, temporary financial difficulties with their repayment obligations.

Covid-19 Impact

- The payment moratorium schemes that have been introduced as a response to COVID-19 raise questions on how banks should handle any reclassification of instruments under the definition of forbearance, as either Performing or Forborne Exposure.
- The moratorium scheme has also resulted in uncertainty regarding the treatment of Past Due and Unlikeliness to Pay, which are important criteria for the Definition of Default.

Regulatory Responses

Published guidelines relating to COVID-19

Multiple regulators have recently released public statements clarifying various points regarding the measures introduced by governments to alleviate the economic impact of COVID-19.

"Accounting for expected credit losses applying IFRS 9 Financial Instruments in the light of current uncertainty resulting from the covid-19 pandemic", published on the 27th of March.

- Statements to support the consistent application of requirements in IFRS® Standards"

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

"COVID-19: IFRS9, capital requirements and loan covenants", published on the 26th March.

- Guidelines issued to the Banks' CRO to reinforce consistent and robust IFRS 9 accounting and the regulatory definition of default.

BANK FOR INTERNATIONAL SETTLEMENTS

"Measures to reflect the impact of COVID-19", published on 3rd April.

- Document setting out guidelines on Expected Credit Losses accounting and on the treatment of extraordinary support measures related to COVID-19.

EUROPEAN CENTRAL BANK
BANKING SUPERVISION

"IFRS9 in the context of COVID-19", published on 4th April.

- Note from the Supervisory Board chair to provide guidance on using forecast in order to avoid excessive Expected Credit Losses.

"Statement on the application of the prudential framework regarding default, Forbearance and IFRS9 in the light of COVID-19 measures", published on the 25th March.

- Clarification on how to treat classification of default, forbearance and accounting treatment.

esma European Securities and Markets Authority

"Statement on IFRS9 implications of COVID-19 related support measures", published on the 25th March.

- Statement to promote consistent application of IFRS9 in the context of the COVID-19 context.

Regulatory Statements and Fintegral Opinions

IFRS9 model

The following statements from regulators provide some clarification on how banks should handle Expected Credit Losses, Significant Increase in Credit Risk (SICR) and macroeconomic scenarios in IFRS9 models.

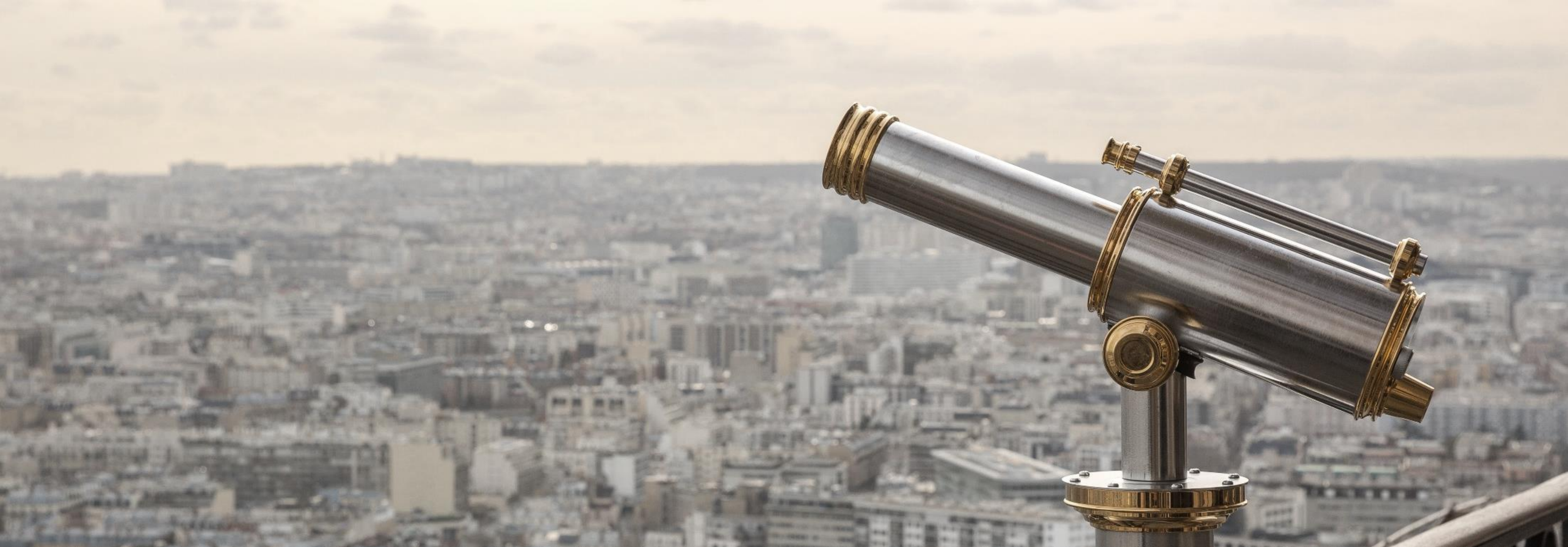
Category	Summary of Regulatory Guidance	Fintegral's Opinion
ECL and SICR	IFRS 9 is based on a set of principles that by nature are not mechanistic and require the application of a certain degree of judgment. The significant increase in credit risk is required to be assessed based on the identification of significant changes over the total expected life of the exposure. Entities should not continue to apply their existing ECL methodology mechanically.	▪ In the short term, banks should maintain their current ECL methodology, but also capture the impact of COVID-19 by applying post-model management overlays at a portfolio level. ▪ Banks should ensure that governance frameworks are extended to include the additional processes, such as overlays and stage-2 classification. ▪ Banks should make use of the option to apply transitional arrangements as per the CRR, even if they were not initially implemented when a bank first adopted the ECL model, in order to reduce the capital burden.
	Regulators state that, other things being equal, payment holidays should not automatically result in the loans involved being moved into Stage 2 or Stage 3 for the purposes of calculating ECL or triggering a default.	▪ Banks should not transfer impacted customers to stage2, especially those in segments for which a payment moratorium has been granted to the majority of the portfolio. ▪ However, credit risk management procedures and monitoring measures should be enhanced, in order to ensure the creditworthiness of each customer is sufficiently captured as accurately as possible.
	Banks are expected to distinguish obligors for which the credit standing would not be significantly affected by the current situation in the long term, from those that would be unlikely to restore their credit worthiness. Exercising this discrimination can help mitigate any potential cliff effect of transfers between stages and avoid exaggerating the effects of the shock.	▪ In order to identify vulnerable customers, banks should perform robust and sound analysis of the sensitivity of customers to various scenarios when generating ECL's estimates.
Macroeconomic scenarios	Banks should assess the extent to which the high degree of uncertainty and any sudden changes in the short-term economic outlook are expected to result in impacts over the entire expected life of the financial instrument.	▪ Banks should define specific COVID-19 scenarios, tailored for the IRFS9 model, which are reasonable and supportable. ▪ Generally, banks should be capable of modelling variations in macroeconomic scenarios simultaneously. ▪ The probability weights of macroeconomic scenarios should also be reviewed and revised where necessary.
	Given the scarcity of available and reliable information in the current context, issuers may face problems in generating reasonable and supportable short-term economic forecast. Issuers should therefore give a greater weight to a long-term stable outlook, as evidenced by past experience, and take into account the relief measures granted by public authorities, such as payment moratoria.	▪ Banks should assign more weight to the specific-period macroeconomic forecast for the short-term outlook and systematically reduce that weight as the forecast loses relevance for time horizons in the more distant future. ▪ Whenever the specific forecast has lost relevance, the long-term forecast should be used.

Regulatory Statements and Fintegral Opinions

Definition of Default

Regulators have provided some clarification on how to handle the Definition of Default, with specific statements on the classification of Past Due, Forbearance and Unlikeliness to Pay under the COVID-19 environment.

Category	Summary of Regulatory Guidance	Fintegral's Opinion
Classification of Past Due	Regulators have agreed that payment moratorium periods relating to the Covid-19 outbreak can be excluded from the counting of days past due.	▪ Internal IT systems should be updated to log payment moratoriums and automatically exclude them from the counting of Past Due days.
Classification of Forbearance	In the current circumstances, the measures that governments and credit institutions are proposing to address the adverse systemic economic impact of the COVID-19 pandemic would not automatically lead to a reclassification under the definition of forbearance.	▪ Banks should implement a system to capture and monitor forbearance exposures that belong to a payment moratorium scheme.
	This applies if the payment moratorium is not borrower specific but addressed to a range a product classes or customers. The length of the delays in payments is fixed for every borrower irrespective of the borrowers' specific financial circumstances.	▪ Banks should capture the impact of changes in credit quality on a collective basis during the period where the assessment cannot yet be captured on an individual basis due to a payment moratorium scheme.
Unlikeliness to Pay	Banks are still obliged to assess the obligor's Unlikeliness to Pay on a case-by-case basis. This assessment refers to the modified schedule of payments and, where there are no concerns in that regard, the exposure may remain in performing status. The assessment should be based on whether the borrower is unlikely to be able to repay the rescheduled payments. That is, for borrowers that are not making payments as permitted by a payment moratorium, the assessment should be based on likelihood of payment of amounts due after the moratorium period ends.	▪ In line with the regulators' expectations, individual assessments should be carried out in a careful manner on a case-by-case basis, which will likely require a manual process. ▪ For the period following the moratorium, banks should pay particular attention to the obligors that have been granted a payment moratorium in order to assesses and identify their ability to meet their obligations in a timely manner.



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