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# IFRS 9 and expected credit loss calculation under COVID-19 pandemic

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Credit holidays, moratoria, grace periods, difficulties with installment payments, uncertainty of forward-looking situation – how to deal with the calculation of the expected credit loss (ECL) of financial instruments and particularly loans in the scope of IFRS 9 during COVID-19 pandemic and how the above-mentioned factors impact ECL and methodologies adopted for the calculation of the latter?

The recently adopted and implemented IFRS 9 standard on "Financial instruments" classification, measurement and impairment calculation should now prove its "solidity" in these economically uncertain times after having been developed in a post-financial crisis environment of 2008.

IFRS 9 incorporated subjectivism to a large extent and requires application of many judgments. It does not provide standard or precise guidance and criteria to be applied for the calculation of ECL either and an exact approach of lifetime losses determination and the application of forward-looking scenarios.

Hence, the banks may have to review the assumptions, judgments and methodologies they implemented or at least not apply them mechanically, as they may no longer hold in the current environment.

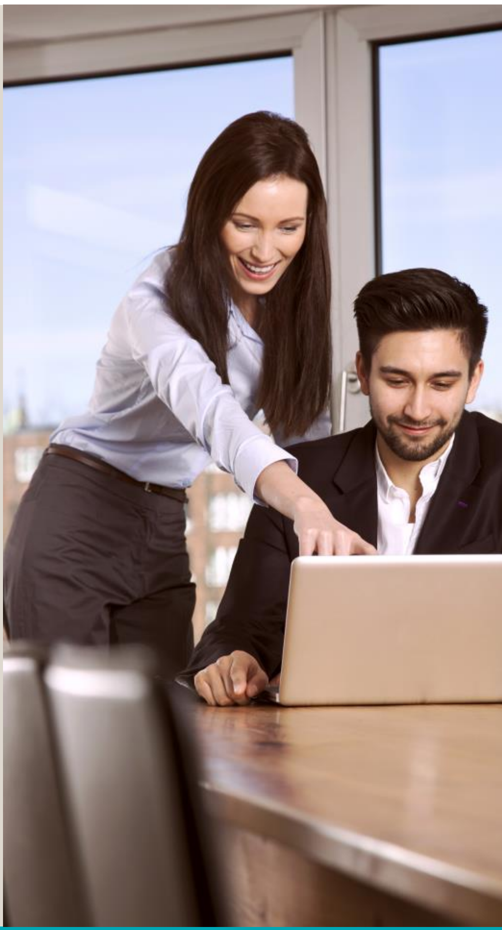
In this context some questions arise, such as:

How to assess significant increase of credit risk (SICR) under the circumstances of the financial difficulties that individuals and companies are facing currently?

How to treat the payment holidays and moratoria?

How to apply forward looking information if the future is uncertain?

What if the borrowers receive support from the government? Should it be taken into account?



In this publication Grant Thornton Armenia presents some recommendations, which are in line with recently circulated European Banking Authorities guidance to banks, European Securities and Markets Authority statement and the IASB statement.

# 1 Significant increase of credit risk (SICR)

IFRS 9 requires to assess at each reporting date whether the credit risk of a financial instrument has increased significantly since its initial recognition. This requirement and best practice assume to assess SICR with a number of quantitative and qualitative indicators and should capture the changes in the lifetime risk of default, i.e. over the entire expected life of the instrument.

Many banks apply IFRS 9 rebuttable presumption that 30 days of past due payment provides evidence of a significant increase in credit risk. However, in the context of COVID-19 outbreak circumstances, which create financial difficulties to many individuals, households and businesses, the associated economic support from governments and financial institutions can be a reason to rebut this presumption. That is why the banks and credit institutions need to carefully consider this fact and disclose their judgements accordingly.

## Payment holidays and moratoria

The measures taken in the context of the COVID-19 outbreak which permit, require or encourage suspension or delays in payments, should not be regarded as automatically being a sign of SICR. Therefore, a moratorium under these circumstances should not in itself be considered as an automatic trigger of SICR. In the context of the SICR assessment, it is necessary to analyze and take into consideration the economic condition and situation under which the above-mentioned measures are taken and the assessment is performed.

## Forbearance

To assess SICR, entities look at the financial situation of the borrower to evaluate the likeliness to pay. Sometimes, credit institutions have to change the payment schedules or credit conditions to allow borrowers to be able to pay the loans.

Generally, according to many authorities (EBA, Basel, local regulators) guidance on forbearance and criteria of unlikeliness to pay, banks should classify financial assets as restructured if the terms of initial credit agreement are changed as the borrower has or may have financial difficulties to pay its obligation.

However, what we see now is that many banks upon their own initiatives or by following governments advice are providing public and private moratoria and grace periods for many types of loans or larger number of customers as a support to resist the negative economic and financial consequences of COVID-19 pandemic. It is assumed that those measures are not borrower specific but are universal, thus in this case banks and credit institutions should not apply automatically the restructuring criteria and classify the financial assets as forborne. At the same time, it does not mean that credit institutions can escape to evaluate the credit quality of the financial assets which benefited from the number of support measures.

## Business debt covenants' breaches

Due to financial difficulties many businesses may breach some covenants. In this context, banks and credit institutions should examine whether the covenant has been breached due to borrower specific issues, or if it is directly related to the pandemic. If the latter, banks should consider waiving the covenant breach. As in case of individual loans, the breach of covenants should not lead mechanically to the significant increase of the credit risk, instead being analyzed the reasons and evaluating each case separately.

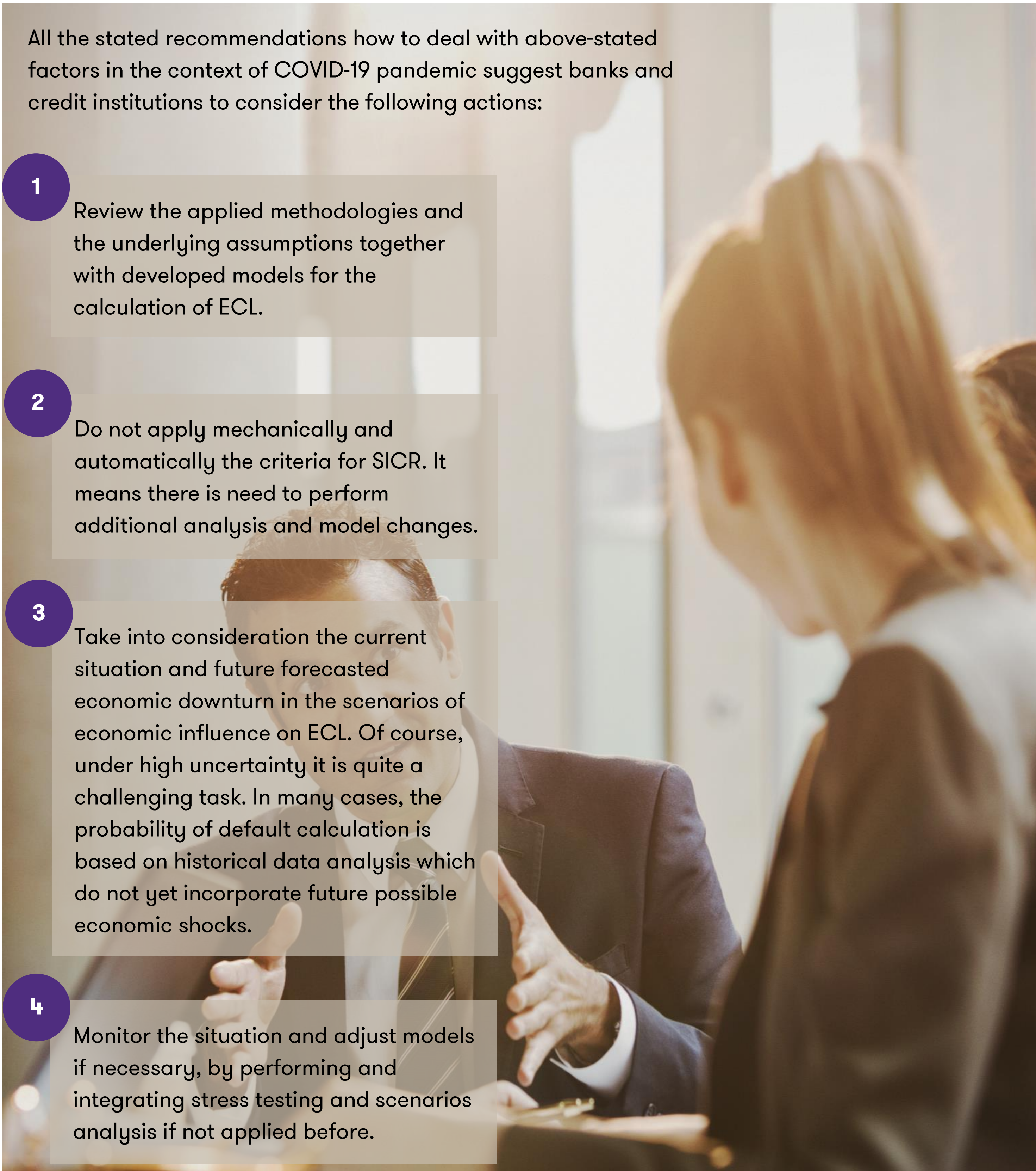
## Looking forward information and macroeconomic scenarios

The application of looking forward information and the development of macroeconomic scenarios were one of the challenges in IFRS 9 implementation. Of course, it is not simple to measure the impact of the future and more difficult when the uncertainty is high and economic downturn is very much probable. It is also difficult to incorporate the specific effects of COVID-19 and government support measures on a reasonable and supportable basis. However, changes in economic conditions should be reflected in macroeconomic scenarios applied by banks and credit institutions. Best practice suggests to develop and apply several scenarios including downward scenarios and to give to each of them some weightings. If the effects of COVID-19 cannot be reflected in models, post-model overlays or adjustments will need to be considered. At each point of time, something new could happen, hence the banks should continue to monitor the environment and economic situation to consider it upon their availability.

## Loans collaterals market value

All the above-mentioned factors affecting SICR identification, as well as the application of looking-forward information are essential in the estimation of probability of default. However, besides this the banks and credit institutions should be prudent with the evaluation of loss given default, another component of ECL calculation. In fact, loss given default can be impacted by the market value of collaterals due to pandemic situation. As a collateral, in many cases, real estate and securities are considered. We already saw corporate securities market value dropping, real estate market reaction is still to come. economies, the real estate value is not yet impacted, in difficult economic situation, people tend to delay or cancel the decisions of real estate buying which will first impact on the demand and as a consequence on market value.

# 2 What should bank and credit institutions consider



All the stated recommendations how to deal with above-stated factors in the context of COVID-19 pandemic suggest banks and credit institutions to consider the following actions:

1. Review the applied methodologies and the underlying assumptions together with developed models for the calculation of ECL.

2. Do not apply mechanically and automatically the criteria for SICR. It means there is need to perform additional analysis and model changes.

3. Take into consideration the current situation and future forecasted economic downturn in the scenarios of economic influence on ECL. Of course, under high uncertainty it is quite a challenging task. In many cases, the probability of default calculation is based on historical data analysis which do not yet incorporate future possible economic shocks.

4. Monitor the situation and adjust models if necessary, by performing and integrating stress testing and scenarios analysis if not applied before.

## Need more support?

Grant Thornton Armenia has profound experience of implementing and validating IFRS 9 methodologies in Caucasus, Central Asia, Europe, Middle East and Mongolia. Our experts will consult you in this difficult situation and provide recommendation regarding IFRS 9 application.

## To find out how we can help you, contact us: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