ICAEW KNOW-HOW

FINANCIAL SERVICES FACULTY

Applying IFRS9 under COVID-19

8 July 2020

PRESENTED BY:

Philippa Kelly, ICAEW

Mark Spencer, BDO LLP

Financial Services Faculty: Join us

Gain sector-specific technical support and expert opinions to keep you up to date in a fast-changing environment for:

- Banking
- Insurance
- Investment Management

Individual Membership is £49.50 (until 31 December 2020)

- *Meet CPD requirements with webinars*
- *Monthly Focus ebulletin*
- *Access exclusive regulatory insights*
- *Find guidelines, articles and top tips to support your career*
- *Influence the regulatory and policy agenda by contributing to our work*
- *Learn from fellow members' wide ranging experience*

For more information, go to: icaew.com/joinfsf

Presenters

Mark Spencer

Financial Services
Accounting Advisory Leader

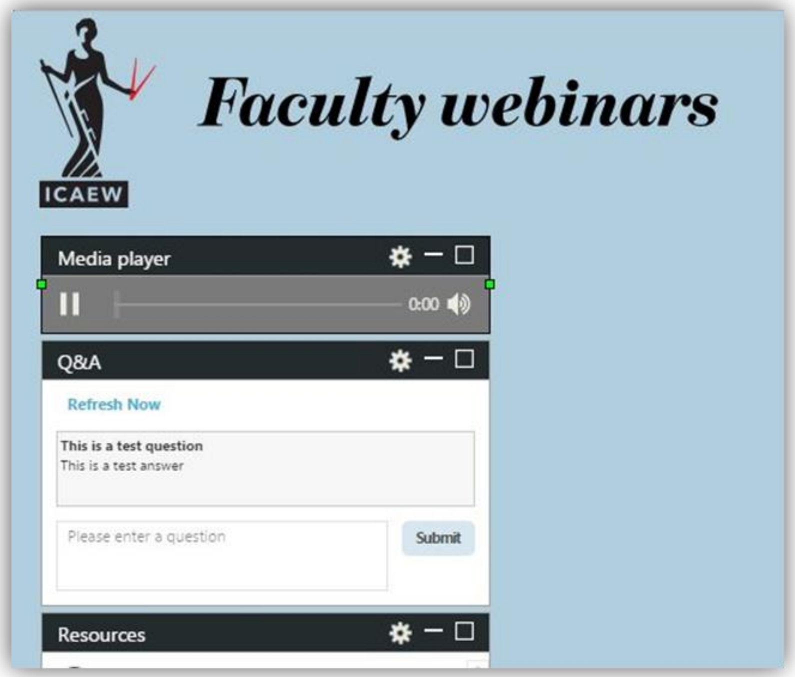
BDO

Philippa Kelly

Head of Financial Services

ICAEW

Ask a question or download resources



Audio problems?
ENSURE YOUR SOUND IS TURNED ON.

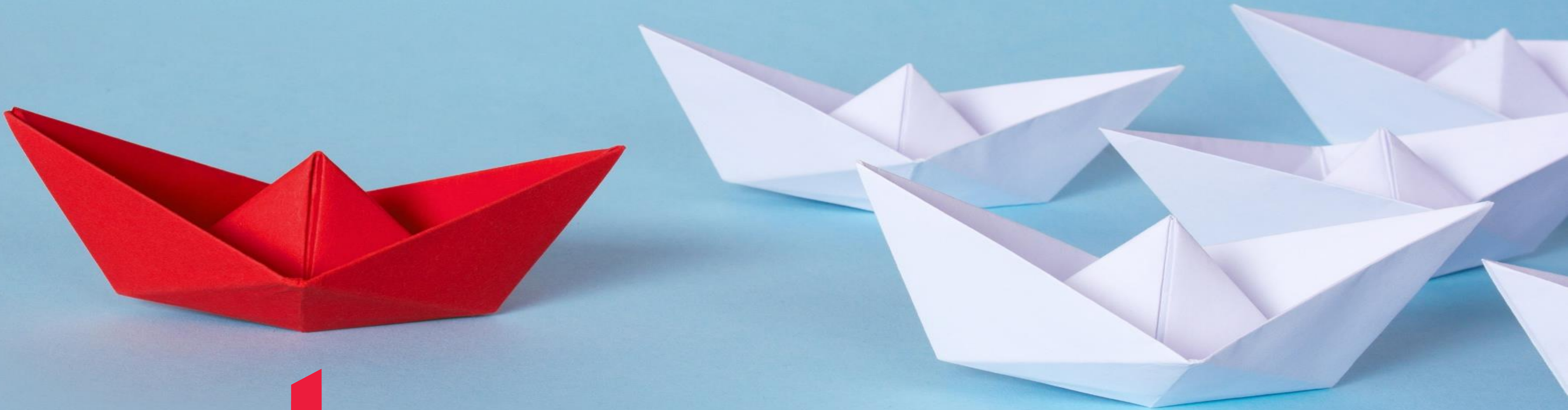
If you experience poor sound quality you may benefit from refreshing your page.

Ask a question
Type your question into the question box then click submit.

Download resources
Look for the resources box to access whatever you need, including these slides.

APPLYING IFRS 9 UNDER COVID-19

8 July 2020



IDEAS | PEOPLE | TRUST

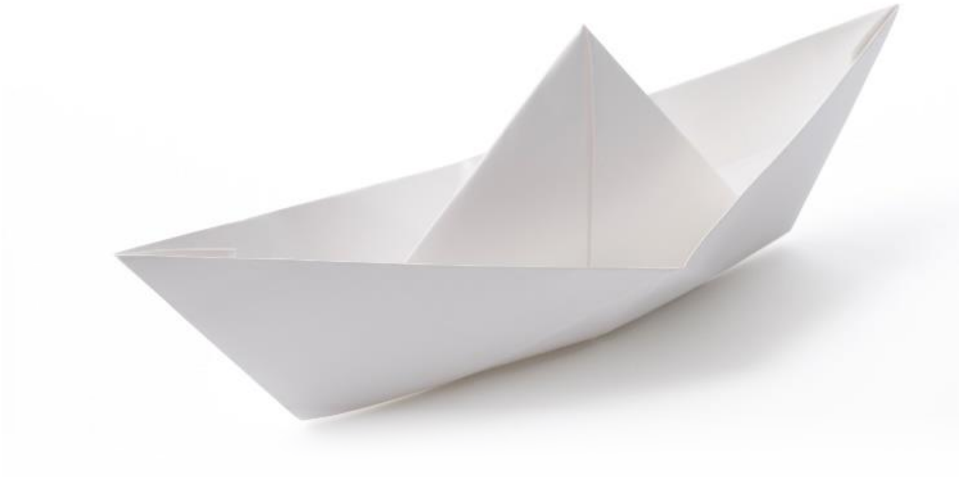
AGENDA

01
Context

02
General considerations about applying IFRS 9 under COVID-19

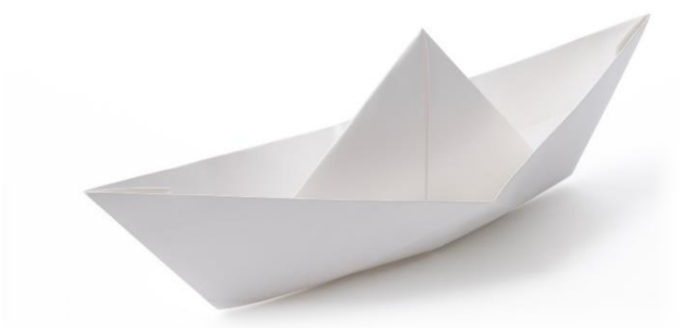
03
PRA “Dear CEO” letter: “Covid-19: IFRS 9, capital requirements and loan covenants”

04
PRA “Dear CEO” letter: “Covid-19: IFRS 9 and capital requirements - Further guidance on initial & further payment deferrals”



CONTEXT

- The 2019 Novel Coronavirus infection ('coronavirus' or 'COVID-19') has had a significant and adverse impact on many economies around the world.
- The effects of the coronavirus will be very wide spread and will impact a vast range of entities and sectors.
- Accounting and financial reporting implications for entities will be similarly broad, and the precise effects will be unique to each entity, depending upon facts and circumstances.
- As the effects of the outbreak change and evolve, it may become difficult to distinguish between which facts and circumstances should be:
    - incorporated into measurement as at period-end; and
    - which should result in potential subsequent event disclosure.
- The WHO declared the coronavirus outbreak to be a Public Health Emergency of International Concern on the 30th January 2020.
- Significant measures were not taken by private sector organisations until early 2020.
- The effects of the coronavirus were generally a 'non-adjusting event' (IAS 10.10-11) up until 31 December 2019.
- Forecasts and assumptions used in preparing financial statements as at 31 December 2019 would therefore reflect little change as a result of the outbreak.
- The impact of the coronavirus would require disclosure though.
- For reporting periods ending after 31 January 2020, the effects of the coronavirus would need to be incorporated into recognition and measurement.



GENERAL CONSIDERATIONS ABOUT APPLYING IFRS 9 UNDER COVID-19

Increase in expected credit losses (‘ECL’)

- Expected credit losses may increase due to an increase in both the **probability of default (‘PD’) and the loss given default (‘LGD’)** for financial assets.
- As all financial assets subject to ECL **will have at least 12-month ECL being estimated and recognised at a minimum**, the effects of uncertainty relating to the coronavirus may be very significant.
- The effects of the coronavirus **may trigger a significant increase in credit risk (‘SICR’)**, and therefore the recognition of a lifetime ECL provision on financial assets.

Modifications to financial assets and liabilities

- Lenders and borrowers may enter into agreements to **modify** the terms of financial instruments.
- Modifications may take **various forms**:
  - reduced interest rates,
  - payment holidays; and
  - covenant waivers.
- IFRS 9 has specific requirements for the modification of assets (for lenders) and liabilities (for borrowers).
- These modifications will generally give rise to **gains for borrowers and losses for lenders.**

ECL on financial guarantee contracts

- These are those **contracts to make specified payments to reimburse for a loss because a specified debtor fails to make payment when due** and can be with:
  - third parties (e.g. some letters of credit and similar contracts issued by lenders); and
  - related parties (e.g. cross guarantees).

Decrease in hedge effectiveness

- May arise due to **forecast transaction no longer being highly probable**.
- May give rise to cash flow hedges being **discontinued**.

GENERAL CONSIDERATIONS ABOUT APPLYING IFRS 9 UNDER COVID-19

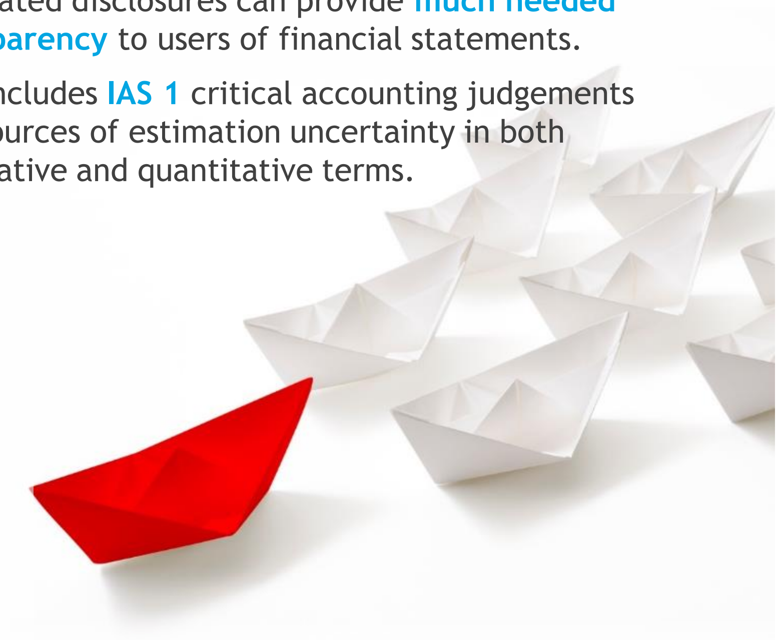
Accounting for ECL

- IFRS 9 does:
  - **Not** set bright lines or a mechanistic approach to determining **when lifetime losses are to be recognised**;
  - **Nor** does it dictate the exact basis on which **forward-looking scenarios should be determined** for considering when estimating ECL.
- IFRS 9 does require the application of **judgement**…
  - and both require and allow entities to **adjust their approach** to determining ECL in different circumstances.
- A number of assumptions and linkages underlying the way ECL has been estimated to date **may no longer hold in the current environment**.
- Entities should therefore **not continue** to apply their existing ECL methodology mechanically.
- E.g. extension of payment holidays to borrowers in a particular class of financial assets should not automatically result in all of them suffering a SICR.

GENERAL CONSIDERATIONS ABOUT APPLYING IFRS 9 UNDER COVID-19

Accounting for ECL

- To assess SICR, IFRS 9 requires entities to assess changes in the risk of a default occurring **over the expected life** of a financial instrument.
- SICR assessment and ECL measurement are required to be based on reasonable and supportable information that is **available without undue cost or effort**.
- Undue cost or effort though **does not mean no** cost or effort, particularly for an entity for which managing credit risk is a core competency.
- In assessing forecast conditions, consideration should be given to the effects of COVID-19 **and** the significant government support measures being undertaken.
- Changes in economic conditions should be reflected in **macroeconomic scenarios and in their weightings**.
- **Post-model adjustments ('PMAs') or overlays** will be needed if the effects of COVID-19 are not reflected in models.
- Environment is subject to rapid change and updated facts and circumstances should continue to be monitored **as new information becomes available**.
- If ECL is based on reasonable and supportable information, and IFRS 9 is not applied mechanistically, then useful information can be provided **despite the high levels of uncertainty**.
- In current stressed environment, IFRS 9 and the associated disclosures can provide **much needed transparency** to users of financial statements.
- This includes **IAS 1** critical accounting judgements and sources of estimation uncertainty in both qualitative and quantitative terms.



PRA "DEAR CEO" LETTER: "COVID-19: IFRS 9, CAPITAL REQUIREMENTS AND LOAN COVENANTS"

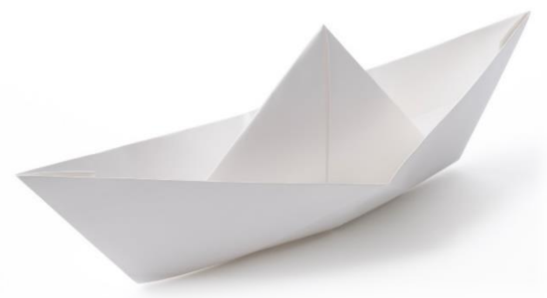
COVID-19: IFRS 9, capital requirements and loan covenants

- The PRA issued its **first "Dear CEO" letter** on **26th March**, in which it stated that is *"pursuing a range of regulatory and supervisory measures to alleviate the financial stability impact of COVID-19 and to maintain the safety and soundness of authorised firms."*
- These **measures** are aimed at ensuring that lenders are able to continue:
  - to lend to households and businesses;
  - support the economy; and
  - provide robust and consistent market disclosures.
- These measures **are expected to remain in place** throughout the period of disruption.
- Information regarding accounting is relevant for IFRS preparers finalising:
  - March to June year-end statutory accounts; and
  - Interim financial reports

  as decisions will need to be taken about **forward-looking estimates of ECL**.

The PRA has highlighted the following key areas of consideration for IFRS 9 application:

1	Consistent and robust IFRS 9 accounting and the regulatory definition of default
2	The treatment of borrowers who breach covenants due to COVID-19
3	The regulatory capital treatment of IFRS 9



PRA "DEAR CEO" LETTER: "COVID-19: IFRS 9, CAPITAL REQUIREMENTS AND LOAN COVENANTS"

1	Consistent and robust IFRS 9 accounting and the regulatory definition of default

- Any changes made to ECL to estimate the overall impact of COVID-19 will be subject to **very high levels of uncertainty**.
- This is because **limited** forward-looking information is currently available on which to base those changes and there is a **lack of clarity** on how sharp and long the recession is to be.
- However, this highlights the need to apply ECL well and **use those assumptions that are most reasonable and supportable** in the current environment.
- This should **enhance consistency** and **reduce the risk of recognising inappropriate levels of ECL**, which is important, given significant overstatement of ECL could prompt tightening of credit conditions.
- To **mitigate these risks**, the PRA is of the view that the following two points are critical and that this guidance is consistent with the requirements of IFRS 9:

a. Making well-balanced and consistent decisions that consider:
   - not just the virus' potential adverse impact but also support provided by governments and central banks to protect economies; and
   - established long-term economic trends, given the challenges of preparing detailed forecasts far into the future.

b. Consider the actions that are and will take place to support borrowers, including the offer of payment holidays
   - the PRA's expectation is that the use of such should not automatically trigger a default under CRR; or
   - result in loans moving to Stage 2 or Stage 3 for calculating ECL under IFRS 9.

PRA "DEAR CEO" LETTER: "COVID-19: IFRS 9, CAPITAL REQUIREMENTS AND LOAN COVENANTS"

1 Consistent and robust IFRS 9 accounting and the regulatory definition of default

- An immediate ECL implication is the use of **economic scenarios and probability-weights**:
  - in a rapidly evolving situation, **consensus data is likely to lag** public sector intervention
  - changes in 2020 period-end ECL are therefore expected to be driven by **overlays**.
- In a similar vein, more **PMAs** are expected due to:
  - in exceptional credit conditions, **traditional credit risk drivers do not work** well in isolation
  - this is because normal relationships with economic variables decrease in terms of their **predictability**
  - short-term liquidity events need to be **distinguished** from credit deterioration events.

- Some of the PRA's observations in this respect are:
  - Consider not just the clear signs that economic and credit conditions are worsening, **but** also take account of the unprecedented levels of public support;
  - Reflect that, while the duration of the temporary economic shock is uncertain, actions that are being taken mean that some borrowers will **not suffer a deterioration in lifetime PD**;
  - Forecast periods are typically likely to involve a **shortening** of that period and a much quicker return to long-term historical trend; and
  - Avoid **double-counting** between adjustments for COVID-19 and other uncertainties (e.g. Brexit).

The use of borrower payment holidays:

- ❑ Is not deemed to necessarily trigger counting days past due or generate arrears under CRR or IFRS 9.
- ❑ Does not necessarily automatically result in being unlikely to pay ('UTP') for CRR or give rise to an IFRS 9 SICR.

PRA "DEAR CEO" LETTER: "COVID-19: IFRS 9, CAPITAL REQUIREMENTS AND LOAN COVENANTS"

2 The treatment of borrowers who breach covenants due to COVID-19

- **Loan covenants** play an important role in lenders' credit risk management.
- However, it is also important that such risk management **distinguishes between** 'normal' covenant breaches and those that are a result of COVID-19.
- The following are **examples of breaches as a result of COVID-19**:

A Temporary changes in borrowers' reported earnings

B Suspension of business or other material adverse event clauses

C Modification of the audit report attached to audited financial statements

Or due to unavoidable delays in providing lenders with:

D Unaudited or audited financial statements

E Covenant compliance certificates

F Third-party valuations

PRA "DEAR CEO" LETTER: "COVID-19: IFRS 9, CAPITAL REQUIREMENTS AND LOAN COVENANTS"

2 The treatment of borrowers who breach covenants due to COVID-19

- The PRA asks lenders to **carefully consider their responses** to potential breaches of covenants arising directly from the COVID-19 pandemic.
- Where uncertainties are of a general nature or are unrelated to the typical liquidity of the borrower, lenders should consider the need to **treat them differently** compared to uncertainties that arise because of borrower specific issues.
- In such instances, lenders should **consider waiving** the resultant covenant breach.
- Lenders should **act in good faith** and not impose new charges or restrictions on borrowers following a covenant breach that are unrelated to the facts and circumstances that led to that breach.
- Breaches or waivers of a covenant relating to a modification of the audit report because of COVID-19 **should not** automatically trigger:
  - a **default** under CRR; and
  - the loans involved **moving** to Stage 2 or Stage 3 under IFRS 9.
- On the former point, a covenant breach **is a possible UTP indicator** but does not automatically trigger default – need to determine whether it does.
- This thought process extends to **other breaches and waivers of covenants** with a direct link to COVID-19.

PRA "DEAR CEO" LETTER: "COVID-19: IFRS 9, CAPITAL REQUIREMENTS AND LOAN COVENANTS"

3	The regulatory capital treatment of IFRS 9

- Transitional arrangements in CRR mean the regulatory capital impact of ECL is being phased in over time
  - During 2020, lenders can **add back** the CET1 equivalent of up to 70% of IFRS 9 ECL.
- Lenders were encouraged to make use of these arrangements in September 2017.
  - These transitional arrangements **cannot be opted in to now**.
- The PRA's intention remains that all aspects of supervision of lenders using the transitional arrangements would be carried out using the 'transitional' data on capital resources and **not the 'fully loaded'** figures.

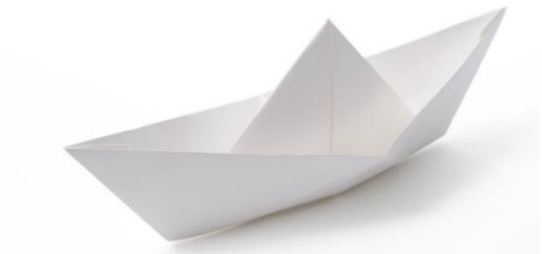
PRA "DEAR CEO" LETTER: "COVID-19: INITIAL AND FURTHER PAYMENT DEFERRALS"

On 4th June, the PRA published a second "Dear CEO" letter with additional guidance to the the letter dated 26th March.

- March guidance related to payment holidays moratoria or deferrals.
- This guidance relates to exits from such initial payment deferrals.
- Letter has guidance for lenders to assess the capital and accounting treatment of the various ways in which those initial payment deferrals might end.
- Letter also considered the illustrative examples set out in May's Monetary Policy Report ('MPR') and interim Financial Stability Report ('FSR'):
    - MPR illustrated a plausible scenario on the impact of COVID-19 for ECL estimation purposes, but, while it consists of useful data points for developing forward-looking scenarios it is, not in itself, a forecast
    - FSR set out a desktop stress test and estimates potential losses at £80bn using assumptions that are overall conservative and prudent but does not draw on lender submissions and the purpose of this test was to assess capital, not estimate IFRS 9 ECL.

The letter has highlighted the following key areas of consideration for IFRS 9 application:

1	Past due count based on agreed schedule for ECL backstop, but loans not past due could suffer SICR
2	Need for other indicators as COVID-19-related deferrals do not automatically trigger SICR / default
3	A holistic assessment that looks beyond past-due and use of deferrals is needed
4	Lenders are to closely align their approach to ECL Stage 3 to the regulatory definition of default



PRA "DEAR CEO" LETTER: "COVID-19: INITIAL AND FURTHER PAYMENT DEFERRALS"

Reiteration of key messages

- The principles outlined in the March letter, including the use of robust and reasonable assumptions, balanced views, review of pre-COVID -19 assumptions and long-term economic trends, are still considered critical.
- Furthermore, the PRA reiterates that the eligibility for payment deferrals **should not automatically** cause the loan to be regarded as exhibiting SICR or being in default.
- Lenders are also reminded of the need to apply sound risk management practices regarding identification of defaults.

1	Past due count based on agreed schedule for ECL backstop, but loans not past due could suffer SICR

- COVID-19 related deferrals that adjust the amounts contractually due **do not trigger the counting of days** for the purposes of ECL backstops based on IFRS 9's 30 and 90 days past due tests.
- For this purpose, the **agreed payment schedule** should be used instead.

- Initial payment deferral did not automatically trigger a SICR and credit impairments to the extent that:
  - individuals taking up payment deferrals are only **faced with temporary liquidity issues**; and
  - it has not **been necessary to tailor deferrals** to individual circumstances and these are therefore **not effective indicators** of financial circumstances.
- The PRA does **not expect immediate resumption of full payments** at the end of initial COVID-19 related payment deferrals - revised schedule of payments may be agreed.
- Separate consideration needs to be given to those borrowers that resume full payments at the end of a payment deferral and those that do not.
- However, for any payments then missed, the normal process for identification of:
  - SICR;
  - credit impairment; and
  - default

would apply.

PRA "DEAR CEO" LETTER: "COVID-19: INITIAL AND FURTHER PAYMENT DEFERRALS"

2 Need for other indicators as COVID-19-related deferrals do not automatically trigger SICR / default

- It should **not be assumed** that loans in which there are further payment deferrals remain in Stage 1.
- Additional information will need to be consider so as to assess loans' ECL stages - **not all loans** eligible for payment deferrals will have suffered a SICR or be credit impaired.
- However, **some will have** and therefore need to be transferred to Stage 2 or Stage 3.
- **Alternative options**, such as extensions of term, should also not, in their selves, automatically result in the loan involved being moved from Stage 1 to Stage 2 or 3.
- May lead to the lender **having more information about the borrower**, e.g. how widely each option is made available needs to be taken into account.
- **IFRS 9's definition of credit-impaired financial asset** includes "*for economic or contractual reasons relating to the borrower's financial* difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider".

3 A holistic assessment that looks beyond past-due and use of deferrals is needed

- Framework needed to **differentiate between** temporary difficulties which are less likely to lead to default and longer-term financial difficulties.
- Simplifications and approximations can be used for groups of borrowers **in the absence of** borrower-level information.
- However, such use it is **unlikely to be appropriate** when the amounts involved are material.
- To assist lenders in making these holistic assessments, the PRA have set out **four elements that it regards as relevant** in identifying SICR and credit impairment:
  - consideration of economic conditions;
  - use of historical information that lenders already hold about borrowers;
  - use of information gathered from borrowers using payment deferrals; and
  - application of judgement when information is not available.

PRA "DEAR CEO" LETTER: "COVID-19: INITIAL AND FURTHER PAYMENT DEFERRALS"

4 Lenders are to closely align their approach to ECL Stage 3 to the regulatory definition of default

- Reiteration that COVID-19 related payment deferrals are **not considered as generating arrears** under CRR and should not be **automatically assumed to be UTP indicators** under CRR.
- Assessments to determine UTP should be based on **agreed schedules of repayments**.
- There is no expectation that an **individual's circumstances** for payment deferral will be investigated.
- Lenders should **utilise the borrower information** that they have to assess for UTP indicators.
- The more lenders **differentiate the options offered** to borrowers based on individual characteristics, the greater the likelihood that the chosen option would be **classified as a distressed restructuring**.
- **Distinction to be made** between borrowers who do not resume full payments due to COVID-19-related issues and those who do not due to financial difficulty that is more long-term.

The PRA understands the difficulty in making this differentiation and encourage a well-balanced and consistent decision that takes into account borrower information.

CONCLUDING REMARKS

As one can see, the key implications of COVID-19 on IFRS 9 for lenders to consider include:

01
Economic scenarios and forward-looking information

02
Application of SICR and default definitions

03
PMAs and overlays

04
Suspension of repossessions

05
Treatment of guarantees

06
Modifications to financial instruments

Need governance processes in place over all of these aspects and more.

CONCLUDING REMARKS

Some of the things you should you be thinking about amongst others:

- Establish a governance framework to oversee the COVID-19 impact on accounting and financial reporting generally and on IFRS 9.
- Ensure that IFRS 9 is reflective of possibly changed credit risk management practices.
- Analyse forward-looking information, economic scenarios and probability weights applied to ECL estimates.
- Use overlays and PMAs where appropriate and justify their use
- Capture high impact economic uncertainty as fully as possible
- Review the basis on which SICR and default are assessed
- Capture scheme eligibility for the purpose of ECL modelling, including changes to said schemes.
- Scrutinise implications of contractual modifications to existing financial assets, including considering the treatment of those borrowers.
- Assess available information (e.g. payment deferral requests).
- Disclose critical accounting judgements and sources of estimation uncertainty, both qualitatively and quantitatively
- Apply IFRS 9 as it is required to be applied (e.g. SICR is a relative assessment of changes in lifetime PDs)

IFRS 9 - RESOURCES

BDO PUBLICATIONS

AVAILABLE ON THE
BDO WEBSITE

IFRS 9 - RESOURCES

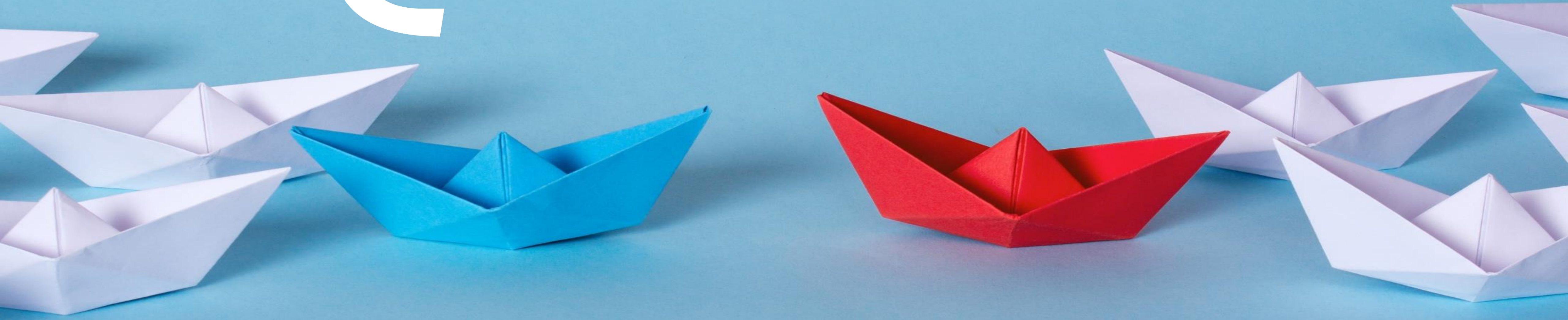
BDO CONTACTS

MARK SPENCER
Accounting Advisory Leader / Financial Services

+44 (0)20 7167 3100
mark.spencer@bdo.co.uk

IDEAS | PEOPLE | TRUST

Q&A



FOR MORE INFORMATION:

MARK SPENCER

+44 (0)20 7167 3100
mark.spencer@bdo.co.uk

42002943

Thank you for attending

Please take the time to fill out our short survey

Contact the Financial Services Faculty

Phone: +44 (0)20 7920 8689

Email: fsf@icaew.com

Web: icaew.com/fsf

This webinar is presented by the Financial Services Faculty. Our Banking, Insurance or Investment Management membership gives you access to exclusive premium resources including webinars, online events and conferences and extensive online resources to support your career.

For more information about membership and our latest joining offers, please visit icaew.com/joinfsf or for more information about Faculties Online, please visit icaew.com/subscribefo.