STATEMENT ON THE APPLICATION OF IFRS 9 IN THE COVID-19 PANDEMIC ENVIRONMENT

The COVID-19 pandemic has globally impacted economic and financial markets. Businesses are experiencing financial and operational challenges associated with measures taken by national governments to address the pandemic. As the spread of the pandemic increases, in both magnitude and duration, businesses will encounter conditions often associated with a general economic downturn.

This statement provides guidance on the application of IFRS 9 by financial institutions in the current Covid-19 environment, taking into account the regulatory measures by the Central Bank of Kenya to mitigate the impact of the pandemic as set out in the Banking Circular No. 3 of 2020 (the "Circular").

The Circular aims to enable banks to work with their customers to alleviate the likely adverse economic effects they may face from the COVID-19 pandemic while safeguarding the soundness of the banking system. In summary, the Circular:

- provides classification relief to banks from clauses 3.2 (classification of loans), 3.3 (classification categories) and 3.5 (classification of renegotiated loans and advances) of CBK/PG/04 in relation to loans whose repayment may be extended or restructured due to the pandemic, for a period of one year;

- requires the banks to document and keep records of all the extended and restructured facilities under the emergency measures, including particular circumstances under the pandemic, monitoring measures adopted and the set timelines for reverting to normal performance; and
- requires banks to meet all the costs related to the extension or restructuring of the facilities.

Whereas the measures require due consideration in determining the expected credit losses (ECLs) under IFRS 9, the Circular primarily applies to the classification and provisioning of loans and advances in accordance with the Prudential Guidelines.

This guidance seeks to achieve consistent application of the IFRS 9 principles by banks, whilst taking into consideration the implications of the Circular.

IFRS 9 sets out principles to be applied in the recognition and measurement of financial instruments and a framework for the measurement of ECLs. The standard requires the application of judgement and based on its broad principles, allows room for entities to determine the most appropriate approach in determining ECLs. As such the standard is not prescriptive and should not be applied in a mechanistic manner.

Financial institutions in Kenya have applied the requirements of IFRS 9 since 2018 and have, over the past two years, refined their models and assumptions based on experience. However, these models will need to be reassessed for appropriateness in the current Covid-19 environment where the presumptive assumptions, estimates and principles of IFRS 9 applied to date may no longer be applicable in the current environment.

The underlying principle in measuring ECLs, and specifically the assessment of a significant increase in credit risk (SICR), probability of default (PD) and loss given default (LGD), require consideration of circumstances over the expected life of a financial instrument. Defining default is also an essential part of measuring ECLs. Therefore, banks will have to analyse the facts of each repayment extension or restructuring measure to determine whether the credit risk of the financial instrument has significantly increased, or the borrower is just experiencing a temporary liquidity constraint from which it will recover post COVID-19. The assessment can be performed on a collective basis, if difficult to assess at individual account level, e.g. sector or industry level.

Therefore, it is important to set-out upfront that the relief measures granted to borrowers through extended and/or restructured facilities under the Circular may not automatically result in a change to the basis of the ECL determination under IFRS 9.

Assessment of SICR and the determination of ECLs

IFRS 9 requires the assessment of whether there has been a significant increase in credit risk in a financial instrument at each reporting date. This assessment is made with reference to the credit risk assessed on initial recognition of the instrument. Whilst the standard sets out backstops (which are rebuttable) in terms of days past due, it emphasizes that this assessment is dependent on multiple indicators, quantitative and qualitative, that are based on reasonable and supportable information that is forward-looking.

The assessment of SICR and the overall measurement of ECLs is with reference to the expected life of the financial instrument and not just based on the ongoing/current/short-term circumstances.

Relief measures set-out in the Circular will have to be carefully assessed to determine their impact on the credit risk of the individual instruments. Whilst an extension or restructuring or other modification to a credit instrument may be indicative of an increase in credit risk, such relief measures could also in themselves provide short-term support to borrowers resulting in unchanged or even a reduction of overall credit risk over the expected lifetime of the instrument.

The standard also, while requiring the use of current and forward-looking information, has requirements for such information to be reasonable and supportable and available without undue cost or effort. Such information could include:

- an actual or expected significant change in an instrument's external credit rating;
- an actual or expected internal credit rating downturn;
- an actual or expected significant change in the operating results of the borrower;
- existing or forecast adverse changes in business, financial, or economic conditions; and/or

- significant changes in the value of the collateral supporting the obligation.

Whilst the current Covid-19 environment is inherently uncertain, the availability of reliable forward-looking information is expected to become increasingly available as time and experience under the current environment progresses. Management should make use of such information but may also consider historical information, and in particular past due information, in determining whether there has been a SICR in circumstances where reasonable and supportable forward-looking information is not available.

Similar judgement may be necessary in the determination of the other key elements in the measurement of ECL, being PD and LGD. Banks will have to assess the changes in these elements arising from the current environment and the effects the relief measures have on the same. Given the uncertainty, and where banks foresee a lack of availability of reasonable and supportable forward-looking information, it may well be appropriate to assign a greater probability to the overall longer-term prospects of default by the borrower, particularly for instruments with longer expected lives. However, it would not be appropriate to completely ignore the current short to medium-term impact of Covid-19 with their respective probability weightings. Facilities that are short-term would most likely need to have greater consideration of the immediate impact arising from Covid-19.

IFRS 9 permits collective assessment on a portfolio basis under certain conditions and also permits effects that may be difficult to build into models to instead be applied as overall adjustments or overlays to the model outcome, which should provide banks sufficient flexibility in adapting their current models to reflect the impact of the new uncertain environment and to continue to monitor its development and reflect the effects of changes on an ongoing basis.

Defining default

Although IFRS 9 does not include a definition of default (other than a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due), financial institutions will have determined their definitions and applied them since they first applied IFRS 9. Whilst such definitions are normally applied consistently period to period, they may need to be reviewed to ensure that they reflect current economic conditions. For example, it is common for banks to consider unlikeliness to pay (UTP) criteria as an indicator of default which may need to be updated to reflect borrowers' non-payment behaviors in the current economic environment. Careful consideration will also be necessary in rebutting the 90-day presumption in the current economic environment and in determining whether the relief measures can reasonably support a rebuttal.

Accounting for extended and restructured facilities

Relief measures as set out in the circular are likely to represent modifications to the terms of the original instrument. Under the requirements of IFRS 9, such modifications would need to be assessed to determine whether they are substantial or not. Where such modifications are determined to be substantial, IFRS 9 would require the original instrument to be derecognized with the recognition of a new instrument under the revised terms.

The assessment of whether a modification of a financial asset is substantial or not is complex and may require significant judgement. We urge preparers to carefully consider modification guidance in IFRS 9.

Where it is determined that such modifications are not substantial, the considerations set out above in respect of SICR and likely changes to the PD and LGD applied in the overall measurement of ECLs would be important. Where such modifications are considered to be substantial, an assessment would need to be made as to whether the newly recognized instrument would represent an originated credit-impaired instrument.

The Circular requires banks to meet the costs related to the extension or restructuring of the facilities. Depending on the restructuring arrangements, the cost will either be immediately expensed to the profit or loss account or require an adjustment to the effective interest rate (EIR) used for income recognition for the remaining term of the instrument.

Disclosures

The current stressed and uncertain environment requires a non-mechanistic approach in the application of IFRS 9 with estimates based on reasonable and supportable information that can provide useful information about ECLs and when combined with the associated disclosures can provide much needed transparency to the users of financial statements.

Enhanced disclosures in the following areas will be highly necessary:

- Accounting policy for determining when a modification to a financial instrument is substantial
- Disclosures in respect of significant judgements and areas of estimation uncertainty that relate to SICR and the measurement of ECLs

- IFRS 7 disclosures in relation to credit risk:
    - Assumptions and judgements applied in the determination of SICR and ECL
    - Specific Covid-19 related disclosure including the impact of the relief measures and how these have affected the determination of SICR and ECLs
    - The forward-looking information considered in determining SICR and ECLs
- Overall financial statement disclosures on principal risks and uncertainties arising from Covid-19 that are not only limited to the measurement of ECLs

Governance and oversight

Given the level of judgement that will be required to comply with the Circular and in the determination of the ECL, it is important that this process is subject to clear internal governance and oversight controls. Banks should develop an internal policy framework for compliance with the Circular and determination of ECL in the COVID-19 environment to be approved by those charged with governance (e.g. Board Credit Committee and/or the Board Audit Committee).