Credit loss reporting for banks and insurance companies

Date: 10 September 2020

Webinar

CPA Beth Kithinji

Disclaimer

The opinions expressed in this presentation and on the following slides are solely those of the presenter and not necessarily those of ICPAK. ICPAK does not guarantee the accuracy or reliability of the information provided herein.

This presentation is confidential and is intended among other things to present a general outline of credit loss reporting. The contents are not to be reproduced or distributed. Each person who has received a copy of this presentation is deemed to have agreed (i) not to reproduce or distribute this presentation, in whole or in part, without the prior written consent of ICPAK (ii) without the prior written consent of the presenter, nor to disclose any information contained in this presentation except to the extent that such information was (a) previously known by such person though a source not bound by any obligation to keep such information confidential (b) in the public domain through no fault of such person, or (c) lawfully obtained at a later date by such person from sources nor bound by any obligation to keep such information confidential, and (iv), to be responsible for any disclosure of this presentation, or the information contained therein, by such person or any of its employees, agents or representatives.

Attendees should note that sessions are audio/video-recorded and may be published in various media, including print, audit and video formats without further notice.

Scope of the impairment requirements

The following table sets out instruments that are in and out of scope of IFRS 9's impairment requirements:

In scope	Out of scope
— Financial assets measured at amortised cost or at FVOCI (this includes loans, trade receivables and debt securities) — Loan commitments not at FVTPL — Financial guarantee not at FVTPL — Lease receivables (IAS 17/ IFRS 16) — Contract assets (IFRS 15)	— Equity investments — Loan commitments at FVTPL — Other financial instruments measured at FVTPL

Expected credit loss definition

Measurement of ECL

ECLs are an unbiased probability-weighted estimate that reflects reasonable and supportable information that is available without undue cost and effort at the reporting date. This includes information about past events, current conditions and forecasts of future economic conditions. [IFRS 9.5.5.17]

IFRS 9 requires the application of judgement and requires entities to adjust their approaches to determining expected credit losses (ECLs) in different circumstances. A number of assumptions and linkages underlying the way entities have implemented the ECL requirements of IFRS 9 to date may no longer hold in the current environment.

High level overview

EL = PD x LGD x EAD

EL
- Expected loss is a statistical measure used to reflect expectations of future losses based on historical data
- The three primary components are derived based on observation, empirical evidence and expert judgment
- The objective is to quantify loss expectations over a 12 month forecast

PD
- Probability of default for an asset or class of assets over the next year
- PD represents an average expectation over the course of an entire business cycle (through-the-cycle) as opposed to specific current expectations (point-in-time)

LGD
- Loss given default based on losses resulting from defaults over the next 12 months
- Ideally the LGD will be separated for secured and unsecured portions of an exposure
- LGD is a prudent parameter based on an assumed downturn in the economic conditions

EAD
- Exposure at default represents the amount an entity stands to lose in the event of a default event
- For a 12 month horizon, the EAD is defined as the current exposure without considering payments
- Undrawn commitments are factored in using statistical probabilities of drawing

- Changes to existing models are necessary to comply with lifetime expected credit loss (LECL) requirements

IFRS 9 ECL - General model

Default not defined

Significant increase in credit risk (credit deterioration) since initial recognition

Impairment recognition

Stage 1	Stage 2	Stage 3
12-month expected loss	Lifetime expected loss	Lifetime expected loss

Interest revenue recognition

Stage 1	Stage 2	Stage 3
EIR on gross amount (excl loss allowance)	EIR on gross amount (excl loss allowance)	EIR on amortised cost (net of loss allowance)

Stage 1
Performing
"The Good"

Stage 2
Under-Performing
"The Bad"

Stage 3
Non-Performing
"The Ugly"

EIR: Effective interest rate

12-month ECLs are the portion of lifetime expected credit losses that represents losses resulting from default events that are possible within 12 months

Lifetime ECLs are the expected credit losses that result from all possible default events over the expected life of a financial instrument

Allowance for impairment - General approach (cont)

12-month expected loss

Lifetime expected loss

Stage 1
Performing

Stage 2
Under-Performing

Stage 3
Non-Performing

Significant increase in credit risk since initial recognition – use forward looking information, internal or external ratings

- Instruments that have *low credit risk* are assumed not to have increased credit risk
- Rebuttable presumption that instrument that are 30 days past due has experienced significant increase in credit risk.
- Undrawn credit facilities, financial guarantees, and off balance sheet exposures will be assessed for impairment

Significant increase in credit risk not defined

To assess SICR IFRS 9 requires that entities assess changes in the risk of a default occurring over **the expected life** of a financial instrument.

More than 30 days past due rebuttable presumption

It may be possible for an entity to rebut the 30 days past due presumption where:

— a borrower faces short-term liquidity constraints as a result of the COVID-19 pandemic; and

— the lender has reasonable and supportable information that the borrower will receive assistance from the government or another third party that will resolve these constraints and there are no other indications of SICR in respect of the individual borrower.

Rebuttal "should be accompanied by a thorough analysis clearly demonstrating that 30 days past due is not correlated with a SICR. Such analysis should consider both current and reasonable and supportable forward-looking information that may cause future cash shortfalls to differ from historical experience."

Banks: COVID-19 impact analysis on IFRS 9 ECL estimates (1/2)

Covid 19: What banks are concerned about

Direct effects of the crisis

- Credit portfolios are deteriorating. Among other things, massive drop in sales in particularly affected sectors.
- Outlook: Rising unemployment, falling incomes
- Active draw – down on lines of credit

Regulatory activities

- Regulatory flexibility on staging of facilities.

Subsidy programmes

- Government guarantees, payment holidays, forced lending

Current focus topics in lending business

Credit process and products	Risk analyses, industry analyses, re-ratings and re – assessment of risk drivers	Establishment and expansion of application and processing routes for the effective use of subsidy programmes	Management of forbearance-, restructuring and reorganisation cases
Credit risk management	Evaluation of the impact on creditworthiness at customer and portfolio level	Review of SICR assessment, need for re – segmentation to ensure Covid risk homogeneity.	Implementation of short and medium-term scenario analyses in the loan book
Credit risk provisioning and capital	Determination of short- and medium-term capital needs; targeted capital allocation	ECL extreme value modelling.	Revision of forward – looking assumptions.

Other key concerns in the Banking sector.

— Fair value volatilities on assets measured at FVOCI and FVTPL

— Fair value and accounting considerations for loans issued on a concessionary basis/ below market rate lending.

— Increased lifetime ECL estimates.

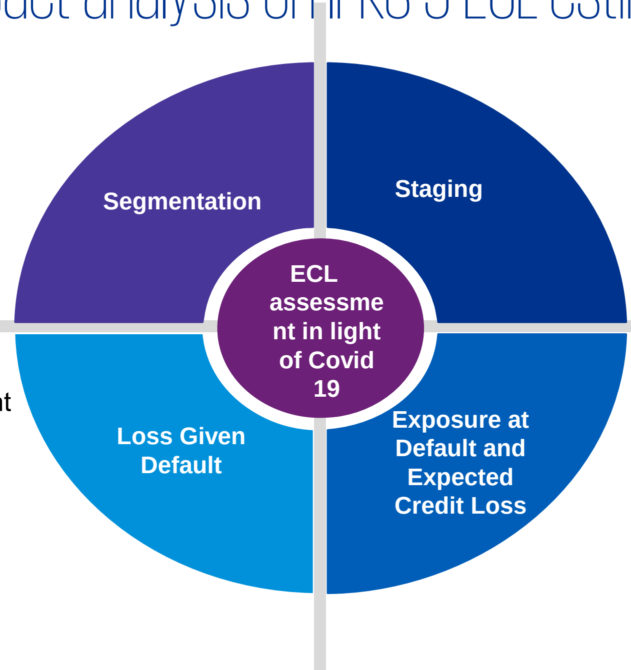
— Enhanced stress testing measures and increased capital requirements.

— Risk correlations in portfolios/ credit concentration risk assessment.

Banks: COVID-19 impact analysis on IFRS 9 ECL estimates (2/2)

- Portfolio re – segmentation for collective SICR assessment.
- Individual SICR assessment depending on obligor – specific information.

- Staging considerations in light of contractual modifications, government relief/ stimulus programs, risk correlation and forward – looking qualitative impact analysis.



- Assessment and incorporation of government relief/ stimulus in LGD assessment.
- Revision of recovery assumptions.
- Considerations on medium – term contractual revaluation..

- Incorporation of contractual extensions (behavioural life) as well as expected increased draw – downs on credit limits.
- Extreme value modelling considerations conditioned on prevailing measures.

Macroeconomic and FLI analysis

- Revision of macroeconomic projections
- Greater emphasis on economic downturn scenario analysis.

- Revision of forward – looking LGD recovery assumptions to incorporate economic downturn.
- Incorporation of qualitative FLI adjustments in staging assessment.

Further considerations

- Recognition and de – recognition of financial assets based on contractual modifications.
- Accounting for government guarantees, relief advances/ loans as well as stimulus packages.
- Credit risk management and mitigants on forced lending.
- Cashflow considerations and enhanced stress testing in light of payment holidays as well as contractual modifications.

Insurance: COVID-19 impact analysis

Investment portfolios

Insurers should disclose the nature and extent of risks arising from financial instruments and how they manage those risks e.g credit risk, liquidity risk. This means that insurers will need to explain the significant impacts of COVID-19 on those risks and how they are managing them.

available-for-sale equity investments.

IAS 39 requires an impairment loss to be recognised if there has been a significant or prolonged decline in the fair value of the investment below its cost. (for insurers that have applied the temporary exemption and using IAS 39)

Debt investments

Assess whether there is a loss event that has affected the estimated future cash flows of any debt investments and whether to recognise an impairment loss.

Operational impacts

In a number of countries, regulators and governments are taking specific actions – e.g. grace periods for premium collection, non-cancellation of insurance coverage during the pandemic and waiving co-pays. These actions may impact assumptions about the timing of premium cash flows or the continued use of historical trends (e.g. loss ratios) to estimate ECL.

Investment portfolios under IAS 39

Assess whether impairment losses should be recognised for investments that are not classified as at FVTPL. Under IAS 39, an investment is impaired if there is objective evidence of a loss event since initial recognition that has an impact on the estimated future cash flows. Indicators of impairment include a borrower's significant financial difficulties or it becoming probable that the borrower will enter bankruptcy or financial reorganisation.

Life insurers

The further decline in interest rates and the downturn in financial markets could lead to signficant impairments of financial assets.

Current Market Developments - impact on valuations

Decrease in Market Liquidity

Decrease in number of price quotations
Loss in consistency across established pricing services. Increased Bid/Offer spreads

Increase of Market Volatility & Uncertainty in Dividends Projections

Market volatility reached levels of the global financial crisis 2008.
Interest rate implied volatilities have spiked
Companies postpone or cancel dividend payments

Increase in Credit Risk

Credit spreads for investment grade and non investment grade entities increased on average by 40 and 340 bps respectively.
Structured finance assets' and leveraged loans discount spreads have doubled and tripled

Impacted Markets

— Fixed Income
— Interest Rate
— FX
— Credit

— Fixed Income
— Interest Rate
— FX & Equity
— Credit

— Fixed Income
— Credit

Fair Value Measurement - impact on LGD

What impacts might COVID-19 have on fair value measurement under IFRS 13?

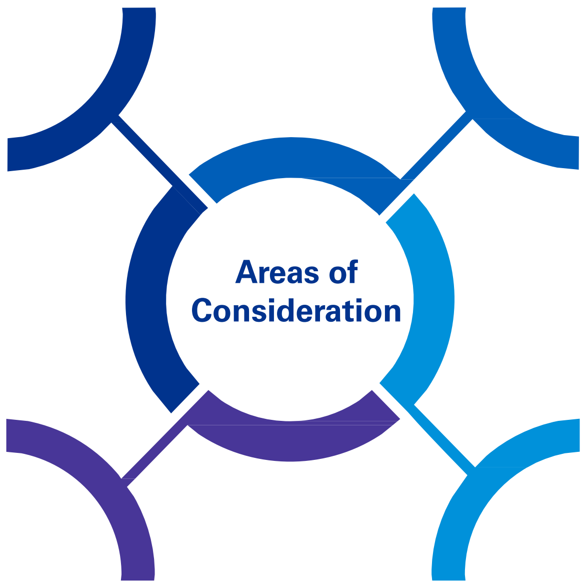
The COVID-19 coronavirus pandemic has significantly affected economic activity and financial markets in 2020. Disruption to business operations and lockdowns have triggered declines in a range of asset prices and increased volatility in financial markets.

- ✓ Reflecting information at the measurement date
- ✓ Using prices in active markets
- ✓ Determining whether a market is active
- ✓ Measuring fair value if volume or level of activity significantly decreased
- ✓ Using inputs based on bid and ask prices
- ✓ Using forward-looking valuation multiples to value unquoted equity investments and cash-generating units
- ✓ The approach to projecting cash flows in a valuation of equity / enterprise value
- ✓ Challenges in projecting cash flows in a valuation of equity / enterprise value
- ✓ Derivatives
- ✓ Reflecting the risks in the discount rate
- ✓ Measuring fair value of investments in investment funds on the basis of Net Asset Value (NAV)
- ✓ Valuation of distressed debt using the income approach
- ✓ Significant valuation uncertainty clauses in valuation reports
- ✓ Disclosures

Resulting Implications on Fair Value Estimates

Valuation of Financial Instruments

- How robust are the valuation processes? Have there been increased trigger breaches? (e.g. collateral disputes, IPV breaches, hedge ineffectiveness etc)
- Did banks change valuation methodologies (mark-to-market→ mark-to-model). If yes, is there a strategy for moving back to mark-to- market?
- Have banks reviewed their credit assessment over fair valued loans and other credit instruments
- Interest rates fell and liquidity costs increased. Is the realised correlation adequately captured in the valuation models
- How do banks quantify close-out-costs considering the increased volatility in bid-offer spreads?



Fair Value Hierarchy

- Methodologies, which for example classify investments based on their type (family approach) may not adequately capture the decreased market liquidity.
- Robust methodologies will likely trigger a re- classification of certain investments, due to reduced observability and consistency of market data.
- The transition from mark-to-market to mark-to- model may result in re-classifications
- Reduction in quotations for market implied inputs and modelling uncertainty (dividends) may result in vanilla OTC products previously being classified as Level 2 to shift in Level 3.

Summary ECL considerations for management

Consider the following when measuring ECL:

- whether additional economic scenarios are needed;
- whether adjustments to model results, based on expert credit judgement, are necessary;
- whether the measurement appropriately captures the types of customers/issuers or regions that are particularly impacted by the economic effects of COVID-19;
- changes in customer behaviour such as drawing more extensively on credit lines and holding on to cash;
- the impact of any assistance to borrowers from a government or regulator – does assistance provided by a government means that government grant accounting is appropriate;
- the impact of any actions planned by the company (e.g. modification, forbearance, limit increases) on the expected cash flows.
- whether it is possible to incorporate COVID-19-related changes in the risk of default into PDs for individual exposures on a timely basis;
- incorporating qualitative factors in identifying SICR – e.g. changes in customer behaviour or requests for payment holidays or limit increases;
- assessing SICR on a collective basis;
- whether modification of contractual terms of a financial instrument leads to recognising a gain or loss on derecognition, or a gain or loss on remeasurement;
- Consider whether the valuation reflects market participants' assumptions based on information available and market conditions at the measurement date; and

Disclosure requirements

Disclosures (including government grants and government assistance)

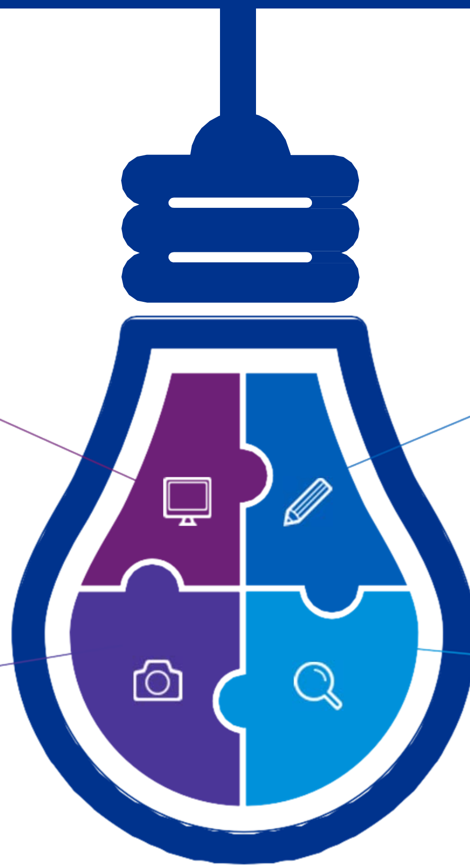
IFRS 7 and IAS 1 contain comprehensive disclosure requirements in respects of risks arising from financial instruments, accounting policies, judgements, assumptions, estimation uncertainties and changes in these areas.

Estimation uncertainty

The COVID-19 pandemic results in increased estimation uncertainty and changes to estimation techniques, assumptions and inputs for measuring ECLs.

New accounting policies, estimation techniques and disclosures

Lenders might also be entering into types of transactions that they have not previously entered into or for which they have not previously developed accounting policies, estimation techniques and disclosures.



IAS 20 disclosures

- The accounting policy adopted, including the method of presentation adopted in the financial statements.
- The nature and extent of government grants recognised in the financial statements.
- Unfulfilled conditions and contingencies attaching to government assistance that has been recognised.
- Government assistance from which the entity has directly benefited even if that assistance has not resulted in the recognition of a government grant.

Difficult accounting challenges arising from COVID-19

Lenders should identify the key judgements, assumptions and estimates made in addressing those challenges and how the underlying transactions impact risks and risk management related to financial instruments.

Disclosure requirements relating to financial instruments for financial institutions that are likely to be impacted by Covid-19

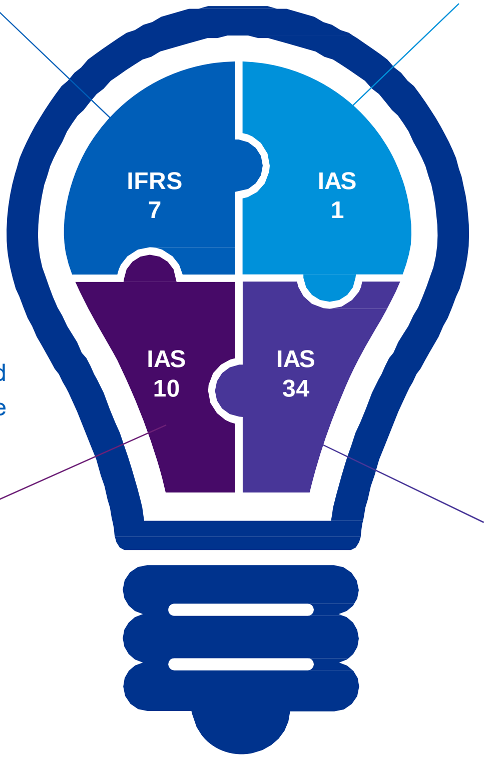
General principles

Nature and extent of risks arising from financial instruments and how the company manages those risks

- A company may have changed the way it does business, that may in turn impact the risk that arises from the transactions it enters into and the way it manages those risks – e.g. changes to terms and conditions of loans it originates.
- A company may need to explain the significant impacts of the COVID-19 outbreak on the risks arising from financial instruments and how it is managing those risks.
- A company may use judgement to determine the disclosures that are both relevant to its business and necessary to meet specific disclosure objectives.
- The types of analysis disclosed previously may need to be adjusted or supplemented to clearly convey the impacts arising from COVID-19.

Post balance sheet events

- With fast changing economic conditions, companies will have to carefully consider whether certain events occurring after the reporting date are material non-adjusting events that need to be disclosed in the financial statements.
- For each material category of non-adjusting event after the reporting period, a company discloses the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made.



Estimation Uncertainty

IAS 1.125 requires disclosure about the assumptions a company makes about the future and other sources of estimation uncertainty at the end of the reporting period that have a significant risk of resulting in a material adjustment within the next financial year. Covid-19 is likely to significantly impact such assumptions. For example, it may result in increased estimation uncertainty and changes to estimation techniques and assumptions for measuring ECL.

Interim financial statements

- A company has to include in its interim financial report an explanation of events and transactions that are significant to the understanding of the changes in its financial position and performance since the end of the last annual reporting period.
- The impact of Covid-19 is likely to be significant and, accordingly, many of the disclosures outlined in these slides may be relevant for interim reporting.
- In addition, IAS 34 has specific disclosure requirements relating to the fair value of financial instruments.

Examples of specific disclosures for banks

Transparent disclosure

Banks will face many difficult accounting challenges arising from Covid-19.

They will need to consider how to provide transparent disclosure.

Examples of specific disclosures for banks

Measurement of ECL

- How it has included updated economic forecasts in response to COVID-19 into the ECL calculation
- How it has updated the weighting of any upside, downside and base case economic scenarios
- How quickly it believes there may be a return to longer-term “normal” economic trends
- How it has incorporated the provision of government support to borrowers that might aid recovery of outstanding balances
- How it has stratified borrowers into segments to perform the assessment on a collective basis
- How it has dealt with the challenge of ECL models that were not designed for the current economic shocks
- How it has calculated overlays and adjustments to ECL models

Methods, assumptions and information used to measure ECLs
– e.g. a bank may need to explain how it has incorporated updated forward-looking information into measuring ECLs

Examples of specific disclosures for banks

Measurement of ECL

Information about changes to the bank's credit risk management practices as a result of COVID-19 and how they relate to the recognition and measurement of ECLs.

A bank may have changed its risk management practices in response to COVID-19 by extending debt relief to borrowers or by following specific guidance issued by governments or regulators.

Examples of specific disclosures for banks

Assessing whether the credit risk of the financial instrument has increased significantly

A bank's methods and indicators used to determine a SICR may have changed in response to COVID-19

Collective assessment

Additional collective assessments may have been performed or financial instruments may have been grouped differently.

A bank may need to disclose decisions made regarding segmenting portfolios by relevant shared credit risk characteristics.

SICR based on (pro)portions

If a bank is not able to group financial instruments based on shared credit risk characteristics and it has recognised lifetime expected credit losses on a portion or proportion of the financial assets for which credit risk is deemed to have increased significantly - the bank may need to disclose how it has determined the (pro)portion in each case.

30 dpd rebuttable presumption

A bank may have rebutted the presumption that there has been a SICR since initial recognition when a loan is more than 30 days past due. Where a bank rebuts this presumption, it should be disclosed.

Foward-looking information

A bank may need to explain how it has incorporated updated forward-looking information into assessing SICR.

Changing automatic triggers

A bank may previously have disclosed an approach that all payment holidays and similar reliefs were a qualitative indicator that automatically required an exposure to be transferred to Stage 2 (or Stage 3), which may no longer be appropriate and if so the disclosure may need to be updated.

Liquidity constraints vs SICR

How a bank has distinguished between cases where a payment holiday provides relief from short-term liquidity constraints impacting the borrower that do not amount to a SICR considering the entire life of the instrument vs. cases where there is a significant increase in the risk of default over the entire remaining life of the instrument (e.g. because of longer-term liquidity or solvency problems).

Examples of specific disclosures for banks

Fair values of financial instruments categorised within Level 3 of fair value hierarchy

Fair value – Level 3 Disclosures

- A company may need to explain how it has incorporated new pricing sources or any change in valuation models used to derive fair value
- A company should include a narrative description of the sensitivity of recurring fair value measurements to changes in unobservable inputs, if a change in those inputs might result in a significantly higher or lower fair value measurement
- A company should include quantitative sensitivity information if changing one or more unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly
- A company should disclose recurring fair value measurements transferred into or out of Level 3 of the fair value hierarchy

Examples of specific disclosures for banks

Government assistance

Disclosures relating to government assistance discussed below for banks may also be applicable to corporates in relation to benefits provided to them such as government guarantees

IAS 20 disclosure requirements for government grants

- The accounting policy adopted, including the method of presentation adopted in the financial statements;
- The nature and extent of government grants recognised in the financial statements; and
- Unfulfilled conditions and contingencies attaching to government assistance that has been recognised

Disclosures about special funding available to support banks and companies

- IAS 20 requires disclosure of government assistance from which an entity has directly benefited even if that assistance has not resulted in the recognition of a government grant

Disclosures about financial guarantees

- A lender shall consider disclosing how it has determined whether a financial guarantee provided by the government is integral to the terms of the loans in its portfolio (or not)

Questions & Answers