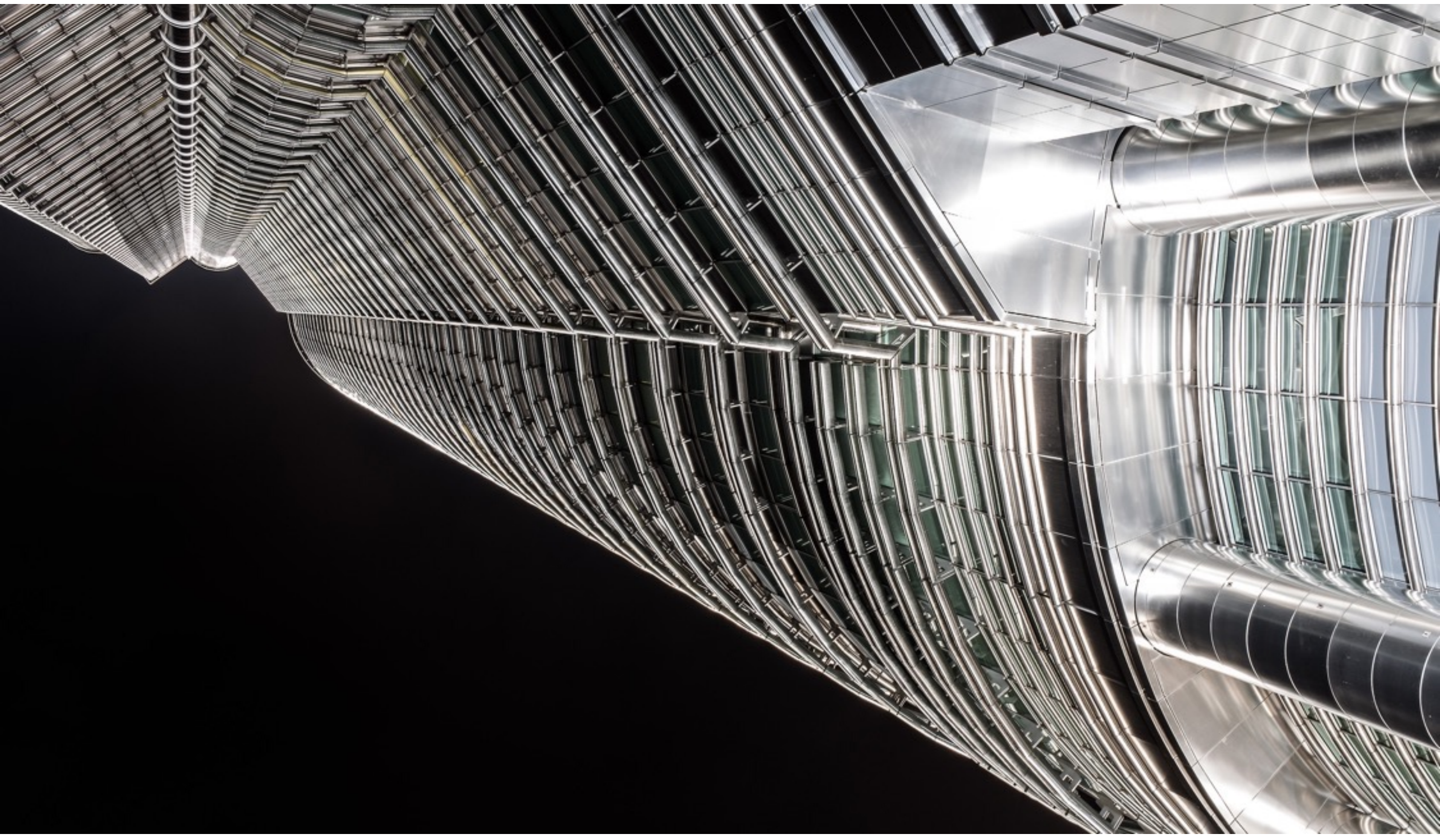
IFRS 9 Accounting Implications in the Current Context of COVID 19 Pandemic



On March 14th, 2020, the Central Bank of UAE announced a comprehensive AED 100 billion targeted economic support scheme to contain the repercussions of the COVID-19 pandemic.

This decision comes at a time when the UAE economy is affected by the global slowdown in growth and trade caused by the pandemic as well as the sharp decline in oil prices.

In the last couple of weeks, authorities and governments have acted rapidly to contain the spread of the virus and enhanced the stimulus needed to support the economies. Last week, several prudential and securities regulators issued guidance commenting on the application of IFRS 9 in the current environment as the banks started to worry about the potential spike in provisions of the loan portfolios.

On the 27th of March 2020, the IASB issued a document to support the consistent application of requirements in IFRS standards, specifically around the application of the Expected Credit Loss (ECL) under IFRS 9 in the context of COVID-19 pandemic.

In this publication, we will analyse the IFRS 9 accounting implications of the recent measures taken by the UAE central bank and the uncertain situation related to the pandemic in the accounting of the Expected Credit Losses and the recent recommendation of International Accounting Standards Board (IASB).

The UAE Central Bank Measures

The targeted Economic Support Scheme unveils a AED 100 billion package (equivalent to 6.7% GDP), consisting of mainly 2 major initiatives along with other measures aiming to boost the most affected sectors in the UAE economy:

1. AED 50 billion zero cost collateralised loans to all banks operating in the UAE.
2. AED 50 billion funds freed up from banks' capital buffers allowing banks to use up to 60% of the capital conservation buffer, and up to 100% for banks designated as systemically important by the CBUAE.

The UAE Banks

In response to these initiatives, the banks are expected to use the funds in granting temporary relief from the payments of principal and interest on outstanding loans for all affected private sector companies and retail customers in the UAE and for a period of up to 6 months.

SMEs & Start-ups

The CBUAE has reduced 15-25% of the capital required for SME loans providing more enablers for the the SME sector.

The Real Estate Sector

As for the real estate sector, banks are given the authority to increase the exposure limit of loan portfolios to up to 30% as opposed to their current level of 20%. To that effect, the Central Bank requires the banks to retain sound lending standards including increasing the loan provision if necessary.

Previous to the current crisis, the real estate sector was suffering from the overall economic slowdown. To that effect, as an initiative to revive the real estate sector, the CBUAE has authorised an increase in Loan-To-Value (LTV) for the first-time buyers by 5%, to encourage investments and as an alternative to the investors' own capital.

IFRS 9 & COVID-19

Following the measures and initiatives taken by authorities, mainly in Europe and other countries worldwide, banks expressed concerns about the effects on the application of the IFRS 9 and the main guidance on the financial instruments credit provisioning. Many regulators have issued guidance around the accounting implications, following which the IASB board issued a document to help support the consistent application of accounting standards.

On March 27th, 2020, the International Accounting Standards Board (the IASB or the Board) has published a short document highlighting the main effects to be taken in the light of current uncertainty caused by the COVID-19 pandemic.

The document has elaborated mainly on the following main principles of the IFRS 9 framework:

- The application of judgement is necessary in not applying mechanically the existing ECL models already implemented. Careful consideration should be taken in the Significant Increase in Credit Risk (SICR) or staging methodology especially in the context of the payment holiday relief allowed by the participating banks in the CBUAE initiative.
- Effects of COVID-19 along with measures taken by governments need to be incorporated in the macro-economic factors to determine the forward-looking impact on the ECL. In the case of the current market, as highlighted in the introduction, the effects of sharp decline in oil prices and their effect on Oil and gas industry would also need to be incorporated as part of the forecast of macro-economic factors.
- Lastly, efforts should be made, to be based on reasonable and supportable information that is available to an entity without undue cost or effort, to reflect the uncertainty of current situation on the ECL by financial institutions and corporates to enable a better transparency to users of the financial statements in the disclosures.

Payment Holidays and its Impacts on Staging

For many banks and financial institutions in the region, the staging assessment included in assessing significant increase in credit risk is based on multifactor analysis, including internal credit grading systems if the grades are reviewed with sufficient frequency, or a more lagging indicator which is payment overdue, or a more borrower specific factor such as direct modification or restructuring observed on the loan.

According to the board,

> **"Entities should not continue to apply their existing ECL methodology mechanically. For example, the extension of payment holidays to all borrowers in particular classes of financial instruments should not automatically result in all those instruments being considered to have suffered an SICR".**

Along with the Board, ESMA (European Securities and Market Authority) has also issued a statement on the same topic stating that measures taken under these circumstances should not automatically trigger the SICR.

In line with this standard, using reasonable and supporting information, entities may consider past due information since initial recognition to determine whether significant credit risk deterioration happened linked to whether the borrower is experiencing a temporary liquidity difficulty or a more permanent constraint impacting the entire expected life of the instrument.

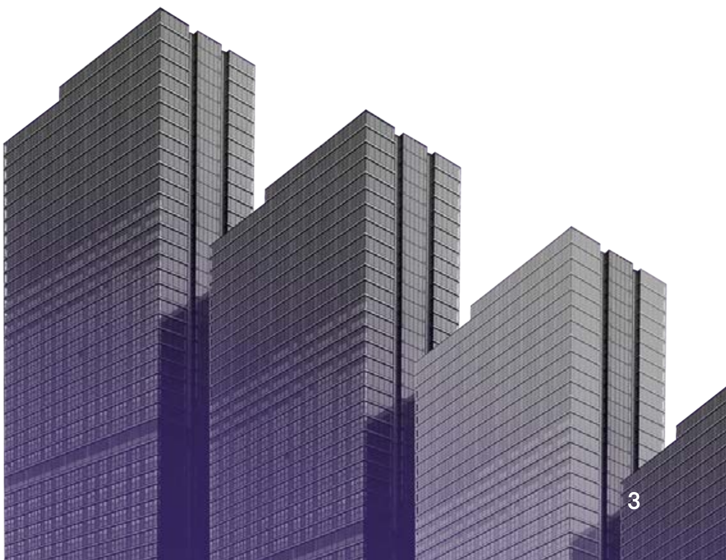
The UAE Focus

Changes in payment behaviour or changes in loan terms (also known as restructuring) are usually a key indicator of increase in credit risk or default, and it is very difficult for entities to overlook these changes without considering any changes in credit risk in this regard. IFRS 9 is principle-based rather than rules-based, therefore, entities may use the guidance that can be adjusted according to the context.

For example, Entities in the UAE mainly use the frequency in a year of a borrower becoming overdue for 30 days. In this scenario, entities may consider 30 days backstop assumption on transferring the instrument from stage 1 to stage 2 and to be rebutted under the current context as per the paragraph B5.5.20 in IFRS 9.

We may agree with the approach stated above on the assessment of the payment behaviour for each customer to determine the temporary character of the financial difficulty, however, this is a key challenge for most banks, as data is not always readily available since initial recognition and also systems are not in place to perform the analysis at an individual basis.

Consequently, the above assessment may be considered as an individual analysis on Corporate and Trade finance customers, however, this might be seen as a challenge for most entities for their retail customers. In that specific case, a more collective approach can be taken at a group or sub-portfolio level at industry wise level for example.



Improved Transparency

One of the key objectives of the disclosure requirements under IFRS 7 is to enable users understand the effect of ECL estimates and changes in credit risks.

In compliance with the requirements of IFRS 7 financial instruments disclosures, entities would need to provide all relevant disclosures related to actual and potential impacts of COVID-19 on the ECL.

The IASB board has stressed on the importance of IFRS 9 associated disclosures to "provide much needed transparency to users of financial statements".

In accordance with IFRS 7 and IAS 1 (Presentation of Financial Statements), where the financial information and financial performance is impacted by the current stressed context, particularly where significant judgement has been used, entities are required to disclose related significant information about the estimates and key assumptions used in the assessment of SICR and the forward looking information in the determination of the overall ECL.

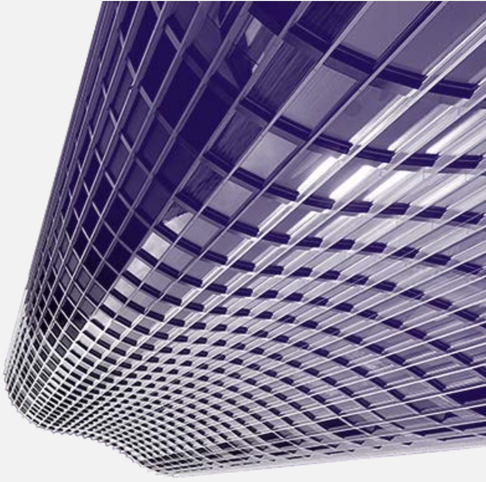
At this time of the year, where entities will start preparing their first quarter financial statements, IAS 34 requires entities to explain events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the previous annual reporting period. They are also required to provide an update to the relevant information included in the financial statements of the previous year. [IAS 34.15, 15C].

The UAE Focus

The challenge we see in the UAE is that disclosures are not always presented to meet the end-user needs to understand the explanations on estimates and judgements and assumptions used in the ECL model. In most cases, each organisation has a different interpretation on the minimum requirements of the IFRS 7 standard. Harmonisation is key and is still on the agenda since IFRS 9 has been effective.

Now the challenge, or rather an opportunity, can be seen to improve the presentation of financial statements specially where entities are expected to adjust their model and parameters to assess the impact on their financial performance.

Consequently, entities are required to provide transparent explanations on the impact of the pandemic crisis, starting from the first quarter of 2020, on their financial position and performance if this is considered material and significant for the end-user of the financial statements.



Future Economic Condition Forecasts

Under IFRS 9 framework, entities should use reasonable and supportable information that is available without undue cost or effort, at the reporting date about past events, current conditions and forecasts of future economic conditions, to determine the Expected Credit Loss.

Depending on the sector and the group of loan portfolio, incorporating macro-economic factors in the ECL is a key step in the assessment. Some entities incorporate the forward-looking factors in the model directly impacting the parameters such as Probability of Default and Loss Given Defaults. Others with less complex structure, may incorporate the forward-looking information outside the model as an overlay adjustment.

For example, for real estate sector, banks would update the LTV measures using estimates of property values using recent sales in the area and the forward-looking information available. Consequently, an expected decline in residential property values would adjust either the internal scoring of the borrower, or on a collective basis, may be applied to the ECL factor as a further adjustment to the computed ECL.

Under the current challenging pandemic context, ESMA pointed out that entities should give a greater weight on the long-term outlook, rather than short-term, taking into account the relief measures granted by public authorities and their impact in the long run of the economic cycle.

The UAE Focus

In our view and in addition to the above, entities in the UAE would need to consider the decline in oil and gas prices along with the decline in property values to have an overall outlook of these forecasts on their impact over the ECL provision for 2020 interim and year end financials.

To Summarize

In the light of recent changes, we believe that entities, whether financial institutions or corporates, will have an impact on the existing IFRS 9 provision: entities should not try to maintain the same level of provisions as last year.

Conditions have changed from the start of the year, and that means budgets need a new iteration to incorporate the impacts on the business, and the ECL provision has to be considered in this exercise.

Auditors will be challenging the numbers as there is a definitive expectation of losses/expected losses to increase. For example, increasing the exposure of banks to SME portfolios coms along with a price: the price of adjusting the provision to counter the risk of future defaults or losses that may arise in the near future.

Organisations will have a difficult task to run scenario analysis and sensitivity analysis in order to determine the effects of not only the COVID-19 outbreak, but also the overall current stressed scenario with oil and gas declines and the ongoing recession, started as of last year, on their financial performance.

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Reach out:

The team at Grant Thornton is available to support you in assessing and managing your audit requirements.

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