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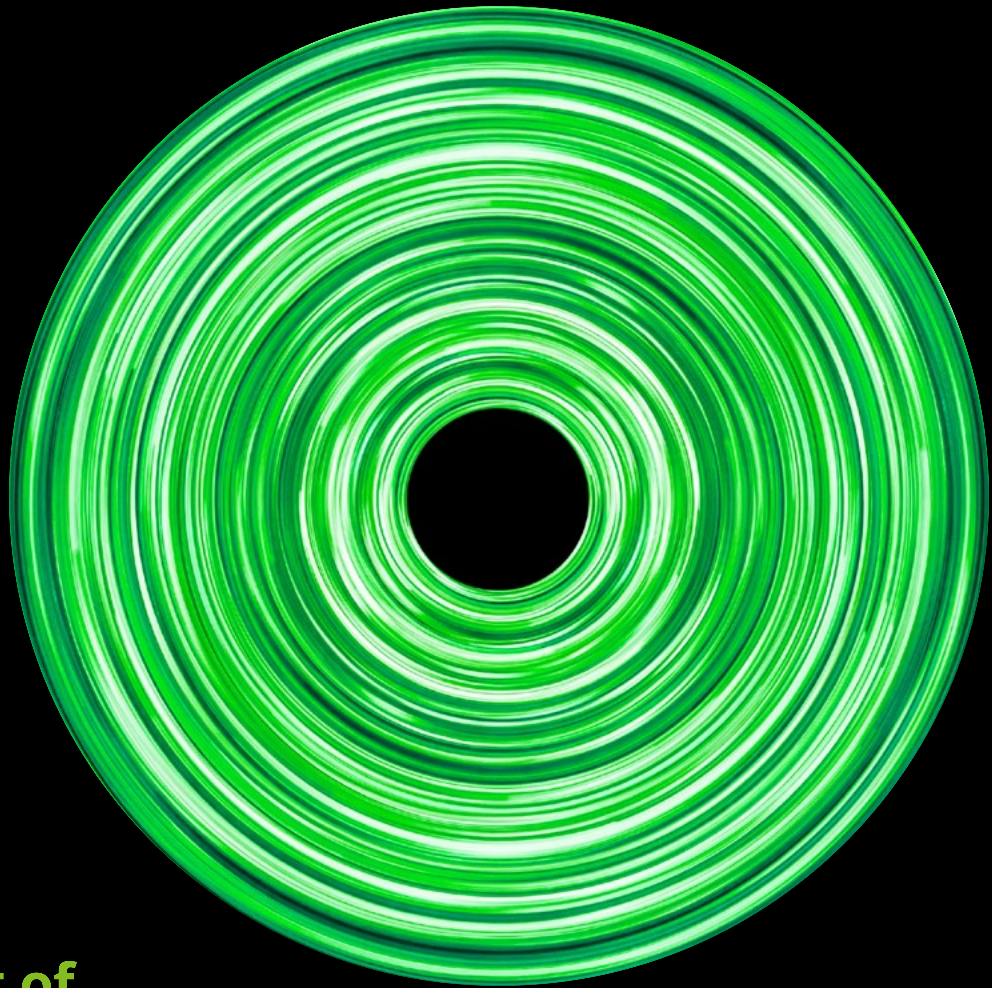

What is the impact of COVID-19 on loan and receivables provisioning?

June 2020

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Expected credit losses (ECL) in a nutshell

The impairment approach in AASB 9 *Financial Instruments* (AASB 9) is based on expectations as opposed to incurred losses under the predecessor accounting standard. This means it is not necessary for a loss event to occur before credit losses are recognised. Instead, a loss allowance is recognised for expected credit losses and is remeasured at each reporting date for changes in those expected credit losses.

AASB 9 is purposefully designed to be forward looking and reflect expectations of future credit events impacting loans and receivables on the balance sheet. It is important to be careful when determining what 'forward looking' information should be used as it must reflect the forward looking information that existed at the reporting date.

Financial reporting considerations for directors and executives

The COVID-19 pandemic is affecting all major economic and financial markets, resulting in many sectors facing challenges associated with the economic conditions. The travel, hospitality, leisure, and retail industries have had the sharpest declines in revenue.

As the pandemic evolves, all entities are expected to experience conditions often associated with a general economic downturn, including, but not limited to, financial market volatility and erosion, deteriorating credit, liquidity concerns, further increases in government intervention, increasing unemployment, broad declines in consumer discretionary spending, increasing inventory levels, reductions in production because of decreased demand, layoffs and other restructuring activities. Contingent on the continuation of these circumstances a potential broader economic downturn could result with a prolonged negative impact on an entity's financial results.

Accounting for ECLs for banks is particularly challenging given ECL accounting is designed to incorporate estimations of credit events, and their consequential cash shortfalls, based on a probability weighted approach.

In times of heightened uncertainty these estimations become significantly more difficult.

These challenges also exist for non-bank corporate entities - due to the credit exposure on their trade receivables, contract assets (recognised under AASB 15 *Revenue from Contracts with Customers*) and lease receivables. Such entities should also consider the impact of COVID-19 on their ECL allowances. Similar considerations are needed for ECL allowances for intergroup debt between a parent and a subsidiary in the separate financial statements or loans to joint ventures and associates.

Despite these challenges, organisations are required to make estimates based on reasonable and supportable information.

In this paper, we highlight some of the governance questions directors and senior executives need to consider when determining the ECL allowance for this reporting period, including:

- Interest-bearing financial assets (e.g. mortgages, commercial loans etc.)
- Trade receivables, contract assets and lease receivables.

INTEREST-BEARING FINANCIAL ASSETS

Economic scenarios

The economic disruption will need to be reflected in modelling economic scenarios. Due to its pervasive nature, and the need to update general economic inputs such as GDP and unemployment rates, it will be necessary to consider the impact of COVID 19 on specific industry and geographic sectors.

Combining macroeconomic factors such as GDP, interest rates, government support measures and unemployment, with sector specific factors like the reduction in the oil price on a borrower's ability to meet its financial obligations, will be challenging. Historical data that does not reflect the current economic environment is unlikely to give reliable forecasts in such uncertain times.

Multiple economic scenarios should incorporate different speeds at which borrowers may resume payments, i.e. the cure rate. Including multiple economic scenarios is particularly important in such uncertain times given that the fact that the cash shortfalls that occur in an economic downturn are not linear. The probabilities assigned to multiple economic scenarios are likely to warrant disclosures of estimation uncertainty.

For many entities, the primary ECL model will provide information without necessarily incorporating multiple economic scenarios. Typically, these multiple economic scenarios are incorporated by amending the primary model using model overlays or adjustments.

Questions to consider

Methodology: What is the approach to overlay multiple economic scenarios into the ECL measurement? For example, banks may consider a 'V shaped' economic recovery scenario that reflects rapid recovery of distressed borrowers. In other words, a sharp drop and a quick recovery. However, given the uncertainty over whether such a recovery will occur, inclusion of other more distressed downside economic scenarios should be considered, such as a 'U shaped' economic recovery where the pace of the recovery is slower. Another possibility could be a double-dip recovery scenario or 'W-shaped' economic recovery or as Deloitte Access Economics describes it a series of waves.

The questions then is: Does the adopted methodology appropriately consider and document:
- Underlying assumptions about the timing and level of recovery ('U-shape', 'V-shape' or 'W-shape' economic recovery) and the basis for these assumptions?
- The data used and the sources of this data?
- The probability weightings that were applied and the basis for these weightings?

Governance: Have governance mechanisms, such as additional credit risk management-focused audit committee meetings, or board credit risk sub-committees, been established or expanded to facilitate a sufficient and robust challenge of economic scenarios and related assumptions? Is there appropriate documentation including ECL methodology memorandums and/or minutes to document conclusions made and the basis for those conclusions?

Internal Controls: What internal controls have been put in place around manual model overlays and are they appropriate to address the associated risks?

Disclosure: Do financial reporting disclosures need to be amended to provide users with sufficient and appropriate information to understand:
- How forward looking information has been incorporated into the ECL in the context of COVID-19?
- Changes in estimation techniques during the reporting period and the reasons for those changes?
- Significant assumptions made during the reporting period?
- How sensitive the ECL allowance is to the significant assumptions relating to the forward looking information?

Broader consistency: Are the economic scenarios reflected in ECL overlays consistent with those used in other areas of financial reporting, for example, in the going concern analysis and impairment analysis?

Staging of the ECL

As part of the process to measure an expected credit loss, AASB 9 requires entities to initially use a low probability of default (PD). This will result in a smaller provision amount. Then, when there is a significant increase in credit risk (SICR), a higher PD is used to measure the expected credit loss. This will result in a larger provision amount. Using a lower PD initially and then a higher PD when there is a SICR is commonly referred to as the 'staging' of the ECL. Consequently, the size of the ECL is directly impacted by whether there has been a SICR.

Many banks have offered payment holidays to a broad range of their customers given the current economic environment rather than tailoring it to the customer's specific situation. Credit systems modelling ECLs commonly consider changes such as payment holidays or arrears as evidence of a SICR. This is because customers typically renegotiate terms of a loan and require payment holidays when they experience hardship. Consequently, when a payment holiday is granted, the credit system may automatically trigger a remeasurement of the ECL using a higher PD.

However, in the COVID-19 economic environment, payment holidays and even arrears are not necessarily indicators of SICR. On the one hand, there are customers that simply have short-term liquidity constraints rather than an increase in their risk of defaulting on the debt altogether. On the other hand, there some customers that are truly in financial difficulty. Separating those that are in financial difficulty from those that are not will be an operational challenge. Granting payment holidays is just one example of a trigger that may cause challenges for the appropriate staging of the ECL measurement. There may be other triggers or inputs that will result in similar challenges.

Credit modelling systems may need to be amended given that not all payment holidays in the current environment are necessarily indicative of a SICR and this may be a model limitation. Like economic scenario overlays, entities may employ the use of overlays to adjust results and correct the model limitations. For example, an entity may switch off the automatic triggers in their ECL models indicating a SICR (i.e. payment holidays). The entity may then use overlays such as statistical analyses or other supportable methods to establish the portion of the portfolio where there was a SICR.

Questions to consider

Impact assessment: Has an approach been identified to determine which indicators of a SICR in the current ECL model are being inappropriately triggered as a result of COVID-19 (for example, payment holidays granted as a result of COVID-19 as opposed to the specific situation of the customer)? Has this approach been properly documented?

Methodology: What specific model overlays have been designed to address model limitations related to staging as a result of COVID-19. For example, if the automatic triggers causing the staging problems are switched off, what overlays have been done to reflect the correct staging of the ECL? Does the adopted methodology appropriately consider and document the:

- Objective of each model overlay (for example, to address staging as a result of removing redundant automatic triggers)?
- Underlying assumptions, how were they developed and how are they supported?
- Data used, the sources of this data, and how it was determined to be an appropriate data source?

Governance: Have governance mechanisms, such as additional credit risk management-focused audit committee meetings, or board credit risk sub-committees, been established or expanded to facilitate sufficient and robust challenge of staging overlays and related assumptions? Is appropriate documentation including ECL methodology memorandums and/or minutes prepared to document conclusions made and the basis for those conclusions?

Internal Controls: What internal controls have been put in place around manual model overlays and are they appropriate to address the associated risks?

Disclosure: Do financial reporting disclosures need to be amended to provide users with sufficient and appropriate information to understand significant assumptions made during the reporting period related to staging of the ECL measurement?

TRADE RECEIVABLES, CONTRACT ASSETS, LEASE RECEIVABLES

AASB 9 allows for a simplified approach to measuring an ECL for trade receivables, contract assets and lease receivables which reduces the complexity of the estimate. Under this approach there is no requirement for a complex staging analysis to be performed. Rather, under the simplified approach, the ECL is always measured at the higher PD.

Most entities use what is commonly referred to as a 'provision matrix' as a means of measuring the ECL for short-term trade receivables, contract assets and lease receivables. A provision matrix applies the relevant loss rates to the trade receivable balances outstanding (i.e. a trade receivable ageing analysis). An entity would apply different loss rates depending on the number of days that a trade receivable is past due. For example:

Trade receivables	0 days past due	30 days past due	60 days past due	90 days past due	More than 120 days past due
Loss rate	1%	2%	3%	20%	100%

A provision matrix is largely based on historical losses and a statistical analysis of the historical data to determine the loss rates used to determine the ECL. The average historical credit losses on a large group of trade receivables provided the basis for a reasonable estimate of the ECL estimate.

However, AASB 9 requires that historical loss rates are adjusted to reflect current conditions and estimates of future economic conditions (i.e. forward looking information). This means that the provision matrix needs to be updated to reflect the COVID-19 economic environment. Similar to the economic scenarios discussed above, adjustments (or 'model overlays') will likely be required that are inherently judgemental.

Questions to consider

Methodology: How are changes in the current economic environment as a result of COVID-19 and forward looking information being incorporated in the specific provision matrix? Does the adopted methodology appropriately consider and document the:

- Disaggregation of the receivable portfolio and the basis for disaggregation? For example, the portfolio may be disaggregated based on the particular industry of the customers making up the receivable balance.
- Data used and the sources of this data? For example, a 10% decline in industry activity.
- Assumptions used and how they were developed? For example, a 10% decline in industry activity could be used as a base for increasing historical losses by 10% if a correlation can be demonstrated. This adjusted historical loss could then be used to calculate the loss rates in the provision matrix.

Governance: Have governance mechanisms, such as additional credit risk management-focused audit committee meetings or board credit risk sub-committees, been established or expanded to facilitate sufficient and robust challenge of forward looking information and related assumptions? Is appropriate documentation including ECL methodology memorandums and/or minutes prepared to document conclusions made and the basis for those conclusions?

Internal Controls: What internal controls have been put in place around manual model overlays and are they appropriate to address the associated risks?

Disclosure: Do financial reporting disclosures need to be amended to provide users with sufficient and appropriate information to understand:

- How forward looking information has been incorporated into the ECL in the context of COVID-19?
- Changes in estimation techniques during the reporting period and the reasons for those changes?
- Significant assumptions made during the reporting period?
- How sensitive the ECL allowance is to the significant assumptions relating to the forward looking information?

OTHER DELOITTE RESOURCES

Please visit Deloitte's IASplus website for global publications as well as the Deloitte Australia website for more information on accounting matters related to COVID-19 and ECLs.

IFRS in Focus – Accounting considerations related to COVID-19:
https://www.iasplus.com/en/publications/global/ifrs-in-focus/2020/coronavirus

IFRS in Focus – Expected credit loss accounting considerations related to COVID-19
https://www.iasplus.com/en/publications/global/ifrs-in-focus/2020/credit-loss-covid-19

Applying the expected credit loss model to trade receivables using a provision matrix
https://www2.deloitte.com/content/dam/Deloitte/au/Documents/audit/deloitte-au-audit-applying-expected-credit-loss-model-trade-receivables-using-provision-matrix-030519.pdf

Measurement of expected credit losses for intercompany loan assets with no documented contractual terms
https://www2.deloitte.com/content/dam/Deloitte/au/Documents/audit/deloitte-au-audit-expected-credit-losses-intercompany-loans-130519.pdf

Deloitte Access Economics – Economic scenarios for COVID-19 recovery
https://www2.deloitte.com/au/en/pages/economics/articles/economic-scenarios-covid-19-recovery.html

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