IFRS 9 and COVID-19: classifying forbearance and problem loans
Introduction

On Thursday 26th March the PRA published guidance to help firms consider important ECL implementation issues caused by the COVID-19 pandemic. The overall aim is to steer firms and auditors to account for the positive effects of government intervention in their financial risk measurement to “reduce the risk of firms recognising inappropriate levels of ECL” and ensure the financial system is “a source of strength for the real economy during this challenging period”.

This note looks at the first two elements of the guidance, which relate to the identification and classification of problem loans. Firms’ choices in this area will have significant financial and disclosure effects for them in the coming months and years.

Practice in this area has improved significantly in recent years to address the issues from the 2008/9 crisis, making balance sheet credit quality (especially during stress) more transparent and incentivising firms to deal with legacy stocks of non-performing loans. This has been seen as a critical remedy to the slower economic recovery experienced by those countries that did not quickly and effectively address the quality of their banks’ balance sheets coming out of the 2008/09 recession.

How firms choose to categorise exposures as “forbearance”, a Significant Increase in Credit Risk (i.e. Stage 2) or “bad” is important. The choice can lead to more intensive reporting and monitoring requirements, increased Risk Weighted Assets (i.e. capital demand), and increases in balance sheet ECL and impairment stock/charge.

In our view, the new guidance indicates a subtle change in the direction of regulation in this area over the last ten years. Indeed, the PRA acknowledges that: “some of the assumptions that we have all been making no longer hold so it is important that we tread carefully and think through things afresh and in detail, in the context of the current unprecedented situation. That will take time. We intend to discuss these issues further with both firms and auditors.” ¹

In Europe there are three sets of rules for categorising forbearance and problem loans. We consider all three in this note:

- the IFRS 9 rules for allocating credit risk exposure to Stage 2 and 3;
- the rules on capital definition of default (including article 178 in the CRR and new EBA rules due to come in to force by end 2020); and
- the FINREP definitions, which also underpin the ECB/EBA rules regarding the management and disclosure of non-performing loans.

Note that the PRA’s guidance is very similar to that issued by the ECB on 25th March and, for simplicity, we refer only to the PRA note. The rationale is equally valid for the ECB statement.

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Figure 1: European Central Bank illustrative connection between NPE, defaulted and impaired definitions

Main driver of the differences (if they exist) is the extent to which the automatic factor of 90 days past due used in NPE is not applied for impaired

Main driver of the differences (if they exist) are the extent to which automatic factors used in NPE are not applied for default, such as:
- 1 year cure period to exit NPE
- Other exposures past due > 90 days past due prevent existing NPE
- NPE due to second forbearance or 30 days past due of a performing forborne in probation

Although there may be some differences in categorisations, for most exposures the three concepts are aligned (impaired=default=NPE)

1. Economic background (and outlook)

The guidance must be interpreted in the context of the PRA’s view of the current and future economic situation:

“…while the reduction in activity associated with COVID-19 could be sharp and large, it is likely to rebound sharply when social distancing measures are lifted. In addition, in the intervening period, while activity is disrupted, substantial and substantive government and central bank measures have been put in place in the UK and internationally to support businesses and households. These measures, which have been evolving rapidly and could evolve further, are expected to remain in place through the period of disruption.”

“…there are clear signs that, taken in isolation, economic and credit conditions are worsening. It is, however, equally important also to take into account the significant economic support measures announced by domestic and international fiscal and monetary authorities and the measures – such as payment holidays and new lending facilities – that are being made available to assist borrowers affected by the COVID-19 outbreak to resume regular payments.”

“…the economic shock from the pandemic should be temporary, although its duration is uncertain. While it is plausible to assume that the economic consequences of the pandemic could mean that some borrowers will suffer a long-term deterioration in credit risk, many will need the support measures in the short-term but will not suffer a deterioration in their lifetime probability of default.”

Why does this matter? If deterioration in the macro-economic outlook indicates that a population of customers have increased default risk (e.g. based on macro adjustments to future probability of default) compared to the default risk at origination, then firms should consider moving some or all impacted loan exposures to Stage 2.

2 Figure 1 has been extracted from the guidance provided by the European Central Bank - https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf
However, if the economic shock is short term in nature, firms have to ask whether the lifetime PD has increased significantly. Such analysis will be easier for firms who use lifetime PD as the basis of their SICR framework rather than shorter term 12-month PD measures which are commonly used in the market, by way of simplification.

Below we consider the prudential treatment where a previously “good” capital and interest owner-occupier mortgage is modified to allow a three month payment holiday and the borrower is not bankrupt or similar. The principles below are equally applicable to other forms of lending e.g. consumer and corporate lending. We exclude instances where a loan’s contractual terms allow for a payment holiday – these are not a modification (although the exercise of this option by a customer may still be a sign of financial distress).

2. Are government-endorsed forbearance schemes (e.g. payment holidays) and similar measures by firms “bad” loans?

The PRA says:

“Our expectation is that eligibility for, and use of, the UK Government’s policy on the extension of payment holidays should not automatically, other things being equal, trigger: a default under CRR; and the loans involved being moved into Stage 2 or Stage 3”.

“We also do not consider the use of such a payment holiday to result automatically in the borrower being considered unlikely to pay under CRR. Firms should continue to assess borrowers for other indicators of unlikeliness to pay, taking into consideration the underlying cause of any financial difficulty and whether it is likely to be temporary as a result of COVID-19 or longer term.”

**Days past due:** if the loan is $\geq$ 90 days past due when the treatment is granted the loan will be “bad” under all three regimes. However, as the counting of days past due is suspended during the payment holiday period, the days past due backstop cannot trigger a new days past due default during the treatment.

**Change in NPV:** where lenders continue to charge interest for the period of the mortgage payment holiday there is typically no change in NPV. If the lender writes off the interest during the payment holiday this will usually lead to a small change in NPV of future cash flows, thereby precluding de-recognition (i.e. not a “substantial modification” or hitting the 10% rule in IFRS 9 B3.3.6) or a default indicator under the EBA’s 1% rule (although the discount rate for regulatory purposes can differ from the EIR, changing this situation).

**Non-accrued status under CRR:** placing an exposure on “non-accrued” status as per article 178 of the CRR, where interest is not recognised due to a credit event, is a default trigger under the capital regime. The fundamental purpose of a payment holiday is to suspend customer payments so, at face value, this should trigger a default. Indeed, most firms include suspension of interest in their regulatory definition of default, which regulators have accepted for a considerable period of time.

**Government mandated schemes:** this situation is considered in the EBA’s Guidelines on the Application of the Definition of Default which says:
“where the repayment of the obligation is suspended because of a law allowing this option or other legal restrictions, the counting of days past due should also be suspended during that period. Nevertheless, in such situations, institutions should analyse, where possible, the reasons for exercising the option for such a suspension and should assess the possible indications of unlikeliness to pay”. In other words, firms still need to be vigilant about the underlying reasons why customers ask to take advantage of the scheme.

Unlikeliness to pay: the customer is unlikely to pay without recourse to realising security. This is the critical category and includes a wide range of indicators. Some relevant “bad” triggers are:

<table>
<thead>
<tr>
<th>IFRS 9</th>
<th>Capital</th>
<th>FINREP NPE</th>
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<tbody>
<tr>
<td>• Basel Default (not required by IFRS 9 but recommended by the BCBS and EBA)</td>
<td>• Stage 3 under IFRS 9 or NPE/NPE Forborne under FINREP</td>
<td>• Basel Default or IFRS 9 Stage 3</td>
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<tr>
<td>• a breach of contract, such as a default or past due event</td>
<td>• doubts that a new distressed restructuring will be paid in full in a timely way including:</td>
<td>• if &gt; 20% of exposures to an obligor are more &gt;90 days past due, all exposures will be considered NPE</td>
</tr>
<tr>
<td>• significant financial difficulty</td>
<td>- a large bullet payment;</td>
<td>• for exposures that are performing forborne and were previously NPE forborne, if additional forbearance is granted or if the exposure becomes more than 30 days past due</td>
</tr>
<tr>
<td>• granting a concession(s) that the lender(s) would not otherwise consider</td>
<td>- significantly lower payments or a grace period at the beginning of the repayment schedule;</td>
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<td></td>
<td>- loans have been subject to forbearance more than once</td>
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<tr>
<td></td>
<td>• sources of recurring income are no longer available to meet the payments and/or concerns about a borrower’s future ability to generate stable and sufficient cash flows</td>
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The critical items relate to: significant financial difficulty, granting a concession that the lender would not otherwise consider and issues with a customer’s current or future income.

In terms of identifying concessions, the go-to set of rules are FINREP, which define forbearance as "concessions towards a debtor that is experiencing or about to experience difficulties in meeting its financial commitments" and may entail "modification of the previous terms and conditions of a contract that the debtor is considered unable to comply with due to its financial difficulties (‘troubled debt’) resulting in insufficient debt service ability and that would not have been granted had the debtor not been experiencing financial difficulties”.

Typically, lenders will only grant concessions when customers are in financial difficulty and, typically, these exposures are higher risk than exposures without a concession (reflecting the underlying risk and customer difficulty that has led to the modification in the first place). Again, typically, we would expect firms to include as “bad” those forbearance treatments where their credit behaviour shows a higher likelihood of future default (and customers are, therefore, “unlikely to pay”). This may (or may not) include payment holidays depending on a firm’s individual analysis.
However, the current circumstances are not typical and the payment holiday scheme is open to all borrowers, whether in financial difficulty or not. The PRA’s statement that a forbearance treatment should not automatically lead to an “unlikely to pay” trigger and “bad” classification is consistent with previously communicated regulatory definitions and, where firms have been more prudent, they may need to reconsider automatic forbearance-related default triggers. However, firms will need to distinguish between those customers that are in financial difficulty and those that are not.

This becomes more subtle when considering the point made by the PRA relating to customers experiencing liquidity rather than credit events where there is good confidence about a borrower’s future ability to generate stable and sufficient cash flows despite temporary financial difficulty. Each firm would have to justify that, despite the need for forbearance, a customer’s ability to repay in full without recourse to collateral remains good. This needs a credit risk judgement to be made that a customer will remain good because of government support in the short term (like the UK’s furlough salary scheme) and, in the medium term, because the customer’s regular source of income could reasonably be expected to recover when the government support is wound down. Some sectors of the economy and sources of employment may emerge from the crisis in better health than others, which could lead to different answers for different customers.

In the UK the critical source of information for understanding these differences in classification is the interaction between banks’ agents and customers to understand their individual circumstances and decide on the best course of action when they are experiencing financial distress.

The level of rigour around these conversations and the record keeping required to justify firms’ decisions has increased significantly since the last recession. Usually, if the agent establishes that the customer’s distress is not temporary, and payment issues are unlikely to be resolved, forbearance is unlikely to be granted as it will not be in the best interests of the customer. This is very different to the situation immediately after the 2008/9 recession and has made it more difficult for firms to “kick the can down the road”.

The FCA has guided that, in these exceptional circumstances, “Firms can choose to make the enquiries they consider necessary in order to judge if a payment holiday best serves the customer’s interests but there is no expectation under this guidance that the firm investigates the circumstances surrounding a request for a payment holiday.” Combined with operational stress, where a surge of enquiries may inhibit firms’ capacity to hold and record high quality conversations with a customer, the ability to collect data to help identify no/some/serious payment difficulty and therefore good versus bad forbearance will be very challenging.

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3 FCA Mortgage and Coronavirus guidance --
3. Are government-endorsed forbearance schemes (e.g. payment holidays) and similar measures by firms Stage 2 loans?

Bad” customers, who hit the triggers described in the section above, would likely be placed in Stage 3. If a loan has not been classed as “bad”, the next question is whether they should be in Stage 2 or Stage 1.

Typically firms do not rebut the 30 days past due "backstop" under IFRS 9 and we consider all accounts that hit this trigger should be considered to be in Stage 2. Firms sometimes apply a cure period to this to prevent movement in staging from the population of accounts that can regularly hop between Stage 1 and Stage 2.

As covered in the previous section, “good” customers should not be considered to be receiving forbearance and should remain in Stage 1. From an auditor's perspective the onus is on firms to evidence this “good” status, which may be challenging.

However, there are then two intermediate groups:

- Customers who should move from Stage 1 to Stage 2 because of an observed credit event (for simplicity we deal with expected credit events in Section 5 below); and
- Customers who are in a probation period and move from Stage 3 to Stage 2 (e.g. FINREP performing forborne having formerly been NPE forborne, detailed in section 4 below).

Dealing with the former, some relevant triggers relating to observed Significant Increase in Credit Risk (SICR) include:

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<tr>
<th>IFRS 9 – Significant Increase in Credit Risk (SICR)</th>
<th>FINREP Forbearance</th>
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<tbody>
<tr>
<td>• Internal credit rating downgrade for the borrower or decrease in behavioural scoring</td>
<td>• Modification due to financial difficulty (&quot;troubled debt&quot;) that would not have been granted in the absence of financial difficulty</td>
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<td>• Changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated</td>
<td>• A difference in favour of the debtor between the original and modified terms</td>
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<tr>
<td>• Changes in external market indicators of credit risk</td>
<td>• Modification where the asset was NPE before the change or the change has prevented the asset from becoming NPE</td>
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<tr>
<td>• Significant increases in credit risk on other financial instruments of the same borrower</td>
<td>• Modification involves total or partial cancellation by write-off</td>
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<tr>
<td>• Significant changes in the value of the collateral supporting the obligation</td>
<td>• Modified contract was totally or partially past due by more than 30 days without being NPE at least once during the three months prior to its modification or would be more than 30 days past due without modification</td>
</tr>
<tr>
<td>• Changes in the loan documentation including... covenant waivers or amendments, interest payment holidays, or other changes to the contractual framework of the instrument</td>
<td>• IFRS 9 substantially modified financial assets</td>
</tr>
<tr>
<td>• Information about the circumstances that led to the modification</td>
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<tr>
<td>• Changes in the entity’s credit management approach</td>
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Larger firms often have forbearance as a qualitative Stage 2 trigger (although this is usually supported by quantitative evidence of higher risk behaviour). As well as being intuitive, the granting of forbearance hits a number of the triggers in the table above.
The problem is that firms’ triggers do not account for the liquidity (as opposed to credit) events described by the regulator and if triggers are not modified for IFRS 9 and FINREP this could lead to excessive allocation of exposures to Stage 2 with associated increases in ECL (from 12 month to lifetime credit losses).

However, the issues described in Section 2 apply too; the ability to collect data to identify the difference between “good” and “bad” forbearance may be challenging.

4. When could “bad” loans be considered “good” again

Another area where regulation has strengthened after the last crisis is in the area of probation periods following bad performance. Under each of the three regimes loans can be returned to “good” under the following circumstances:

**IFRS 9:** evidence that the criteria for the recognition of lifetime ECL are no longer met may include a history of up-to-date and timely payment performance against the modified contractual terms. Typically a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased.

**Capital:** where no trigger of default has applied for at least three months. For a defaulted distressed restructure this increases to one year and the customer must have made a “material payment” (i.e. the amount previously past due or written off), have met their agreed payment schedule and have shown no unlikeliness to pay indicators.

**FINREP:**
- NPE to good: capital and IFRS 9 exit criteria have been met AND full repayment is likely AND the customer has no amounts >90 days past due.
- NPE forborne to forborne: as per the latter plus at least one year since forbearance measures were applied AND no concern regarding the full repayment of the exposure according to the post-forbearance conditions AND one year has passed since the latest between the moment where forbearance measures were applied and the moment where exposures have been classified as non-performing.
- Forborne to good: exposure is considered performing AND a minimum of two years has passed from the date the exposure was considered to be performing AND regular payments have been made during at least half of the probation period AND none of the exposures to the debtor are >30 days past due.

The duration of these probation periods, particularly under FINREP, mean that the consequences of assigning a loan to “bad” or “forbearance” can have a long tail effect.
5. Is there a practical solution?
The critical challenge is how firms and auditors might easily use information that is already available for credit and regulatory reporting to evolve their established triggers, deal with the new market environment and meet the definitional requirements above. Such a framework could act as a proxy for firms’ agents’ conversations with customers and, if sufficiently compelling, may allow firms and auditors to take an “innocent until proven guilty” view on forbearance rather than having to consider all concessions as Stage 2 or “bad” in the absence of more detailed information.

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Figure 2 has been extracted from the guidance provided by the European Central Bank - https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf
An illustrative set of triggers might include:

- Payment history: has the customer made regular payments over, say, the last year on the loan in question and their other credit obligations?
- Delinquency status: post treatment has the customer made all agreed payments on the loan in question and their other credit obligations (i.e. never one penny / one day past due)?
- Collateral: is the customer in negative equity?
- Leverage: has the customer seen a recent increase in leverage or indebtedness?
- Repeat forbearance: has the customer been granted subsequent forbearance treatments?
- Default risk: has the customer’s PD remained stable with no significant change in other risk drivers during the payment holiday?

The presence of any of these or similar indicators suggest that the customer’s circumstances are more credit-like and should be treated as a Significant Increase in Credit Risk and Stage 2. Firms’ FINREP triggers may also need consistent modification and if a facility is classified as FINREP forborne or NPE forborne we consider it should not be classified as Stage 1.

The approach set out above is consistent with FINREP, which requires performing forbearance exposures to be reclassified as Forborne NPE when additional forbearance measures are applied to a performing forborne exposure under probation that has been reclassified out of non-performing category, or the exposure becomes more than 30 days past due.

6. Scenarios and coverage

Stage 2 and Stage 3 exposures are likely to increase based on observed credit events and the rationale above. In addition, the overall financial impact depends on forward-looking expectations - firms’ views on scenarios and the likely impact of government relief measures – which will have a significant effect on ECL coverage as a result of forward-looking stage allocation and ECL estimation.

The PRA’s expectation that firms “reflect the temporary nature of the shock, and fully take into account the significant economic support measures already announced by global fiscal and monetary authorities” is well put, pointing firms consider a “V”-shaped base scenario with rapid recovery of distressed borrowers aided by the announced policy measures. As well as reassessing their scenarios, firms are likely to have to reconsider the behaviour of their models and the potential need for overlays to reflect, for example, expectations of higher cure rates than observed historically.

This is consistent with the statement from the EBA which said “within its prudential remit, the ECB recommends that all banks avoid procyclical assumptions in their models to determine provisions and that those banks that have not done this so far opt for the IFRS 9 transitional rules.”

However, auditors have an obligation to be sceptical and they will need to be convinced that firms’ view of the likely speed and size of recovery, alongside credible alternative scenarios, are an unbiased reflection of potential loss outcomes.
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