Moody's Analytics

Kenya Bankers Association

Better Faster Decisions

# East Africa Webinar Series: Classification of Financial Instruments Under IFRS 9

July, 2020

Moody's Analytics

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Better Faster Decisions

# East Africa Webinar Series

Episode 1
Thursday, 2 July

12:00 BST | 14:00 EAT

Navigating Credit Risk & Expected Losses: COVID-19

Episode 2
Thursday, 9 July

12:00 BST | 14:00 EAT

Classification and Stage Allocation of Financial Instruments Under IFRS 9

Episode 3
Thursday, 16 July

12:00 BST | 14:00 EAT

Risk Based Loan Pricing

# Speakers

Kennedy Mutisya - Chief Financial Officer **Kenya Bankers Association**

Armen Mirzoyan – Senior Economist, **Moody’s Analytics**

Nash Subedar – Relationship Management, **Moody’s Analytics**

Metin Epozdemir, CFA – Risk and Finance, **Moody’s Analytics**

# Agenda

1) Application of IFRS 9 in the COVID-19 environment by Mr Kennedy Mutisya, CFO, Kenya Bankers Association
2) Criteria for Significant Increase in Credit Risk (SICR)
   - Why SICR matters for IFRS 9 Provisions and Recent Regulatory Guidance.
   - Determining Significant Increase in Credit Risk and Challenges in the Current Environment
   - Practical Implementation Examples
3) Q&A

# Application of IFRS 9 in the COVID-19 Environment

# CBK Relief Measures

- Review of the cash reserve ratio to release liquidity to banks to support distressed borrowers impacted by COVID-19 pandemic
- Relief from clauses 3.2 (classification of loans), 3.3 (classification categories) and 3.5 (classification of renegotiated loans & advances) for loans whose repayment are extended or restructured due to the pandemic, for a period of one year from 2nd March 2020
- Banks to meet all the costs related to the extension and restructuring of the facilities
- Banks to document and keep records of all extended and restructured facilities under the emergency measures

# ICPAK Guidance

- IFRS 9 is not expected to be applied in a mechanistic manner and is not prescriptive……
- The standard requires the application of judgement to be based on the broad principles to determine the most appropriate approaches/policies; guided by faithful presentation
- Judgements should be supported by reasonable and supportable evidence
- Need to reassess the appropriateness of policies & models for appropriateness in the COVID-19 environment - presumptions, estimates and principles previously applied may no longer by appropriate.
- Entities are required to develop estimates based on the best available information about past events, current environment, and forecasts of economic conditions

# IMPAIRMENT CONSIDERATIONS

- Assessment is dependent on multiple indicators, quantitative and qualitative, based on reasonable and supportable information that is forward-looking.
- Significant Increase in Credit Risk considerations
- Analyse the facts of each restructured financial instrument to determine whether the credit risk of the financial instrument has significantly increased, or the borrower is only experiencing a temporary liquidity constraint from which it will recover post COVID-19.
- The assessment can be performed on a collective basis, if it is difficult to assess at individual account level e.g. by product or sector/industry grouping

**Significant Increase in Credit Risk considerations**

- Consider the impact of the restructuring on the credit risk of the individual instruments; could be an indicator of SICR, but could also provide short-term support to borrowers resulting in unchanged or reduction of overall credit risk over the expected life of the instrument
- Use all reasonable and supportable evidence without undue cost or effort

# IMPAIRMENT CONSIDERATIONS

- Some of the information to consider in determining SICR
- Significant change in the operating results of borrower
- Change in economic environment affecting borrower’s ability to meets financial obligations
- environment affecting borrower’s ability to meets financial obligations
- Significant changes in the value of the collateral supporting the obligation
- Actual or expected or external downgrade in internal credit rating

# DISCLOSURES

- Enhanced disclosures in the following areas will be highly necessary:
- Accounting policy for determining when a modification to a financial instrument is substantial
- Sufficient disclosures of significant judgement and areas of estimation uncertainty relating to SICR and measurement of ECL to enable users of financial statements to understand the impact of COVID-19
- IFRS 7 disclosures in relation to credit risk
- Overall financial statements disclose on principal risks and uncertainties arising from Covid-19 that are not only limited to the measurement of expected credit losses

Thank You

2

# Criteria for Significant Increase in Credit Risk (SICR)

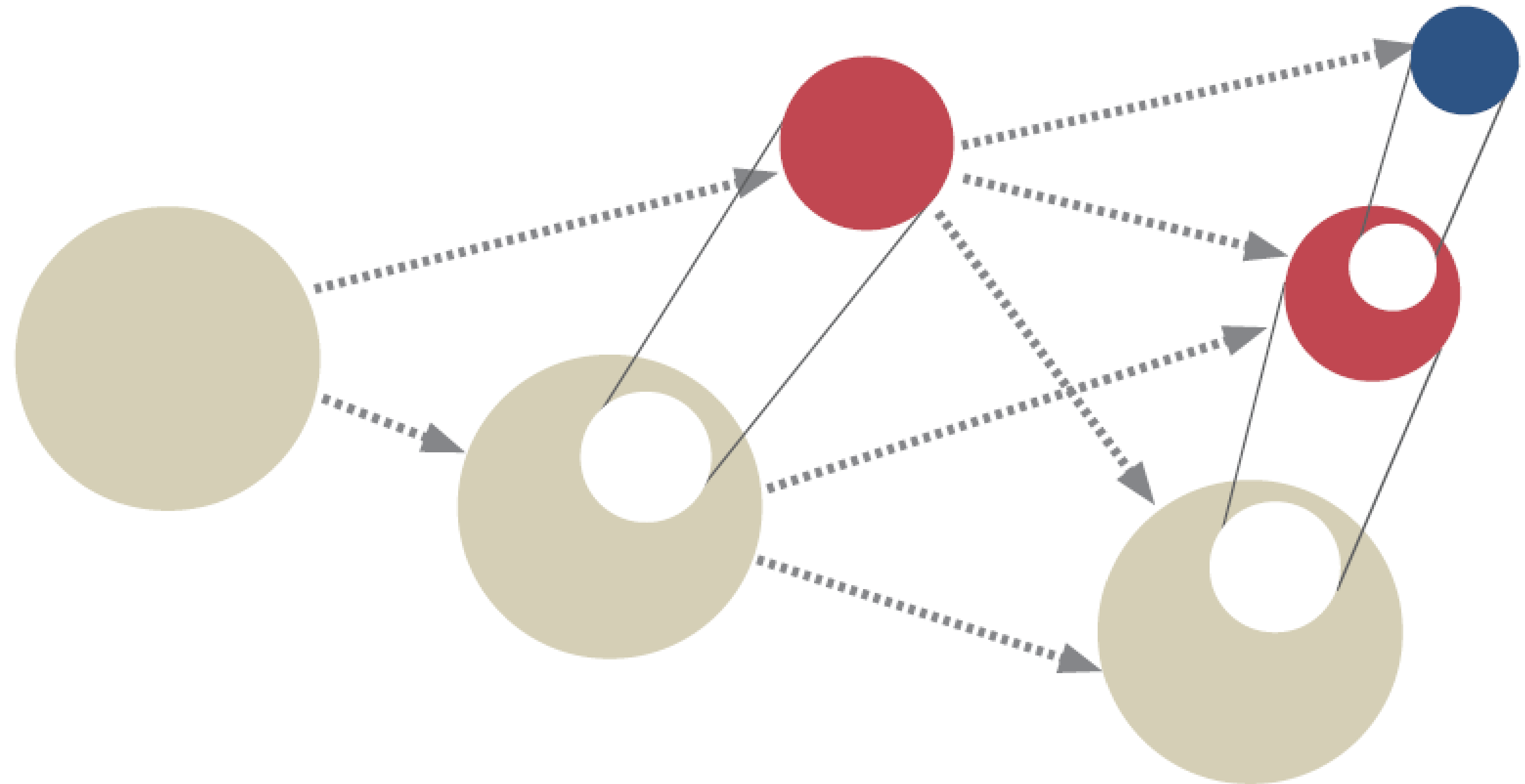
# A Forward Looking Impairment Model

## A Primer on Expected Credit Loss for IFRS 9 Provisions

- Stage 1
- Stage 2
- Stage 3

IFRS 9 requires lifetime expected credit losses to be recognised when there are significant increases in credit risk since initial recognition.

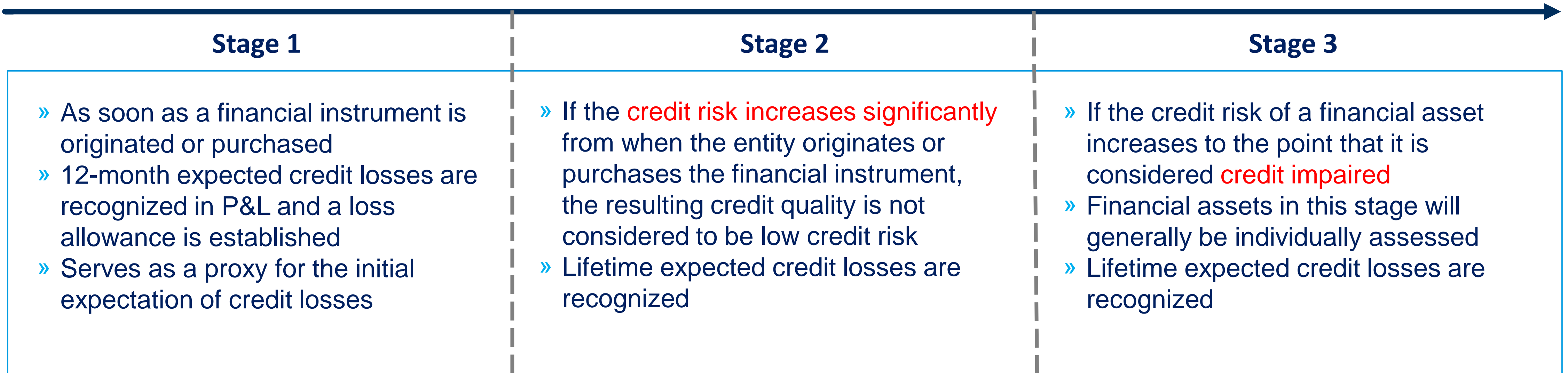
Expected credit losses are updated at each reporting date for new information and changes in expectations even if there has not been a significant increase in credit risk.

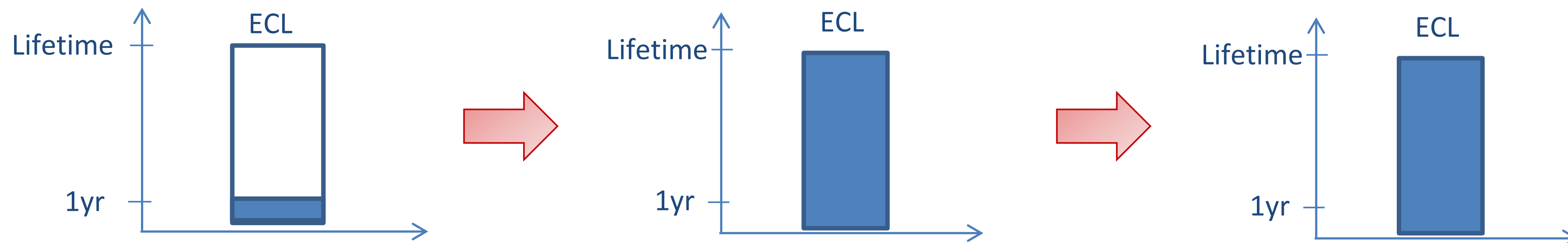


Source: IFRS 9 Financial Instruments – Project Summary Presentation from IASB, July 2014

# Impairment Recognition

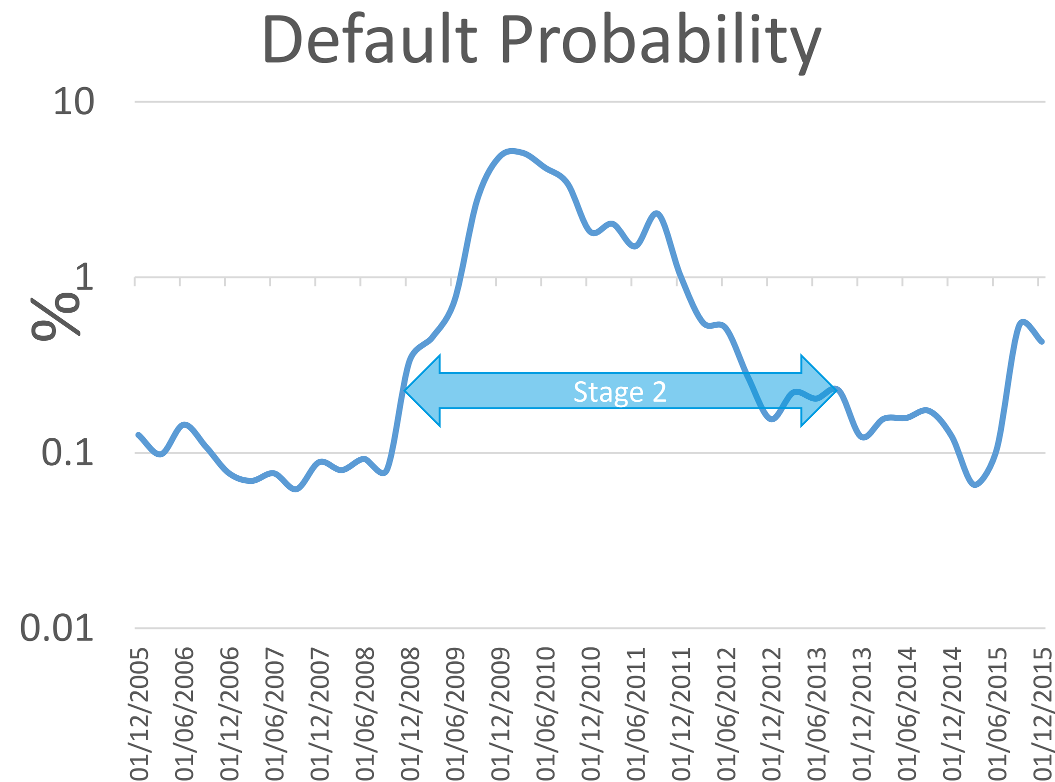
## Forward-looking "Expected Credit Loss" Model

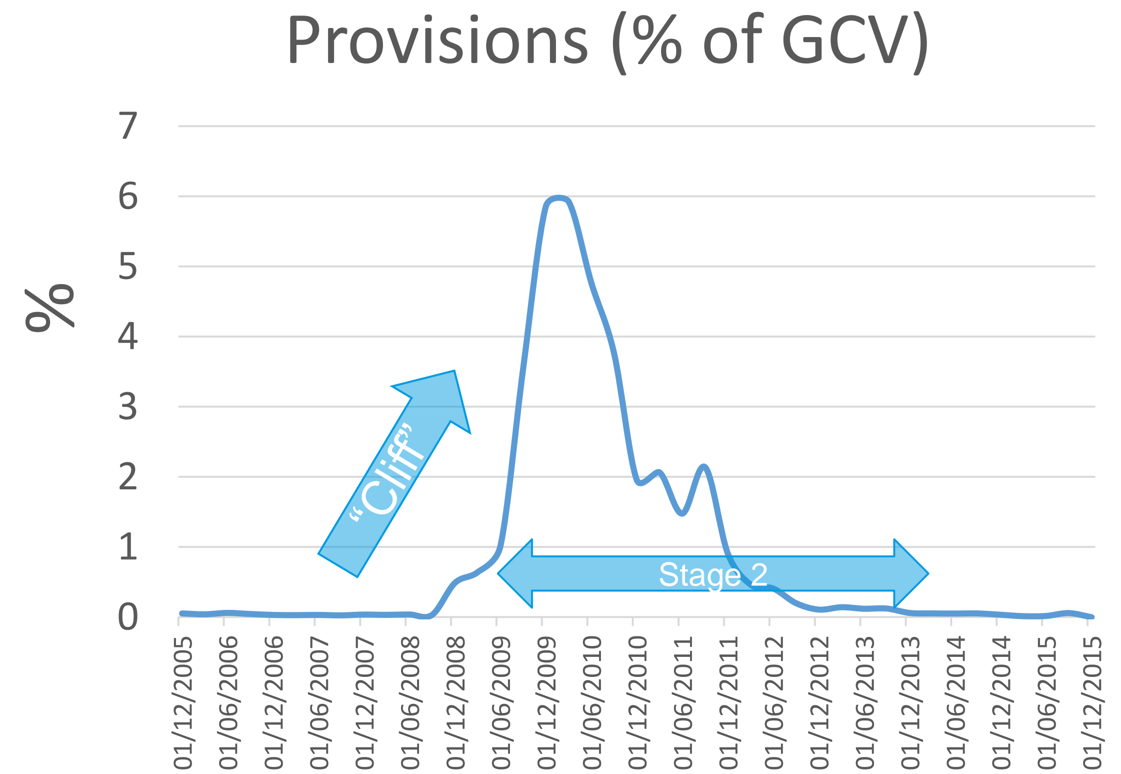


# Implications for Volatility of P&L and Capital

» Simplified Example of a 10Y Term Loan with 4% coupon rate and 45% LGD originated in 2005 Q4 (EUR 10,000,000 initial amount)




**Source: Moody's Analytics, CreditEdge™, ImpairmentStudio™**

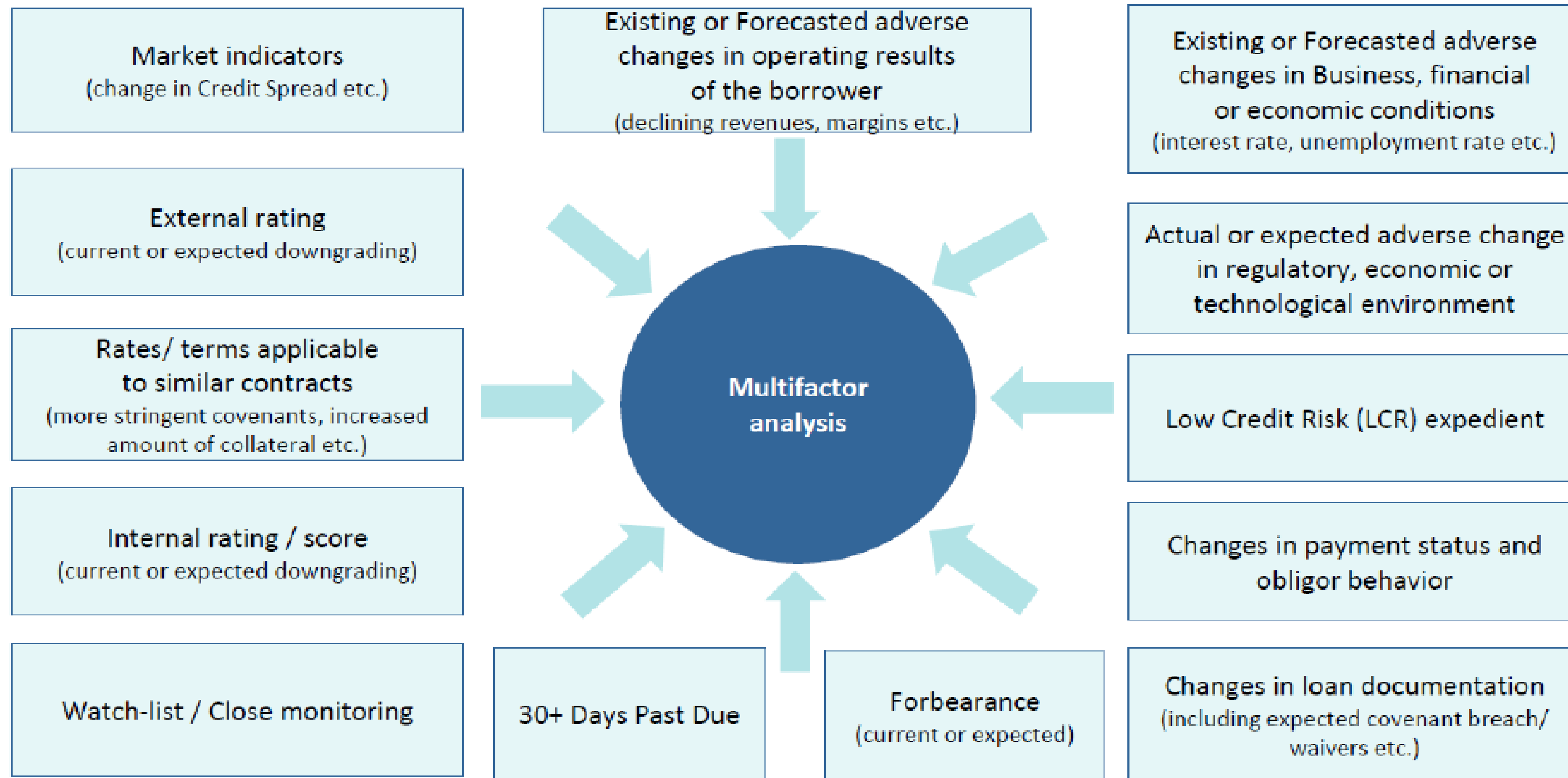
# Regulatory Response to Coronavirus (COVID-19)

## On Moratoria, Payment Holidays or Deferrals

| | |
|---|---|
| **BoE/PRA** | – ‘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, result in the loans involved being moved into Stage 2 or Stage 3 for the purposes of calculating ECL or trigger a default under the EU Capital Requirements Regulation (CRR).’ **‘… Firms will therefore need to consider other indicators to determine the appropriate treatment’** Dear CEO Letters by the PRA CEO Sam Woods in **March and June 2020**. |
| **ECB/EBA** | – ‘The EBA calls for ***flexibility and pragmatism*** in the application of the prudential framework and clarifies that, in case of debt moratoria, there is no automatic classification in default, forborne, or IFRS 9 status.’ **Statement on the application of the prudential framework regarding**<br>– **Default, Forbearance and IFRS9 in light of COVID-19 measures of 25 March 2020** |
| **BCBS** | – SICR assessment: relief measures, granted either by public authorities, or by banks on a voluntary basis, should not automatically result in exposures moving from a 12-month ECL to a lifetime ECL measurement.<br>– Where banks are able to develop forecasts based on reasonable and supportable information, ECL estimates should reflect the mitigating effect of the significant economic support and payment relief measures.<br>– **While estimating ECL, banks should not apply the standard *mechanistically* and should use the *flexibility* inherent in IFRS 9, for example to give due weight to long-term economic trends.** |
| **CBUAE** | – SICR assessment: Categorization of exposures into groups based on impact of COVID-19 crisis to determine if “BAU” staging criteria should be applied.<br>– Due to the high degree of uncertainty surrounding the economic consequences of the COVID-19 crisis, institutions are not expected to incorporate the updated forecasts into ECL until September 1, 2020.<br>– Institutions are not required to update model parameters to account for this crisis, instead they are required to adjust inputs, critically assess model outputs and apply judgmental overlay if needed.<br>– Institutions have the option to employ add-ons at portfolio or product level to holistically reflect changes in the economic environment. |

# Staging Rules Review

## List of non-exhaustive SICR Factors



# Transferring Criteria from Stage 1 to Stage 2

> " At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall **use the change in the risk of a default occurring over the expected life of the financial instrument** instead of the change in the amount of expected credit losses. "
>
> *(5.5.3, IFRS 9)*

- Identify how to quantitatively assess a significant increase in credit risk
  - Analysis to select optimal driver / drivers
  - Analysis to determine threshold criteria
- Identify how to qualitatively assess a significant increase in credit risk
  - Assess the availability and conceptual suitability of qualitative and non-statistical factors.
  - Demonstrate these factors lead to increased risk and are not already captured in drivers selected by quantitative assessment.
  - Analysis to determine threshold criteria
- Backward transitions

# Staging Rules

- **Qualitative staging**
  - There are a series of characteristics that can trigger the allocation into stage 2.
  - Qualitative rule is determined by the Bank or the regulator. Usually, when combined with quantitative staging, it is used as an overlay.
- **Quantitative staging**
  - Use statistical methods to determine what is a Significant Increase in Credit Risk (SICR)

# Staging Rules

## Qualitative Assessment

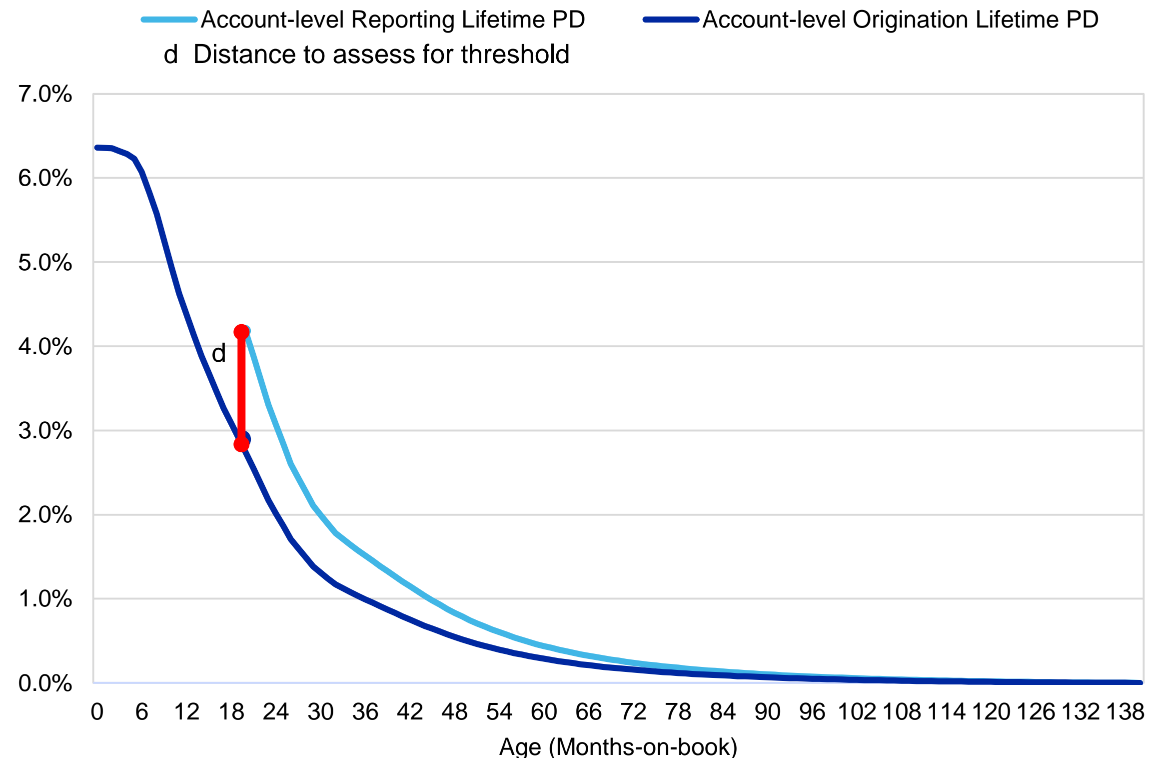
There are a series of characteristics that can trigger the allocation into stage 2. The cut-off is generally agreed with the Bank and it depends on the available information and internal uses of it.

Some examples:

- Days overdue ≥ 30
- Early watch list: pre-defined risk category selected by the Bank
- Affordability score: cut-off used by the Bank to classify risky accounts
- Death
- Bankruptcy
- Any other useful metric to classify risk that is not part of the default definition

# Staging Rules
## Quantitative Assessment

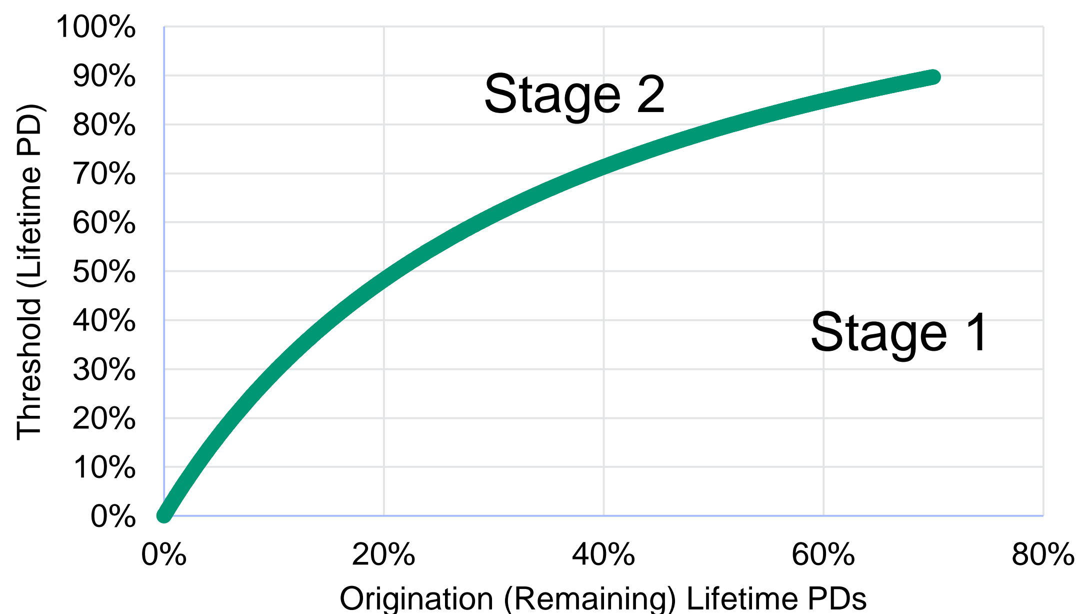
- Stage allocation can be quantitatively assessed using a metric that shows the change in credit risk since initial recognition.
- To measure the change in risk since initial recognition, we examine the proportional difference between the lifetime PD at the latest reporting date with the lifetime PD at the same age as the reporting date forecasted at origination.
- Distance *b* is utilized as the metric and is the percentage increase to the lifetime PD curve between origination and reporting date. Increases are examined to determine how to identify which are deemed significant.

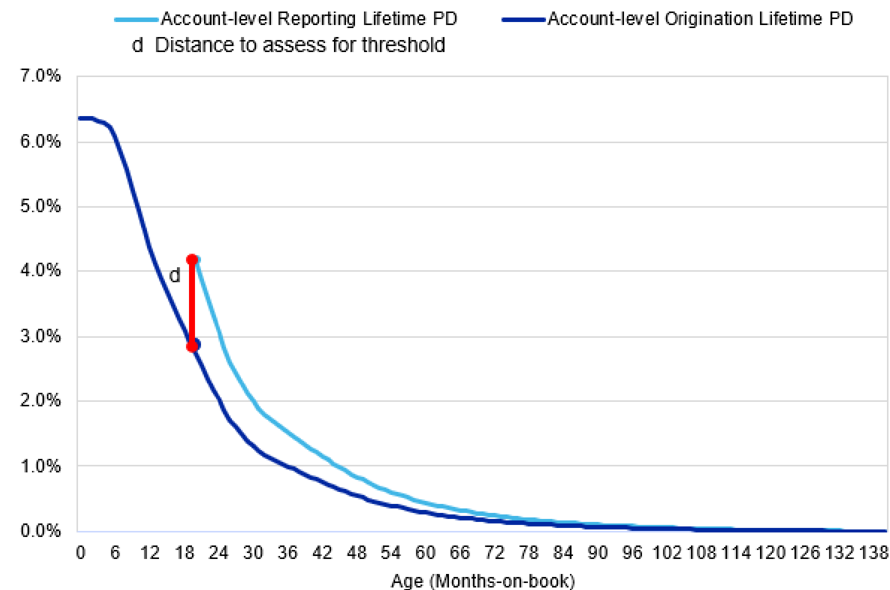


# Staging Rules

## Quantitative Assessment

| Status | Criteria | Stage |
|---|---|---|
| Non-Default | Reporting Lifetime PD ≤ Origination Lifetime PD (observed at reporting date) + Buffer | 1 |
| Non-Default | Reporting Lifetime PD > Origination Lifetime PD (observed at reporting date) + Buffer | 2 |
| Default | | 3 |



# Threshold Selection

## Quantitative vs Regulatory Guidance

- **Approach 1**: Numeric optimisation
  - Optimize an accuracy ratio from good: bad odds analysis based on relative threshold to determine SICR. Buffer is the optimal value of *d* to identify SICR

- **Approach 2**: EBA Stress Test Methodology Reference
  - The selection of the buffer is such that the PD threshold of the observed median lifetime PD at origination is 3 times this median.

*"S2 exposures are those whose credit risk has increased significantly since initial recognition at the reporting date and for which the entity must measure loss allowance at an amount equal to the lifetime expected credit losses. Banks shall project significant increase in credit risk in line with their accounting approaches. However, for the purpose of the stress test projections banks shall also assume without prejudice to other triggers that S1 assets which experience a threefold increase of annual point-in-time PD compared to the corresponding value at initial recognition (i.e. a 200% relative increase) undergo a significant increase in credit risk (SICR) and hence become S2 "*

# Stage Allocation

## Final Assessment

| Example | Default | Qualitative Assessment | Quantitative Assessment | Stage Allocation |
|---|---|---|---|---|
| Case 1 | No | 1 | 1 | 1 |
| Case 2 | No | 1 | 2 | 2 |
| Case 3 | No | 2 | 1 | 2 |
| Case 4 | No | 2 | 2 | 2 |
| Case 5 | Yes | 1 | 1 | 3 |
| Case 6 | Yes | 1 | 2 | 3 |
| Case 7 | Yes | 2 | 1 | 3 |
| Case 8 | Yes | 2 | 2 | 3 |

# Implementation Example

## Rating or Implied Rating Based Stage Allocation

- Ratings based on standardized (e.g. Moody's) credit ratings or an internal credit rating system.
- Compare a PD implied rating at reporting date to the rating at origination
- The reporting date rating is implied by a conditional probability weighted PD across (n) scenarios
- Provide a value for Stage 2 and Stage 3 which could be interpreted as number of credit notch downgrades (Relative Threshold).
- Provide an Absolute Threshold based on the rating for newly originated exposures..

| Rating | Stage 2 | Stage 3 | Absolute |
| --- | --- | --- | --- |
| Aaa | 1 | 16 | 1 |
| Aa1 | 3 | 15 | 1 |
| Aa2 | 2 | 14 | 1 |
| Aa3 | 1 | 13 | 1 |
| A1 | 3 | 12 | 1 |
| A2 | 2 | 11 | 1 |
| A3 | 1 | 10 | 1 |
| Baa1 | 3 | 9 | 2 |
| Baa2 | 2 | 8 | 2 |

# Implementation Example

## PD Based Stage Allocation

- Determine the function to compare PDs:
  - Percent Change
  - Difference
  - Log Change
- Determine the change level of the PD based on function (Relative Threshold).
- Determine the threshold level of PD for determining transition to Stage 2 (Absolute Threshold).
- Determine the Stage 3 PD threshold level.
- If {[(PD Change > x) and PD Level > y] or PD Limit > z}, then instrument transitions from Stage 1 to Stage 2. If PD > Stage 3 PD, then instrument transitions to Stage 3.

Edit Stage Allocation

Name *

Annualized PD Based Stage Transfer

34 / 50

Percent Change

Difference

Log Change

0.0501

PD Change *

200

PD Limit *

0.5

CANCEL

SAVE

# Implementation Example

## Incorporate the Backstop Assumptions

Step 2: Enter Stage Allocation Behavior

Specify your settings from an uploac 's Analytics preset settings.

Rating Based Stage Allocation *

Moodys

Use days past due

Stage Rule *

And

Or

Current

DPD30

DPD60

DPD90

DPD120

Stage 3 *

DPD90

# 3

# Q&A

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