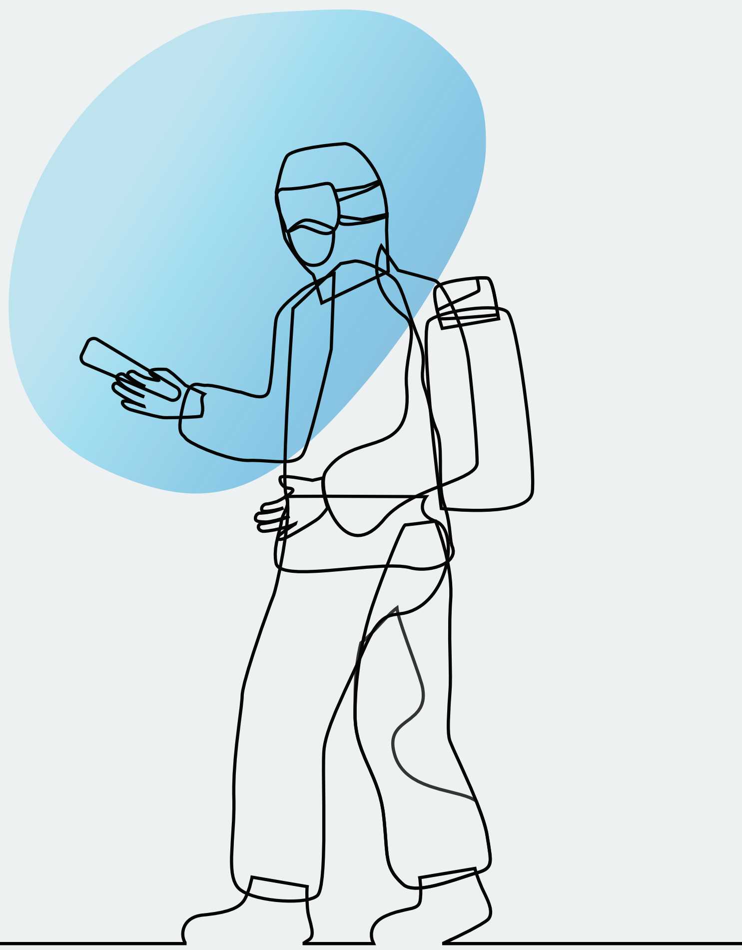
Accounting treatment of Covid-19 measures (regulators' response)



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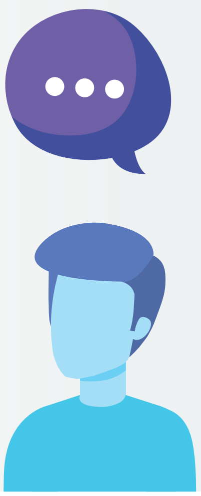
Several prudential and regulatory bodies have issued comments on application of IFRS 9 in the current environment. Their joint feature is a **call to carefully consider judgements and estimates that are going to be made, while avoiding mechanical application of current IFRS 9 models and methodologies.** Among them are the European Securities and Markets Authority (**ESMA**) and the European Banking Authority (**EBA**) which made public statements on IFRS 9 accounting and risk related treatment of various government aid measures and other issues related to COVID-19. **Application of all these measures should be carefully considered under the IFRS 9** requirements. Banks are called to draw upon the flexibility embedded into the accounting and regulatory frameworks in order to maintain soundness. **The considerations are equally relevant in the Serbian banking environment due to introduced "moratoria" for all credit commitments.**

Accounting for modifications

Agreeing to changes in the contractual cash flows of loans are considered to be modifications and thus **have to be accounted for under the general IFRS 9 requirements for modification of financial assets.** As a first step, it should be determined **whether modification is substantial**, leading to the **derecognition** of the old financial asset and recognition of the new financial asset. If this is the case, the **derecognition gain/loss should be recognized**. Otherwise, modification gain/loss should be recognized by discounting renegotiated cash flows using the original effective interest rate. IFRS 9 does not contain any specific guidance for this context, but rather banks should **follow general principles of the standard and accounting policy they already have in place** for modifications of financial assets under IFRS 9. It can be noted that the decision might be highly judgmental and dependent on both qualitative and quantitative criteria. Needles to say, **appropriate and sufficient disclosures** are also expected once they become due. In case of **substantial modification, criteria for POCI recognition become relevant** and judgement needs to be applied on the classification of newly recognized financial assets.

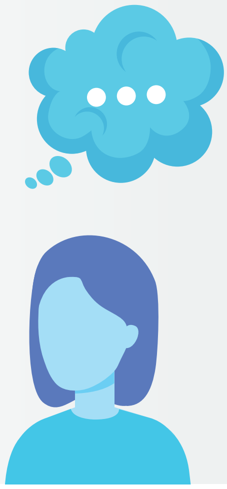
The first impression is that accounting for promulgated aid measures (including "moratoria" introduced by the NBS for Serbian banks) will represent a weighty **operational burden** for banks, but also **may result in (significant) modification / derecognition effects recognized in the P&L**, taking into account that they relate to entire loan portfolios – the ensuing gymnastics required to calculate those are yet to be understood. There are also numerous open questions as to **how new cash flows should be calculated in order to comply with the issued by-law.**



Forbearance

Government imposed or voluntarily provided measures taken as a response to Covid-19 crisis to the extent they are not borrower specific **do not have to be classified as forbearance measures – no automatic reclassification**. Rather, the situation has to be analyzed on a **case by case basis**, and borrowers who experience financial difficulties and for which specific measures are tailored should be reported as satisfying the definition of forbearance.

Individual assessment of the borrowers before making the classification is a challenging task, given that entire portfolios are impacted. Case by case analysis might be difficult to conduct in practice and banks have to find solutions to stay compliant.



Significant increase in credit risk (SICR)

Relief measures individually agreed with any borrower are usually considered as a forbearance indicator and/or indicator of SICR. However, government-imposed measures (such as "moratoria" introduced by the NBS) that apply to all borrowers and are aimed at addressing system-wide risks **should not be taken automatically as the only evidence that credit risk of the borrower has increased.** These measures have to be analyzed by taking into account all different aspects to distinguish between, for example, whether credit risk has significantly increased or the borrower is experiencing temporary liquidity issues. The assessment might be difficult to perform on an **individual instrument level**, so a collective basis (on sub-groups of financial instruments) might work as a solution. Regulators are warning that potential exaggeration of the negative effects of the ongoing shock should be avoided. However, taking a look at the current conditions of certain industries (for example transportation, tourism) it is an understatement to say they are hit by the current situation which will affect them in the short and medium term.

Banks are called to distinguish between borrowers whose creditworthiness would not be heavily affected by the current situation in the long term and those that will be the real victims of the current crisis. Staging of clients becomes more challenging than ever given all the uncertainties and possibly will result in **P&L volatility**.

Prudential identification of Default

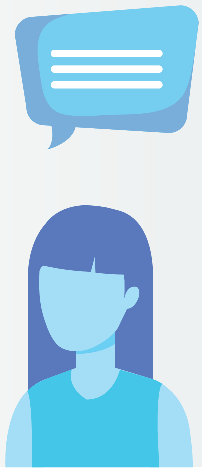
Identification of default should be done under true circumstances proving that **economic loss is likely to happen**. Previously issued EBA guidelines on the application of the definition of default already explicitly account for the possibility that moratoria may extend to a period of 90 days. The **delay in settlement of obligations** should be calculated based on the modified payment schedule, and it should be **considered together with other evidence of unlikeliness to pay** in the period after the moratorium/other measures.

Expected Credit Loss estimation

IFRS 9 requires the use of best possible information when determining the ECL. Given the level of uncertainty and sudden changes in the short-term economic outlook, it will be difficult to incorporate those in the ECL measurement.

Current models and methodologies might have to be adjusted – specifically reflected in macroeconomic scenarios.

Embedding Serbian macroeconomic factors proved to be a massive exercise for local banks, and the current situation will certainly introduce more complexities. Banks have challenging task to assess how these uncertainties and sudden crises are expected to impact financial instruments over their lifetimes. These questions will be especially challenging for the Q1 2020 and H1 2020 ECL calculations.



The availability of reliable information in the current situation is to be taken into account when assessing ECLs. The assumptions have to be made as to how the crisis (its duration and severity) and the numerous government aid measures will influence future developments. The ECB recommended that **greater weight should be given to long-term stable outlook** evidenced by past experience in the current state of uncertainty. At first look, it might sound like a call for avoiding exaggeration in ECL measurement and appears more like the incurred loss model.

Transparency

Sufficient and reliable disclosures on potential and actual impact of COVID-19 are expected under IFRS 7 requirements. Judgements and estimates regarding ECL recognition will be especially important – **SICR criteria, incorporation of forward-looking information, accounting for modifications, POCI recognition** – to name but a few of the most important.

Conclusion

Once again, it seems banks have challenging task ahead – **reconciling recommendations of regulators with IFRS 9 requirements**, all in turbulent times whose end is still out of sight.

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