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Has the impact of increased economic uncertainty on credit risk been appropriately considered?

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Ewa Bialkowska
Director
KPMG IFRG Limited (UK)

In times of increased economic uncertainty, it may be challenging for companies to incorporate forward-looking information that is available without undue cost or effort into their assessment of whether credit risk on a financial instrument has increased significantly.

What's the issue?

Assessing credit risk – Identifying significant increases in credit risk and credit impairment

The assessment of credit risk – the risk of a borrower defaulting – is usually an integral part of measuring expected credit losses (ECLs) under IFRS 9 *Financial Instruments*. Except for some trade and lease receivables, a company needs to assess at each reporting date whether the credit risk on a financial instrument has increased significantly since initial recognition. If it has, then ECLs are recognised over the expected life of the exposure; if it has not, then ECLs are limited to those over the next 12 months of the life of the exposure. A company also needs to assess whether an exposure is credit-impaired. [IFRS 9.5.5.3]

Similar to other aspects of ECL measurement, assessing whether there is a significant increase in credit risk (SICR) since initial recognition is forward-looking and considers reasonable and supportable information that is available without undue cost or effort at the reporting date. [Insights 7.8.110.60]

External events – e.g. a natural disaster, geopolitical events or pandemic – may significantly increase economic uncertainty. The challenge for companies in times of increased economic uncertainty is to incorporate into the SICR assessment forward-looking information that is available without undue cost or effort.

Getting into more detail

Identifying SICR is usually material for banks and other financial institutions. Many banks calculate explicit probabilities of default (PDs) for individual exposures and use these to perform quantitative assessments of SICR. They will need to consider how they can incorporate the impact of increased economic uncertainty on the risk of default into PDs for individual exposures on a timely basis. [IFRS 9.5.5.9]

Companies also need to consider qualitative factors when identifying SICR. For example, changes in customer behaviour, requests for payment holidays or credit limit increases, or the introduction of sanctions against certain businesses may indicate SICR or credit impairment. [IFRS 9.B5.5.18]

If a company is not able to identify key drivers of credit risk on an individual instrument basis, then it may need to assess SICR on a collective basis. For example, it might need to consider whether, on the basis of the information available at the reporting date, credit risk has increased significantly for all or some borrowers in certain industries or regions and, if so, transfer all or a portion of those exposures to Stage 2 (or Stage 3 if they are credit-impaired). [IFRS 9.B5.5.16]

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Government assistance provided directly to borrowers might reduce the probability of a borrower defaulting and so avoid SICR occurring in some cases. However, when assessing whether credit risk has increased significantly, the probability of recovering cash flows under a financial guarantee that is integral to the terms of the financial asset is not considered. This means that expected recovery of loans to customers from government guarantees might be included in the measurement of ECLs, but this guarantee may not reduce the probability of default or avoid SICR occurring.

Sovereign exposures

Companies with exposures to governments, including investments in sovereign bonds, will need to update their measurements of ECLs and assessments of whether there is a significant increase in credit risk. Increased economic uncertainty puts pressure on government finances. During times of increased economic uncertainty, the likelihood of SICR occurring in the near future will be elevated for sovereign exposures that are at the lower end of the investment grade rating range with a negative outlook. For example, SICR is likely to occur in sovereign exposures that, subsequent to initial recognition, become subject to sanctions. [IFRS 9.5.5.9]

Modifications and forbearance

As borrowers face greater risk of financial stress from increased economic uncertainty, they might approach lenders to ask for concessions against the current terms of their borrowings. For example, they might request relaxation of covenants, delayed repayment of interest or principal, or a reduction in the interest rate. Governments might encourage banks to provide concessions for particular types of customers.

Also, governments may pass legislation that affects the contractual terms of certain financial assets.

Both lenders and borrowers will need to analyse any such arrangements carefully to determine the appropriate accounting – i.e. they will need to assess whether:

- there has been a change in the contractual terms of a financial instrument and, if so, whether it leads to a derecognition gain or loss, or a remeasurement of its amortised cost; [IFRS 9.5.4.3] and
- for the lender, the arrangement indicates SICR or a credit impairment, or results in a partial write-off of the loan. [IFRS 9.5.5.12]

If a government provides assistance to a lender and this in turn enables the lender to provide support to its customers, then the lender will need to consider how to account for that assistance – in particular, whether government grant accounting under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* is required. [Insights 7.8.130]

Disclosures

A company is required to disclose the nature and extent of risks arising from financial instruments and how it manages those risks. Therefore, a company will need to explain the significant impacts of increased economic uncertainty on the risks arising from financial instruments and on how it is managing those risks. It will need to use judgement to determine the specific disclosures that are relevant to its business and necessary to meet these objectives. [IFRS 7.31]

Examples of specific disclosures include the following.

- How management determined whether the credit risk of the financial instrument has increased significantly since initial recognition. The methods and indicators used may have changed in response to the current conditions – e.g. additional collective assessments may have been performed or financial instruments may have been grouped differently. [IFRS 7.35F]

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- The methods, assumptions and information used to assess SICR – e.g. a company may need to explain how it has incorporated updated forward-looking information into assessing SICR. [IFRS 7.35G]
- Quantitative and qualitative information that allows evaluation of the amounts arising from ECLs. The types of analysis disclosed previously may need to be adjusted or supplemented to clearly convey impacts arising from the increased economic uncertainty. [IFRS 7.35H-L]
- Information on the assumptions that the company has made about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in a material adjustment within the next financial year. [IAS 1.125]

Actions for management

Consider:

- whether it is possible to incorporate the impacts of increased economic uncertainty- on the risk of default into PDs for individual exposures on a timely basis;
- incorporating qualitative factors in identifying SICR – e.g. changes in customer behaviour, requests for payment holidays or limit increases, or introduction of sanctions;
- assessing SICR on a collective basis;
- whether modification of contractual terms of a financial instrument leads to recognising a gain or loss on derecognition, or a gain or loss on remeasurement; and
- whether assistance provided by a government means that government grant accounting is appropriate.

References to 'Insights' mean our publication **Insights into IFRS®**

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