

# Impact of Covid-19 on credit



**The pandemic presented a test case to Jordanian banks' business continuity management and risk mitigation tools, which were supported by regulatory changes to mitigate the immediate impact of credit risk, the probability of default (PD) and granting policies. Additionally, banks' fair value measurements were affected and business models were revised across the board.**

## Credit risk

Banks in Jordan should consider qualitative factors when granting payment holidays and before adjusting significant increase in credit risk (SICR). Using qualitative factors and closely examining an individual customer's financial health for a credit risk assessment has been necessitated by the pandemic, which has made such forward-looking analysis tricky due to ongoing economic uncertainty.

During the pandemic, banks approached payment holiday requests on a case-by-case basis. While previously such requests could rely on quantitative comparisons to industry benchmarks, pandemic-induced economic uncertainty necessitated a deeper look at an individual company's cashflow, sales, debt, liquidity and other metrics. Additionally, increased attention has been paid to a customer's industry, as covid-19 had an outside effect on certain sectors while leaving others relatively unscathed.

Previously, the granting of a payment holiday would trigger an automatic increase in SICR. During

the pandemic the CBJ instructed banks to not consider delayed payments as a reschedule (an SICR flag), meaning that the loans were not reclassified as stage 2. Regulators encouraged banks to develop more nuanced forecasting models that consider an individual company's likely performance during the pandemic.

Such forecasting models are challenging. Incorporating accurate forward-looking information about economic impact of the Covid-19 into the SICR assessment requires a crystal ball and the world's smartest epidemiologists. Most banks don't have either of those at their disposal.

Instead, banks need to consider qualitative factors when adjusting SICR. For example, changes in customer behavior or requests for payment holidays or credit limit increases may indicate SICR or credit impairment. Consideration should be given to tailored payment holiday packages granted as these packages should be granted by the banks after analyzing the customers financial positions.

## Probability of default (PD) and granting policies

A similar approach can be taken to avoid arbitrary Covid-19 overlays on probability of default (PD) models. Existing PD models use historical experience to derive links between changes in economic conditions and customer behavior. However, these historical relationships are unlikely to read across to the Covid-19 pandemic. Therefore, adjustments to model results, similar to adjustments made for SICR analyses, could be necessary to reflect the information available at the reporting date appropriately.

Further, such nuanced approaches to appraising a customer's financial health should be applied to granting policies, especially in the current environment of low-interest rates and government-encouraged lending. Jordanian banks injected JOD1,557 billion into the economy during the pandemic and net credit facilities have increased by JOD908 million during the first four months of 2021 to reach JOD29.5 billion.

Amidst this lending spree—which helped keep the economy afloat during the pandemic—banks revised their policies to take a closer look at corporate clients' financial health, using practices similar to those within their SICR and PD model analyses.

## Fair value measurement

During an economic downturn, there may be a significant decrease in the volume or level of activity in the market for a financial instrument compared with its normal market activity. If an entity concludes that the volume or level of activity of an asset or liability has significantly decreased, further analysis of the transactions or quoted prices may be required to conclude that whether quoted prices represent fair value.

Banks should increase the rigor of their analysis to challenge the valuation of Level 3 instruments and the accuracy of risk premiums when based on historical information due to the increased uncertainty resulting from Covid-19.

Uncertainty should imply a risk premium and, in some cases, new

risk premiums can be developed to further assess fair value. For example, industry specific risk premiums are useful during downturns (like the pandemic) that have outside effects on certain industries. The tourism sector or sectors with an over-reliance on global supply chains could have been earmarked for industry-specific risk premiums.

Key fair value measurement aspects that banks may wish to consider include:

### Do some instruments need to move from Level 2 to Level 3?

There has been a reduction in quotation for market implied inputs which may lead to vanilla OTC products previously classified as Level 2 to level 3. Some equity derivatives could also need to be reclassified due to an increase in judgement in dividend projections.

### Do I need to revise policies or other supporting documentation?

The current crisis may require changes in the existing IPV process, and any valuation methodology changes need to

be reflected accordingly. This includes any transition from mark-to-market to mark-to-model approach that will impact levelling of investments.

### Have policies around observability been considered in the current context?

Fair Value Hierarchy methodologies based on criteria such as number of market quotes and the dispersion among them would trigger a re-classification in this context due to reduced observability / consistency of market data. In addition, banks may need to consider closely significant intraday movements and decline in price quotations that create additional parameter uncertainty, which may affect the observability of valuation parameters and affect the Fair Value Hierarchy.<sup>7</sup>

### Business model revisions

Banks are currently are straining to meet liquidity requirements, which has led to situations where banks sell or retain certain financial instruments in a manner inconsistent with their adopted business models.



<sup>7</sup> <https://home.kpmg/bh/en/home/insights/2020/05/covid-19-implications-on-ifs-13-fair-value-measurement>.



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Attention should be given to ensure that entities are complying with IFRS 9 business models. For example, a bank's sale of financial assets at amortized cost might prompt the entity to revise their business model for this class of financial assets, resulting in:

- Further selling of financial assets at amortized cost
- Frequent or material selling of financial assets at fair value for other comprehensive income
- Retaining financial assets classified at fair value through profit or losses for long period of time
- Having potential or actual restrictions permitted or placed on financial instruments

That said, Jordanian banks have maintained high capital buffers and are well-above their liquidity targets:

- Average capital adequacy ratio (CAR) was 18.3% as of December 2020 — sufficiently higher than the minimum requirement in Jordan (12%) and Basel's minimum ratio of 10.5%
- Average liquidity coverage ratio (LCR) was 136.5% at the end of 2020 which is higher than the minimum requirement in Jordan (100%)

#### Expected credit losses

Under IFRS 9 Financial Instruments, expected credit losses (ECL) are based on reasonable and supportable information that is available without undue cost or effort at the reporting date. This includes information about borrower-specific attributes, past events, current conditions and forecasts of future economic conditions.

Models, by their nature, are expected to be relatively stable and work on the law of large numbers, distribution tails, and calibrations to central tendencies. Most banks would not have developed models that would autocalibrate to changes in the macroeconomic factors, systemic loan payment holidays, loan forbearances, and extreme volatility in financial markets. This therefore renders the following questions: Are risk models still reliable? What actions should be taken given their widespread usage in risk



management, pricing, financial reporting, and business decision-making?

Model validation involves the processes and activities that verify models are performing as intended, and is a core element of model risk management (MRM). For instance, the Basel Committee's minimum standards for internal ratings-based (IRB) institutions require a regular cycle of model validation "that includes monitoring of model performance and stability; review of model relationships; and testing of model outputs against outcomes."

Recent supervisory activities and regulatory guidance indicate that third party model validation is increasingly becoming an area of concern to European supervisors and other regional regulators, requiring banks to comply with heightened expectations. Banks need to ensure they have adequate in-house knowledge, and to remember that they remain responsible for all activities related to their internal models, including overseeing all risks and managing the outsourcing arrangements. This driven as Banks often have insufficient in-house capabilities to internally manage model validation activities mainly due

to a lack of skilled resources and inadequate IT infrastructure. Therefore, financial institutions may choose to involve a third-party service provider to perform model validation tasks, enabling them to focus on their core business and giving them access to tools and services that are not available in-house. However, it's vital that those third parties validating banks' models understand the related model risks and have the resources, expertise and independence to perform thorough assessments.

In order to maintain sufficient in-house understanding of validation, regulators like the ECB recommend that banks should:

- Understand major model assumptions and risk estimation processes
- Retain access to information provided by borrowers
- Compare any external data used in the validation process with their own
- Understand what definitions of default are being used
- Retain access to all the data needed to perform independent validations
- Establish a change policy covering models developed by third parties; and
- Agree the triggers for, and the processes of, model change with service providers.

In addition, they re-emphasized the responsibility of management bodies for all of their institutions' activities, and reminds banks that they must ensure sufficient resources are in place to oversee all risks and outsourced activities.



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