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Impact of COVID-19 when measuring expected credit losses (ECL)

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Deterioration in credit risk

The Malaysian Accounting Standards Board (MASB) issued a statement on 25 March 2020 relating to considerations in measuring expected credit losses (ECLs) under MFRS 9, *Financial Instruments*. MASB emphasised that the principles-based nature of MFRS 9 requires and allows for judgement in addressing the accounting challenges arising from COVID-19.

On 27 March 2020, the International Accounting Standards Board (IASB) issued its statement on IFRS 9, affirming that the standard does not set "bright lines or a mechanistic approach" to determining when lifetime losses are required to be recognised.

Adapting information on potential scenarios

Although information is still limited under the current circumstances, MFRS 9 requires reporting entities to assess potential scenarios involving general deterioration in credit risk. Reporting entities will require a holistic assessment that should capture the changes in the lifetime risk of default – i.e. over the entire expected life of the instrument.

The assessment may require significant judgement and should consider both quantitative and qualitative factors – e.g. changes in customer behaviour or requests for payment holidays or limit increases. Stress testing scenarios will need to be sufficiently robust in order to cover events to the scale of COVID-19.

ECL Estimation

ECLs are measured reflecting an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. It takes into account reasonable and supportable information on-hand that is available without undue cost and effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

MFRS 9 includes a rebuttable presumption that a loan that is more than 30 days past due has undergone a deterioration in credit risk. Reporting entities may need to adapt the supportable information on-hand on potential scenarios and make judgements in estimating the ECLs.

If COVID-19 impacts on credit risk cannot be identified at an individual instrument level, then it may be necessary to assess credit risk deterioration on a collective basis – e.g. for a group or part of a group of loans.

Disclosures and forecasts

Sufficient disclosures

- MASB emphasised the importance of financial statements having sufficient disclosures of the key assumptions used and the judgements made in estimating the ECLs, particularly since reporting entities may not have similar historical data as a reference point to compute the ECLs.
- It is important to provide all relevant disclosures about actual and potential impacts of COVID-19 to comply with MFRS 7, *Financial Instruments: Disclosures*. Additional information should be provided about significant judgements.

Forecasts of future conditions

- MASB reminded reporting entities to incorporate forecasts of future conditions over the entire remaining expected life of a loan only to the extent of the availability of supportable information.
- Reporting entities will face challenges in developing reasonable and supportable forecasts. They need to consider how long the economic shock may persist before a reversion to long-term stable trends occurs and how government support might mitigate the shock.

Temporary shocks

- The impact of temporary shocks could be determined to affect mainly the 12-month ECLs.
- Reporting entities need to consider how much the current uncertainty and changes in the short-term economic outlook are expected to result in impacts over the entire life of a financial instrument.

Government measures

- Government measures that provide support to borrowers should be considered in forecasts because they may reduce the lifetime risk of default.

Economic conditions

- Changes in economic conditions should be reflected in macroeconomic scenarios applied by reporting entities and in their weightings.
- If the effects of COVID-19 cannot be reflected in models, post-model overlays or adjustments will need to be considered.

Rescheduling and restructuring ("R&R)

R&R

- On 24 March 2020, Bank Negara Malaysia announced payment moratoriums to assist individuals and small and medium-sized enterprises (SMEs) and corporations to manage the COVID-19 outbreak. Measures to allow rescheduling and restructuring in payments of a loan should not be regarded as automatically meaning the loan has suffered a significant increase in credit risk.
- Instead, the lender needs to analyse the conditions under which the measures are implemented and consider all facts and circumstances. A key issue is to distinguish temporary liquidity constraints on a borrower from a credit risk deterioration over the life of the instrument.

Stage transfer criteria

- Moratoriums provided to borrowers should not automatically result in a stage transfer under MFRS 9 in the absence of other factors relevant to the assessment of whether there has been a significant increase in credit risk.

Potential Day 1 modification loss

- There is potential Day 1 modification loss on loans with payment moratorium if lenders do not compound interest on the deferred payments.

Actions to take now

Consider:

- whether it is possible to incorporate COVID-19-related changes into a holistic assessment that should capture the changes in the lifetime risk of default – i.e. over the entire expected life of the instrument;
- incorporating qualitative factors in identifying deteriorating credit risks – e.g. changes in customer behaviour or requests for payment holidays or limit increases;
- assessing deteriorating credit risks on a collective basis;
- how long the economic shock may persist, how government support might mitigate the shock and consider post-model overlays or adjustments in macroeconomic scenarios; and,
- provide all relevant disclosures about actual and potential impacts of COVID-19 to comply with MFRS 7.

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