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Effects of the coronavirus pandemic on impairment of financial instruments according to IFRS 9 in the quarterly financial statements of banks as of 31 March 2020

Technical note of the IDW Banking Committee (adopted on 26.03.2020, prepared in cooperation with the IDW Working Group Financial Instruments according to IFRS)

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1. Background

The granting of loans by banks is linked to extensive supervisory regulations. The credit risk of debtors plays a major role in this context. The impairment requirements for the recognition and measurement of financial instruments in the financial statements may, in conjunction with existing regulatory requirements, result in fewer loans being granted.

Against the background of the current effects of the coronavirus pandemic, the IDW has addressed with the issue of recognising losses allowances for financial instruments in accordance with IFRS 9.

2. Overview

The impairment model of IFRS 9 is based - with certain exceptions - on three stages:

- Financial instruments are initially allocated to **Stage 1**. In essence, for these financial instruments, the loss allowance is calculated as the present value of the expected credit losses resulting from possible cash shortfalls within the next twelve months after the reporting date (*12-month expected credit loss*).
- If the credit risk has increased significantly as of the reporting date since initial recognition, the financial instruments concerned must be transferred to **Stage 2**. In Stage 2 the loss allowance for a financial instrument is measured at an amount equal to the *life-time expected credit losses*.
- If, in addition to a significant increase in the credit risk on the reporting, there is also objective evidence of impairment (i.e. the financial asset that is credit-impaired), the interest revenue is calculated based on the amortised cost (i.e. the gross carrying amount less the loss allowance). Financial assets in this stage will generally be

assessed individually. Lifetime expected credit losses are recognised on these financial assets (**Stage 3**).¹

Against the background of the coronavirus pandemic and the expected consequences for the economic situation, questions arise regarding the application of the impairment model under IFRS 9.

3. Interpretational Guidance

- The dynamic spread of the coronavirus represents a (worldwide) extreme situation that could not be foreseen in this form. The current substantial economic losses are offset by political stabilisation measures that have been announced and, in some cases, already initiated, as well as temporary regulatory relief measures at hitherto unprecedented levels. It is hardly realistically possible to estimate the lasting economic consequences as of 31 March 2020. The estimates made by leading experts show a wide range.
- The recognition and measurement of impairment losses under IFRS 9 is the subject of numerous national, European and international debates. Most recently, on 25 March 2020, ESMA² issued a public statement on the "Accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9", which is supported by CEAOB³. ESMA is also in close contact with the IASB.
- In its statement, ESMA comes to the following conclusions. In doing so, it emphasises that the comprehensive government measures to stabilise the economy must also be taken into account appropriately in the assessment under IFRS 9.
 - Assessment of whether the credit risk has increased significantly
 - It is a holistic assessment of numerous quantitative and qualitative indicators (cf. IFRS 9.B5.5.17), which focuses on the changes in the lifetime risk of default, i.e. over the entire expected life of the instrument.
 - As the governmental stabilisation measures are designed to mitigate the adverse effects of COVID-19 and the associated economic consequences, their impact should be considered when assessing whether the probability of default (with regard to the *lifetime risk of default*) has increased significantly. In this context, the use of individual government measures, e.g. a moratorium, should not in itself lead to a trigger to transfer to a different Stage.
 - ESMA points out that IFRS 9.5.5.11 allows an entity to determine whether the credit risk has increased significantly since initial recognition on the basis of the information on past due if information that is more forward-looking than the information on past due status (either

¹ Refer to <https://www.ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments/#about>. For further information, see *IDW statement on accounting: Individual questions regarding the accounting of financial instruments in accordance with IFRS 9 (IDW RS HFA 48)*.

² Refer to https://www.esma.europa.eu/sites/default/files/library/esma32-63-951_statement_on_ifrs_9_implications_of_covid-19_related_support_measures.pdf

³ Refer to https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200325-ceaob-statement-covid-19_en.pdf

- on an individual or collective basis) is only available at an undue cost or effort. In this case, there is a rebuttable presumption of a significant increase in credit risk if contractual payments are more than 30 days past due. ESMA reminds issuers to carefully consider whether this presumption can be rebutted against the background of the corona pandemic and the stabilisation measures that have been announced or initiated.
- In the event that a debtor is granted relief by the creditor of a financial instrument as a result of the coronavirus pandemic, all facts and circumstances of the individual case must be analysed. In this context, a distinction must be made as to whether the credit risk of the financial instrument has increased significantly or whether the debtor is only experiencing a temporary liquidity constraint and there has been no significant increase in the credit risk.
 - Estimation of expected losses
 - Companies should assess the extent to which current events impact on their sustainable economic development. It is recommended that issues place greater weight on the consideration of long-term stable scenarios and thus do not emphasise short-term developments.
 - Public guarantees
 - The value of collateral or the occurrence of a guarantee does not affect the assessment of whether the credit risk has increased significantly.
 - ESMA points out that, in principle, public guarantees should only be taken into account when measuring expected losses (see IFRS 9.B.5.5.12). The exact consequences for the financial statements will depend on how the public guarantees are structured. They may be designed as an integral part of the financial instrument or they may be considered as separate.
 - Modifications
 - There is a need to carefully analyse whether the government stabilisation measures lead to a modification of a financial instrument, which – if substantial – would result in it having to be derecognised - and reinstated as a new financial instrument.
 - Transparency
 - ESMA stresses the importance of providing all relevant disclosures relating to the expected impact of the coronavirus pandemic.
 - Views of the IDW Banking Committee
 - The IDW Banking Committee supports the ESMA's views as set out above.
 - In particular, the Committee shares the view that the current situation does not lead to an undifferentiated, automatic transfer of financial instruments from Stage 1 to Stage 2 or even Stage 3 by 31 March 2020. An automatic transfer could lead to the economic risks being significantly overstated. The transfer between Stages is based on the consideration of reasonable and supportable forward-looking information, the effects of which on the credit risk is derived from past experience. However, such a dynamic globally extreme situation is

unprecedented. This leads to extreme estimation uncertainty, requiring the appropriate exercise of discretionary leeway.

- Against this background, the preparers of the financial statements need to carefully consider the macroeconomic scenarios and their relative weightings both in regard to the transfer between Stages and their estimation of the expected loss, making adjustments if necessary. In doing so, appropriate consideration must also be given to government stabilisation measures.
- In addition, it is necessary to examine whether a loss allowance calculated on the basis of the credit risk models in use (including the procedure for transfer between Stages) requires adjustment (so-called management adjustments).
- In the opinion of the IDW Banking Committee, the presentation of the economic situation includes transparent reporting by banks on the possible consequences of the coronavirus pandemic, despite all the uncertainties, and with an explanation of the main assumptions made.
- It is to be expected that banks will incorporate current and future findings into their customary processes. Going forward to reporting dates beyond 31 March 2020, whether a transfer from Stage 1 to Stage 2 will be necessary will also depend on whether the measures promised by the Federal Government, some of which have already been introduced, will indeed ensure that companies affected by the coronavirus pandemic are able to service their debts.
- The Federal Ministry of Finance (BMF) and the Federal Financial Supervisory Authority (BaFin) have issued the following statement in this regard:
*"In view of the Corona crisis, the Federal Government as well as the Bundestag and Bundesrat have adopted far-reaching support programmes for companies operating in the economy. For the expected duration of the crisis, this will not only reduce ongoing cost burdens through moratoria, deferrals, etc., but will also directly strengthen liquidity and, if necessary, capital, in order to compensate as far as possible for corona-related disruptions in the functioning of the affected companies. At the same time, this improves the companies' ability to service their debts to their banks and avoids a significant increase in default risks."*⁴
- In the opinion of the IDW Banking Committee, corresponding stabilisation measures mean that an undifferentiated, any automatic transfer between Stages is not appropriate even for reporting dates after 31 March 2020.

The above comments are subject to the provision that the IASB and the IFRS Interpretations Committee do not subsequently express a different opinion.

On 27 March 2020 the IASB published a document addressing questions regarding the application of IFRS 9 "Financial Instruments" during the period of enhanced economic uncertainty arising from the COVID-19 pandemic.⁵ The IASB document supports the views of the IDW Banking Committee as described above.

⁴ https://www.bafin.de/DE/Aufsicht/CoronaVirus/CoronaVirus_node.html.

⁵ Refer to <https://cdn.ifrs.org/-/media/feature/supporting-implementation/ifrs-9/ifrs-9-ecl-and-coronavirus.pdf?la=en>.