ECL Model: Its Impact in the midst of the COVID-19 Global Crisis

-The test of a Financial Crisis-driven model in times of Global Crisis

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Abstract:

The disruption throughout the globe due to the COVID-19 pandemic has caused tremendous uncertainty and difficulty in the financial sector. The Expected Credit Loss (ECL) model was introduced in the aftermath of the 2008 global financial crisis to curb the loopholes of the incurred loss model and to provide a forward-looking approach in the accounting of loan loss provisioning by inclusion of various credit measures. The current global COVID-19 disruption is an event when the ECL model should provide transparency to users of financial statements. This paper is a modest attempt to shed light on the factors to be considered in accounting for ECL in the light of the current uncertainty resulting from the COVID-19 disruptions.

Keywords: COVID-19, Global Financial Crisis, IRACP, IND-AS, probability of default, SICR, EIR.

1. Introduction

With the deferment in applicability of IND AS to 1st Apr. 2019 in respect of the Scheduled Commercial Bank, the current rule based provisioning norms namely “Income Recognition, Asset Classification & Provisioning (IRACP)” as prescribed by the RBI scheduled to be transitioned to “Expected Credit Loss Model (ECL Model)” based on the contents of “Ind AS 109 Financial Instruments”. IND AS 109 replaces the existing “Incurred Loss Model” with a forward-looking “ECL Model”. With this transition, entities can no longer afford to wait till the occurrence of a loss event and thereafter resort to provisioning; instead, entities are expected to be forward-looking and should exercise credit modelling leading to, making of needed provisions based on changes in the quality of credit.

Source: Created by the authors according to the IFRS 9 - Financial Instruments.

2. Need and Applicability of Expected Credit Loss (ECL):

Past experiences of financial crisis have revealed the need to be proactive in reckoning the potential deterioration in the credit quality of the financial assets. Further adequate disclosures of an increase in credit risk will facilitate prudent decision-making and initiate needed corrective measures.

Source: Created by the authors according to the IFRS 9 - Financial Instruments.

Para 5.5.1 of IND AS 109 specifies the applicability of the “ECL Model” to:

2.1. A financial asset which is measured at amortised cost and which meets below conditions:

a. It is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows, and

b. The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

2.2. A financial asset shall be measured at fair value through other comprehensive income and which meet below conditions:

a. The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets, and,

b. The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

2.3. A lease receivable,

2.4. A contract asset or a loan commitment and,

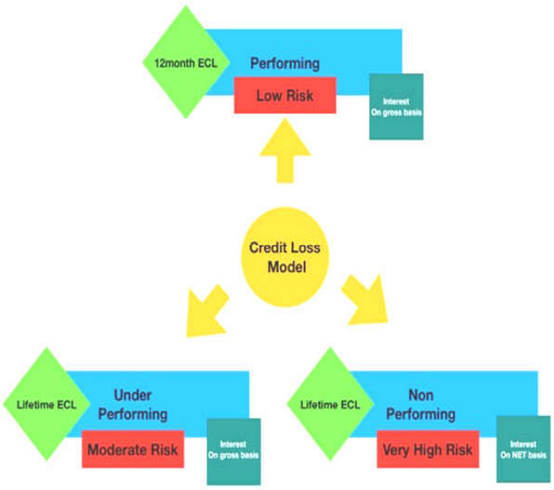
2.5. A financial guarantee contract to which the impairment requirements apply.

Note that almost all the financial statements will have elements of assets having nexus to “Credit Risk”; consequently, the model would be applicable to all the entities that have contractual receivables or recoveries from other entities.

3. Expected Credit Loss Model:

The Expected Credit Loss model is the probability-weighted estimate of credit losses (i.e., the present value of all cash shortfalls) over the expected life of a Financial Instrument.

Credit losses are nothing but the differences between the contractual cash flow due to the entity and the cash flow that the entity actually expects to receive.



Source: Created by the authors according to the IFRS 9 - Financial Instruments.

"Para 5.5 of IND AS 109" discusses the "General Approach" for recognition of expected credit losses.

Under the general approach, an entity must determine whether the financial asset is in one of the three stages to determine the amount of Expected Credit Loss to recognise & the manner in which interest income should be recognised. At a broad level, the model works by assessing the credit quality and categorizing the financial assets into three stages, namely performing, underperforming, and non-performing.

3.1. Performing Stage:

a. Asset Quality: Will include those financial instruments for which there is no material decline in credit risk since initial recognition or those which have low credit risk at the reporting date.

b. Provisioning & Income Recognition: For these assets, 12-month expected credit losses are recognised. 12-month ECL means the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date. Interest revenue is calculated on the gross carrying amount of the asset (that is, without deduction for credit allowance).

3.2. Underperforming Stage:

a. Asset Quality: Will include those financial instruments for which there is a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date), but which do not have objective evidence of impairment.

b. Provisioning & Income Recognition: For these assets, lifetime ECL is recognised, but interest revenue is still calculated on the gross carrying amount of the asset. Lifetime ECL are the expected credit losses that result from all possible default events over the expected life of the financial instrument. Expected credit losses are the weighted average credit losses with the probability of default ('PD') as the weight.

3.3. Non-Performing Stage:

a. Asset Quality: Will include those financial assets for which there is objective evidence of impairment at the reporting date.

b. Provisioning & Income Recognition: For these assets, lifetime ECL is recognised and interest revenue is calculated on the net carrying amount (that is, net of credit allowance).

4. The approach of ECL at the time of the COVID-19 disruption

The ECL model requires the application of judgment and differs from entity to entity. Such application of judgment and approaches is considered based on the industrial practices as well as the business environment in which the entity operates. For example, a financial institution may not have an aggressive approach in determining ECL for the portfolios serving the affluent sections of the economy as compared to the low-credit-score portfolios. However, conventional assumptions taken in the ECL model may not hold well in the current environment we are going through. The assumptions of a significant increase in credit risk (SICR), at times when there is extension in the repayment structure, may be a classical example of SICR, which would result in stage-shifting of the credit exposure. But the same would not hold well in times of such a disruption, where the financial sector regulator has proposed to extend a three-month moratorium for repayment of term loans, considering the disruption to the economy.

We arrive at ECL estimates with the help of three primary data points [B5.5.49];

- Best available information about the past events;
- Best available information about the current conditions; and
- Forecast of economic conditions.

In the current COVID-19 disruptions, the entities should actively consider the effects of the COVID-19 disruption, as well as the measures taken by the government and regulators in the current situation, as well as the prospective measures that would affect the forecast. Such measures should be considered as forward-looking “macro-economic information” [B5.5.4] and accordingly be considered by the entities.

However, it is easier said than done, considering the rapid changes and updates in the current stressed environment. But if the ECL estimates are arrived at, after proper consideration of reasonable and supportable information, the same can provide better transparency to the financial statements and aid in providing assurance to the stakeholders.

The major component in ECL computation is the probability of default (PD). To arrive at the PD, we use historical PD by assessing the entity's internal credit rating data as well as forward macroeconomic factors in determining PD term structures. While assessing the forward-looking PD, entities will have to consider the disruption in the business of the borrowers. Such disruption would have resulted in reduced economic activity, which in turn would have significantly increased the likelihood of default.

5. Effect of the moratorium grant on loan repayments on ECL

To address the stress in the financial sector caused by COVID-19, several measures have been taken by the RBI to mitigate the burden on debt servicing due to the disruption. These measures include a moratorium on term loans, deferring interest payments on working capital, and easing working capital financing. The lending institutions have been permitted to allow a moratorium of three months on payment of all instalments falling due between March 1, 2020, and May 31, 2020. The explanation below specifies the effect of the moratorium.

5.1. Effect on credit risk and stage shifting

Since the moratorium is to be considered as a repayment holiday where the borrower is granted an option to not pay during the moratorium period, the same cannot be considered as a factor in determining a change in the credit risk complexion of the borrower. The provisions of para 5.5.12 of Ind AS 109 are self-explanatory on the point that if there has been a modification of the contractual terms of a loan, then, in order to see whether there has been a SICR, the entity shall compare the credit risk before the modification, and the credit risk after the modification. Sure enough, the restructuring under the disruption scenario is not indicative of any increase in the probability of default.

Accordingly, the same should ideally not be considered as a factor for considering SICR, and in turn, should not result in the shifting of the financial instruments from one stage to another.

5.2. Effect on rebuttable presumption about credit deterioration

The moratorium granted by the RBI seeks to amend the payment schedule without resulting in a restructuring. There is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. However, the rebuttal may be offered in case the payments are more than 30 days past due. The very meaning of "past due" is something that is not paid when due. The moratorium amends the payment schedule. What is not due cannot be past due.

5.3. Effect on the Effective interest rate (EIR) for the loan and income during the moratorium

The whole idea of the modification is to compute the interest for the deferment of EMIs due to moratorium, and to compensate the lender fully for the same. The IRR for the loan after restructuring should, in principle, be the same as that before restructuring. Hence, there should be no impact on the EIR.

As the EIR remains constant, there will be recognition of income for the entire Holiday period. For example, for the month of March 2020, interest will be accrued. The carrying value of the asset will be increased to the extent of such interest recognised. In essence, the P/L will not be impacted.

Also, there will not arise any modification gain or loss as per para 5.4.3 of Ind AS 109 since the EIR remains constant.

5.4. Requirement of Impairment Testing of financial assets

The revision in the payment schedule does not result in a modification of the financial asset, which could have resulted in an impairment testing of the financial asset. Since the contractual modification in case of the moratorium is not a result of a credit event, the question of any impairment for this reason does not arise.

6. Conclusion

The concept of ECL is a fallout of the Global Financial Crisis; it will be interesting to see how fairly the model lives up to providing transparency to the users of financial statements at this time of global disruption. The current situation is difficult, creating high levels of uncertainty but certain measures may be adopted by entities in curbing the situation to some extent, such as developing more than one scenarios for the potential impact of the COVID-19 disruptions treated as macro-economic information as per the para B5.5.4 of Ind AS 109 and effect of measures taken by the government and the regulators in the true spirit with which the same is implemented.

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