ZiCA
Zambia Institute of Chartered Accountants

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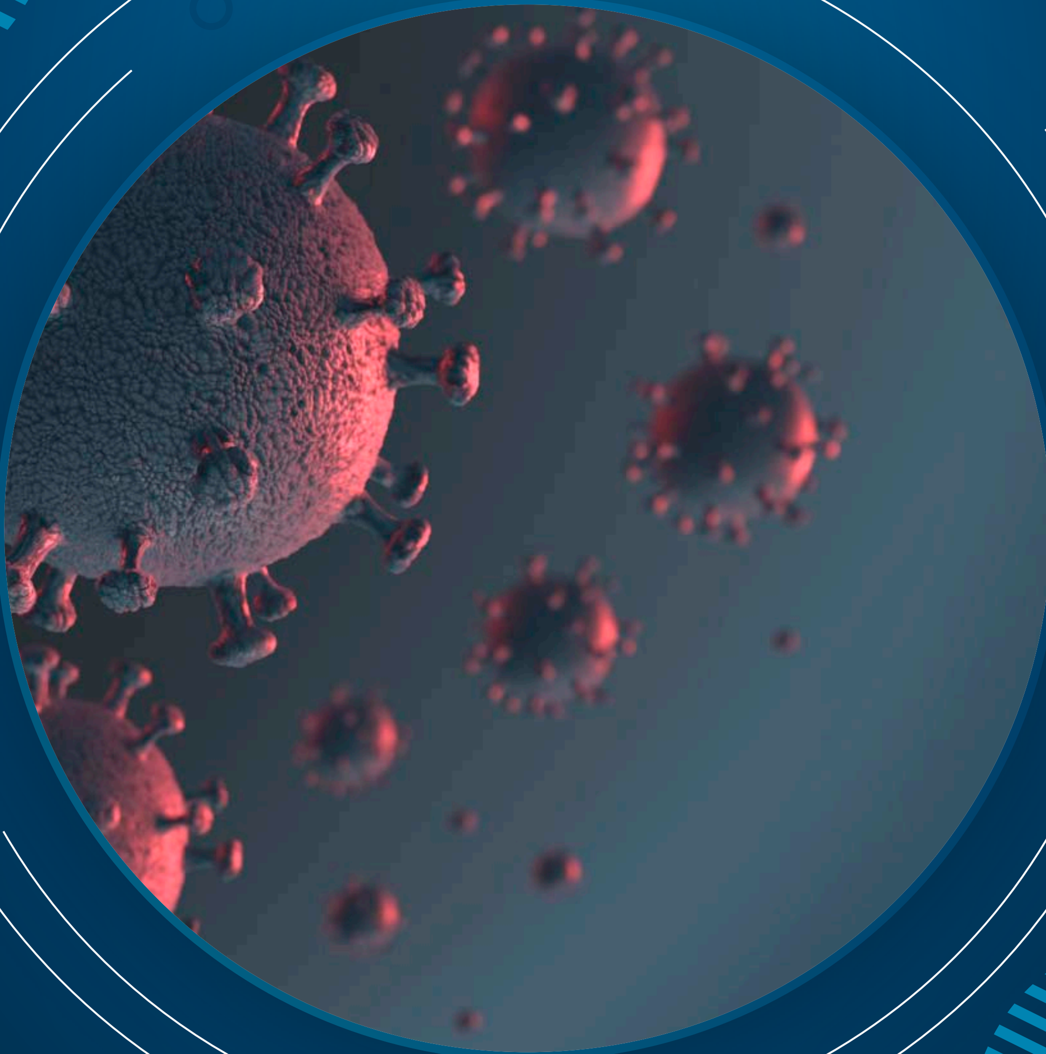

1.0 INTRODUCTION

The IFRS 9 standard has been adopted internationally as the standard to establish principles for the financial reporting of financial assets and financial liabilities by all entities to all types of financial instruments. The standard needs to be applied consistently across all territories including Zambia to ensure that financial statements are consistent and comparable across jurisdictions. In this regard, Zambia Institute of Chartered Accountants (ZICA) is not able to make any modification to the IFRS standard..

In light of the above, financial institutions need to ensure that they continue to adhere to the requirements of the IFRS 9 standard as this will ensure that they do not receive qualifications of financial statements from their auditors.

ZICA understands the concerns that the Banking Community has raised over the adverse systemic economic impact of the COVID-19 pandemic and welcome the measures that several banks are proposing and anticipating to implement in the form of general moratorium, payment holidays and other industry-wide payment relief initiatives.

Therefore, ZICA is providing guidance on a number of aspects on how the IFRS 9 framework works, with the aim to provide clarity to the Zambian banking sector on how to handle in a consistent manner, aspects related to;

(i). the classification of loans in default;
(ii). the identification of forborne exposures and
(iii). the accounting treatment.

IFRS 9 sets out a framework for determining the amount of expected credit losses (ECL) that should be recognised. It requires that lifetime ECLs be recognised when there is a significant increase in credit risk (SICR) on a financial instrument. However, it does not set bright lines or a mechanistic approach to determining when lifetime losses are required to be recognised. Nor does it dictate the exact basis on which entities should determine forward looking scenarios to consider when estimating ECLs." **- IASB**

2.0 ACCOUNTING AND REGULATORY FRAMEWORK CONSIDERATIONS

The main principle behind the accounting treatment, identification of forborne exposures and the definition of default in the IFRS 9 framework is to ensure a sound identification of credit impaired assets on the balance sheets.

Given the above, it is important to ensure consistency and comparability in risk metrics as a basis for the banks, regulators and the general public to monitor the effects of the Corona Virus on the financial services sector and general public.

At the same time, there are limitations about the operational capability of banks to make an in-depth assessments of the effects of the crisis under the current circumstances, and as a consequence short-term operational flexibility of the current requirement, as allowed by IFRS 9 is necessary.

Given the nature of the present crisis with potential medium to long term implications, it is important that the flexibility embedded in the accounting and regulatory frameworks is fully embraced by institutions to help ensure that financial institutions remain sound through the crisis.

3.0 OVERVIEW ON MORATORIUM

Our view as ZICA is that any moratorium considered by any financial institution as a general response to COVID-19 pandemic, in so far as they are not responding to risks that are borrower specific, but rather addressed to broad ranges of product classes or customers, must not be automatically classified as forbearance measures, in the application of IFRS 9 and with due regard to an Institution's adopted definitions of default. We would like to advise that the IFRS 9 standard should not be applied in a mechanical way.

> *Though downside risks have risen considerably, we caution users not to immediately adopt the darkest conceivable path as their expectation"*
> **- Moody's Analytics**

Ordinarily, modifications or rescheduling / restructuring of receivables that are undertaken by a financier could mean, based on the standard, that there is a significant increase in credit risk and the need to recognise loss allowances for lifetime expected credit losses. However, in the current environment, in which regulatory action or industry wide actions may be driving payment moratoriums, it may not be appropriate to simply assume that rescheduling / restructuring, in itself, would necessarily mean that lifetime expected credit losses are relevant for all receivables.

The application of IFRS 9 allows for use of judgement. In this regard, where financial institutions provide relief measures to their customers to mitigate the effects of COVID-19, such as application of payment holidays, reduction of interest rates and extension of loan tenures, financial institutions should not necessarily interpret this as meaning that there is significant increase in credit risk (SICR), which should result in an increase in provisioning.

In addition, consideration would need to be given to whether the payment moratoriums could enable the obligors who are affected by the COVID-19 outbreak to resume regular payments in the foreseeable future, such that significant increase in credit risk would not occur over the expected remaining lives of the receivables.

The financial institutions are to ensure that their assumptions and judgements are based on supportable and reasonable information. In this regard, financial institutions need to assess whether the changes impact on the risk of a default occurring over the expected life of a financial instrument.

Therefore, it is an important obligation for banks and other institutions to assess the credit quality of the exposures benefiting from the relief measures that may be proposed and identifying any situation where the borrower is unlikely to settle in the long run.

4.0 IDENTIFICATION OF DEFAULT

The identification of default includes a number of mitigating factors to ensure that classification to default is done under true circumstances where economic losses are likely to be taken.

(1). In terms of the past due criteria under the BOZ regulations and IFRS 9 presumptive definition, defaults do not have to happen until 90 days past due on material credit obligation, providing sufficient time to restructure the loans where necessary. This is particularly relevant if the moratorium is activated as a result of the COVID-19 pandemic. **(Note: In this regard, we are requesting that the BOZ guidelines on the application of the definition of default must explicitly account for the possibility that moratoriums may be extended during this period and therefore should be treated similarly to the extent they have similar purpose and characteristics).**

(2). ZICA is below providing the criteria to determine under what characteristics such similar treatment may apply.

a. Loans can be renegotiated in a way that the financial position of the lender does not diminish (i.e. the net present value of cash flows of the loan remains the same after restructuring). In this case, if the obligor remains likely to meet its obligations under the renegotiated contract, there is no need to classify the exposure as defaulted (should not automatically be classified as defaulted). This type of restructuring should not be considered as a distressed restructuring; on the contrary it has to be considered a suitable measure to give relief to borrowers, which are temporarily not able to service their loan obligations due to COVID-19 disruptions. (Note: BOZ needs to address this in the prudential requirements as well).

b. Only material amounts past due lead to default, as the amounts overdue have to exceed the materiality threshold, which ensures that only delay of significant amounts lead to a default classification.

(3). As discussed in section 3 above and as further clarified below, ZICA has recognised a number of considerations that are important, as these measures will have a significant impact on the classification of loans, as follows:

i. In the case of the moratorium permitting suspension or delays in payments, this impacts the 90 days past due criterion, as the delays are counted based on the modified schedule of payments. While institutions are still obliged to assess the obligor's unlikeliness to pay on a case-by-case basis, this assessment refers to the modified schedule of payments, and where there are no concerns in that regard the exposure may remain in performing status.

ii. It is the expectation of ZICA that such individual assessments should be done in a careful manner, which does not entail mechanically going by the current model's classification output. Moreover should institutions face a substantial number of individual assessments, they should prioritise the analysis using their risk-based approach. Initial assessment should focus on those individual exposures most likely to have had a significant impact and can initially be done at the portfolio level, if need be. In the period directly after the moratorium, institutions should pay particular attention to those exposures which experience delays in payments.

iii. There is need to identify those who are unlikely to pay when a moratorium is lifted. Any assessment will furthermore need to be done on a consistent basis based on reliable information and taking on board all measures that are being put in place and impact the creditworthiness of customers.

> *It is important to understand that IFRS 9 does not set bright lines or a mechanistic approach to determining when lifetime losses are required to be recognised, nor does it dictate the exact basis on which entities should determine forward looking scenarios to consider when estimating ECLs*
>
> **- This ZICA Guidance**

5.0 WHAT WE ARE SAYING IN SUMMARY

> *Given that modelling assumptions and methodologies that prevail in normal times may prove impaired in the current context of extraordinary uncertainty, it appears of paramount importance that significant institutions pay particular attention to the governance of model updates, adjustments and overlays that will prove necessary going forward."*
> - European Central Bank (ECB)

In the current circumstances, any proposals to address the adverse systemic economic impact of the COVID-19 pandemic would not automatically lead to a reclassification under the definition of forbearance.

ZICA notes that the offering and acceptance of terms set out in general moratorium would not necessarily lead to a reclassification of any loan under the definition of forbearance, as either performing or non-performing forborne. In other words, no automatic reclassification is needed when general measures are being offered.

For the purposes of supervisory reporting, the definition of forbearance is designed to be reported when credit institutions offer specific measures to help a specific borrower who is experiencing or likely to experience temporary financial difficulties with their repayment obligations. The individual assessment of the borrower's financial difficulties and granting measures tailored to this financial situation of the borrower are at the core of the IFRS's definition of forbearance.

The moratorium may be introduced as a response to COVID-19 pandemic and which aims to address systemic risks and alleviate potential risks that may occur in the wider Zambian economy. In this sense, these measures are not borrower-specific, although they may be based on broader product classes, as the length of the delays in payments is fixed for every borrower irrespective of the borrowers' specific financial circumstances.

In this regard, the aspects related to IFRS9 is based on a set of principles that, by nature are not mechanistic and require the application of a certain degree of judgment. The significant increase in credit risk (SICR) is required to be assessed based on the identification of significant changes over the total expected life of the exposure.

IFRS 9 offers a certain degree of flexibility in the sense that it does not dictate when a significant increase in credit risk has occurred. Rather it requires an assessment to be made on the basis of quantitative and qualitative triggers. In this regard, there is no strict mechanical way to apply this. The financial institutions' assessment of whether there has been a significant increase in credit risk should be performed through the identification of significant changes over the total expected life of the exposure.

ZICA is of the view that the application of moratorium, aimed at addressing the adverse systemic economic impact of the COVID-19 pandemic, should not be considered by themselves as an automatic trigger to conclude that a significant increase in credit risk has occurred.

It can therefore be seen that IFRS 9 still provides for room to apply judgement and that mitigation measures granted to customers by financial institutions do not automatically imply that there is significant increase in credit risk which should result in increased provisioning

THE IASB COMMENTING ON EXPECTED CREDIT LOSSES

Although current circumstances are difficult and create high levels of uncertainty, If ECL estimates are based on reasonable and supportable information and IFRS 9 is not applied mechanistically, useful information can be provided about ECLs. Indeed, in the current stressed environment, IFRS 9 and the associated disclosures can provide much needed transparency to users of financial statements

IFRS 9 requires considering all reasonable and supportable information available without undue cost (including forward looking information) that may affect the credit risk of a financial instrument since its original recognition. Institutions should consider the current exceptional circumstances when determining which information can be considered reasonable and supportable information as foreseen under IFRS9, also taking into account the expected nature of the shock (i.e. whether it is expected to be temporary or not) and the scarcity of available and reliable information.

It is important to under that IFRS 9 does not set bright lines or a mechanistic approach to determining when lifetime losses are required to be recognised, nor does it dictate the exact basis on which entities should determine forward looking scenarios to consider when estimating ECLs. Therefore Institutions should carefully assess the extent to which, amongst other facts, the high-degree of uncertainty and any sudden changes in the short-term economic outlook are expected to result in impacts over the expected life of the financial instrument.

In doing so, institutions would be expected to distinguish between obligors for which the credit standing would not be significantly affected by the current situation in the long term, from those that would be unlikely to restore their credit worthiness. Exercising this discrimination would contribute to mitigate any potential cliff effect of transfers between stages and would help to avoid exaggerating the effects of the shock.

In any case, in determining the impact on banks' income statements stemming from the recognition of the expected credit losses (ECL) the mitigation provided by the existence of collateral would need to be considered. *(As part of this guidance, we have noted that Bank of Zambia has considered the exceptional circumstances of COVID – 19 and has extended the transition prudential arrangement on IFRS 9 adoption from 3 years to 5 years, to ensure that the regulatory capital is not eroded,).*

ZICA will continue its efforts on monitoring the institutions' practices in the current circumstances in order to understand better the impact of IFRS 9 on capital requirements as well as the way banks are applying judgment in the assessment of the level of and changes in credit risk of their exposures.