
25 March 2020

Statement on the application of the prudential framework regarding Default, Forbearance and IFRS9 in light of COVID-19 measures

The EBA supports the measures taken and proposed by national governments and EU bodies to address the adverse systemic economic impact of the COVID-19 pandemic in the form of general moratorium, payment holidays stemming from public measures or industry-wide payment relief initiatives taken by credit institutions (referred to as public and private moratoria in this statement). In this regard, the EBA sees the need to clarify a number of aspects on the functioning of the prudential framework, with the aim to provide clarity to the EU banking sector on how to handle in a consistent manner, aspects related to (i) the classification of loans in default, (ii) the identification of forbore exposures and (iii) the accounting treatment.

General considerations on the accounting and regulatory framework

It is important to recall that the main principle behind the accounting treatment, identification of forbore exposures and the definition of default in the prudential framework is to ensure a sound identification of credit impaired assets on bank balance sheets. The consistency and comparability in risk metrics is a pre-condition for banks, supervisors and the general public to monitor the effects of the current crisis. At the same time, there is a broad understanding that the operational capability of banks in making in-depth assessments may be more limited under the current circumstances, hence short-term flexibility in operational requirements is warranted. Given the nature of the present shock which may also have medium and long term implications the flexibility embedded in the accounting and regulatory frameworks is to be fully used by institutions to help maintain soundness through the crisis and provide critical functions to the economy.

The EBA is of the view that the public and private moratoria, as a response to COVID-19 epidemic to the extent they are not borrower specific but rather addressed to broad ranges of product classes or customers, do not have to be automatically classified as forbearance measures, as for IFRS9 and the definition of default. However, this does not remove the obligations for credit institutions to assess the credit quality of the exposures benefiting from these measures and identify any situation of unlikeliness to pay of the borrowers accordingly.

Prudential identification of default

The prudential 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.

- In terms of the past due criteria, 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 in light of the moratoria being activated as a result of the COVID-19 pandemic. The EBA guidelines on the application of the definition of default already explicitly account for the possibility that public moratoria may extend this period. Public and private moratoria should be treated similarly to the extent they have similar purpose and characteristics. The EBA will shortly provide criteria to determine under what characteristics such similar treatment may apply.
- 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 (no automaticity in the classification 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 serve their loan obligations due to COVID-19 disruptions.
- Only material amounts past due lead to default, as the amounts overdue have to exceed materiality threshold, which ensures that only delay of significant amounts lead to a default classification.

As regards the moratoria, a number of considerations are important, as these measures will have a significant impact on the classification of loans. These include:

- In the case of public and private moratoria 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 unlikelihood 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.
- It is the expectation of the EBA that such individual assessments should be done in a careful manner, which does not entail any automatism in the classification. 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

on the revised schedule and identify potential unlikelihood to pay in a timely manner and in a discriminative manner. 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.

Classification of forbearance

In the current circumstances, the measures that governments and credit institutions are proposing to address the adverse systemic economic impact of the COVID-19 pandemic would not automatically lead to a reclassification under the definition of forbearance.

- The EBA notes that the offering and acceptance of terms set out in general moratoria would not necessarily lead to a reclassification of any loan under the definition of forbearance, as either performing or non-performing forbore. 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 EBA's definition of forbearance.
- The moratoria being introduced as a response to COVID-19 pandemic aim to address systemic risks and alleviate potential risks that may occur in the wider EU economy in the future. 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.

Considerations on IFRS9

The EBA has coordinated with the European Securities and Markets Authority (ESMA), which issued a statement on the financial reporting aspects in light of COVID-19 measures on 25 March 2020. Both statements are consistent and should be read jointly as regards the aspects related to IFRS9.

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 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 automatism to apply. The institutions' assessment of whether there has been a significant

increase in credit risk is performed through the identification of significant changes over the total expected life of the exposure. The EBA is of the view that the application of public or private moratoria, 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

- 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. 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 or public guarantees would need to be considered. Competent authorities should also duly consider the exceptional circumstances when authorizing institutions to opt for the application of IFRS 9 transitional arrangements envisaged in the CRR.
- The EBA will continue its efforts, started with the benchmarking on IFRS 9, 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.