IFRS accounting considerations in view of the coronavirus pandemic for Armenian banks and credit organizations

Building a better working world

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1. Background

The coronavirus outbreak was first reported near the end of 2019. In late 2019, a cluster of cases displaying the symptoms of a 'pneumonia of unknown cause' were identified in Wuhan, the capital of China's Hubei province. On 31 December 2019, China alerted the World Health Organisation (WHO) about this new virus. On 30 January 2020, the International Health Regulations Emergency Committee of the WHO declared the outbreak a 'Public Health Emergency of International Concern'. Since then, the virus has spread worldwide. On 11 March 2020, the WHO declared the coronavirus outbreak a pandemic. The virus has significantly impacted the world economy. Many countries have imposed travel bans on millions of people and more people in more locations are subject to quarantine measures. Businesses are dealing with lost revenue and disrupted supply chains. While some countries have started to ease the lockdown, the relaxation has been gradual and, as a result of the disruption to businesses, millions of workers have lost their jobs. The pandemic has also resulted in significant volatility in the financial and commodities markets worldwide. Various governments have announced measures to provide both financial and non-financial assistance to the disrupted industry sectors and the affected business organisations.

Since the outbreak of coronavirus in Armenia, the Government of the Republic of Armenia ("the Government") has unveiled 22 programs to address the impact of COVID-19, of which 13 programs are addressed to combat the social impact of the virus and the other 9 programs are addressed to combat the economic impact.

Measures to address the economic impact of COVID-19, among others, include:

- Co-financing or refinancing targeted loans provided to business entities by licensed banks or credit organizations (hereinafter together referred to as "banks") operating in the territory of the Republic of Armenia.
- Loans of up to AMD 50 million to qualifying SMEs with good credit histories and tax records. These loans will be provided through all banks operating in the Republic of Armenia, which will receive a service fee for each credit line from the Government, as represented by the Investment Support Center.

Besides these measures, banks have voluntarily granted payment holidays to some of their borrowers. The holidays are for a limited period (2-3 months) and were mostly intended for individuals and individual entrepreneurs, although some banks offered holidays for legal entities as well. Further, the banks are offering an individual approach to renegotiating loan terms for borrowers who do not automatically qualify for the announced payment holidays.

The economic lockdown has also affected rent agreements for companies, including banks. Due to the decreased level of economic activity, rent concessions, including decreased rent considerations and rent holidays for some periods, have been negotiated for some banks' branches that were mostly affected by the lockdown.

In this brochure, we analyse accounting considerations for banks in respect of the following aspects:

- Loan modifications
- Expected credit loss (ECL) assessments
- Government co-financed and fully financed loans to qualifying borrowers, provided through banks – recognition related aspects
- Rent concessions.

2. Loan modifications

Payment holidays, as well as the renegotiation of loans to borrowers affected by COVID-19, result in the modification of loan agreements. IFRS 9 provides guidance on determining if a modification of a financial liability is substantial, which includes a comparison of the cash flows before and after the modification, discounted at the original effective interest rate (EIR), commonly referred to as the ‘10% test’. If the difference between these discounted cash flows is more than 10%, the instrument is derecognised. For financial assets, there is no explicit guidance in IFRS 9 for when a modification should result in derecognition. Hence, banks apply their own accounting policies, which are often based on qualitative considerations and, in some cases, include the ‘10% test’. However, the IFRS Interpretations Committee has indicated that applying the ‘10% test’ in isolation would not always be appropriate, because of potential inconsistencies with the impairment requirements in IFRS 9. Some preparers may apply different accounting policies depending on whether a modification is granted due to the financial difficulty of the borrower, with some concluding that such circumstance would rarely result in the derecognition of the financial asset. If a measure provides temporary relief to debtors and the net economic value of the loan is not significantly affected, the modification would be unlikely to be considered substantial.

If, following the guidance above, a modification of a financial asset or liability does not result in derecognition, the original EIR is retained and there is a catch-up adjustment to profit or loss for the changes in expected cash flows discounted at the original EIR. For floating rate instruments, a change in the market rate of interest is accounted for prospectively. However, any other contractual change (e.g., the spread applied above the interest rate) would also result in a catch-up adjustment at the date of modification.

For banks, loan modifications resulting from payment holidays and a renegotiation of loan terms might have the following practical accounting applications.

- The banks should determine if a modification is substantial and results in derecognition of the original instrument. As mentioned above, in the absence of explicit guidance in IFRS 9 in respect of this, the banks should apply their own accounting policies. As payment holidays are granted for a relatively short period, the are not expected to result in the derecognition of the original instruments. However, the banks should also consider qualitative criteria of their own accounting policies, such as a change of loan currency, modifications that result in cases when the instrument would no longer pass the SPPI test, etc.
- If a modification of a financial asset does not result in derecognition, the banks will record a modification gain or loss by recalculating the gross carrying amount of the financial asset as the present value of the renegotiated or modified contractual cash flows, discounted at the financial asset’s original EIR. Depending on banks’ accounting policies, this gain or loss may be recorded as an adjustment to interest income or as a separate caption in the income statement.

3. Considerations for expected credit loss (ECL) assessments by banks

The accounting impact of relief measures on ECL depends on the details of the arrangements. For example, the extension of payment holidays or a waiver of a breach of covenant to all borrowers in particular classes of financial instruments should not automatically result in all those instruments suffering a significant increase in credit risk (SICR). This would be the case even if a moratorium results in a loss for the lender (e.g., if interest payments are reduced or waived), if it is provided irrespective of the borrowers' individual circumstances. In other situations, if the relief measures are available only to those who meet certain criteria, banks need to carefully assess whether such criteria themselves might indicate a SICR for the affected borrowers.

For instance, a SICR is more likely to have occurred if a borrower applies for a relief measure which is available only to corporates which have suspended operations or individuals who have lost employment. Another example is if the relief, such as a deferral of loan payments, is offered to all participants in certain industries. This circumstance may indicate that borrowers in that industry are exposed to a higher risk of business failure and, thus, a higher probability of default as a class. In combination with other reasonable and supportable information, this is more likely to result in the classification of the related loans and other exposures in this portfolio, or a portion of them, into stage 2. The assessment should be made irrespective of the fact that a concession is imposed by laws or regulations. Banks are also expected to exercise judgement, in light of all facts and circumstances, including the effect of Government support, to determine if the respective loans are credit impaired and should therefore be classified as stage 3.

Regulators in the international practice have stressed the need to differentiate a temporary liquidity need from a SICR and highlighted that there may be very limited information available to make this determination at an individual borrower level. This means that lenders should distinguish between obligors whose long-term credit risk is unlikely to be significantly affected by the pandemic from those who may be more permanently impacted. In light of the above, the 30 days past due backstop assumption may need to be rebutted in the current circumstances.

Banks whose models include such events as automatic SICR triggers may need to include overlays to unwind the effects if they determine that a SICR trigger is not warranted in this situation.

For retail loans, data to determine whether a SICR has occurred for individual borrowers will often be unavailable. For wholesale exposures, more information is generally available on individual obligors, although the SICR assessment will still be difficult. A lender may consider that borrowers in certain industries (e.g., tourism and hospitality) are exposed to a higher risk of business failure and, thus, an increased PD.

When it is not practical to determine a SICR on an individual basis, a collective approach to staging should be considered. This will also be challenging. A possible method could be to transfer to stage 2 a portion of those customers who have been granted a payment holiday or a waiver of a covenant breach, whose PD was already close to the level that would trigger an SICR. Any approach will require considerable judgement.

As indicated previously, if a measure provides temporary relief to borrowers and the net economic value of the loan is not significantly affected, the modification would be unlikely to be considered substantial. It follows that the effect of any such waiver of interest or capital (measured using the original effective interest rate of the loan) must be recorded as an expense in profit or loss as soon as it is granted.

Where additional rounds of relief measures are extended to existing borrowers, the same considerations which were applicable to assessing the initial relief are also applicable in determining whether the additional relief constitutes a SICR. If the extension of the relief measures is offered only to selected borrowers (e.g., upon individual requests) it may be harder to conclude that a SICR has not occurred, as the need for additional relief may be in response to further deterioration in the borrower's financial position.

Individual and collective assessment, multiple macroeconomic scenarios and management overlays

Whether the impact of the pandemic is reflected in an individual ECL assessment (e.g., estimation of probability of default on an individual basis), factored into the scenario analysis of future macroeconomic conditions on a collective basis, or adjusted through management overlays, depends on the bank's systems and processes and the facts and circumstances. In practice, banks may probably consider a combination of these approaches. In estimating the impact of the coronavirus pandemic, banks should, however, avoid double-counting of the effects of various assumptions applied in individual assessment, macroeconomic scenarios and management overlays.

Due to the abnormal circumstances, it may take time before banks detect changes in risk indicators at a specific borrower level and are able to reassess the affected exposures. In order to accelerate the reflection of such changes in credit quality not yet detected at an individual level, it may be appropriate to adjust ratings and the probabilities of default on a collective basis, considering risk characteristics such as the industry or geographical location of the borrowers. However, many methods for performing collective assessments make use of historical information, which may not be relevant in the current circumstances.

Many financial institutions consider multiple macroeconomic scenarios in the assessment of ECL. The current situation is not likely to have been reflected in any of the scenarios used for the ECL estimates at the prior year end and, as such, will need to be updated. In addition to updating GDP expectations for the various scenarios, a challenge will be to estimate how the impact of the coronavirus pandemic and any related Government programmes will affect specific sectors and borrowers, especially as the details surrounding many Government programmes are currently evolving.

The IASB noted that a number of assumptions and linkages underlying the way ECL has been implemented to date may no longer hold in the current environment. For example, the relationship between GDP and other macroeconomic variables, such as unemployment and interest rates, and sector-specific variables, such as oil prices, is very likely to be different from what has been experienced in the past and is currently used in economic forecasting models. The probability weightings assigned to macroeconomic scenarios may also need to be revisited. However, the IASB still expects changes in economic conditions to be reflected in the macroeconomic scenarios and in their weightings and, when the effects of the pandemic cannot be reflected in the models, post-model overlays or adjustments will need to be considered.

In estimating overlays, banks may consider historical experience, including, for instance, the impact of similar events. However, it appears clear that the widespread nature and severity of the consequences of the coronavirus pandemic is not directly comparable with any recent similar events. It may be appropriate for this purpose to plot several possible scenarios of what might happen over the coming months and assign weightings to them, to ensure that any overlay reflects the inherent uncertainty and non-linearity of potential outcomes.

Disclosures

Given the inherent level of uncertainty and the sensitivity of judgements and estimates, the disclosure of the key assumptions used and judgements made in estimating ECL is particularly important. This is the case both for annual reporters and for banks that will prepare interim financial statements under IAS 34, as the inputs into the ECL measurement may have significantly changed compared to their most recent annual or interim financial report. Important disclosures would include, for example, the values of the key macroeconomic inputs used in the multiple economic scenario analysis and the probability weights of these scenarios, as well as the assumptions used to determine how the different challenges for specific sectors and regions have been taken into account and the effect of any management overlays.

Lenders will be expected to provide more information on their exposures by sectors. To the extent that banks have some flexibility to do so in the framework of IAS 34, it is likely that some of the disclosures normally given in an interim report which are not related to credit risk will be reduced, to focus on the information of particular concern to users at this time.

In addition, banks should provide disclosures to allow users of financial statements to understand the nature of any material reliefs offered to their borrowers, including those enforced by governments, and how they have assessed whether they constitute forbearance, whether they result in a substantial modification of the contract, their effect on staging and the impact on the overall ECL.

Banks should also consider any guidance and expectations on disclosures of ECL in the current environment that may be issued by the Central Bank of Armenia or other regulatory bodies.

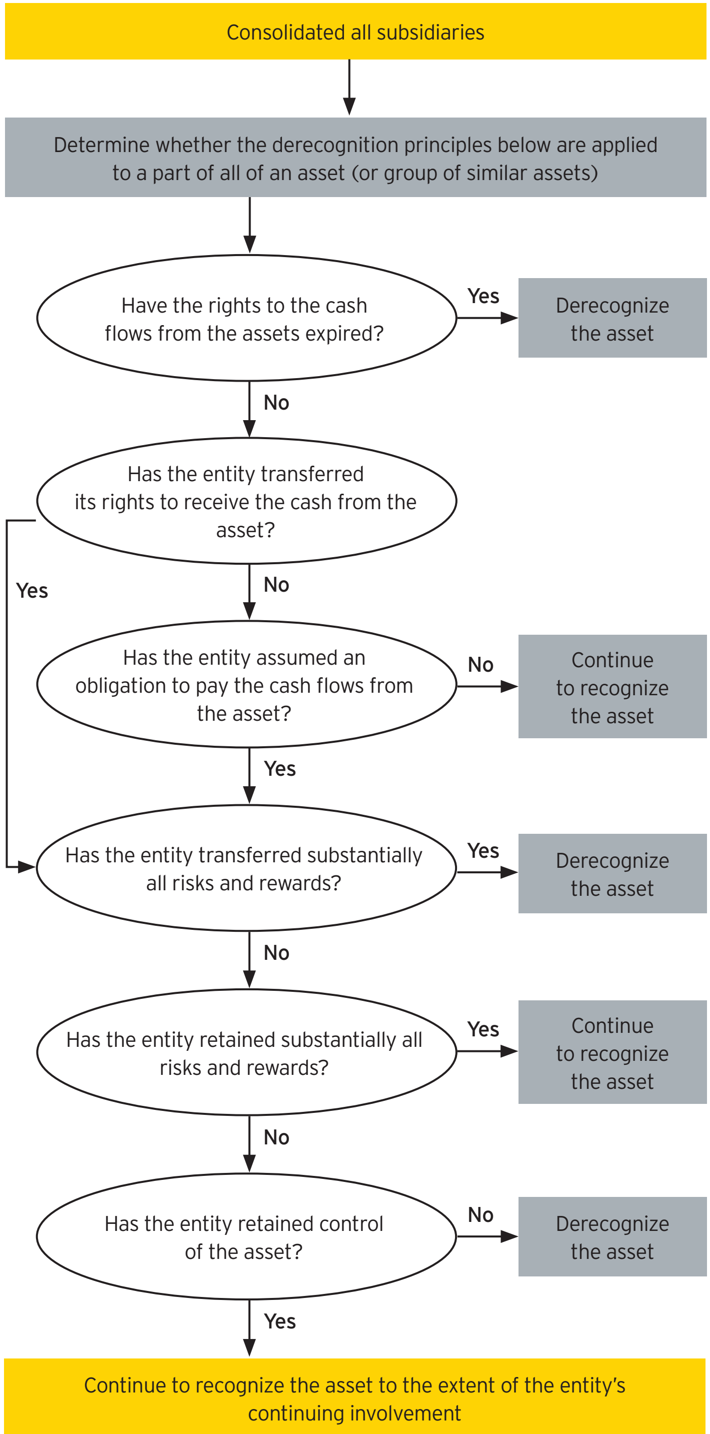
4. Government co-financed and fully financed loans to qualifying borrowers, provided through banks – recognition related aspects

As described above, the Government has launched different programs to combat the economic impact of the virus. These programs, among other measures, involve the provision of loans and co-financing of loans by the Government to qualifying borrowers.

Banks are supposed to act as an agent in these programs, by channelling loans from the Government to the ultimate borrowers. For these purposes, for each loan two separate loan agreements are concluded – between the bank and the Government (Loan Agreement 1) and between the bank and the ultimate borrower (Loan Agreement 2). The banks receive the financing from the Government, provide the loan to the ultimate borrower, collect loan repayments from the ultimate borrower according to the terms of Loan Agreement 2, and remit these repayments to the Government according to the terms of Loan Agreement 1.

The banks should determine whether these arrangements result in the recognition of respective financial instruments (loans to the ultimate borrowers and loans from the Government) on the banks' balance sheet. To determine this, the banks should analyse IFRS 9 derecognition criteria for financial assets. If the derecognition criteria analysed below are met, neither financial instrument is recognized in the bank's balance sheet.

The provisions of IFRS 9 concerning the derecognition of financial assets are complex, but are summarised in the flowchart below (IFRS 9 B3.2.1).



If the analysis above results in the recognition of Loan Agreement 1 and Loan Agreement 2 on the banks' balance sheet, the loans are recognized at fair value on initial recognition. If the loans are granted on non-market terms (i.e. the interest rate is below the market rates), a fair value adjustment should be recognized on the initial recognition of the loans. The adjustment is recognized in the profit and loss statement for Loan Agreement 2, while the benefit of the below-market rate of Loan Agreement 1 should be accounted for as a Government grant in accordance with IAS 20.

5. Rent concessions

On 28 May 2020, the IASB issued Covid-19-Related Rent Concessions – amendment to IFRS 16 Leases (the amendment). The Board amended the standard to provide relief to lessees from applying IFRS 16 guidance on lease modification accounting for rent concessions arising as a direct consequence of the coronavirus pandemic. The relief is not available to lessors. As a practical expedient, a lessee may elect not to assess whether a coronavirus pandemic-related rent concession from a lessor is a lease modification. A lessee that makes this election accounts for any change in lease payments resulting from the coronavirus pandemic-related rent concession the same way it would account for the change under IFRS 16 if the change was not a lease modification. The practical expedient applies only to rent concessions occurring as a direct consequence of the coronavirus pandemic and only if all of the following conditions are met:

- The change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change
- Any reduction in lease payments affects only payments originally due on or before 30 June 2021 (for example, a rent concession would meet this condition if it results in reduced lease payments before 30 June 2021 and increased lease payments that extend beyond 30 June 2021)
- There is no substantive change to other terms and conditions of the lease

Application of the exemption by lessees will be permitted but not required.

Accounting for rent concessions that are not accounted for as lease modifications

The amendment to IFRS 16 does not provide explicit guidance about how a lessee accounts for a rent concession when applying the practical expedient. It states that a lessee making the election accounts for any change in lease payments resulting from the coronavirus-pandemic related rent concession the same way it would account for the change under IFRS 16 if the change were not a lease modification.

We believe there are several potential approaches for accounting for a rent concession which is not accounted for as a lease modification, including:

- Accounting for a concession in the form of forgiveness or deferral of lease payments as a negative variable lease payment (Approach 1)
- Accounting for a concession in the form of forgiveness or deferral of lease payments as a resolution of a contingency that fixes previously variable lease payments (Approach 2)
- Accounting for a concession in the form of a deferral of payments as if the lease is unchanged (Approach 3).

Accounting for a concession in the form of forgiveness or deferral of lease payments as a negative variable lease payment (Approach 1)

When a lessor grants a concession that contractually releases a lessee from certain lease payments or defers lease payments, we believe a lessee may account for the concession as a negative variable lease payment. In this case, the lessee would remeasure the remaining consideration in the contract and, if the contract contains multiple lease and non-lease components, reallocate the consideration to the lease and non-lease components (using unchanged allocation percentages). The lessee would also not update the discount rate used to measure the lease liability. In this case, the lessee would recognise the allocated portion of the forgiven payments as a negative variable lease expense in the period when changes in facts and circumstances on which the variable lease payments are based occur. This approach is similar to that used by the lessor to recognise variable lease income.

Accounting for a concession in the form of forgiveness or deferral of lease payments as a resolution of a contingency that fixes previously variable lease payments (Approach 2)

We believe that a lessee may account for a rent concession in the same manner as it would account for a resolution of a contingency that fixes previously variable lease payments. In this case, the lessee would remeasure the remaining consideration in the contract and, if the contract contains multiple lease and non-lease components, reallocate the consideration to the lease and non-lease components (using unchanged allocation percentages). The lessee would also not update the discount rate used to measure the lease liability. Therefore, the lessee would remeasure its lease liability using the remeasured consideration (e.g., reflecting the lease payment reduction or lease payment deferral provided by the lessor), with a corresponding adjustment to the right-of-use asset.

Accounting for a concession in the form of a deferral of lease payments as if the lease is unchanged (Approach 3)

When a lessor permits a lessee to defer a lease payment, we believe the lessee may account for the concession by continuing to account for the lease liability and right-of-use asset using the rights and obligations of the existing lease and recognising a separate lease payable (that generally does not accrue interest) in the period that the allocated lease cash payment is due. In this case, the lessee would reduce the lease payable when it makes the lease payment at the revised payment date.

This approach of recording a lease payable for the future payment would allow the lease liability to be accreted using the original incremental borrowing rate and would result in a lease liability balance of zero at the end of the lease term (i.e., the lessee would not need to revisit the accretion of its lease liability based on the revised timing of payments). In many cases, this will allow a lessee to use its existing systems to account for the lease liability using the existing payment schedule and discount rate.

Transition and effective date

Lessees will apply the practical expedient retrospectively, recognising the cumulative effect of initially applying the amendment as an adjustment to the opening balance of retained earnings (or other component of equity as appropriate) at the beginning of the annual reporting period in which the lessee first applies the amendment. A lessee will apply the amendment for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted.

Disclosure

Banks applying the exemption will be required to disclose that fact.

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