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Summary

Since 2018 the implementation of IFRS 9 has presented a significant challenge to the microfinance industry. Although most institutions received unqualified audit opinions, it can typically be expected that the initial implementation did not fully reflect all of the standard's requirements, including reliable statistical models. In combination with significant management judgement, resulting provisions were acceptable but not necessarily always adequate.

In the coming years the industry, including external auditors, is expected to improve its knowledge and develop an industry practice to further calibrate concepts and statistical models. Over time, the superiority of IFRS 9 compared to its predecessor standard IAS 39 will become more visible.

The COVID pandemic comes at an early stage of this process, confronting banks and microfinance institutions (jointly "MFIs") with additional challenges. The issues arising from both weaknesses in the statistical models and underlying data and a high degree of management judgement are likely to be amplified. The large share of restructured loan portfolio, based on MFIs' own initiative or government regulation, is particularly difficult to assess. The diversity of what constitutes "IFRS 9 compliant provisions" has therefore increased significantly.

Investors are eagerly awaiting the audited financial statements of their investees to get further clarification on the financial impact of the COVID pandemic. However, great caution should be applied when assessing the results. MFIs will likely face increased scrutiny from their external auditors, but low reliability of Expected Credit Loss (ECL) calculations, a large degree of management judgment and missing disclosures will make it difficult or even impossible to judge the adequateness of the impairment provisions shown.

1) Purpose of IFRS 9

As a response to the financial crisis of 2008, global policy makers revised capital requirements for financial institutions, installed new and stricter oversight, and tightened banking regulations in other areas. Large criticism was also directed at IFRS and its standards on the recognition of impairment losses on financial instruments. The rules at the time were considered excessively focused on historical data and incurred credit losses. This allowed financial institutions to neglect the consideration of credit losses from expected future loss events, thereby amplifying a cyclical provisioning approach ("too little too late"). In effect, loan provision levels were too low to weather a systemic crisis.

¹ The views expressed in this paper represent the personal opinions of the authors and should not be read as the institutional views of I.D. Inspiring Development GmbH. For questions or comments, please contact the authors:

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Though the reform of financial instruments accounting already began in 2002, the work was accelerated in response to the financial crisis. The aim was to address deficiencies in respect to the timely recognition of expected credit losses (ECLs), the complexity of multiple impairment models, and own credit risk.

As a result, IFRS 9 *Financial Instruments* was issued on 24 July 2014 as a replacement of IAS 39 *Financial Instruments: Recognition and Measurement* and was mandatorily effective for periods beginning on or after 1 January 2018. The key changes to the impairment model were:

- One impairment model versus the multiple models under IAS 39
- ECLs combined with explicitly forward-looking considerations versus the previous incurred credit loss model
- Introduction of a staging methodology to classify loans in a “healthy” loan portfolio (stage 1), a loan portfolio exhibiting a Significant Increase in Credit Risk or “SICR” (stage 2) and a credit-impaired loan portfolio (stage 3)
- Accelerated recognition of credit losses, i.e., recognition of lifetime credit losses for stage 2 and 3 financial instruments

The new standard also provided changes to initial asset classification, measurement of own credit risk, hedge accounting and disclosure requirements.

2) Issues during implementation

The microfinance industry faced significant challenges in the implementation of IFRS 9, in particular:

- Technical issues, i.e., lack of statistical knowledge, inadequate ECL calculation tools, limitations in data availability and overall data quality issues
- Missing or inadequate definitions of staging triggers for SICR
- Challenges of understanding key drivers for the forward-looking considerations, their reflection in impairment models, and using management judgment to arrive at reasonable provisioning rates.

The challenges were exacerbated by an overall lack of experience in the industry and the audit profession. This included the issue of missing data history for back testing or cross-checking provisioning calculations. The strong focus on a minimum level of formal compliance in terms of documentation and disclosure requirements in the annual financial statements seem to have also distracted attention from the substance, i.e., the adequate level of provisions. In our view, the initial implementation of IFRS 9 left considerable room for MFIs to influence their level of impairment provisions while still being compliant with IFRS 9 in external auditors’ judgement.

3) Assessment of the current state of implementation and COVID-specific observations

The implementation of a comprehensive standard such as IFRS 9 is not a one-off exercise. Instead, refinements and further developments will be required over time to make results more reliable and make the implementation fully compliant with the standard - not only in form but also in substance. Both MFIs and external auditors will build up knowledge, capacity and experience in using IFRS 9, which will gradually increase the reliability of results. However, limited progress has been made since implementation and the COVID pandemic brings a fair number of additional challenges to the still weak concepts and models in many institutions. Our key concerns regarding the current status of IFRS 9 implementations are the following:

- **Use of management judgement**

MFI's still often lack adequate conceptual frameworks on how IFRS 9 is interpreted and implemented, i.e., they often copy the general principles of IFRS 9, remain vague in their application, and lack industry specific and customized conceptual frameworks.

Though not intended, the absence of an MFI-specific and detailed framework leads to excessive use of management judgment. The COVID crisis not only triggered this management judgement to be applied, but even amplified the inherent degree of management judgment in certain conceptual areas as they became more complex and subjective, e.g., how to deal with higher levels of uncertainty and volatility in historical ECL calculations, how to address the question of staging for different types of restructuring/modifications, how to adequately group loans into cohorts of similar credit risk characteristics, etc. Most of these discussions will be held between management and external auditors and the outcomes will be unknown to recipients of the annual financial statements, despite the fact that these discussions significantly impact provisioning levels.

- **ECL calculations**

Many institutions continue to lack statistical knowledge on how to accurately calculate Probabilities of Default (PDs) and Losses Given Defaults (LGDs), and face difficulties in adjusting models that were initially implemented with strong reliance on external support. Observed issues include:

- Inappropriate grouping of credit risks, often performed on the entire portfolio without sub-categories, or performed in a way that such grouping positively impacts overall ECL results
- Deficiencies in the ECL tools, such as missing recovery data replaced by recovery assumptions, no model migration into the write-off category, and unflagged rescheduling or restructurings
- Inadequate treatment of collateral in the ECL calculations, such as high valuation assumptions, a lack of periodic re-valuations, and too-short assumptions on time to realization
- Missing considerations on the time value of money, which is particularly problematic in high interest rate environments
- Weak forward-looking models with simple regression models based on GDP growth projections, or other models with limited or no statistical validity

The statistical models and calculation results are difficult for external auditors to challenge as long as a minimum formal compliance with the standard is presented, particularly when the conceptual framework – accepted during first implementation – provides sufficient room for the approaches and judgments applied.

Under the conditions of the pandemic, the reliance on inherent judgments is amplified due to higher levels of uncertainty and a stronger incentive to reach desired provisioning levels in view of weakened performance:

- While the general method of ECL calculations remains unchanged, the COVID crisis renders historical data difficult to interpret. Judgments must be made on whether the effects of the crisis have already peaked and are reflected in recent statistical data, or whether further deteriorations are to be expected. The judgment will often require post-model adjustments and overlays.
- Historical data for restructured loans is typically limited and/or reflects a different loss history when compared to the current, large-scale restructurings – making statistical results highly arbitrary.
- In ECL models that consider the value of collateral, reductions in value should result in higher ECLs, especially when the collateral of significant parts of the loan portfolio are expected to be

repossessed or the loans foreclosed. However, many MFIs do not have in place re-valuation processes or apply mechanical re-valuation processes.

- The requirement for more detailed assessment of ECLs became apparent during the COVID crisis, as demonstrated by the impact on businesses in the hotel, restaurant and tourism industry. Purely statistical, forward-looking models based on GDP growth projections are not able to fully reflect sectoral differences, therefore requiring significant management judgement to ensure adequate provisions.

A weak first-time implementation of ECL calculations already entailed a high level of uncertainty about the adequacy of calculated provisions while still being considered IFRS 9 compliant. The pandemic has greatly aggravated the situation, as management judgement is required and asked for in the current situation. At the same time, this greatly broadens the scope in which provisions can be set. External auditors are expected to apply greater scrutiny on the models in the use and interpretation applied but will meet strong opposition from management. In addition, the external reader of the financial statements will have little to no ability to judge, which level of often necessary compromise has been applied.

- **Staging criteria**

Most MFIs apply a mechanical approach to staging for non-restructured loans by using the maximum thresholds of IFRS 9 and solely relying on days past due, i.e., PAR30 for the transfer from stage 1 (healthy loans) to stage 2 (SICR), and PAR 90 for stage 2 to stage 3 migration (credit-impaired or default). Especially the first stage transfer is critical as it requires an increase of provisions from 12-month to the lifetime ECLs.

A concern with the reliance on this sole staging criteria is that the timing of the stage transfer happens too late. Though the time lag until a loan exposure will reach PAR30 may seem short, some borrowers will avoid falling into arrears despite severe financial difficulties. Also, the treatment of the restructured loan portfolio became an important factor.

Generally, most MFIs assess modified loan exposures as a SICR to be transferred to stage 2. Observed weaknesses would include:

- A lack of detailed definitions of modifications in MFIs' restructuring policy, including a clear segregation between SICR relevant loan modifications from technical changes in payment plans or payment dates.
- Missing approach or details to curing/probation periods, i.e., whether a restructured loan exposure, once it has migrated to stage 2 can cure into a healthy stage 1 exposure.

While the implied issues pre-COVID might have been tolerable, the nature and magnitude of restructured portfolios makes them highly relevant, adding additional aspects:

- The large-scale extension of payment holidays to borrowers ("blanket moratorium") have been provided partly on the MFIs own initiative or induced by the government or regulator. They should not automatically be considered to have suffered an SICR, if it is provided irrespective of the borrowers' individual circumstances. However, the institution would still need to test the SICR assumption, for example through pre-COVID-19 risk classifications. We expect limited transparency on the approaches chosen and the level of scrutiny applied: Large parts of the loan portfolio could be disclosed as „healthy“ stage 1 portfolio despite already exhibiting signs of increased credit risk.
- Specifically, in the case of non-government mandated selected modifications (i.e., voluntary modifications for parts of the loan portfolio) MFIs will encounter discussions on whether or not such concessions were only granted because customers are in financial difficulty, i.e., encountered an SICR.

- The absence of a detailed approach to curing/probation periods becomes significantly more critical during the COVID crisis due to the large amounts of restructured loans. While IFRS 9 does not have a specific threshold or guidance, MFIs should reassess their threshold, if available.

The large volumes of restructured loans currently managed by MFIs leave ample room for management judgement. This decreases the level of transparency significantly, including the possibility of MFIs actively managing their provisioning levels under financial pressure.

4) Conclusion

While MFIs managed to implement IFRS 9 without significant delays or regulatory conflicts in 2018, the pre-crisis level of implementation was often characterized by simplistic interpretations, mechanical applications, and a certain level of (tolerated) non-compliance. Looking forward, industry practice will gradually materialize and external auditors and regulators will become more knowledgeable and critical of existing set-ups.

At this stage we see significant room to drive provisioning levels in different directions, despite external auditors' efforts to ensure IFRS 9 compliance. Many MFIs face pressure as a result of deteriorating portfolio quality and decreasing income levels. Such institutions may choose to make use of this leeway to buy valuable time, gradually absorbing the crisis impact on their financials. This is understandable and might even facilitate successful turnarounds. However, investors will not be able to rely fully on the 2020 IFRS annual financial statements to judge the adequacy of provisioning levels. Instead, the full picture of the actual impairment losses and capital impact might only become visible over time, perhaps beyond 2021 if MFIs' liquidity levels allow for such long push-outs.