BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Deputy Governor and
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4 June 2020

Dear Chief Executive Officer,

Covid-19: IFRS 9 and capital requirements — Further guidance on initial and further payment deferrals

On 26 March 2020, I wrote to you and other CEOs of UK banks and building societies ('firms') providing guidance on, among other things, consistent and robust application in the context of Covid-19 of the definition of default in the Capital Requirements Regulation ('CRR') and of the expected credit loss accounting ('ECL') requirements of International Financial Reporting Standard 9 ('IFRS 9').[1] The PRA has an interest in the implementation of ECL given its statutory objectives and the link between financial accounts and regulatory capital.

The purpose of providing the guidance was to help firms implement existing regulatory and accounting requirements in a robust, well-balanced and consistent way, notwithstanding the unique challenges created by Covid-19 related events. Such an implementation should help firms mitigate the risk that each of them approach the challenges differently and as a result recognise inappropriate or inconsistent levels of ECL or apply inconsistent regulatory capital treatments.

Much of the March guidance related to payment holidays, moratoria or deferrals ('payment deferrals'). The first payment deferrals are now coming to an end and earlier this week the FCA published updated guidance on how lenders should treat retail mortgage borrowers at the end of the initial deferral period ('the FCA's guidance').[2] As a consequence, firms are assessing the capital and accounting treatment of the various ways in which those initial payment deferrals might end. The purpose of this letter is to update the March guidance to address exits from initial payment deferrals.[3]

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[1] March 2020: https://www.bankofengland.co.uk/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants

[2] May 2020: https://www.fca.org.uk/publications/finalised-guidance/mortgages-and-coronavirus-updated-guidance-firms.

[3] When the FCA issued its updated guidance in draft on 22 May 2020, the PRA issued a high-level view on the implications of that draft updated guidance for our March guidance. https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-on-application-regulatory-capital-ifrs9. This letter adds detail to that high-level view.

We consider the guidance in this letter to be consistent with IFRS and CRR. However, we also recognise it is the responsibility of firms to satisfy themselves that they have prepared their annual and interim financial reports in accordance with the applicable reporting frameworks and for auditors to reach their own audit or review conclusions about those reports. Similarly, it is for firms to ensure they comply with the requirements of CRR.

Principles underlying the guidance in this letter

The detailed guidance is set out in the annex but in summary our view is as follows.

- When there has been a payment deferral, counting of days past due should be based on the agreed schedule for the purposes of the ECL backstops[4] and for the CRR definition of default. However, loans that are not past due can still have suffered a significant increase in credit risk ('SICR'), credit impairment or default.

- Eligibility for, and use of, Covid-19 related initial and further payment deferrals taken up in accordance with the FCA's guidance on the subject does not on its own automatically result in a loan (a) being regarded as having suffered a SICR or being credit-impaired for ECL, or (b) triggering a default under CRR. Firms will therefore need to consider other indicators to determine the appropriate treatment. For example, for CRR purposes, firms will need to assess whether the deferral should be considered a distressed restructuring and in cases where it is likely to result in a diminished financial obligation this may be an indication of default.

- Firms are likely to have limited borrower-specific information to make the determinations on an individual borrower-basis. Firms will therefore need to make holistic assessments that look beyond past-due information and use of payment deferrals in order to treat such loans appropriately for accounting and regulatory purposes.

- We do not envisage that these holistic assessments for accounting and CRR purposes will be made at the time when a payment deferral is taken up, as the FCA guidance does not require such information to be available at that time. These assessments are expected to be made subsequently and be based on the information available at the next and subsequent reporting dates.

[4] A 30 days past due backstop is used to determine moves to stage 2 and a 90 days past due backstop is used to determine moves to stage 3.

The illustrative examples in the Monetary Policy Review and Interim Financial Stability Review

In May 2020 the Bank of England's Monetary Policy Committee published its latest Monetary Policy Report ('MPR'). The MPR contained a 'plausible illustrative economic scenario', based on among other things a set of stylised assumptions about the pandemic and the responses of governments, households and businesses. As the MPR explains, although the scenario is highly conditional, it helps to illustrate the potential impact of Covid-19 on the economy and the channels through which the impact is felt. As such, the illustrative scenario is not a central or any other sort of forecast. However, it might be one of many useful data points to take into account in developing forward-looking scenarios for ECL purposes.

The Bank's Financial Policy Committee ('FPC') published an Interim Financial Stability Report ('FSR') at the same time as the MPR. The FSR set out a desktop stress test designed to explore the losses that the major UK banks and building societies might experience in the MPR's illustrative scenario. This exercise was based on conservative and prudent assumptions. In addition, it built on the results of the 2019 Annual Concurrent Stress Test, so the conservatism that was part of that stress test fed through into the work. The resulting estimates of £80 billion of credit losses by the end 2021 are reflective of those prudent stress assumptions. It is important to note that this exercise was a stress test, not a forecast, and was intended to enable the FPC to make judgments as to whether the core banking system would have sufficient capital buffers and capacity to provide credit to support the UK economy.

Unlike a regular stress test, the desktop stress test did not draw on submissions from banks. Ahead of banks' Q2 2020 reporting, the PRA intends to gather further information from firms on estimated provision levels to enable us to compare the timing and amount of losses modelled under the FPC desktop stress test to those anticipated by banks. This information will enable us to identify any significant outliers and to further refine our estimates for future capital exercises.

If you have any questions concerning this letter, please get in touch with your usual supervisory contact.

We will be publishing this letter on the Bank of England website.

Yours sincerely

S. Woods

Sam Woods
Deputy Governor and CEO, Prudential Regulation Authority

Annex—Treatment of Covid-19 related payment deferrals under IFRS 9 and the Capital Requirements Regulation (CRR)

1 This PRA guidance has been developed in the context of the May 2020 FCA guidance on Covid-19 related mortgage payment deferrals.[5] It is expected to be broadly relevant to similarly designed government-endorsed schemes and measures by firms that respond to the adverse economic impact of the virus. Firms should satisfy themselves of the degree of similarity in such cases, and that the prudential treatment applied complies with the requirements of CRR. The guidance is not intended to be applied to payment deferrals that are not Covid-19 related. It will be reviewed in due course in light of future developments.

2 Under the FCA's guidance, if a borrower states they wish to take up a further payment deferral then one should be made available and the extent to which it is full or partial is ultimately the borrower's choice. There is no expectation that the lender will investigate the circumstances surrounding the request or will gather the information necessary to satisfy itself that the borrower's choice is the right one. However, the guidance allows lenders to offer additional options to borrowers where the lender reasonably considers it to be in the borrower's best interest to do so. How a lender uses this flexibility – and in particular the extent to which lenders offer the same options and terms to all borrowers of a broadly similar risk – can have accounting and regulatory capital implications. We have addressed the implications of this flexibility in the guidance below.

Overview of previous PRA guidance covering initial payment deferrals

3 Underlying the accounting guidance in our 26 March letter[6] ('March accounting guidance') were a number of principles, all of which we continue to regard as critical in implementing IFRS 9's expected credit loss ('ECL') requirements:

- ECL should be implemented well and on the basis of the most robust, reasonable and supportable assumptions in the current environment, in order to enhance consistency and reduce the risk of firms recognising inappropriate levels of ECL, whether they be under-statements or over-statements.

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[5] https://www.fca.org.uk/publications/finalised-guidance/mortgages-and-coronavirus-updated-guidance-firms.

[6] March 2020: https://www.bankofengland.co.uk/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants.

- Forward-looking assessments need to take a balanced view of both the potential impact of the virus and the substantial and substantive level of support provided by governments and central banks domestically and internationally to protect the economy.

- The assumptions that have been used in implementing ECL prior to Covid-19 and related actions should not be applied mechanically to the current circumstances, because those assumptions may no longer hold in the context of the current unprecedented situation.

- The need for well-balanced decisions and the need to use reasonable and supportable assumptions also means that due weight will need to be given to established long-term economic trends, given the challenges of preparing detailed forecasts far into the future and the substantial and substantive support provided by governments and central banks domestically and internationally to protect the economy.

4 On the CRR, the 26 March letter made clear our expectation that eligibility for, and the taking up of, Covid-19 related payment deferrals should not in itself automatically cause the loan involved to be regarded as in default, because it does not trigger the counting of days past due or generate arrears, or automatically result in the borrower being considered unlikely to pay under the CRR.

5 The guidance also reminded firms to apply sound risk management practices regarding the identification of defaults.

Initial payment deferrals

6 A key theme in the March accounting guidance was that, although in the past a payment deferral that was not anticipated in the contractual terms of the loan would typically be regarded as an indicator of a SICR or credit impairment for ECL, the link between a payment deferral and SICR and credit impairments is not as strong in the case of the Covid-19 related payment deferrals, because:

- Such payment deferrals are available to borrowers against the economic backdrop of wide-scale, but in many cases temporary, loss of income related to lockdown measures. Some of the borrowers taking up payment deferrals will have financial difficulties that need to be recognised as a SICR or credit impairment. However, some will only have temporary liquidity issues that make it difficult for them to make the next few payments but do not have a significant impact on life-of-loan probability of default or the attributes consistent with a loan that is credit impaired.

- Under the FCA's guidance it has not been necessary to tailor the payment deferral to the individual financial circumstances of the borrower, so the fact a payment deferral has been taken up tends not to be an effective indicator of the financial circumstances of that individual or therefore of SICR or credit impairment.

7 For those reasons, the PRA's March accounting guidance gave the treatment of Covid-19 related payment deferrals as an example of past assumptions that should not be applied mechanically. In particular, it explained that eligibility for, and use of, Covid-19 related payment deferrals should not automatically result in a loan being regarded as having suffered a SICR or becoming credit-impaired. In order to determine whether a SICR or credit impairment has occurred, firms will need to consider indicators other than the use of the payment deferral.

8 Another example given was that the use of a Covid-19 related payment deferral that adjusts the amounts contractually due would not trigger the counting of days for the purposes of the ECL backstops based on 30 and 90 days past due tests. The agreed payment schedule should be used instead.

Borrowers that resume full payments at the end of a payment deferral

9 The PRA would not expect the immediate resumption of full payments at the end of a Covid-19 related payment deferral to be regarded as an indicator of SICR or credit impairment for ECL purposes or default for CRR purposes – even if a revised schedule of repayments is agreed to smooth the cash-flow effect of the deferred amount. However, if any payments on the revised schedule are missed, normal processes for identification of SICR, credit impairment and default would apply.

Borrowers that do not resume full payments at the end of a payment deferral

<u>Identifying whether a significant increase in credit risk or credit impairment has occurred for ECL purposes</u>

<u>Further payment deferrals do not automatically mean a SICR or credit impairment; nor should the assumption be that all the loans involved remain in stage 1</u>

10 The guidance issued by the FCA in March and April on payment deferrals for mortgages, credit cards and other types of credit exposure envisaged that payment deferrals would be available to most borrowers, including borrowers facing temporary difficulties in making near-term

payments due to a temporary loss of income related to Covid-19. The updated FCA guidance on mortgage payment deferrals envisages that that will remain the case.

11 Temporary difficulties making near-term payments due to a temporary loss of income do not on their own automatically result in a significant increase in lifetime credit risk or a detrimental impact on the estimated future cash flows from the loan; in other words, they do not on their own automatically result in a SICR or credit impairment. Because use of a payment deferral does not necessarily mean the loan has suffered a SICR or credit impairment, firms will have to consider other information to allocate loans between ECL stages. Although it would not be appropriate for firms to assume all loans subject to or eligible for payment deferrals have necessarily suffered a SICR or are credit impaired, it is unlikely to be the case that none of those loans have been so affected; some should be in stage 2 or 3.

12 Similarly, although the counting of days past due is not triggered for the ECL backstops based on days past due if a payment deferral has been taken up, it is important to bear in mind that loans that are not past due can still have suffered a SICR or be credit impaired.

Offering options in addition to payment deferrals does not automatically mean a SICR or credit impairment

13 Under the FCA’s guidance, if a borrower states they need a further payment deferral they should be offered one but the lender is also allowed to offer additional options if it reasonably considers it to be in the customer’s best interest to do so. Offering borrowers the option of a full or partial payment deferral – or alternatives such as extension of term – to manage their return to full repayment and to pay back amounts accrued from previous payment deferral should not of itself automatically result in the loan involved being moved from stage 1 to stage 2 or 3.

14 However, the more the offering is based on the individual financial circumstances of the borrower, the more information it will convey about the borrower and, as a result, the more potential it has to be an indicator of SICR or credit impairments. So, where options are offered to customers, how widely each option is made available needs to be taken into account because it might affect the strength of the link between taking up an option and SICR or credit impairment. For example, if certain measures are offered only to individual or groups of borrowers that meet higher risk criteria, this is more likely to provide evidence that there has been a SICR or credit impairment. In such cases, careful judgment will need to be applied to

assess whether those risk criteria themselves might in substance be an indicator of a SICR or credit impairment.

15 Under the FCA's guidance, although the firm can offer alternatives in addition to a payment deferral, the decision as to how to proceed is the borrower's alone. Where the measure taken up by the borrower is based on the borrowers' own assessment of their near-term payments it may give little relevant information about their long-term likeliness to repay.

16 IFRS 9's definition of 'credit impaired' refers to 'events that have a detrimental impact on the estimated future cash flows'. The standard states that one example of evidence that there has been a credit impairment is when a concession has been offered 'for economic or contractual reasons relating to the borrower's financial circumstances' that the lender would not otherwise have considered. Firms should seek to distinguish credit impairment concessions from options that allow borrowers flexibility but do not affect life-of-loan credit risk or estimated future cash flows. Temporary payment difficulties are not necessarily an indicator of SICR for the reasons set out above, and so it follows they should not automatically be an indicator of credit impairment either. This is similar to the distinction made where loans contain an explicit clause permitting the borrower a payment deferral, where use of such options exercised at a customer's discretion is not seen as an indicator of credit impairment (or SICR).

<u>A framework is needed for making holistic assessments of loans subject to payment deferrals for indicators of SICR or credit impairment</u>

17 It follows from the above that the facts and circumstances underlying the taking up of a further payment deferral need to be considered carefully to determine whether the loan involved has suffered a SICR or credit impairment. In theory, it is important to differentiate between temporary difficulties in making near-term payments as these are less likely to effect the risk of a default occurring over the expected life of the loan, relative to longer-term financial difficulties. In practice, it will be difficult to identify individual borrowers that are only suffering temporary difficulties as firms are likely to have limited information about why the borrower is using a payment deferral. Careful consideration of the facts and circumstances will therefore be important to meet IFRS 9's objective 9 of recognising lifetime losses on all loans where there has been a SICR.

18 IFRS 9 does not expect firms to incur undue cost or effort to gather information and envisages the use of holistic assessments based on reasonable and supportable information to try to

estimate whether SICR has occurred for groups of borrowers in the absence of borrower-level information, so it is possible that simplifications and approximations will need to be used. However, where the amounts involved are material, it is unlikely to be appropriate to use any kind of rebuttable presumption (eg that the use of a further payment deferral means the borrower has or has not suffered a SICR).

19 It will be important for firms to make holistic assessments that aim to identify all borrowers using payment deferrals that have suffered a SICR or credit impairment and for those assessments to look beyond past-due information and use of payment deferrals. To assist firms to do that, and as a result make more consistent ECL estimates, we thought it would be helpful to set out:

- A framework that could be used based on four elements: (a) consideration of economic conditions, (b) use of historical information that firms already hold about borrowers, (c) information gathered from customers using payment deferrals and (d) application of expert judgment.
- Information we regard as relevant in identifying a SICR and credit impairment, without being prescriptive or exclusive of other available information.

20 These assessments are to support financial and prudential reporting and will be based on the information available to the firm at that time, which will in many cases be later than when the payment deferral is taken up. We do not envisage any such assessment being made at the time the payment deferral is taken up but rather at the next and subsequent reporting dates.

(a) Consideration of economic conditions

21 The treatment of payment deferrals should be considered in the context of the current economic conditions.

- It will be important to assess what is a temporary difficulty in the context of the duration of lockdown measures and job retention schemes. For example, some borrowers may face temporary payment difficulties due to a reduction in income while lockdown measures remain in place that will be mitigated by a payment deferral in conjunction with use of furlough schemes. There will be a further cohort of borrowers who need further temporary measures to manage an orderly return to full repayment. In either case, a borrower receiving a further payment deferral while lockdown measures remain in place or shortly thereafter may be consistent with that borrower being in temporary difficulty because the difficulty will not necessarily have a significant impact on the risk of a default occurring over the expected life of the loan.

- As the precise duration of lockdown is unknown, it is unlikely to be appropriate to apply strict or arbitrary time limits to define what constitutes a temporary difficulty. However, once the temporary conditions of Covid-19 have receded, a request for a further payment deferral is more likely to indicate SICR or credit impairment.

22 When assessing SICR, an initial step will be to consider the impact of updated economic scenarios and weightings on loan-level probability of default ('PD'). The result of this step is likely to be that some loans with payment deferrals will move to stage 2.

(b) Use of historical information that firms already hold about borrowers

23 We regard it as important for firms to carry out additional analysis to assess the level of risk associated with borrowers that have taken up payment holidays and to use that analysis to check that the firms' models and SICR criteria are operating effectively. This is because of the inherent limitations in models and the limited information available on the performance of these borrowers.

24 Information that firms already hold can be used to determine specific segments of the portfolio using payment deferrals exhibiting higher risk indicators that have suffered SICR or credit impairment. For example:

- Payment history on the loan in question, including whether the borrower was up-to-date or in arrears when the payment deferral was taken up and whether payments were made during the payment deferral period.

- Payment history or utilisation of credit limits on other products with the same borrower, including current account turnover.

- Adverse credit bureau payment scores consistent with arrears on other products or high indebtedness.

- The last known debt-to-income ratio.

- The last known industry or sector the borrower is in or exposed to (eg based on the original loan application).

- Whether the borrower is close to meeting a SICR threshold based on loan-level PDs, after updating for economic scenarios.

(c) Information gathered from customers using payment deferrals

25 The FCA's guidance makes it clear that the FCA has no expectation that a lender will gather borrower-specific information or will investigate a borrower's request for a payment deferral before or at the time a deferral is made available. The guidance is also clear that, although the lender can offer borrowers requesting payment deferrals alternatives to consider (as long as the lender reasonably considers it to be in the customer's best interest to do so), there is no expectation that the lender will gather enough borrower-specific information to tailor that offering to the borrower's specific needs. Indeed, tailoring the offering is likely to have regulatory implications (see next section).

26 Nevertheless, we understand that some firms are considering gathering information from customers taking payment deferrals that can later be used in combination with other information to support their financial and prudential reporting in subsequent periods. To support these considerations we set out below information that firms might consider collecting from borrowers either when processing a further payment deferral or subsequently to support identification of SICR or credit impairment:

- The borrowers' current employment status (eg self-employed, part-time or full-time employment, on furlough or unemployed).
- What industry or sector the borrower is in or exposed to.
- The reason why the borrower is requesting a further payment deferral (eg whether their employment status or other household income changed following the commencement of lockdown measures).
- Information to perform a simplified income and expenditure analysis. This could be as simple as confirming by what percentage household income has reduced compared to the same time last year.

27 There are challenges and inherent limitations in collecting and using data from customers taking a payment deferral given the large volume of customers involved. It is for firms to determine what (if any) information it is practical to collect and how that is done. The above list is illustrative only and it is not expected that all firms will be able to collect all of the

information above for all borrowers. Specific questions may vary by bank to, for example, take into account existing information held about borrowers and operational capacity.

28 We do not envisage that data provided by borrowers taking a payment deferral will be verified by the lender. However, it will be important to sense-check whether data collected from customers is consistent with available national or industry-wide statistics. For example, statistics on unemployment, universal credit claimants and use of furlough schemes might be used to assess whether customers’ responses appear reasonable.

(d) Application of judgment

29 The approach taken to analysis will need to reflect the information available to firms at the time. Where individual information is not available, segmentation should be considered in order to identify groups of borrowers that have suffered SICR. Where data gaps exist, it might be possible to gather sufficient information for a representative or random sample of borrowers, and then allocate segments of a portfolio on the basis of the sample results.

30 The results of the analysis based on the information above might confirm that the firm’s other SICR criteria are working effectively, or it may lead to the firm making high-level adjustments to the allocation of segments of the portfolio between ECL stages, so as to comply with the principles underpinning IFRS 9. This might involve moving pools of higher risk loans to stage 2 or keeping pools of lower risk loans in stage 1. Care will be needed to avoid the risk of double counting.

31 Firms should apply materiality in the normal way to these assessments. This probably means, for example, limited analysis where there is no material difference between 12-month and lifetime ECL for customers that have received a payment holiday and more detailed analysis where there is a material difference.

Credit impairment and the regulatory definition of default

32 It is common practice at the moment for firms to align their approach to ECL stage 3 quite closely to their regulatory definition of default. Where that is the case, the analysis below on the regulatory definition of default will be relevant not only for CRR purposes but also in assessing whether there has been a credit impairment for ECL purposes.

Regulatory definition of default

33 We do not consider the use of a Covid-19 related payment deferral taken up in accordance with the FCA's guidance – regardless of whether it is an initial payment deferral or a further payment deferral - as triggering the counting of days past due or as generating arrears under the CRR. (Henceforth we will refer to both as 'past due' for simplicity.)

34 We also do not consider the use of an initial or further payment deferral as resulting automatically in the borrower being considered unlikely to pay under the CRR.

35 When assessing whether the borrower is past due on any material credit obligation owed to the institution or has any indicators of unlikeliness to pay, firms should make the assessment based on the agreed schedule of payments.

36 For the purpose of agreeing a payment holiday, and consistent with the FCA guidance, the PRA has no expectation that the firm investigates the circumstances surrounding a borrower's request for a payment deferral or other measures before agreeing them with the borrower.

37 For the purpose of assessing whether a borrower receiving a payment holiday or other measures should be considered to be in default under the CRR, firms should utilise borrower information that they have to assess borrowers for indicators of unlikeliness to pay. This should take into consideration the underlying reason why the borrower does not resume full payments and whether it is likely to be temporary as a result of Covid-19 or longer-term. As part of this assessment, we expect that firms could give consideration to the non-exhaustive types of data set out in paragraphs 24 and 26 above. We do not envisage that data provided by borrowers when requesting a payment deferral will need to be verified by firms.

38 To the extent that firms offer the same options and terms to all borrowers of a broadly similar risk, we do not expect the borrower's choice of any particular type of option to automatically trigger default although the firm should still consider whether there are any other indicators of unlikeliness to pay. However, the more a firm differentiates the options offered to a borrower based on their individual characteristics, the greater the likelihood that the chosen option would be classified as a distressed restructuring under the CRR. Consequently in cases where this is considered likely to result in a diminished financial obligation, the firm would need to assess whether this could result in a default.

39 Regardless of the measures chosen by a borrower, when assessing unlikeliness to pay, we consider it important for firms to consider the distinction between:

- Borrowers who do not resume full payments due to Covid-19 related issues that can reasonably be expected to be temporary (for example, a borrower suffering a temporary reduction in income due to being furloughed but whose income and financial position can reasonably be expected to return to levels allowing full payment resumptions once Covid-19 related restrictions are lifted).

  Firms might reasonably conclude that such borrowers are facing short-term liquidity problems rather than longer-term financial difficulty. Firms should take a proportionate approach to the assessment of unlikeliness to pay for this cohort of borrowers that appropriately reflects their expected longer term ability to pay.

- Borrowers who do not resume full payments due to financial difficulty that is likely to be more long-term (for example, the borrower has been made redundant and is unlikely to have sufficient sources of income to resume payments in the longer-term).

  For these borrowers, firms might reasonably conclude that the concessions offered are due to the borrower being in longer-term financial difficulty. Firms would then need to assess whether this results in a distressed restructuring that is likely to result in a diminished financial obligation, which may be an indication of default. We expect that it will be possible for firms to demonstrate without detailed quantitative analysis whether or not payment deferrals and similar measures where interest continues to accrue result in a diminished financial obligation.

40 The PRA recognises that distinguishing between different types of payment or other financial difficulty is not easy in the current environment, given the extraordinary level of economic uncertainty and the complex interactions between various public-sector and private-sector Covid-19 related support measures. We encourage firms to make well-balanced and consistent decisions that take into account the information they have regarding the borrower, the potential impact of Covid-19, and also the unprecedented level of support provided by governments and central banks domestically and internationally to protect the economy.