BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Statement re guidance on the application of regulatory capital and IFRS 9 requirements to payment holidays granted or extended to address the challenges of Covid-19

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Background

On 20 March 2020 the Bank of England ('Bank') and Prudential Regulation Authority ('PRA') announced a number of supervisory and prudential policy measures aimed at addressing the challenges of Covid-19.[1] That announcement contained some high-level comments about the application of the International Financial Reporting Standards 9 ('IFRS 9') expected credit loss accounting ('ECL') in the context of those challenges.

On 26 March 2020, the PRA wrote to the CEOs of UK banks and building societies ('firms') providing guidance on, among other things, the application of ECL and of the regulatory definition of default in the context of Covid-19.[2] As explained in our previous guidance, the PRA has an interest in the implementation of ECL given its statutory objectives and the link between financial accounts and regulatory capital, and the purpose of the guidance was to help firms to implement existing accounting and regulatory requirements in a robust, well-balanced and consistent way, notwithstanding the unique challenges being created by Covid-19 related events. This was necessary to mitigate the risk that each firm would approach the challenges differently and as a result recognise inappropriate or inconsistent levels of ECL, or apply inconsistent regulatory capital treatments.

Much of the previous guidance related to the treatment of the payment holidays or deferrals ('payment deferrals') that were being offered at the time. The first payment deferrals are now coming to an end and the FCA has published today in draft form updated guidance on how lenders should treat borrowers at the end of the initial deferral period. As a consequence, firms are assessing the capital and accounting treatment for exit from, and in some cases extension of, payment deferrals. This statement sets out the PRA's high-level view on the implications of that draft updated guidance for the guidance we issued earlier, and on accounting and the regulatory definition of default more generally. We will provide further detail when the FCA has finalised its guidance.

Consistent with the scope of the draft updated FCA guidance, this statement focuses on mortgage products. However, we expect its guidance to be broadly relevant to similar government-endorsed schemes, and similar measures by lenders, to respond to the adverse economic impact of the virus.

The guidance in this statement has been developed in the context of Covid-19 and will be reviewed in light of future developments. We believe the guidance is consistent with IFRS and the Capital Requirements Regulation ('CRR'). However, we also recognise it is the responsibility of firms to satisfy themselves that they have prepared their annual and interim

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[1] March 2020: https://www.bankofengland.co.uk/news/2020/march/boe-announces-supervisory-and-prudential-policy-measures-to-address-the-challenges-of-covid-19

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

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.

Treatment of payment deferrals, extensions to payment deferrals and exit from payment deferrals

In summary, our view is that eligibility for, and use of, Covid-19 related payment deferrals or extensions to those deferrals granted in accordance with the FCA's proposed guidance would not automatically result in a loan: (a) being regarded as having suffered a significant increase in credit risk ('SICR') or being credit-impaired for ECL purposes, or (b) triggering a default under CRR. That means:

- Our guidance has not changed for payment deferrals related to Covid-19 that are granted to borrowers for the first time. That includes existing payment deferrals granted prior to this guidance and new payment deferrals granted to borrowers who have not yet had a payment deferral.
- Borrowers coming to the end of an existing payment deferral will have different abilities to pay and varying financial situations. The FCA's proposed guidance explains that, where borrowers are coming to the end of an existing payment deferral, lenders should distinguish between those who are able to resume full payments immediately and those who are unable to resume full payments due to circumstances arising out of Covid-19. The key judgments for regulatory capital and ECL purposes is whether those borrowers who do not resume full payments at the end of a payment deferral should be treated as in default (for CRR) or as having suffered a significant increase in credit risk or credit impaired (for IFRS 9).

The rest of this statement covers these two issues.

Regulatory definition of default

<u>Borrowers able to resume full payments</u>

For a borrower coming to the end of a payment deferral granted in accordance with the FCA's guidance who is able to resume full payments, the PRA would not expect them to be regarded as being in default for CRR purposes provided payments are made under an agreed revised schedule.

<u>Borrowers unable to resume full payments</u>

We do not consider the use of a Covid-19 related payment deferral granted in accordance with the FCA's proposed guidance as triggering the counting of days past due or as generating arrears under CRR. We also do not consider the use of such a payment deferral to result automatically in the borrower being considered unlikely to pay under CRR. 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 revised schedule of payments. This applies both to borrowers who are granted a further payment deferral under the terms of the FCA's proposed guidance and to borrowers granted payment deferrals for the first time under the terms of the FCA's proposed guidance.

Firms are reminded to apply sound risk management practices regarding the identification of defaults. Firms should continue to utilise borrower information they have to assess borrowers for indicators of unlikeliness to pay, taking into consideration the underlying cause of any financial difficulty and whether it is likely to be temporary as a result of Covid-19 or longer term. In particular, for the purpose of assessing unlikeliness to pay, we expect firms to place significant weight on information they have as to the reason why a borrower is unable to resume full payments at the end of the payment deferral, and not to focus only on the type of further measures applied.

In applying CRR, we regard it as important for firms to consider the distinction between:

- Borrowers who do not resume full payments due to direct 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. This would typically result in the concessions being considered forbearance under CRR. Firms would then need to assess whether this results in a distressed restructuring that is likely to result in a diminished financial obligation and therefore a 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

The PRA recognises that distinguishing between temporary and longer term financial impacts is difficult in the current environment given the extraordinary level of economic uncertainty and the complex interactions between various public 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.

Identifying whether a significant increase in credit risk or credit impairment has occurred for IFRS 9

Underlying the guidance in our 26 March letter were three basic principles, all of which we continue to regard as critical in implementing IFRS 9's 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.
- Forward-looking assessments need to take a balanced view of both the potential impact of the virus and the unprecedented 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.

A key judgement for ECL is how to account for those borrowers who do not resume full payments at the end of a payment deferral but are instead granted a further full or partial payment deferral. Our view is that eligibility for, and use of, Covid-19 related payment deferrals or extensions to those deferrals granted in accordance with the FCA's proposed guidance would not automatically result in a loan being regarded as having suffered a SICR or being credit-impaired for ECL purposes. That is because the proposed guidance envisages that further payment deferrals can be used to manage short-term liquidity difficulties.

IFRS 9 requires the use of a 30 days past due test as a backstop in determining whether a loan has suffered a SICR and should be moved from stage 1 to stage 2. A 90 days past due backstop is required to be used in determining whether the loan is credit-impaired and should be moved to Stage 3. If a payment deferral has been granted in accordance with the FCA's proposed guidance, the revised schedule of payments should be used to trigger the counting of days past due for these purposes. However, even loans that are not past due can suffer a SICR or be credit impaired.

More broadly, when assessing loans for evidence of a SICR or of the loan being credit-impaired, it will continue to be important to distinguish borrowers using payment deferrals to manage temporary difficulties in making near-term payments from other borrowers, because some of the borrowers using payment deferrals to manage temporary difficulties in making near-term payments might not have suffered a SICR or be credit-impaired. However, as some will have suffered a SICR or be credit-impaired it will be important to consider other SICR and credit impairment indicators beyond whether the borrower is past-due. This will involve careful judgement as payment deferrals may be granted without the lender collecting detailed information about the circumstances of the borrower and might possibly involve high-level allocations of loans between the stages.