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COVID-19:

Bad debt provisioning

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Context

The novel coronavirus (COVID-19) pandemic is spreading around the globe rapidly. COVID-19 has taken its toll on not just human life, but businesses and financial markets too, the extent of which is currently indeterminate.

"COVID-19 has triggered an extremely severe economic shock that is fundamentally different in nature and scope from types of shocks previously witnessed"
Central Bank of Ireland: Quarterly Bulletin April 2020

Context cont’d

While COVID-19 has had an impact on almost all entities, either directly or indirectly, some of the worst hit sectors are aviation, hospitality and retail with more and more sectors coming under its radar with widespread lockdowns being enforced across the world. Financial services have also been affected with the inability of borrowers to keep up with repayment schedules.

Credit Unions need to carefully consider the implications of this situation on bad debt provisioning.

Directors' responsibilities

A key responsibility for directors is to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the credit union and of the income and expenditure of the credit union for that period.

<u>In preparing those financial statements the directors are required to:</u>

- Select suitable accounting policies and then apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State whether the financial statements have been prepared in accordance with applicable accounting standards, identify those standards, and note the effect and reason for any material departure from those standards; and
- Prepare the financial statements on the going concern basis unless it is inappropriate to presume that the credit union will continue in business.

Directors’ responsibilities cont’d

As credit unions navigate through these challenging times of COVID-19, the accounting policy for impairment of financial assets, and in particular the credit union’s **bad debt provisioning policy** which reflects significant judgements and estimates made by directors, will require **increased focus and consideration** this year.

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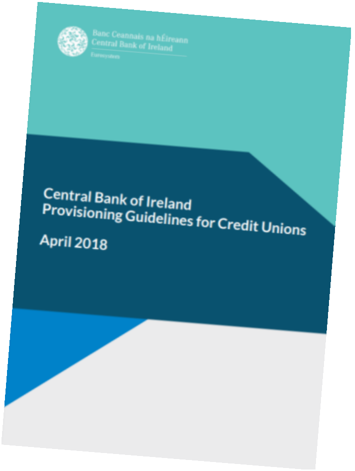
Financial Reporting Standard 102 (“FRS 102”):
Concepts and pervasive principles

The principles of **FRS 102** with its foundations in the basic concept of **prudence** (FRS 102, 2.9) complemented with the **Central Bank of Ireland Provisioning Guidelines for Credit Unions** issued in April 2018 continue to provide **sufficient breadth and depth** to enable the reflection of the specific circumstances of COVID-19.

FRC Financial Reporting Council

FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland



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FRS 102:
Impairment of financial assets

In accordance with FRS 102, 11.21, financial assets, which include loans to members, are required to be assessed for **objective evidence of impairment**, with the assessment being conducted on either an individual or collective basis as appropriate and determined by the credit union. Loans are impaired where there is objective evidence that the recoverable amount of an asset is less than its carrying amount.

Impairment losses must be recognised in the Income and Expenditure Account immediately.

FRS 102:
Impairment of financial assets cont'd

FRS 102, 11.22, **Objective evidence** that a financial asset or group of assets is impaired includes observable data that come to the attention of the holder of the asset about the following loss events:

a) **Significant financial difficulty** of the issuer or obligor;

b) **A breach of contract, such as a default or delinquency in interest or principal payments;**

c) The creditor, for economic or legal reasons relating to the debtor's financial difficulty, **granting to the debtor a concession that the creditor would not otherwise consider;**

d) It has become probable that the debtor will enter bankruptcy or other financial reorganisation; and

e) **Observable data indicating that there has been a measurable decrease in the estimated future cash flows** from a group of financial assets since the initial recognition of those assets, even though the decrease cannot yet be identified with the individual financial assets in the group, such as adverse national or local economic conditions or adverse changes in industry conditions.

FRS 102, 11.23, **Other factors (triggers) may also be evidence of impairment**, including **significant changes with an adverse effect** that have taken place in the technological, **market, economic** or legal **environment** in which the issuer operates.

FRS 102:
Impairment of financial assets cont'd

The estimation of impairment losses is inherently uncertain and depends upon many factors, and consequently, the judgements and estimates made by directors in respect of these factors require to be carefully addressed in the credit union's bad debt provisioning policy.

Given the significant and rapidly changing economic environment arising from COVID-19 and the associated changes to borrowers' circumstances, it is important now that directors review, and augment where necessary, the credit union's **bad debt provisioning policy.** The policy needs to be sufficiently **detailed and robust** to respond to these changes and to identify any associated impairment losses, thereby ensuring that the **level of provisions** being held for loans is **adequate** on an on-going basis and reflects the **timely recognition of any impairment losses**.

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Areas requiring enhanced focus

Areas requiring enhanced focus to obtain relevant and current information, and provide insights to inform the review of the credit union's bad debt provisioning policy include the following:

Sectoral analysis

Complete an analysis of the loan book to identify exposures to particular sectors/employers e.g. hospitality, construction, retail etc.

Procedures/resourcing

Ensure that there are adequate procedures and resources in place to accurately and consistently record any changes to borrowers' circumstances.

Credit control policy

Ensure that payment break options/temporary arrangements are clearly defined in the credit control policy including the eligibility criteria with same being kept under review.

Recording

Establish a detailed system for the recording of loans with payment break options/temporary arrangements in place ensuring sufficient information is being captured.

Reviewing

Frequently review all loans with payment break options/temporary arrangements in place for compliance with the credit control policy.

Monitoring

Monitor on a regular basis (e.g. monthly) all loans with payment break options/temporary arrangements in place and record any on-going changes to borrowers' circumstances.

Collateral

Review the adequacy and valuation of collateral held in respect of applicable loans. This would include assessing the legal enforceability and determining any practical barriers to realising the collateral.

Stratification

Review the stratification of the loan book to determine what loans are capable of being assessed on a collective basis (i.e. loans with similar credit risk characteristics) and what loans require individual assessment.

Final comments

Review of bad debt provisioning policy

Regularly review (e.g. quarterly) the bad debt provisioning policy to ensure that it continues to be sufficiently detailed and robust to respond to the on-going changing economic environment and the associated changes to borrowers' circumstances.

Frequency of loan book reviews

Increase the frequency of completing loan book reviews (e.g. monthly) and record any movement in the level of provisions in the monthly management accounts.

Prudence

Adopt a prudent approach to bad debt provisioning ensuring the level of provisions being held for loans is adequate on an on-going basis and reflects the timely recognition of any impairment losses.

It is important to remember that this situation is constantly changing. The bad debt provisioning policy needs to be reviewed regularly and loan book reviews kept up to date. It is crucial to ensure all judgements and estimates made are current and based on the information available at the latest date possible.

The information contained in these slides does not purport to be comprehensive or exhaustive but is purely for guidance and discussion purposes only. Points made are not listed in order of importance.

