Application Guidance Notes on SLFRS 9 *Financial Instruments*

Background:

SLFRS 9 was introduced in 2012 and with the impairment section; the full version was adopted in Sri Lanka in the year 2014. The standard is effective for financial periods beginning on or after 01st January 2018. To support the smooth transition to the Standard, CA Sri Lanka issued Technical notes and a Statement of Alternative Treatment (SoAT) on the Figures in the Interim Financial Statements permitting the entities to follow LKAS *39 Financial Instruments: Recognition and Measurement.*

Upon the Post Implementation Review being carried out with the stakeholders in the financial services industry, i.e. CEOs of Licensed Commercial Banks and Specialised Banks, Licensed Finance Companies and Specialised Leasing Companies through Sri Lanka Banks' Association, Finance Houses Association of Sri Lanka, and Leasing Association of Sri Lanka and also with the panel of auditors; CA Sri Lanka intends to provide the following Application Guidance Notes in relation to SLFRS 9:

1. Application of the Rebuttable Presumption on the Impairment for the Financial Asset Portfolios:

<u>Analysis:</u>

Paragraph 5.5.11 of SLFRS 9:

If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information when determining whether credit risk has increased significantly since initial recognition. However, when information that is more forward-looking than past due status (either on an individual or a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since the initial recognition. Regardless of the way in which an entity assesses significant increases in credit risk, there is a **rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due**. An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due.

Paragraph B5.5.37 of SLFRS 9:

When defining default for the purposes of determining the risk of a default occurring, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a **rebuttable presumption that default does not occur later than when a financial asset is 90 days past due** unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. The definition of default used for these purposes shall be applied consistently to all financial instruments unless information becomes available that demonstrates that another default definition is more appropriate for a particular financial instrument.

Recommendation:

Accordingly, if reasonable and supportable forward-looking information is available without undue cost or effort; it shall use such information in determining whether there have been significant increases in credit risk since initial recognition than past due status (either on an individual or a collective basis). Regardless of the way in which an entity assesses significant increases in credit risk; there is a **rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. That can be rebutted,** if reasonable and supportable information is available without undue cost or effort to demonstrate otherwise.

Further, with regard to the default definition on individual instrument basis (which shall be applied in consistent with the definition used for internal credit risk management purposes considering the qualitative indicators when appropriate); there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due which can be rebutted subject to reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate.

The above provisions are expected to apply with regard to the rebuttable presumption on financial assets. However, in circumstances where reasonable and supportable information are not available in a structured manner; the management may exercise its judgement taking into account their **past experience, business model and the internal credit risk management framework** in determining whether the presumption can be rebutted.

Further, in taking such a determination, the regulatory provisions also need be taken into consideration.

eg:

- Recent concessions on SME loans – Circular No: 6 of 2019 dated 26th April 2019 issued by CBSL
- Classification as Non-Performing Loans - Section 2 (i) of the Finance Companies (Provision for Bad and Doubtful Debts) Direction No. 3 of 2006.

  Loans will be classified as non-performing, where payment of principal and/or interest have been in arrears for a period of 6 months or more and that would indicate how an entity manages the credit risk in terms of business model.

2. Concessions to Tourism Industry

The adverse impact on the tourism industry following the recent incidents, the Government has formulated that concessions to be granted to individuals and entities in the tourism industry through the financial services sector. Accordingly, for classification and provisioning purposes in terms of SLFRS 9, it is permitted to maintain Loans offered to the tourism sector in the same category during the moratorium period proposed. Further, capital and interest falling due during the moratorium period will be converted to a term loan, which shall be recovered within a specified period of time.

(i) Recognition of interest income during the moratorium period:

Analysis:

Paragraph 5.4.1 of SLFRS 9:
Interest revenue shall be calculated by using the effective interest method. This shall be calculated by applying the effective interest rate to the gross carrying amount of a financial asset except for:

(a) *purchased or originated credit-impaired financial assets*. For those financial assets, the entity shall apply the *credit-adjusted effective interest rate* to the *amortised cost* of the financial asset from initial recognition.

(b) financial assets that are not purchased or originated credit-impaired financial assets but subsequently have become *credit-impaired financial assets*. For those financial assets, the entity shall apply the effective interest rate to the amortised cost of the financial asset in subsequent reporting periods.

Paragraph 5.4.2 of SLFRS 9:
An entity that, in a reporting period, calculates interest revenue by applying the effective interest method to the amortised cost of a financial asset in accordance with paragraph 5.4.1(b), shall, in subsequent reporting periods, calculate the interest revenue by applying the effective interest rate to the gross carrying amount if the credit risk on the financial instrument improves so that the financial asset is no longer credit-impaired and the improvement can be related objectively to an event occurring after the requirements in paragraph 5.4.1(b) were applied (such as an improvement in the borrower's credit rating).

Recommendation:

Accordingly, interest revenue shall be calculated by using the effective interest method applied to the gross carrying amount of a financial asset that is covered under moratorium.

However, for financial assets that subsequently have become *credit-impaired,* effective interest rate shall be applied to the amortised cost of such assets in subsequent reporting periods; provided that the gross carrying amount can be again applied where the credit risk on such financial instrument improves (so that the financial asset is no longer credit-impaired and the improvement can be related objectively to an event occurring after the credit impairment that had been taken place previously).

(ii) Consideration of the rescheduled loans (term loans)

Background:

As per the arrangement, capital and interest falling due during the moratorium period will be converted into a term loan. Accordingly, there would be a modification of the financial assets where the lending entity would be required to re-estimate the cash flows attached to the financial assets.

Analysis:

The entity may need to assess **whether the financial assets need to be derecognized** under SLFRS 9 paragraph 3.2.3(a) which states that an entity shall derecognize a financial asset, **when the contractual rights to the cash flows from the financial assets expire**. On that basis, de-recognition of financial assets on the revised terms would occur where the moratorium results in substantial modification to the original cash flows which could be seen as an expiry of those cash flows.

In accordance with the paragraph B5.5.25 of SLFRS 9, in some circumstances the renegotiation or modification of the contractual cash flows of a financial asset can lead to the derecognition of the existing financial asset.

When the modification of a financial asset results in the derecognition of the existing financial asset and the subsequent recognition of the modified financial asset, **the modified asset is considered to be a 'new' financial asset** for the purposes of this Standard. Accordingly, in terms of B5.5.26 of SLFRS 9, the date of the modification shall be treated as the date of initial recognition of that financial asset when applying the impairment requirements to the modified financial asset. This typically means that **measuring the loss allowance at an amount equal to 12-month expected credit losses until the requirements for the recognition of lifetime expected credit losses** in paragraph 5.5.3 **are met**. However, in some circumstances following a modification that results in derecognition of the original financial asset; there may be evidence that the modified financial asset is credit-impaired at initial recognition, and thus, the financial asset should be recognised as an originated credit-impaired financial asset. Accordingly, the holder of the financial asset should perform a quantitative and qualitative evaluation of whether the modification is substantial.

Appendix A of SLFRS 9:
A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred.

Evidence that a financial asset is credit-impaired include observable data about the following events:

(a) significant financial difficulty of the issuer or the borrower;
(b) a breach of contract, such as a default or past due event;
(c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
(d) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
(e) the disappearance of an active market for that financial asset because of financial difficulties; or
(f) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event—instead, the combined effect of several events may have caused financial assets to become credit-impaired.

Paragraph 5.4.3 of SLFRS 9:

When the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with this Standard, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a modification gain or loss in profit or loss. The gross carrying amount of the financial asset shall be recalculated as the present value of the renegotiated or modified contractual cash flows that are discounted at the financial asset's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated.

Paragraph B5.5.27 of SLFRS 9:

If the contractual cash flows on a financial asset have been renegotiated or otherwise modified, but the financial asset is not derecognised, that financial asset is not automatically considered to have lower credit risk. **An entity shall assess whether there has been a significant increase in credit risk since initial recognition on the basis of all reasonable and supportable information that is available without undue cost or effort**. This includes historical and forward-looking information and an assessment of the credit risk over the expected life of the financial asset, which includes information about the circumstances that led to the modification. Evidence that the criteria for the recognition of lifetime expected credit losses are no longer met may include a history of up-to-date and timely payment performance against the modified contractual terms. Typically, a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased.

For the purpose of SLFRS 9, management must exercise judgment to determine what would constitute “undue cost or effort”. As such, an entity may consider the cost or effort in comparison to the benefits received from users of the financial statements in determining the work to be performed.

Recommendation:

When there is a **significant modification to the original cash flows** that could be seen as an expiry of those cash flows, it can lead to **derecognition of the financial asset, and is considered as a 'new' financial asset**. In such circumstances, the loss allowance is measured at an amount equal to 12-month expected credit losses unless such new asset is credit impaired on initial recognition that requires to recognize lifetime expected credit losses.

Circumstances may lead to renegotiation or modification of contractual cash flows of a financial asset, that does not result in derecognition. This modification will not result in significant deterioration of credit risk during the period of moratorium. .

Accordingly, unless it is considered otherwise in the judgement of management, specific circumstances that led to provide relief measures by the regulator may not be considered to result in significant deterioration of credit risk during the period from the date of occurring such circumstances until the date of the commencement of the relief measures by the entity.

(iii) Disclosure requirements

Recommendation:

General disclosures in terms of SLFRS 7 *Financial Instruments: Disclosures* need to be followed in the financial statements. In addition to the general disclosures required, in relation to impairment requirements of financial assets which have had modifications to their contractual cash flows need to provide disclosures required by 35F(f), 35I(b) and 35J paragraphs of SLFRS 7.