THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

Guidance for Identification of Elevated Risk Industries Resulted from the Pandemic for the Assessment of Expected Credit Losses in line with SLFRS 9 Financial Instruments

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Objective:

The objective of the guidance is to provide a general framework for the financial institutions in order to identify **Elevated Risk Industries** during the COVID 19 pandemic period. Financial institutions shall consider the general guidance stated in this document together with the portfolio characteristics of the respective financial institutions when identifying elevated risk industries.

Framework:

Significant Increase In Credit Risk (SICR) assessment considers changes in the risk of default occurring over the lifetime of a financial instrument. Adverse economic impact resulting from COVID-19 may indicate a credit deterioration affecting many borrowers. As such, key issue will be to distinguish between cases where the payment holidays provides relief from short-term liquidity constraints impacting the borrower that do not amount to a. SICR.

Without doubt, this will be an extremely challenging task and will largely be dependent on the lender's broader views on the macroeconomic impact of COVID-19, For example the magnitude of impact resulting from the pandemic and the time to recover, when and how quickly there may be a return to longer-term "normal" economic trends and the nature, extent and duration of direct government support to borrowers will be key factors in this regard [SLFRS 9.5.5.9].

Individual Impairment Assessment

The rapid onset of the COVID-19 outbreak, the larger number of borrowers affected, the vast difference between its economic impact and other recent financial shocks, and the high level of uncertainty regarding its future economic effects means that it is unlikely that the lender is able to perform a comprehensive definitive assessment, including the consideration of forward-looking information for each individual exposure.

Under individual impairment, both objective evidence of incurred losses (stage 3) and SICR (stage 2) need to be considered as appropriate. The criteria specified below illustrates how an institution could develop a framework to assess the magnitude of impact of the pandemic in order to determine the elevated risk borrowers. Financial institutions could extend similar assessment to determine the elevated risk industries.

Following illustrative qualitative factors can be considered to assess the impact arising out of the COVID-19:

1. Emergence of new competition with products or services substantially overlapping with the borrower's product/service offering
2. Emergence of new competition with low-cost substitute products from other jurisdictions
3. Substantial variation in demand beyond the seasonal/cyclical variability

4. Increased non recovery from industries, irrespective of relief measures (non-repayment of performing facilities in a specified sector due to regulatory relief measures shall not be considered)
5. Closure of plants, factories, which significantly affect the future business operations given the current environment
6. Non-performing Loans (NPL) ratio of a particular industry exceeds the overall average NPLs of the financial institution
7. Changes in government policies and regulations directly impacting the borrower's business
8. Resilience of the business model to respond to the pandemic (Eg: availability of online sales/ location of the key operating centers/ size of store networks/ impact of implementing protocols)
9. Pre COVID-19 financial strength (Eg: pre COVID working capital / pre COVID Debt to Equity/ Pre COVID Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) margin etc
10. Assessment of operational flexibility, including the soundness and adaptability of a business model in the new environment. (These factors can be evaluated through transaction data: current-account inflows, credit-line utilisation, and the evolution of point-of-sale transactions)
11. Availability of adverse factors such as significant erosion of the net worth of the business, substantial delays in commencing commercial operations and significant cost overruns
12. Other qualitative and quantitative information gathered during the application process on relief measures.

While evaluating the risk elevated borrowers due to the pandemic, financial institutions shall consider a holistic assessment on the illustrative criteria stated above by considering a scoring mechanism of the identified triggers. The list of triggers could be enhanced based on the respective Financial Institution's risk appetite and risk characteristics. While performing this assessment , financial institutions may come up with their own trigger libraries to assess the impact of risk elevation due to the pandemic environment.

Functions of an Illustrative Scoring Model:

Objective of a scoring model is to assess all triggers with reasonable and appropriate weightage to derive at the overall assessment on the risk of the customer. Institutions could consider appropriate score bandwidth to arrive at such estimates.

Illustration of the score:

1- No Impact
2- Minimal Impact
3- Moderate Impact
4- Significant Impact
5- Very Significant Impact

Maximum score will be dependent on the count of triggers. If there are 12 triggers, maximum score would be 60. Because per trigger highest score assigned would be 5. Upon scoring all the triggers, If the overall score is 36><60, such assessments could be determined to be with elevated risk characteristics by the financial institutions. Determination of the score bandwidth has to be based on the respective scores assigned and the number of triggers elected by the respective institute.

Similar scoring methods could be considered by the financial institutions for the determination of the elevated risk industries as appropriate.

Collective Impairment Assessment

The adverse impact on the industries resulting from the pandemic shall be considered while estimating Expected Credit Losses (ECLs). In order to aid such assessment, institutions shall determine the elevated risk industries while performing the collective impairment. The objective of this section is to lay down general guidance for identification of elevated risk industries while determining ECLs.

When it is unlikely that the lender is able to perform a comprehensive definitive assessment, including the consideration of forward-looking information for each individual exposure; lifetime ECLs are recognised on a collective basis. That considers comprehensive credit risk information, incorporating all relevant credit information including forward-looking information, in order to approximate the result of recognising lifetime ECLs when there has been a SICR since initial recognition on an individual instrument level [SLFRS 9.B5.5.1-6, IFRS 9.IE 29-39].

The lenders can consider whether a top-down approach to stage transfers can be considered (see SLFRS 9.B5.5.6 and IFRS 9. IE39). ECL estimates are very sensitive to macroeconomic forecasts. Evidence is available to show that deterioration in the Gross Domestic Product (GDP) outlook could lead to a manifold increase in the Probability of Default (PD). Top-down approach for collective assessment supports institutions to assess the macroeconomic outlook of the respective industries to identify the elevated risk sectors at an overall level. This could be analysed based on two criteria:

1. The impact to the sector that can be analysed based on the sector GDP contribution (pre and post COVID environment)
2. Estimated recovery of the industry based on the magnitude of impact

Management shall consider following key steps when identifying elevated risk industries:

Step-01: List down the sector GDP contribution Pre-COVID and during the pandemic period
Step-02: Identify the sectors with the largest deficiency of the GDP contribution
Step-03: For such sectors estimate the time to recover
Step-04: Rank order the sectors from the longest time to recover to shortest time to recovery. The sectors which requires the longest time could be deemed as the elevated risk Industries.

(Aforesaid criteria reflects an illustrative/alternative method of identifying elevated risk industries. Management may enhance the criteria as appropriate to yield comprehensive outcome)

Further Assessment of Elevated Risk Industries/Sectors

Magnitude of impact of the elevated risk industries could vary upon multiple factors. Institutions will require to perform more granular review for such sectors to determine the effect of the pandemic. Information stated below illustrates an assessment that entities could perform to identify the level of impact to entities within respective sectors.

Automotive Sector:

Factors that indicates a faster recovery **No SICR**	**Factors that will mitigate the elevated risk** **No SICR**	**Factors that will contribute towards an elevated risk** **SICR indicator available**
▪ Availability of maintenance and repair arm ▪ Manufacture and sale of vehicle parts and accessories ▪ Sale of secondhand/ registered vehicles	▪ Strong brand presence with Sole distribution agency ▪ Parent Company support to mitigate any temporary liquidity issues ▪ Pre COVID-19 high inventory levels	▪ Having only import and sale business models ▪ Sale of luxury brands

Tourism and Hotels Sector:

Factors that indicates a faster recovery **No SICR**	**Factors that will mitigate the elevated risk** **No SICR**	**Factors that will contribute towards an elevated risk** **SICR indications available**
Hotels operated under COVID regulations to facilitate quarantine activities	▪ Strong brand with own travel agents ▪ Companies has strong parental support or part of group company ▪ Adopted to post COVID tourist regulations (E.g. category 1, category 2 hotel)	▪ Companies which do not have parent support or own travel agencies ▪ High employee turnover due to financial difficulties ▪ Properties that are under construction

Construction Sector:

Factors that indicates a faster recovery **No SICR**	**Factors that will mitigate the elevated risk** **No SICR**	**Factors that will contributes towards an elevated risk** **SICR indications available**
Recent wins of major projects	▪ Strong brand or parent Company strong support ▪ Pre COVID lower debt and high cash reserves ▪ Pre COVID high number of long-term projects	▪ Deferment of existing projects ▪ Sub-contractors ▪ Pre COVID lower number of projects

Performing further analysis based on the illustrative criteria would enable the institutions to avoid classifying an entire industry/sector as elevated risk industry based on the additional information available. Institutions will be required to develop criteria for similar assessments for all industries which would enable a comprehensive assessment on the industry risk. The above illustration has been provided for automotive, tourism and construction sectors. However, management may conduct similar assessment for all other relevant and applicable sectors as appropriate.

Effective Date:

This guideline is applicable with immediate effect. It is expected that the financial institutions will take into consideration the available data and disclose the assumptions used. Further, the specific information pertaining to the financial institution also need to be taken into the consideration. Financial institutions may use an advanced / comprehensive methodology other than what is stated in this guidance notes, provided appropriate disclosures are included in the financial statements.

Annexure: Illustration on the Collective Assessment

This illustration has been included to provide further guidance in applying the collective assessment on impairment purpose. Hence, this cannot be considered as an integral part of this guideline.

1.1 Assessment of the impact to the sectors (the magnitude) has been analysed using second quarter output numbers (considering the lock down period of the country from April to June 2020)

Table 3: A10; Gross Domestic Product (GDP) at constant (2010) market prices, second quarter 2019 & 2020

Rs. Million

#	ISIC	Gross Value Added (GVA) by economic activity (SLSIC)	Q2-2019 Value Added	Q2 2020, Value Added @ Constant (2010)		
				Value Added	Shares	P2P change
1	A	Agriculture, Forestry & Fishing	165,978	156,237	8.1	(5.9)
2	B,C,D & E	Manufacturing, mining and quarrying and other industry	416,071	331,687	17.1	(20.3)
2.1	C	Of which: Manufacturing activities	321,992	255,722	13.2	(20.6)
3	F	Construction	165,834	115,925	6.0	(30.1)
4	G,H & I	Wholesale and retail trade, transportation and storage, accommodation and food service activities	535,522	433,991	22.4	(19.0)
5	J	Information and communication	19,324	22,744	1.2	17.7
6	K	Financial and insurance activities	227,125	245,622	12.7	8.1
7	L	Real estate activities (including ownership of dwelling)	142,568	118,404	6.1	(16.9)
8	M & N	Professional, scientific, technical, administration and supporting service activities	41,645	35,590	1.8	(14.5)
9	O,P & Q	Public administration, defense, education, human health and social work activities	194,932	197,587	10.2	1.4
10	R,S,T & U	Other services (excluding own-services)	231,848	158,792	8.2	(31.5)
		Equals Gross Value Added (GVA), at bp	**2,140,846**	**1,816,580**	**93.8**	**(15.1)**
		(+) Taxes less subsidies on products	171,231	119,693	6.2	(30.1)
		Equals GDP at market price	**2,312,078**	**1,936,273**	**100.0**	**(16.3)**

Source: Department of Census and Statistics

1.2 Assessment of the estimated time to recovery has been analyzed using second quarter output numbers (This will indicate the sectors that have revert to average after the lifting of lock down period)

Table 3: A10; Gross Domestic Product (GDP) at constant (2010) market prices, Third Quarter 2020

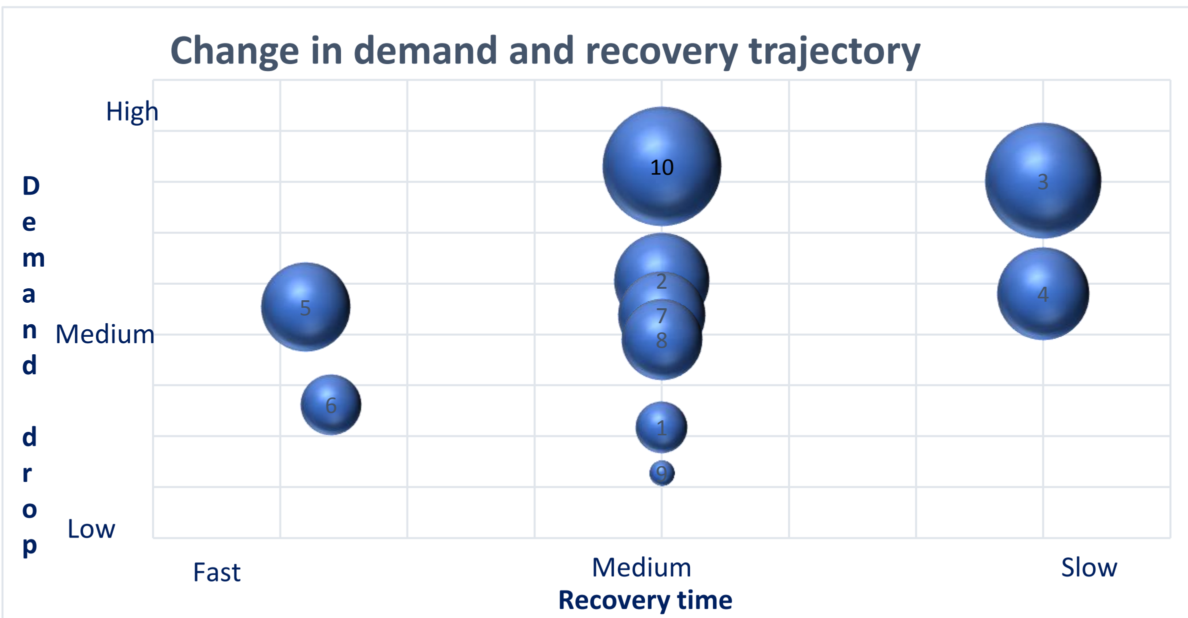
Rs. Million

#	ISIC	Gross Value Added (GVA) by economic activity (SLSIC)	Q3-2019 Value Added	Value Added @ Constant (2010) prices (Rs.		
				Value Added	Shares	P2P change
1	A	Agriculture, Forestry & Fishing	173,634	181,094	7.1	4.3
2	B,C,D & E	Manufacturing, mining and quarrying and other industry	500,674	519,743	20.4	3.8
2.1	C	Of which: Manufacturing activities	406,201	427,647	16.8	5.3
3	F	Construction	167,023	151,828	6.0	(9.1)
4	G,H & I	Wholesale and retail trade, transportation and storage, accommodation and food service activities	584,739	580,167	22.8	(0.8)
5	J	Information and communication	17,330	20,000	0.8	15.4
6	K	Financial and insurance activities	225,272	249,291	9.8	10.7
7	L	Real estate activities (including ownership of dwelling)	145,688	150,147	5.9	3.1
8	M & N	Professional, scientific, technical, administration and supporting service activities	42,420	43,070	1.7	1.5
9	O,P & Q	Public administration, defense, education, human health and social work activities	197,806	202,325	7.9	2.3
10	R,S,T & U	Other services (excluding own-services)	239,598	238,509	9.4	(0.5)
		Equals Gross Value Added (GVA), at bp	**2,294,183**	**2,336,176**	**91.8**	**1.8**
		(+) Taxes less subsidies on products	215,235	209,687	8.2	(2.6)
		Equals GDP at market price	**2,509,418**	**2,545,863**	**100.0**	**1.5**

Source: Department of Census and Statistics

*****As per the above, construction and wholesale and retail trade, accommodation and food services have shown slow growth compared to prior year (within 6 months despite of the moratorium).

#	Industry/ Sector	Drop in output compared to PY	Estimated Recovery time
1	Agriculture, Forestry & Fishing	-5.9	Medium
2	Manufacturing, mining and quarrying and other industry	-20.3	Medium
3	Construction	-30.1	High
4	Wholesale and retail trade, transportation and storage, accommodation and food service activities	-19	High
5	Information and communication	17.7	Low
6	Financial and insurance activities	8.1	Low
7	Real estate activities (including ownership of dwelling)	-16.9	Medium
8	Professional, scientific, technical, administration and supporting service activities	-14.5	Medium
9	Public administration, defense, education, human health and social work activities	-1.4	Medium
10	Other services (excluding own services)	-31.5	Medium



Risk elevated industries