Financial Stability Institute | BIS

FSI Briefs

No 8

Payment holidays in the age of Covid: implications for loan valuations, market trust and financial stability

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May 2020

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Authorised by the Chairman of the FSI, Fernando Restoy.

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ISSN 2708-1117 (online)
ISBN 978-92-9259-388-9 (online)

Payment holidays in the age of Covid: implications for loan valuations, market trust and financial stability[1]

Highlights

- *Governments and banks have introduced payment deferral programmes to support borrowers affected by Covid-19. But deferred payments are not forgiven and must be repaid in the future, raising prospective risks to the banking system. Thus, they should be designed to balance near-term economic relief benefits with longer-term financial stability considerations.*
- *The Basel Committee on Banking Supervision (BCBS) and several prudential authorities have issued statements clarifying how payment deferrals should be considered in assessing credit risk under applicable accounting frameworks. These measures aim to encourage banks to continue lending, to avert an even deeper recession.*
- *Prudential authorities are caught "between a rock and a hard place" as they encourage banks – through various relief measures – to provide credit to solvent, but cash-strapped borrowers, while keeping in mind the longer-term implications of these measures for the health of banks and national banking systems.*
- *In navigating these tensions, banks and supervisors face a daunting task as borrowers that may be granted payment holidays have varying risk profiles. Distinguishing between illiquid and insolvent borrowers – amidst an uncertain outlook – should help guide banks' efforts to support viable borrowers, while preserving the integrity of their reported financial metrics.*

1. Introduction

The Covid-19 pandemic has inflicted severe economic hardship on millions of households and businesses. In response, governments have introduced a range of fiscal, monetary and financial measures to support affected individuals and businesses.

These include a temporary suspension of debt obligations owed to banks and other financial institutions. In this context, global standard setters and several prudential authorities have clarified how the various public and private payment deferral programmes should be considered by banks and supervisors in assessing the credit quality of such exposures in applicable accounting frameworks.

Statements on the application of accounting standards have been issued by the International Accounting Standards Board (IASB), the BCBS and several prudential authorities that have adopted International Financial Reporting Standards (IFRS). These encourage banks to use the flexibility allowed under IFRS 9 – the standard that deals with how banks estimate provisions for expected credit losses (ECL)[2] for loans held at amortised cost. These clarifying statements were considered necessary to ensure that

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[2] The US framework for implementing ECL provisioning is known as the current expected credit loss (CECL) model, which became effective in 2020 for large listed US banks. In response to Covid-19, the US President signed into law the Coronavirus Aid, Relief and Economic Security Act (CARES Act) in March 2020, which allows banks that were previously required to adopt CECL on 1 January 2020 the option to postpone its implementation. See Zamil (2020) for further details.

banks do not take a procyclical approach in estimating ECL provisions associated with borrowers who might be experiencing temporary cash flow problems due to Covid-19. This is because a sudden and sharp spike in ECL provisions reduces a bank's reported net income, which could affect the flow of credit to distressed consumers and businesses and hence exacerbate cyclicality (see Borio and Restoy (2020)).

This Brief investigates how payment deferral programmes are structured, outlining the complex trade-offs involved, including how such schemes are reflected in the financial statements of banks and their implications for preserving market trust and in fostering financial stability. Section 2 focuses on the payment deferral programmes launched in several jurisdictions, while Section 3 summarises their accounting treatment under IFRS 9. Section 4 discusses some practical considerations related to the treatment of payment holidays in banks' published financial statements. Section 5 concludes.

2. Overview of payment deferral programmes

Many jurisdictions have implemented payment deferral programmes, as national governments move to sustain economic activity. These measures aim to alleviate the cash-flow pressure of distressed corporate and individual borrowers affected by Covid-19. Table 1 shows examples in selected jurisdictions.

Key features of selected payment deferral programmes — Table 1

Jurisdiction	Initiative	Scope	Duration	Eligibility criteria
Australia	Banking association	Principal and interest	Up to six months	Affected individuals and SMEs not in arrears on 1 January 2020.
Canada	Banking association	Principal and interest	Up to six months	Affected mortgagors in good standing.
Hong Kong SAR	Centrally coordinated by financial sector authority	Principal only	Up to six months	SMEs not more than 30 days past due at the launch date of the relief programme and not in the process of ceasing operations or declaring bankruptcy or liquidation.
Italy	Legislative moratorium	Principal and interest	Up to 18 months	Affected mortagagors and SMEs. SMEs with loans that are more than 90 days past due are excluded.
Singapore	Centrally coordinated by financial sector authority	Principal and interest	Until 31 December 2020	SMEs not more than 90 days past due as of 6 April 2020.
South Africa	Banking association	Principal and interest	Up to three months	Individuals and SMEs who were up to date with their payments on 29 February 2020 and have a good track record of paying their debts on time.
Spain	Legislative moratorium	Principal and interest	Up to three months	Financially vulnerable mortagagors.
United Kingdom	Centrally coordinated by financial sector authority	Principal and interest	Up to three months	Affected retail customers.
United States	Legislative moratorium	Principal and interest	Up to 180 days	Affected mortgagors.

Sources: Allen and Overy (2020), Australian Banking Association (2020), Banking Association South Africa (2020), Canadian Bankers Association (2020), Consumer Financial Protection Bureau (2020), Dijkman and Salomão Garcia (2020), Financial Conduct Authority (2020), HKMA (2020) and Monetary Authority of Singapore (2020).

In some jurisdictions, a temporary suspension of debt obligations is legally mandated for borrowers that meet certain conditions. In these jurisdictions, banks are obliged to suspend repayments of all eligible borrowers that make an application. In other jurisdictions, there is no binding requirement but authorities have coordinated with the industry and issued guidance, encouraging banks to work constructively with pandemic-affected borrowers. Further, some bank associations and individual banks worldwide have offered payment deferrals to affected borrowers. In such cases, banks have the discretion to determine eligible borrowers and the terms of the restructured loan.

The scope of payment deferral programmes typically covers the suspension of both principal and interest payments for a predetermined period and a prohibition on banks charging penalties and fees on loans to which the suspension applies. In many cases, particularly for legislative moratoriums, loan maturities are extended to accommodate the repayment of the deferred payments. Other types of arrangement are also possible such as keeping the maturity unchanged while distributing the deferred amount across the remaining instalments or through a balloon payment at maturity.

Payment deferral plans typically include a definition of eligible borrowers and the types of loan that qualify. The programmes usually target affected individuals and small and medium-sized enterprises (SMEs). The eligibility conditions depend on the pandemic's impact on the borrower's repayment capacity, including loss of employment or a reduction in working hours for individuals and any decline in a firm's income and turnover. Another type of commonly used criterion seeks to exclude borrowers without a good credit standing prior to the outbreak.

While some features of payment deferral programmes are designed to provide immediate relief to affected borrowers, they may also increase longer-term financial stability risks. For example, a legislative moratorium with flexible eligibility criteria may deliver maximum near-term relief while increasing banks' exposure to credit risk. On the other hand, when public guarantees[3] are used in combination with legally mandated payment deferrals, the reduced discretion of banks to select eligible borrowers is at least partially offset by the government guarantee. Finally, the length of the grace period may be a relevant risk driver, particularly if both principal and interest payments are suspended. In this situation, loan balances will grow over time, owing to the negative amortisation[4] from the deferral of interest payments, increasing risks for borrowers and banks. Table 2 highlights some of these complex trade-offs.

Design of payment deferral programmes and policy trade-offs — Table 2

<table>
<tr><td colspan="2" rowspan="2"></td><td colspan="2">Longer-term risks to financial stability</td></tr>
<tr><td>Higher</td><td>Lower</td></tr>
<tr><td rowspan="2">Degree of borrower relief</td><td>Maximum relief</td><td>Mandatory bank participation
Deferral of principal and interest
Flexible borrower eligibility criteria
Longer duration</td><td></td></tr>
<tr><td>Moderate relief</td><td></td><td>Voluntary bank participation
Deferral of principal only
Strict borrower eligibility critieria
Shorter duration</td></tr>
<tr><td colspan="2"></td><td>No public guarantees</td><td>Public guarantees</td></tr>
</table>

Source: FSI analysis.

[3] See Baudino (2020) for a discussion on the use of public guarantees in response to Covid-19.

[4] Negative amortisation occurs whenever the loan repayment for any period is less than the interest charged over the same period so that the outstanding loan balance grows, rather than declines, over time.

3. Accounting treatment of payment deferrals

Overview

An important consideration for banks, supervisors and market participants is how payment holidays that are granted to affected borrowers are reflected in banks' published financial statements. These decisions are shaped, first, by the prevailing accounting standard used in various jurisdictions; and, second, by any recent official statements on how pandemic-affected exposures should be considered in the applicable accounting frameworks. The outcomes are consequential, given the close links between a bank's credit risk profile and its level of ECL provisions, which can materially affect its earnings and reported equity. For the sake of brevity, this section focuses primarily on how payment holidays are treated in jurisdictions that have adopted ECL accounting methodologies under IFRS 9, which in turn drive the reported published financial statements of banks.[5]

Treatment of payment holidays under IFRS 9

Loan classification and measurement

In jurisdictions that have adopted IFRS 9, banks are required to classify financial instruments into three categories: "performing" (Stage 1), "underperforming" (Stage 2) and "non-performing" (Stage 3). Once a loan has experienced a "significant increase in credit risk" (SICR) since initial credit recognition or is impaired, it should be moved to Stages 2 and 3, respectively. The three-stage classification process is used not only to signify the credit quality of an exposure but also to determine the method used to calculate ECL provisions, with exposures under Stage 1 subject to provisions based on 12 month ECL,[6] while Stages 2 and 3 require lifetime ECLs.[7] Table 3 summarises the classification, measurement and interest accrual requirements under IFRS 9.

As a general rule, if banks grant payment holidays to a specific borrower facing financial difficulty, it may suggest that, at a minimum, a SICR has occurred, triggering a Stage 2 designation and lifetime ECLs. The standard also includes a rebuttable presumption that any loan that is past due more than 30 days has experienced SICR, while a loan past due 90 days or more is assumed to be in default (Stage 3).

Under the above conditions, the implications of payment deferrals for banks would be threefold: first, they would need to publicly disclose these exposures as Stage 2 or 3, suggesting a deterioration in the credit quality of their loan portfolio; second, their provisions may increase as their estimates will now be based on lifetime rather than 12-month ECLs; and, third, if payment deferrals trigger a reclassification to Stage 3, interest income could fall as the accruals are based on the net carrying value of the loans. These latter two issues could put pressure on banks' reported net income, and hence their equity.

In addition, if a loan is modified (eg via payment deferrals or other changes in terms and conditions), IFRS 9 requires entities to assess if the revised terms will lead to a decline in the expected net proceeds from the loan (eg the net present value of the cash flows fall after debt restructuring); and, if so, banks are required to record ECL provisions for the difference.

[5] Coming into the pandemic, several jurisdictions (eg Canada, countries in the European Union, several Asian countries and the United Kingdom, among others) operated under IFRS 9, while others remained under either the previous "incurred loss" provisioning approach under International Accounting Standards (IAS) 39 or have developed their own asset classification and provisioning methodology that are country-specific.

[6] That is, the likelihood of default over the next 12 months multiplied by the loss-given-default.

[7] That is, the likelihood of default over the life of the loan multiplied by the loss-given-default.

IFRS 9 – classification, measurement and interest accruals — Table 3

	Stage 1 (performing)	**Stage 2 (underperforming)**	**Stage 3 (non-performing)** Any one or more of the following events suggest evidence of credit impairment
Classification (credit quality)	• Performing loan & no SICR since credit origination	• SICR since credit origination • SICR not defined but various qualitative factors listed as information that may be relevant to assess SICR • Loans past due more than 30 days assumed to have experienced SICR (rebuttable)	• Significant financial difficulty of borrower • A breach of contract such as default or past-due event (presumed that loans 90 days past due more have defaulted – can be rebutted) • The lender has granted the borrower a concession due to the borrower's financial difficulty • It is probable that the borrower will enter bankruptcy • The disappearance of an active market for that financial asset because of financial difficulties • The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses
Measurement (Provisioning)	12-month ECL	Lifetime ECL	Lifetime ECL
Accrual of Interest income	Based on gross loan amount (eg without deducting the applicable provisions)		Based on net loan amount (gross loans minus the applicable provisions)

Source: IFRS 9.

Authorities' public statements on Covid-19 related payment deferrals

With respect to pandemic-related payment moratoria, the IASB, BCBS and several prudential authorities have clarified that the utilisation of a payment deferral programme should not, by itself, result in an automatic trigger for SICR and would not necessarily require a migration of all such loans from Stage 1 to Stages 2 or 3, thus avoiding the need for lifetime ECL provisions.[8] Authorities have argued that Covid-related debt moratoria are not borrower-specific and target a wide range of borrowers, many of whom might only be experiencing temporary cash flow difficulties. In general, their stance seeks to differentiate measures that have a preventative nature and aim to sustain economic activity in relation to borrower-specific payment holidays that are carried out under normal circumstances.[9]

Moreover, only a few authorities have specifically issued statements with respect to whether pandemic-related payment deferrals should be considered "debt modifications" under applicable accounting standards; and if so, how they should be treated.[10] This is mainly because payment deferrals

8 In this context, some authorities highlight that the framework offers flexibility since it does not specify what characterises a SICR. See Bank of England (2020) for an example.

9 In this regard, the European Banking Authority (EBA), the umbrella prudential banking regulator of 27 member states of the European Union, issued applicable guidelines that specify conditions that the general legislative and non-legislative moratoriums have to fulfil in order not to be considered forbearance. See EBA (2020) for further details.

10 In this regard, the US regulatory agencies have confirmed, in consultation with the US Financial Accounting Standards Board (FASB), that short-term loan modifications made on a good faith basis to borrowers affected by Covid-19 and who were paying as agreed prior to the debt modification would not be considered a "troubled debt restructuring" for accounting purposes. In effect, this means that a further analysis on whether a bank experiences a loss (based on net present value analysis) associated with the restructuring does not have to be made and thus no provisions need to be taken for such exposures.

are not forgiven and must be repaid in future periods without any (principal) haircuts, resulting in little or no decline in the net present value of the loan after modification, particularly if the length of the deferral period is relatively short-term in nature.

Disclosure

Public disclosures are essential if stakeholders are to understand the actual and potential effects of payment moratoriums on banks' financial soundness. Accordingly, authorities have issued statements supporting the disclosure of quantitative and qualitative information relevant to the evaluation of the ECL recorded and the understanding of the assumptions and judgments made in their estimate. This includes, for example, disclosure of information on judgments made on how payment deferrals have been factored into the assessment of SICR and ECL, as well as the use of forward-looking information.[11]

4. Practical considerations

Overview

Payment deferrals increase future risks to both borrowers and banks, as the missed payments are not forgiven and must be repaid. This can lead to a situation where the missed interest payments are added to the loan balance, resulting in a higher debt repayment burden for borrowers, once the payment holiday period ends. At the same time, IFRS 9 allows banks to recognise interest income on these missed payments, raising prospective risks if borrowers are ultimately unable to repay. In addition, if the payment moratorium is lengthy, the deferred interest payments that are added to a borrower's loan balance and the corresponding amount that are recognised in banks' interest income accounts will increase, accentuating medium-term risks for borrowers and banks.

The extent to which these risks materialise, and how they affect the accounting classification and measurement of loans, depends on two factors: first, the borrowers' ability to repay the debt once the deferral period ends; and, second, the availability of collateral support, including the existence of public guarantees[12] that back the underlying exposures. In this context – and for illustrative purposes – it might be helpful to take stock of three groups of borrowers who may be affected by the pandemic, as depicted in Figure 1 below:

Figure 1 – Spectrum of affected borrowers

[11] In addition to these requirements, the European Securities and Markets Authority highlights the need for issuers to disclose (i) their accounting policy for determining when a modification is substantial if relevant to an understanding of their financial statements, and (ii) judgments made that have the most significant effect on the amounts recognised in their financial statements. Similarly, the Australian Prudential Regulation Authority requires that banks publicly disclose the nature and terms of any repayment deferrals given to a broad class of loans and the volume of loans to which they are applied.

[12] As several payment deferral programmes are combined with public guarantees, ECL provisions need to reflect these risk mitigants. In practice, this means that even if a loan is classified as Stage 3 (non-performing), but backed by a 100% public guarantee of the principal balance, the ECL provisions required would be zero. When governments grant only partial guarantees, the unguaranteed portion must be considered in estimating ECL provisions.

Solvent and insolvent borrowers

At one end of the spectrum are borrowers whose loans were performing as agreed before the pandemic hit and are not yet significantly affected. For these debtors, the loan classification and measurement of ECL provisions are relatively straightforward.

At the other extreme are borrowers who may already have been struggling to meet their financial obligations and, consequently, were classified in the Stage 2 or 3 category before the onset of Covid-19. In these cases, while the probability of default may still increase even if the loan classification remains unchanged, the main challenge is, arguably, the measurement of ECLs, which will likely be driven by the value of collateral. This is because it may be difficult to arrive at reasonable collateral valuations, particularly for distressed borrowers amidst an uncertain economic outlook.

The space between solvency and insolvency

An even more complex issue is the treatment of the middle group of solvent but illiquid borrowers, since this encompasses a large number of borrowers with varying risk profiles. This group of debtors may have been paying as agreed before the pandemic (eg classified as Stage 1), but have been impacted by the crisis. In this regard, banks need to differentiate between borrowers whose cash flow difficulties are considered temporary in nature and other debtors with more chronic problems. For borrowers who are judged to be solvent but temporarily illiquid, payment deferral measures may be effective and the impact on classification and ECL measurement may be minimal.

Other debtors within this middle group, however, may experience more chronic problems and might not be able to repay their loans even after the payment deferral period is over. Such circumstances may result in a classification downgrade (to Stage 2/3) and an increase in ECL provisions. In these situations, there may be a need to explore whether negotiating principal haircuts, rather than relying solely on payment deferrals, might put borrowers on a more sustainable footing. While this approach may result in the recognition of higher short-term losses, it could enhance banks' longer-term resilience as it may help them to recoup the revised principal loan balance. Lastly, the longer it takes for the global economy to rebound, the greater the likelihood that some debtors who were initially perceived as having only temporary liquidity problems will migrate to the group with more permanent financial difficulties.

These overall credit risk assessments – which are within the spirit of various authorities' recent statements that there should not be an automatic assumption that borrowers granted payment holidays have experienced credit deterioration (or SICR in accounting language) – should help guide the accounting classification and measurement of such loans. Distinguishing between these sets of borrowers will be critical if banks are to continue providing support to viable borrowers, while faithfully reflecting the underlying credit risks in their financial statements.

5. Concluding remarks

Payment deferral programmes provide an indispensable lifeline to consumers and businesses affected by Covid-19, but they could also increase future risks to the banking system. Therefore, their design will be critical in balancing the short-term needs of borrowers with longer-term financial stability considerations. In particular, the financial stability implications of payment deferral programmes will be driven by the extent to which borrowers will be able and willing to repay their debt obligations once the payment holidays expire, particularly in the absence of a public guarantee.

The famous American investor, Warren Buffett, once said "It's only when the tide goes out that you learn who has been swimming naked." The cumulative impact of Covid-19 and payment deferral programmes on bank balance sheets depends on many factors and will only become apparent over time. Therefore, the timely classification and measurement of credit risk is critical for banks to provide confidence to supervisors and their stakeholders on their financial health. Delaying loss recognition until the tide goes out may leave banks and supervisors with fewer options for dealing with the repercussions.

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