European Securities and Markets Authority

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PUBLIC STATEMENT

Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions[1]

The European Securities and Markets Authority (ESMA) is issuing this Public Statement on forbearance practices in order to promote consistent application of European securities and markets legislation[2], and more specifically that of International Financial Reporting Standards (IFRS).

ESMA would like to stress the need for transparency and the importance of appropriate and consistent application of the recognition, measurement and disclosure principles provided within IFRS in order to ensure the proper functioning of financial markets.

Therefore financial institutions and their auditors should take this Public Statement into due consideration with regard to exposure and the effect of forbearance related practices, when preparing or auditing IFRS financial statements for the year ending 31 December 2012.

As a result of the financial and economic crisis, there has been increased interest by investors and other market participants in credit risk exposures and impairment recognised for financial assets, in particular on the forbearance practices that financial institutions extend towards their borrowers. This interest reflects the need for transparency and accuracy in financial information, as markets need to be confident that the financial statements of issuers accurately reflect credit risk exposures and the credit quality of their financial assets.

In July 2012, the Advisory Scientific Committee of the European Systemic Risk Board (ESRB) issued its report on *Forbearance, resolution and deposit insurance*[3]. In the report it identified forbearance as a practice that could be unproblematic when it is "*the result of entrepreneurial judgments to the effect that patience may eventually pay off*" but might also be "*designed to disguise problems in lending, delaying write-downs of bad loans, as a way of gaming with creditors and supervisors*". The European Banking

[1] This statement would be relevant also for non-financial issuers having a significant amount of forbearance activities.
[2] According to European Regulation no 1095/2010 establishing the European Securities and Markets Authority (ESMA), ESMA shall act in the field of financial reporting, to ensure the effective and consistent application of European Securities and Markets legislation.
[3] http://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_1207.pdf?204986e6f35bc5913ec897547c3cf266.

ESMA • CS 60747 – 103 rue de Grenelle • 75345 Paris Cedex 07 • France • Tel. +33 (0) 1 58 36 43 21 • www.esma.europa.eu

Authority (EBA) has been engaged in developing a common definition of forbearance, which could assist in assessing the extent and impact of forbearance practices. ESMA's efforts focus on external financial reporting in IFRS financial statements and thus complement the efforts of EBA with respect to supervisory reporting.

In order to address the concerns that the Financial Stability Board (FSB) had raised with regard to disclosing information about bank risks, the Enhanced Disclosure Task Force (EDTF) published a report[4] in October 2012. This report recommended that banks provide specific information in their external reporting that would enable users to better understand, "*the nature and extent of the bank's loan forbearance and modification practices and how they may affect the reported level of impaired or non-performing loans*".

ESMA, based on the EDTF's concerns, has decided to focus on activities that promote consistent treatment of forbearance-related practices in IFRS financial statements. Consistent use of impairment principles and enhanced transparency on forbearance practices, and their effect on the presentation of impaired assets, promotes comparability among the financial statements of financial institutions. ESMA notes that if the credit risk of an asset changes to the extent that losses are incurred, IFRS requires the recognition of impairment losses, whether or not the assets are subject to forbearance measures. Forbearance should not lead to avoiding or postponing the recognition of impairment or obscuring the level of credit risk resulting from forborn assets.

ESMA, together with national enforcers, conducted a limited fact-finding exercise on the accounting treatment relating to forbearance practices in the 2011 annual IFRS financial statements of a sample of financial institutions listed on regulated markets in the European Economic Area. On this basis, ESMA noted that disclosures about forbearance practices in the financial statements diverged significantly and were often limited in the amount of information provided and vague as to content. ESMA found that in some cases it was unclear whether forbearance measures were considered objective evidence of impairment and whether, and to what extent, the need for forbearance led to recognition of impairment losses.

The results of the fact-finding exercise also indicated that issuers consider a number of different practices are caught under the umbrella of *forbearance measures*.

[4] The EDTF report '*Enhancing the risk disclosures of banks*' is available at the FSB website under http://www.financialstabilityboard.org/publications/r_121029.pdf.

Forbearance and objective evidence of impairment

ESMA is of the view that the indicators of objective evidence of impairment in IAS 39 - *Financial Instruments: Recognition and Measurement* cover forbearance measures, even though IFRS does not use the term *forbearance*. Paragraph 59(c) of IAS 39 states that objective evidence of impairment includes circumstances when the lender, for economic or legal reasons related to the borrower's financial difficulty, grants to the borrower a concession that the lender would not otherwise consider. Consequently, the practice of extending forbearance measures constitutes an objective indicator that requires assessing whether impairment is needed.

Forbearance measures occur in situations in which the borrower is considered to be unable to meet the terms and conditions of the contract due to financial difficulties. Based on these difficulties, the issuer decides to modify the terms and conditions of the contract to allow the borrower sufficient ability to service the debt or refinance the contract, either totally or partially[5].

If a decision is made to extend a concession, modify the contractual terms or refinance, which is not related to the financial difficulties of the borrower, then forbearance has not occurred. Issuers and auditors should apply their judgement to determine whether a concession was extended due to financial difficulties of the borrower. ESMA reminds issuers that measures that relate to the financial difficulties of the borrower should not be combined with circumstances where modification of contractual terms is undertaken for other reasons (e.g. commercial)[6].

Modification of the terms and conditions of the contract may include, but is not necessarily limited to, the reduction of the interest rate, principal, accrued interest or the rescheduling of the dates of payment of principal and/or interests. Some examples of these measures include:

- a move to interest only schedules;
- temporary payment holidays;
- extension of the loan term;
- arrangements leading to payment of fees or charges on behalf of the borrower (e.g. in case of mortgage or property loans, payment of outstanding fees and charges to protect security of a property, taxes or maintenance of the property);
- amendment or lack of enforcement of covenants (e.g. suspension of application of a covenant that has been breached due to financial difficulties); and
- capitalisation of arrears or partial debt write-off.

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[5] In case of financial difficulties of the borrower, lack of action by the lender towards the borrower (e.g. lack of enforcement of covenants in the contract) can be considered a form of forbearance and is objective evidence of impairment according to paragraph 59(a) of IAS 39.

[6] In those cases, the modification of the financial asset might lead, depending on facts and circumstances, to derecognition or impairment of the original asset or to revision of estimates of the receipts in line with paragraph AG 8 of IAS 39. Even outside of the scope of this statement, ESMA reminds issuers that application of paragraph AG 8 would lead to immediate recognition of the difference between the present value of the modified asset and the carrying amount of the original asset in profit or loss.

In this context refinancing comprises those loan arrangements that are entered into to ensure, totally or partially, the repayment of other contracts for which the borrower is unable to meet the previous terms.

Assessment of impairment of assets subject to forbearance practices

As a forbearance measure is objective evidence of impairment, once such a measure has been identified, in accordance with paragraph 59(c) of IAS 39, an issuer shall evaluate whether this loss event has had an impact on the estimated future cash flows of the financial asset. Accordingly, future estimated cash flows may need to be reduced or delayed, normally implying a decrease of their estimated present value and thus giving rise to an impairment loss which must be recognised.

In accordance with paragraph 63 of IAS 39, the issuer measures the amount of the impairment loss as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred), discounted at the original effective interest rate (i.e. the effective interest rate before modification of the terms of the contract).

ESMA emphasises that it is a requirement of paragraph 63 of IAS 39 to base impairment calculations on the estimated future cash flows and not the contractual cash flows of the forborn loans. ESMA notes that there needs to be an assessment of whether, after the forbearance measures have been granted, the debtor's current ability to service the debt supports the estimated expected cash flows. It can therefore not be straightforwardly considered that contractually modified cash flows now match the debt service ability of the borrower and equal the estimated future cash-flows.

In estimating the future cash flows from the asset when a borrower experiences financial difficulties, issuers inevitably encounter a high degree of uncertainty regarding the appropriate measurement of the impairment of that financial asset. As indicated in example E4.3 of the Implementation Guidance to IAS 39, although it is sometimes possible that modification of the terms of the contract might not lead to impairment (such as when the lender will receive interest on interest and the present value of the estimated future principal and interest payments discounted at the original effective interest rate will equal the carrying amount of the loan), such a fact pattern is unlikely given the financial difficulties of the borrower. Consequently, ESMA considers that given that these measures are extended to borrowers with financial difficulties, issuers should apply a heightened level of scepticism when estimating the future cash flows, collateral values as well as other parameters (such as the probability of default, the loss given default etc) used in calculating the impairment of forborn financial assets.

There are cases where, following an individual impairment assessment of financial assets, some individual assets may not be found to be impaired; or other cases where individual assets are not individually assessed for impairment. In these situations, a collective impairment assessment is conducted as required

by paragraph 64 of IAS 39, whereby those assets are grouped on the basis of similar credit risk characteristics. ESMA is of the view that forbearance measures extended on individual financial instruments may be indicative of changes in the credit risk of the groups they belong to.

In order to ensure that changes in such risks are captured and reported appropriately, ESMA urges issuers to analyse the credit risk characteristics of assets for which forbearance measures have been applied more closely, when assessing for specific as well as collective impairment.

ESMA would like to remind issuers that objective evidence of impairment is identified at the level of the borrower rather than at the level of individual contract. Consequently, once objective evidence of impairment has been identified based on economic difficulties of the borrower, all contracts of the borrower shall be subject to an assessment of impairment, in accordance with paragraph 59(a) of IAS 39. In some circumstances, forbearance measures may lead to derecognition of the original financial asset. In those instances the new asset would be recognised at its fair value and the difference between the carrying amount of the original asset and the fair value of the newly recognised asset recognised immediately in profit or loss. ESMA notes that IFRS does not provide clear guidance regarding in which circumstances a modification of contractual terms would lead to derecognition of the financial asset and expects issuers to specify in their accounting when forborn financial assets are derecognised and when impairment principles are applied to original financial assets (forborn financial assets that are not derecognised).

Disclosures in the year-end IFRS financial statements

ESMA would like to stress the importance of issuers providing all relevant disclosures related to their exposures to assets that are subject to forbearance measures in order to comply with the requirements of IFRS 7 - *Financial Instruments: Disclosures*. ESMA would also like to remind issuers that in order to achieve a fair presentation they are required, according to the principles in paragraphs 7 and 31 of IFRS 7, to disclose information that enables users of financial statements to evaluate the significance of financial instruments to their financial position and performance and the nature and extent of risks arising from financial instruments to which issuers are exposed. Clear disclosures are particularly important for areas in which management judgement, as permitted by IFRSs, is applied.

In order to enable users of financial statements to better understand issuers' exposure to the credit risks related to assets subject to forbearance practices, ESMA expects financial institutions to provide within their IFRS financial statements specific disclosures relating to forbearance activities and their impact on the financial position and performance.

ESMA is aware that not all financial institutions engage in material levels of forbearance activities. At the same time, given the current market situation, ESMA is of the view that, although not required by IFRS, a negative statement stating that a financial institution does not undertake forbearance measures in relation

to a specific business line and/or that such practices are not material to its business as a whole is in itself very useful information for users of financial statements.

IFRS 7 requires disclosures related to both qualitative and quantitative aspects of exposure to each type of risk arising from financial instruments, inter alia, credit risk. In particular, paragraph 21 of IFRS 7 asks issuers to disclose a summary of significant accounting policies. The issuer's choice of accounting policies is important in addressing measurement criteria used for assessing impairment. Furthermore, paragraph 33 of IFRS 7 mandates disclosures of objectives, policies and processes for managing the risk and the methods used to measure risk.

In relation to quantitative information, paragraph 36(c) of IFRS 7 requires issuers to provide information about the credit quality of financial assets even if these are neither past due nor impaired. At the same time paragraph 35 of IFRS 7 notes that, if the quantitative data disclosed as at the end of the reporting period is unrepresentative of an entity's exposure to risk during that period, an entity should provide further information that is representative.

On that basis, ESMA expects that financial institutions should provide the following disclosures in their annual IFRS financial statements:

1. details of the types of forbearance measures and practices undertaken during the reporting period;
2. description of the risks related to the forbearance measures undertaken, description of how these risks are managed and monitored for internal management purposes;
3. accounting policies applied in respect of the forborn assets, in particular:
   - distinguishing between the circumstances where a forbearance related measure results in the derecognition of the original asset and where it leads to impairment of the original asset and the consequences to the accounting treatment of the asset;
   - methodologies for assessing and calculating impairment of forborn assets taking into account risk characteristics, including a description of specific and/or collective assessment of impairment;
   - defining when an issuer no longer considers an asset to be forborn together with any consequences on the risk classification of the asset (e.g. impact on impairment status, impact on assessment and calculation impairment losses) ;
   - describing the criteria for recognition of impairment losses and the impact on the risk classification of forborn exposures as impaired/non-impaired for different types of forbearance measures for example, where forbearance measures:
     - lead to an impairment loss being recognised;
     - do not lead to an impairment loss being recognised;
     - have been extended to assets that had been already impaired in previous reporting periods and were still considered to be impaired at the date of forbearance;
     - have led to derecognition of the original asset;

- consisted in refinancing of existing exposures; and

4. a description of any changes in these aspects of forbearance measures from the prior period.

Financial institutions should provide quantitative disclosures in order to enable users to evaluate the impact of forbearance measures on the credit risk profile of their loan portfolios and their impairment charges:

- quantitative information on the level of forbearance activity in the financial institution as a whole, including, the carrying amount of assets subject to forbearance measures in comparison with the other assets remaining in the respective portfolio and the level of collective and specific impairment allowance held against those assets. In order to be useful, such disclosures should include a reconciliation from the opening balances to the closing balances of forborn assets specifying assets to which forbearance measures have been extended during the reporting period and assets which are no longer considered to be forborn as well as effects of the forbearance measures recognised in profit or loss during the reporting period (impairment loss, loss recognised on derecognition);
- amount of interest income recognised in respect of forborn assets;
- when original forborn assets have been derecognised during the reporting period, carrying amount of the newly recognised assets arising from the forbearance measures;
- analysis of the credit quality of financial assets as required by IFRS 7 (i.e. providing information on financial assets disaggregated into those neither past due nor impaired, those past due but not impaired and those considered as impaired) specifically for financial assets subject to forbearance measures together with the level of impairment and level of collateral held as appropriate; and
- disaggregation of the forborn financial assets by type of forbearance measure, business segment/portfolio, industry sector, geographical region in circumstances where required to provide relevant additional information to users of financial statements.

For enhanced transparency, when practicable and relevant, and after having taken into account materiality considerations, as defined under IFRS, all these qualitative and quantitative disclosures should be provided in a single note, with appropriate cross-references to other notes to the financial statements.

Next steps

ESMA together with national competent authorities will continue to monitor the level of transparency that issuers provide in their financial statements on forbearance related measures and their impact on impairment, and will consider whether further action is needed in order to ensure that the appropriate accounting treatment and level of transparency is provided by European issuers.

ESMA would expect that financial institutions include both qualitative and quantitative disclosures on forbearance in their 2012 annual audited IFRS financial statements. ESMA is aware that financial

institutions might not have collected sufficiently detailed quantitative information relating to forbearance to enable full disclosures along the lines requested in this statement to be made in the 2012 financial statements. Nevertheless, ESMA expects that such quantitative disclosures are included in the financial statements to the maximum extent possible. However, ESMA expects that these recommendations to be implemented and reflected in 2013's annual financial statements, thereby enhancing the comparability of the IFRS financial statements of financial institutions in the European Union.

ESMA will continue to monitor developments in the area of forbearance and co-operate with EBA and ESRB in addressing further this issue.