

Did Expected Credit Loss Fair for Indonesian Banks in COVID-19?

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In this paper, we explore the impact of the COVID-19 crisis on the accounting practices associated with the Expected Credit Loss (ECL) approach by Peryataan Standar Akuntansi Keuangan (PSAK) 71. Given the complexity of the pandemic, the neutral application of existing accounting standards is of more importance than ever as it ensures objective decision-useful information that serves comparability, maintenance of a level playing field and transparency. Worldwide interventions by banking regulators, however, have considerable potential to interfere with these fundamental contributions of financial statements. The result is that for banks under PSAK 71 it is not even entirely clear what assessments banks can and will use in their calculations estimating the effects of COVID-19.

Key words: *ECL, PSAK, COVID-19, Accounting Practices*

Introduction

Accounting for loan loss provisioning worldwide is covered in a subset of accounting standards. It is not our goal to comprehensively address all related accounting issues, but we explore similarities and differences in standards and whether their application will result in a level playing field across banks worldwide (Barnoussi et al., 2020). Pernyataan Standar Akuntansi Keuangan (PSAK) 71 introduced Expected Credit Loss (ECL) models, which are based on forward-looking information. Accounting for loan loss provisions, or ECL is especially challenging for banks as it is developed to integrate approximations of credit events and consequent cash deficit, and is based on a model that uses statistical weighted probabilities of risks (Gerald A. Edwards, 2017; Harris et al., 2018; Novotny-Farkas, 2016; Rathnakar, 2020). Since 2019 entities published for the first time their annual reports based on PSAK 71. Consequently, there has been little opportunity to examine the impact of ECL accounting (Witjaksono, 2017, 2018). Given the high uncertainty associated with the scale of this crisis, banks will find it even more challenging to use the probability estimations that are embedded in the ECL model.

In addition to potential differences between accounting by banks worldwide, we see several interventions influencing the application of current standards. Banking supervisory bodies, accounting standards setters and other regulators around the world have rushed to develop guidance for reporting entities regarding the financial reporting challenges and implications of COVID-19. Banks should be very careful in assessing the effects of COVID-19 on loans and valuation (Ozili & Arun, 2020; PWC, 2017; Shvyreva et al., 2020; Tahat et al., 2016)

In this paper, we explore the impact of the COVID-19 crisis on the accounting practices associated with the ECL approach by PSAK 71. Accounting for financial instruments is a topic that has a long history of controversy and which was also at the center of the previous Global Financial Crisis (GFC) (Howieson 2011). Within the reporting issues related to the COVID-19 crisis, accounting standards setters, Ikatan Akuntan Indonesia (IAI), have publicly recognised that the COVID-19 pandemic has the most direct implications for the issue of accounting for and reporting upon ECL.

ECL model from PSAK 71

PSAK 71 provides accounting guidance on how companies should value financial instruments (Witjaksono, 2017, 2018). Under PSAK 71 all financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs. Subsequent measurement falls into one of three categories: amortized cost; fair value through other comprehensive income (FVTOCI); or fair value through profit or loss (FVTPL). For all financial assets not measured at FVTPL, PSAK 71 introduced a new impairment model based on ECL.

PSAK 71 has a general approach for measuring impairment losses. Under this approach, entities are required to apportion the ECL into either: (1) 12-month ECLs, that represent the ECL that result from default events on a financial instrument that are possible within the 12 months after the reporting date; and (2) life-time ECLs, defined as the expected credit losses arising from all possible default events over the entire expected maturity of the financial instrument.

ECL measurement

PSAK 71 is purposely designed to be forward-looking, reflecting expectations of future credit events assessed at the reporting date. The standard contains a non-exhaustive list of information that may be relevant in assessing changes in credit risk, including an actual or expected significant adverse change in the economic environment and existing or forecast adverse changes in business, financial or economic conditions (Witjaksono, 2017, 2018). Entities must incorporate not only past due information but also all relevant credit information, including forward-looking macroeconomic information, to approximate the result of recognising lifetime

ECL when there has been a significant increase in credit risk since initial recognition on an individual instrument level.

An entity calculates the allowance for credit losses (loan loss provision) by considering on a discounted basis the cash shortfalls it would incur in various default scenarios for prescribed future periods and multiplying the shortfalls by the probability of each scenario occurring. It is common to use regulatory capital models for this purpose (Gerald A. Edwards, 2017; Harris et al., 2018; Ozili & Arun, 2020; Tahat et al., 2016). In summary, banks need to incorporate the following input into their ECL model: probability of default; exposure at default; and loss given default.

ECL model in COVID-19

Considerable judgement is exercised in determining the extent of the loan loss provision (impairment) for financial assets assessed for impairment both individually and collectively. The loan loss provision for financial assets is based on assumptions about the risk of default and expected loss rates. The use of different assumptions could produce significantly different estimates of ECL and the inclusion of forward-looking macroeconomic scenarios requires judgement (Barnoussi et al., 2020).

Many banks base their scenario approach on judgements (Ozili & Arun, 2020). Banks could leverage on approaches already adopted by some big global banks. These approaches include the Consensus Economic Scenario Approach or the Monte Carlo Simulation Approach. These approaches use mainly economic variables such as unemployment rates, GDP growth, house prices, commodity prices and short-term interest rates. These models which are normally very useful, are struggling to incorporate the extreme economic conditions and the levels of government support measures associated with the current COVID-19 pandemic. Consequently, banks need to change their initial risk models to avoid misestimating credit risk.

Banks have had to make many judgements in constructing models to comply with the PSAK 71 impairment requirements. Differing approaches for certain key judgements may result in PSAK 71 impairment provisions being treated inconsistently across banks and between jurisdictions, particularly during periods of stress. Governments and banks in many jurisdictions have introduced extraordinary measures to alleviate the financial and economic impact of COVID-19. The relief measures include a range of different payment moratoriums and government guarantees (Shvyreva et al., 2020). Given the fact that the COVID-19 crisis is still quite new and the impact on future economic conditions is very hard to predict, banks are finding it very difficult to identify the 'reasonable and supportable information' (Ozili & Arun, 2020) that they can use in their scenario models. Consequently, the approach adopted by any particular entity varies depending on its specific situation and the methodology it adopts in assessing ECL. Banks are likely to incorporate estimates of forward-looking macro-economic factors into multiple scenarios about the future economy. The extent to which a subsequent

spread of the COVID-19 virus would be factored into these possible scenarios, and the associated probabilities of such scenarios, will vary depending on characteristics of the financial asset, such as location and industry.

Bank regulators have reacted to the COVID-19 crisis in different ways (Ozili & Arun, 2020). Even before the COVID-19 crisis, banking regulators in several jurisdictions had adopted the approach of smoothing over time or delaying the impact of the adoption of the ECL model on capital adequacy measures. Such a practice eased the large impact of the transition from the incurred loss model to the ECL and assists banks to strengthen their capital position. Since the rise of the COVID-19 crisis and the consequential government relief initiatives, regulators and banking supervisors have provided further guidance, about the estimation of expected losses of financial assets. The crisis has also created an opportunity for those who are critical of the ECL model to lobby for a delay in its application or even, ultimately, the repeal of the ECL requirements.

Unlike the situation at the time of the GFC 2008, it is the principles-based nature of PSAK 71 that is being leveraged by banking supervisors and banks with the objective of at least maintaining the image, if not the substance, of stability in the financial system (Witjaksono, 2017, 2018). The potential for moral hazard in this 'regulation lite' approach but believes the current crisis makes it worth the risk. Perhaps the most significant of these assumptions is that the economic impacts of the COVID-19 crisis are temporary and short-term. As a consequence of this assumption that the effects are temporary, Indonesia banking regulators have promoted guidance that essentially suspends the requirements of PSAK 71.

Conclusions

This paper reflects on the current developments regarding COVID-19 pandemic's effects on financial accounting and reporting. For 2019 annual reports the concerns will primarily be reflected in going concern issues, non-adjusting balance sheet events and additional disclosures in auditing reports. For 2020, high uncertainty will affect the financial reporting of banks worldwide. The potential negative consequences for the stability of the world's financial sector could be substantial.

Given the complexity of the pandemic, the neutral application of existing accounting standards is of more importance than ever as it ensures objective decision-useful information that serves comparability, maintenance of a level playing field and transparency. Worldwide interventions by banking regulators, however, have considerable potential to interfere with these fundamental contributions of financial statements. The result is that for banks under PSAK 71 it is not even entirely clear what assessments banks can and will use in their calculations estimating the effects of COVID-19. The types of assumptions made, sensitivity analyses and other aspects of operationalising ECL are largely a 'black box' to those outside the banking sector. Full and informative disclosures will be of utmost importance to financial statement



users at this challenging time. Again, academics can contribute to our understanding of the types, appropriateness and limitations of the judgements made by those who use these models. Such research may be able to identify biases that decision-makers bring to these ECL measurements and ways in which those judgements can be improved.

This paper comes with several limitations. We have only been able to access publicly available information which is likely to be incomplete in describing the behaviour of the various parties we have described here. More importantly, the COVID-19 crisis is continuing to unfold as we write and later circumstances may impact on the relationship between accounting standard setters and banking regulators.

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