COVID-19: impact on the financial services sector

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Background

COVID-19 has already had a significant impact on the global financial markets, including India, and it may have accounting and reporting implications for many entities. As Coronavirus continues to spread, and more information comes to light, the BFSI sector with 31 March 2020 year-ends, needs to consider this impact on their business and in their financial statement reporting. COVID-19 may impact the BFSI sector in a significant way, particularly in their financial reporting for entities that follow Indian GAAP as well the entities that follow Ind AS.

Impact on banks

The Reserve Bank of India has taken certain measures to give some relief to the lending institutions in the areas of liquidity, regulation and supervision, and financial markets. The following are some of the business and accounting considerations for banks:

Credit risk assessment

The RBI has given certain waivers to the borrowers which include moratorium to pay principal and interest with relaxation on their classification as a non-performing asset or a restructured asset. This has been implemented to help borrowers tide over temporary financial difficulties. However, banks will have to identify and monitor the borrowers who are facing temporary and long-term financial difficulties. Such borrowers will be provisioned accordingly.

Due to the pandemic, it might become too cumbersome or difficult for banks to determine the extent and adequacy of collaterals available with them and the subsequent provisioning. There may be additional disclosures required in the financial statements and the computation of capital adequacy for COVID-19.

Banks would therefore be required to maintain robust risk management functions and track their borrowers individually to determine and segregate the permanent impact from the temporary impact and make appropriate provisions. We have mentioned below some of the key areas that merit consideration:

Liquidity

Given the situation of the lock down in the country, the defaults may have increased substantially as many companies would have lost revenue for a long time. An increase in defaults is likely to cause issues in liquidity and capital adequacy. However, the RBI has come up with certain measures to provide liquidity to all the lending institutions. These include[1]:

- Auctions of targeted long-term repos operations of up to three years tenor of appropriate sizes at a floating rate linked to the policy repo rate to be deployed in investment grade corporate bonds, commercial papers and non-convertible debentures over and above the outstanding level of their investments in these bonds as on 27 March 2020 (50% from primary market issuance and 50% from secondary market including from mutual funds and non-banking finance companies).
- Reduction of Cash Reserve Ratio (CRR) of all banks by 100 basis points to 3% of the net demand and time liabilities with effect from the reporting fortnight beginning 28 March 2020. This dispensation is available for a period of one year ending on 26 March 2021 and will release liquidity symmetrically benefitting banks.
- The requirement of minimum daily CRR balance maintenance has been reduced from 90% to 80%, effective from the first day of the reporting fortnight beginning 28 March 2020. This one-time dispensation is available up to 26 June 2020.
- Under the Marginal Standing Facility (MSF), RBI has permitted banks to borrow overnight at their discretion by dipping up to 2% into the Statutory Liquidity Ratio. This limit has been increased to 3% with immediate effect. This measure will be applicable up to 30 June 2020.
- The central bank has widened the existing policy rate corridor from 50 bps to 65 bps. Under the new corridor, the reverse repo rate under the liquidity adjustment facility (LAF) would be 40 basis points (bps) lower than the policy repo rate. The MSF rate would continue to be 25 bps above the policy repo rate. Further, consequent upon the widening of the LAF corridor, the reverse repo rate under the LAF stands reduced by 90 basis points to 4.0%. The widening of the corridor between the reference rates is expected to ease short-term volatility and bring stability to money markets.
- Policy repo rate has also been reduced under the LAF from 5.15% to 4.40% (i.e., by 75 basis points) with immediate effect. Accordingly, the MSF rate and the bank rate to stand reduced from 5.40% to 4.65%.

The above advantages would be offset by the moratorium being allowed to the borrowers. On an overall basis, there would be liquidity in the banking system. However, this may impact the banks in the following ways:

- The reduced minimum daily Cash Reserve Ratio (CRR) maintenance to 80% would allow banks to use excess money in certain days. However, aggregate CRR will have to be maintained on an overall basis. Accordingly, the banks are required to have adequate processes in place to ensure that excess funds are used only for short-term purposes so as to maintain the overall CRR.

Source: RBI press release on Statement on Developmental and Regulatory Policies, Seventh Bi-monthly Monetary Policy Statement, 2019-20 Resolution of the Monetary Policy Committee (MPC) Reserve Bank of India dated 27 March 2020.

- The banks may need to set up sufficient processes to ensure that these funds from the targeted long-term repos are deployed only in the allowed investments. The management of the bank will have to be ensure that the bank manages the duration of the investments based on the borrowings under the long-term repos to avoid any asset liability mismatches. It is important for banks to analyze its impact on the Net Demand and Time Liabilities (NDTL) computations as well as the capital requirements. Though not specifically mentioned, but these amounts would need to be disclosed separately. In addition to the above, the Banks would be required to analyze the credit risk appropriately as Income Recognition and Asset Classification (IRAC) norms would be applicable to the investments.

Going concern and impact of subsequent events

Given the unpredictability of the potential impact of the outbreak of COVID-19, there may be material uncertainties that cast significant doubt on the entity's ability to operate under the going-concern basis. If the entity prepares the financial statements under the going-concern assumption, it will be required to disclose these material uncertainties in the financial statements to clarify that the assumption is subject to such material uncertainty.

The degree of consideration required, the conclusion reached, and the required level of disclosure will depend on the facts and circumstances in each case. This is because not all entities will be affected in the same manner and to the same extent. Significant judgement and continual updates to the assessments till the date of issuance of the financial statements may be required, given the evolving nature of the outbreak and the uncertainties involved.

Further the BFSI sector in India will need to ensure that effective processes are in place to identify and disclose material events such as bankruptcies of the borrowers or the impact on lending portfolio due to liquidity or business issues in particular sectors such as real-estate, Small and Micro Enterprises (SME), etc. after the reporting period.

Revisiting hedging strategies

Business transactions may be postponed or cancelled, or they may occur in significantly lower volumes than initially forecasted due to COVID-19 lockdown. If an entity has designated a transaction such as the expected issuance of debt, as a hedged forecasted transaction in a cash flow hedge, the entity will need to consider whether the transaction is still a highly probable forecasted transaction. This includes whether the volume or amounts involved will be lower than how they were forecasted or whether there is uncertainty on the duration about the forecasted transaction.

Currently, increased volatility and decline in prices across many asset classes have impacted the trading books of banks and consequently, the capital allocated to address such market and counterparty credit risks. Firms will need to consider how quickly they can adjust their hedging strategies across forex, commodities, equities or fixed income as the COVID-19 situation evolves.

The offshore Indian Rupee (INR) derivative market such as the Non-Deliverable Forward (NDF) market has been growing rapidly in the recent times. At present, Indian banks are not permitted to participate in this market. However, RBI in consultation with the government, has permitted banks in India which operate International Financial Services Centre (IFSC) Banking Units (IBUs) to participate in the NDF market with effect from 1 June 2020. This decision allows banks to participate through their branches in India, their foreign branches or through their IBUs. This was a long-standing demand of the industry and has the potential to help in removing segmentation between offshore and onshore markets for banks with international presence at this juncture and allow better price discovery and forex risk management.

Adverse impact on specific loan covenant ratios being triggered

Given the current crisis and its impact on capital markets and businesses across, banks and NBFCs will face clients who are potentially experiencing stressed financial conditions, including deterioration of their credit ratings and credit quality. In certain cases, there is a likeliness of borrowers to breach certain covenants linked to ratios like the current ratio, profitability ratios, return on equity (ROE), debt coverage ratios, etc.

In some cases, the covenants breach could lead to classification of a loan as a non-performing asset.

Impact on NBFCs

The following are some of the key impacts on the NBFCs:

Business model re-assessment

Due to significant change in the market conditions, firms may have to revisit their business model assessment for their existing financial instruments. In case the sale of loans or investments is due to an increase in credit risk, then it would be consistent with the business model objective hold to collect as the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows and the sale is triggered due to significant deterioration in the market condition or counterpart specific credit risks problem. However, the entity may have to assess the business model of such financial assets/ instruments which it plans to sell.

Complexity in determining the impact on expected credit loss

There may be large-scale business disruptions that can potentially give rise to liquidity issues for certain entities. This might also have consequential impacts on the credit quality along the supply chain. The deterioration in credit quality of loan portfolios due to the outbreak will have a significant impact on the expected credit loss (ECL) measurement.

To compute ECL, companies need to keep the following specific factors in mind:

- A case by case ECL impact would need to be done industry-wise given the varying degree of COVID-19 impact across various industries that constitute the borrower population.
- Entities should carefully assess the extent to which the high-degree of uncertainty and any sudden changes in the short-term economic outlook are expected to affect the life of their financial instruments. It is important to remember IND AS 109/IFRS 9 has always been based on a set of principles that, by nature, are not mechanistic and offer a certain degree of flexibility. A greater emphasis may be attributed to a long-term stable outlook, as evidenced by past experiences, and to the relief measures granted by regulatory authorities.
- Macro-economic factors will be a key input in computing ECL since the RBI and the Finance Ministry has introduced several measures in this regard.
- Thirty-days norm may not be enough for a stage's classification. There may be a need for firms to consider qualitative criteria. If the payment terms are extended, considering the current economic circumstances, the terms and conditions of the extension will have to be assessed to determine their impacts on the ECL estimate along with any other accounting impacts. For e.g., if the payment terms of a receivable are extended from 90 days to 180 days, this would likely not be considered a substantial modification of the receivable. However, such extension is expected to result in an increase in probability of default (PD), which would, in turn, affect the measurement of ECL.
- Valuation of collateral in determining the loss given default (LGD) need to be considered considering the impact of the outbreak on the values of collaterals and guarantees (e.g., shares or bonds prices, real-estate values and the credit standing of guarantor(s)).

Besides these factors, entities will be also required to assess and apply significant judgements. They will have to update their macroeconomic scenarios and consider the use of top-down management overlays to calibrate the ECL risks that are not yet fully captured by their business models. Given the level of uncertainty and the sensitivity of judgements and estimates, disclosures of the key assumptions used, and judgements made in estimating ECL, as well as the impact of any relief measures, is going to be critical.

Fair value computation may undergo a change

Ind AS 113 Fair Value Measurement specifies the measurement date exit price estimate based on assumptions (including those about risks) that market participants would make under current market conditions. The first quarter of 2020 has seen increasing market volatility. On the basis that these are still quoted prices in an active market or are still observable, the increase in volatility should not change the way fair value is measured at the measurement date.

In Level 3 where unobservable inputs are significant to the measurement as a whole, incorporating such increase in volatility into valuation models may pose challenges to reporting entities. When making critical assessments and judgements for measuring fair value, the entity should consider what conditions, and corresponding assumptions, were known to market participants. While volatility in the financial markets may suggest that the prices are aberrations and do not reflect the fair value, it would not be appropriate for an entity to disregard market prices at the measurement date, unless those prices are from transactions that are not orderly. The concept of an orderly transaction is intended to distinguish a fair value measurement from the price in a distressed sale or forced liquidation. The intent is to convey the current value of the asset or liability at the measurement date, not its potential value at a future date.

Mark to market losses depleting capital

Given the sizeable portion of NBFCs' loan or investment portfolio may be classified at fair value through other comprehensive income (FVOCI), the MTM losses could potentially wipe out a significant amount of capital resulting in potential breach of capital adequacy norms and may further require capitalization to continue its trading operations.

Impact on insurers

Insurers are getting impacted in terms of their assets and liability reflected in the balance sheet. This, as a result, threatens their business continuity as well as future growth. The pandemic is an acid test for financial institutions and more so insurers as a stress that they have tested and scrutinized in their financial risk analysis, operational risk analysis and business continuity planning.

As an impact, insurers can expect to be flooded with general inquiries and claims across multiple different lines, whether that be for health, life or non-life cover. The following are the specific areas that are likely to be affected in the Indian insurance sector:

Mortality claims

Life and health insurers while evaluating the impact of COVID-19 on their claims, may consider alternative scenarios that would have led to the spread of the pandemic. This may vary from short-term outbreaks (viz., one to two months) to medium-term epidemic (viz., up to six months) and longer-term pandemic (viz., effects lasting for around 12 months). Health insurers also need to factor in the capacity of the Indian healthcare system and the effectiveness of actions taken by the government.

Loss of profit clause

Quite a few companies may eye claims under the loss of profit clause in their insurance contracts. This typically covers losses due to factory shutdowns when unforeseen circumstances such as fire or accidents occur. Many companies had taken insurance policies to cover loss arising due to certain unforeseen circumstances, but it is uncertain whether they will be covered for Coronavirus under such policies.

Financial and cash flow impact

All insurers including reinsurers in India will need to evaluate the pandemic's impact on their financial statement and cash flows. This includes:

- On the asset side, how will ratings and expected loss in the debt portfolio be affected? What is the likely range of monetary policy responses from RBI and how will these affect short-term yields? Will evolving market conditions (e.g., possible contraction of bond issuance and trading volumes) make it feasible to execute an effective reinvestment strategy? How will duration-matching/asset and liability management (ALM) objectives be met amidst market uncertainty?
- On the liability side, what will be the impact of the stretched healthcare system on mortality, which includes deaths due to COVID-19 and otherwise? How will the health, economic and social impacts of the pandemic affect lapse rates?

Broadly, all insurers need to analyze financial and operational risks and their impact on the cost of capital under different economic scenarios, viz., deflationary conditions, economic downturn or stagflation. Accordingly, these insurers needs to define the triggers for remedial management actions under each of these scenarios.

Appendix

RBI	Reserve Bank of India
GAAP	Generally Accepted Accounting Principles
Ind AS	Indian Accounting Standards
NBFC	non-banking financial company
BFSI	banking, financial services and insurance
MTM	mark to market
IPO	Initial Public Offering
ECL	expected credit loss
bps	basis points
CRR	Cash Reserve Ratio
NDTL	Net Demand and Time Liabilities
IRAC	Income Recognition and Asset Classification
ROE	return on equity
PD	probability of default
LGD	loss given default
ALM	asset and liability management

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