Guidance Note to Members
Computing Expected Credit Losses for Sovereign Debt

Issued by: Auditing & Accounting Standards Committee
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The ICATT Council has approved the following guidance prepared by the Auditing & Accounting Standards Committee for our members.

IFRS 9 – Financial Instruments became effective for all financial years beginning on or after 1 January 2018. IFRS 9 establishes an Expected Credit Loss (ECL) model which replaces the Incurred Credit Loss model under IAS 39. This requirement results in the recognition of provisions for impairment before objective evidence of impairment is available.

ICATT has developed the following general guidance to assist its members in approaching the determination of ECLs for sovereign debt for which objective evidence of impairment does not already exist on adoption of IFRS 9.
This paper does not seek to provide a comprehensive analysis of all possible approaches to addressing the issue but highlights several common approaches which might be considered by members in so doing.

Classifying the Sovereign

The reporter will need to establish its business model for holding the sovereign debt. That is to say whether the debt falls into the category of "hold to collect", "hold to collect and sell" or "held for trading". Once this is determined the reporter will need to confirm that the instrument does not fail the SPPI test (i.e. whether cash flows related to the instrument are solely payments of principal and interest (SPPI) or subject to other factors. If the instrument fails the SPPI test then it needs to be measured at fair value through the profit and loss account and is not measured using an ECL. Once classified as "hold to collect" or "hold to collect and sell" the general ECL model is applied on these instruments.

Determining the Stage of the Sovereign

The reporter will need to determine what criteria will be used to establish whether a sovereign has experienced a significant increase in credit risk. This will determine whether the ECL is being calculated at a 12 month point (stage 1) or on a lifetime basis (stage 2). The definition can include multiple criteria which can be mutually exclusive or combined.

For example the reporter can compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition. This could be done by comparing the relative credit rating of the instrument as at initial recognition with that as of the reporting date. Thresholds can be set for what is considered a significant shift in credit ratings. The use of absolute credit ratings (i.e. without relative comparison to ratings at initial recognition) is not recommended.

Establishing a Probability of Default (PD)

Gathering Historical Data

One common approach to determining the historical PD of a sovereign issuer is using published historical default statistics for the sovereign instruments of a comparable rating. Such statistics may be obtained from default studies conducted by reputable rating agencies. In some cases, the published PDs are cumulative or conditional. In these instances, adjustments should be made to arrive at unconditional PDs. It is common for such information to be presented in a table format showing PDs by rating type over the life of the instrument. This can be the basis for a stage 1 or stage 2 PD used in computing 12 month or lifetime ECL's.

If the sovereign is not rated by an international rating agency the reporter could take one of two courses of action before adopting the matrix:
i) Obtain or determine a rating using another rating model most appropriate to the data available for that sovereign, and seek a converter which advises on the relative ratings of the model used and the rating scheme of the agency which has a transition matrix ; or
ii) Get information on how the rating agency computes sovereign ratings and try to compute an equivalent rating under the rating agency model for the unrated sovereign.

Determining the forward-looking PD

In determining the forward-looking PD, users must consider multiple forward looking scenarios. For sovereign debt the approach to coming up with scenarios other than that which exists at the balance sheet date should involve consideration of the following:
i) Can the macroeconomic factor(s) that have the biggest impact on the PD of the sovereign be reasonably identified;
ii) Can the correlation between those macroeconomic factor(s) and the PD of the sovereign be proven or does the strength of the correlation have to be assumed;
iii) Can the macroeconomic factor be reasonably forecasted at least over a 12 month horizon or will this also be subject to judgement and assumptions;
iv) Can a reasonable probability be assigned to at least two different possible scenarios based on historical data and the reliability of the forecast.
v) Based on the above can the reporter predict the reasonable possible changes in the macroeconomic factor, the probability of at least one of those changes, and the impact that change would have on historical PD's of that sovereign.

One possible way of determining a forward-looking PD is to use a transition matrix.

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Establishing Exposure at Default (EAD)

Using the completed forward-looking PD table (referred to above) the entity should end up with a probability of default at each settlement period after the reporting date. The entity can use an appropriate interpolation method to arrive at missing settlement points as necessary. The entity should be able to forecast the remaining balance outstanding on the debt instrument at each of those points and should compute ECL at each of those dates and combine them using a probability weighted approach to come up with the stage 1 (using settlement points over the next 12 months) or lifetime PD (using the remaining settlement points over the instruments life) depending on the stage in which the sovereign is classified.

Establishing Loss Given Default (LGD)

In most cases sovereign debt is unsecured. As a result the LGD would be 100% of the EAD if solely based on collateral held. However IFRS 9 allows the reporter to factor in an expected rate of recovery on unsecured exposures if there is a sound basis. There are international studies done by reputable rating agencies which are available and which calculate the historical experience of losses on restructures of sovereign debt. These studies could inform an LGD of less than 100% on the basis that no sovereign is likely to pay nothing on any defaulted debt.