SUPERINTENDENCY OF BANKS OF PANAMA

Annex to Circular on COVID-19 and IFRS 9.

I. Background

During this period that began on March 9, 2020, when the first COVID-19 case in Panama was announced, effects similar to those that have occurred in other countries have been triggered as a result of the disruption in economic activities, including the fall in the gross domestic product and the suspension or loss of jobs. This has made it difficult for many individuals and businesses to meet their financial and other obligations.

The National Government along with the banking industry has taken relief measures that allow debtors to extend their payments and banks to provide them with greater flexibility so that they can continue to provide support to their customers in distress.

In this regard, on March 16, 2020 the Superintendency of Banks of Panama (SBP) issued Rule 2-2020 that implements special and temporary measures for the treatment of banks' loan portfolio.

On June 18, 2020, the National Assembly approved in third reading Law 156, which was promulgated by the Executive Branch on June 30, 2020. By means of this Law, a payments standstill was established on loans granted by banks, cooperatives and finance companies until December 31, 2020, for individuals and legal persons financially affected due to the state of national emergency due to COVID-19.

Rule 2-2020 was updated on September 11, 2020 through Rule 9-2020.

This disruption in economic activities may be temporary for some and permanent for others, which will have effects on the financial statements of the banks. These effects must be appropriately reflected under the current accounting framework, i.e. the International Financial Reporting Standards (IFRS).

However, IFRS and especially IFRS 9 "Financial Instruments" are standards based on principles and open to interpretation. In response to this, and following the line of the main international regulators, on April 13, 2020, the SBP issued Circular SBP-DR-0120-2020 that provides preliminary comments on the constitution of provisions for expected credit losses in the loan portfolio.

This guide includes the principles of Circular SBP-DR-0120-2020 and proposes practical solutions to manage the economic uncertainty derived from COVID-19, using the flexibilities incorporated in IFRS 9. The purpose of this guide is to achieve a certain degree of consistency through the banks located in Panama and that the provisions are properly calculated.

II. Segmentation of the loan portfolio from top to bottom

The first step in the process is that banks identify the risks in their loan portfolio. To do this, the evaluation must begin with the segmentation of the portfolio from top to bottom, i.e. from general to specific. In this regard, an example of segmentation could be:

First level: Country of placement
Second level: Corporate loans or Consumer loans
Third level: Economic or professional activities
Fourth level: Type of debtors
Fifth level: Type of facilities
Sixth level: Type of financial relief

The first level takes into account that the economic effects of COVID-19 are not the same in all countries and, therefore, debtors may be more or less affected by the banks.

The second level is the classic differentiation between corporate and consumer loans. At the third level, these categories are divided by economic or professional activity, and here the expectation of reopening plays a role, according to the [economic] block to which one belongs. Examples of business activities would be: construction, tourism, agriculture, trade, industry, etc. In regards to consumer loans: government employees, private sector employees, retirees, the agriculture sector, self-employed or freelance professionals, and others.

At the fourth level, we would classify the debtors according to the degree of affectation due to COVID-19, for example:

In corporate banking, those debtors temporarily affected by the crisis with liquidity problems and who will most likely recover and be able to meet their obligations. On the other hand, customers who are expected to be significantly affected by the long-term crisis and who will present insolvency problems. For this, the analysis will be conducted based on economic activity and expectations of reopening of [economic] blocks.

In retail banking, it is important to see what their current situation is: full-paid employee, [employee] with reduced working hours, suspended contract, unemployed, professional services subject to restrictions, and others. This has an important relationship with the economic activity to which they are linked.

At the fifth level we would have the segmentation by type of loan facility.

For corporate loans: syndicated loans, commercial loans, commercial mortgages, leasing and others.

For consumer loans: mortgage, personal loan, car loan, credit cards and others.

Finally, the last level of segmentation corresponds to the type of financial relief to which the debtor is availing himself: automatic payment standstill, modified special mention loans, extended standstill, restructuring, and others.

III. Risk level assignment

Once the portfolio has been segmented by its intrinsic characteristics and type of financial relief, it is necessary to classify the loan portfolio based on its risk levels. Said classification will subsequently help [the bank] to make the segregation by stages indicated by IFRS 9 (see Section V).

In this categorization, models based on arrears should be used, as well as internal models based on portfolio rating (scoring models, homologation to regulatory categories included in Rule 4-2013, etc.).

IV. Determine significant increase in credit risk (SICR) and location in Stage 1, 2 or 3

IFRS 9 requires banks to evaluate, at each accounting close, whether the credit risk of a financial instrument has increased significantly from its origination to the date of evaluation. To do this, banks must define in the first instance whether they rebut the presumption of the standard of 30 days in arrears for Stage 2 and 90 days of default for Stage 3. If they rebut the presumption, banks must define the SICR and default considering the quantitative and qualitative factors that best explain the credit risk in accordance with the types of financial relief.

On the other hand, as indicated in the aforementioned Circular SBP-DR-0120-2020, the extension of loan payments or modified special mention loans established by Rule 2-2020 or its extensions, does not automatically translate into SICR of such loans. In other words, the mechanisms that banks have to automatically trigger a SICR may not be appropriate for this type of loans in the current circumstances. However, it is illusory to think that none of these modified and extended loans will not eventually end up significantly impacted by the COVID-19 crisis and result in SICR, default or impairment. Hence the importance of a cautious analysis of portfolio segmentation and its risk level assignment together with the qualitative and quantitative evaluation of the SICR, as a basis for making an adequate provision for expected credit losses.

With regard to the location of facilities by stage, the analysis should be done, for individually significant exposures, on a case-by-case basis. For customers with less important exposures and particularly with consumer loans, the analysis should be collectively on the respective portfolio.

In summary, banks at this point should have differentiated those clients who as a consequence of the crisis have a temporary liquidity problem that prevents them from meeting their short-term financial obligations, from those who, in addition to their liquidity problems, also have solvency problems and that their post-crisis future is compromised and that they should be classified as Stage 2 or 3, according to the SICR definition.

V. Calculation of provisions for expected credit losses (ECL)

IFRS 9 determines that entities will measure ECLs in a way that reflects *"an unbiased probability weighted amount that is determined by evaluating a range of possible outcomes."* And that it is based on *"reasonable and sustainable information that is available without undue cost or effort at the reporting date on past events, current conditions and forecasts of future economic conditions."* In other words, ECLs should be point-in-time and forward looking so that they are not too pessimistic or too optimistic. In the current circumstances, the calculation of ECLs presents great challenges due to the uncertainty about the economic consequences of the pandemic.

For the calculation of the ECL, the classification in stages as discussed in Section IV, according to the following deterioration model, must be taken into account:

	Stage 1	**Stage 2**	**Stage 3**
Reason for inclusion at each stage	Initial recognition and non-SICR	SICR	Default
Calculation of the provision	12-month ECL	Lifetime ECL during the remaining lifetime of the asset	Lifetime ECL during the remaining lifetime of the asset
Calculation of interest at the effective rate on	Gross book value	Gross book value	Net book value

Although IFRS 9 does not prescribe it, the formula generally applied to the aforementioned stages for calculating ECL is as follows:

ECL = EAD x PD x LGD where

EAD = Exposure at default
PD = Probability at default
LGD = Loss given default

Now, as indicated in Circular SBP-DR-0120-2020 *"banks must make their estimates of expected losses based on the best information available of past events, current conditions and scenario-based future economic outlooks. As for the outlooks, these must include COVID-19 effects, according to the publicly available information, and the support measures implemented by the government. We recognize that it may be difficult to obtain this information at the moment and* *that due to the current changing conditions, adjustments to the models and scenarios in the near future would be required."*

The purpose of the model adjustments (overlays) is precisely to adjust the PD and LGD estimates, to incorporate the effects of the forward looking analysis. These estimates must take into account the new macroeconomic scenarios that must be carried out with caution in view of the prevailing uncertainties and that will be refined as such uncertainties dissipate. For now, we suggest evaluating post-model adjustments with a view to incorporating macroeconomic scenarios for the end of October 31, 2020, adjustable during the following months as new reasonable and sustainable information becomes available. Or, the recalibration of the parameters of models as long as the Bank has all the qualitative and quantitative elements as a result of COVID-19, or that there are elements of judgment that indicate the need to rectify deficiencies found before the crisis.

Each bank is responsible for making its estimates using the macroeconomic variables that they deem appropriate, however, as a reference, the Superintendency of Banks of Panama is using for its projections a GDP decrease rate of 10.7% and an unemployment rate at the end of 2020 of 18%, although the latter according to other sources may be lower.

One issue to take into consideration is the value of the guarantees since we know that, as a consequence of COVID-19, there have been decreases in the value of the real estate and, as a consequence, the LGD values may have increased and, therefore, so would the value of ECL if the value of the guarantee is not enough to cover the loan balance.

VI. Rebuttal of the standard

As indicated above, the IFRS 9 allows to rebut the presumption of the standard of 30 days in arrears for Stage 2 and 90 days of default for Stage 3. If the presumption is rebutted, the SICR must be defined and default considering the qualitative and quantitative factors that best explain the credit risk according to the types of financial reliefs.

In this regard, in order to rebut the aforementioned assumptions, it must be done with robust, reasonable and bearable documentation. For this purpose, the banks must coordinate with their external auditors the documentation they must provide to satisfy the audit procedures.