IFRS9 in practice

IFRS9 Impairment requirements and proposed solutions for non-financial corporates

In our first paper[1], we explored the high level requirements and implications of the IFRS9 (CECL[2]) Impairment standard. In this subsequent paper, we will focus on the decisions and changes that non-financial corporates will have to go through in order to ensure that their trade receivables management systems can provide the necessary data for the IFRS9 regulation.

In addition, we will elaborate in more detail on the role that credit insurance and external credit information can play in supporting non-financial corporates to comply with the standard.

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[1] Change ahead. Trade Credit Risk accounting in the new world of IFRS9
[2] For the purpose of this paper, all references to IFRS9 also apply to CECL

"Many corporates may already use a provision matrix to calculate their current impairment allowance, but they would need to consider how they can incorporate forward-looking information into their historical customer default rates.

Entities would also need to group receivables into various customer segments that have similar loss patterns (e.g. by geography, product type, customer rating or type of collateral)."

Ernst&Young
IFRS9 for non-financial entities

Current process

Currently, many non-financial corporates rely on provisioning matrices where provisioning rates (percentages) are applied to overdue receivables according to the length of time they are overdue (see example 1 in the Appendix). Under the current impairment methodology (IAS 39), the general rule is that provisions are made only for those receivables where there is objective evidence of an impairment (i.e. the 'incurred loss model'). In most cases, this objective evidence is the trade receivables not having been paid on time, but it could also be, for example, information received about financial difficulties of the buyer.

As a result, it is not uncommon for corporates to make very limited provisions or no provisions at all for receivables that are not yet overdue (i.e. there is no evidence of an incurred loss).

The provisioning rates (loss rates) are estimated based on the combination of historical experience and expert judgement while considering two key factors:

- The likelihood that a particular buyer will become bankrupt and the receivable not paid (i.e. the probability of default or POD)

- Should the buyer become bankrupt, what portion of the outstanding amount can be expected to be recovered from the buyer and what would then be the final loss (i.e. the loss given default or LGD)

While it is not always necessary for corporates to break down the provisioning rates into POD and LGD, it helps to understand the main factors influencing the provisioning rates. Example 1 in the Appendix shows a simplified calculation of provisioning based on the incurred loss model following the IAS 39 methodology.

What needs to change?

Instead of the current practice where companies make very limited provisions or no provisions at all for receivables that are not yet overdue (i.e. where there is no evidence of an incurred loss), from 2018 onward companies will need to recognise the 'Expected Credit Losses' (ECL) on their financial statements for all of their receivables. This enhancement addresses criticism that the existing methodology (the 'Incurred Loss Model') recognises credit losses too late.

Under IFRS9, the provisions should represent the Expected Credit Losses (ECL) and because there is credit risk inherent in every receivable, credit losses have to be recognised for all receivables even if the loss expectations are very low. Any evidence of a problem will influence the expectations about potential losses and thus should also affect the ECL provisioning value. Further, the ECL provisions must be calculated already at the moment the invoice is sent to the buyer. Example 2 in the Appendix demonstrates this.

It is likely that under IFRS9 most non-financial corporates will choose to apply a 'simplified approach'3 to their trade receivables as this simplification will allow them to leverage their existing provisioning practises. However, they will still have to make a number of adjustments to their existing processes in order to fulfil the new requirements as highlighted in the quote on the previous page.

The implication of the quoted statement is that the provisioning rates for past due receivables will have to be adjusted and a separate provisioning matrix will have to be prepared for every relevant buyer grouping (segment) that shares the same level of credit risk (Example 3 in the Appendix).
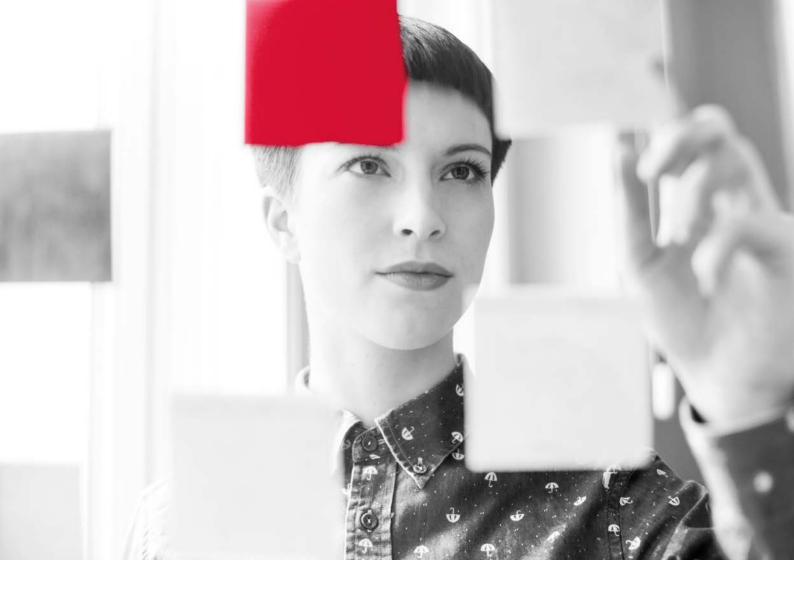
To establish these segments and the respective ECL provisioning rates, non-financial corporates will have to rely less on expert judgement and more on historical credit risk information and credit risk analysis. Further, the data should also be considered in the context of the current macroeconomic environment (i.e. the forward-looking adjustment).

In order to achieve all the above, a number of challenges need to be addressed:

1. Collection of historical buyer data needed for credit risk segmentation & analysis

2. Segmentation of buyers and creation of provisioning matrices for each segment

3. Derivation of the ECL forward-looking provisioning rates for each matrix

4. Preparation of elaborate disclosures and reports for both the internal and external stakeholders.

For many corporates, performing the steps above represents a significant operational challenge as well as costly exercise. Moreover all the data, calculations and methodological choices made in the implementation process are subject to external audit.

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[3] The impairment model includes some operational simplifications for trade and lease receivables and contractual assets that do not contain a significant financing component.

Positive impact of credit insurance and collection services on IFRS9 requirements

Credit insurance

can significantly reduce expected credit losses in the receivables portfolio because non-performance of a buyer is covered by insurance. Having credit insurance in place ensures that the insured non-payment is reimbursed by up to the covered percentage agreed, subject to the policy terms and conditions. The percentage of the receivable that remains uncovered represents the retained risk of the insured. However, for this portion, collection services can be used, thus further reducing the potential risk. The insured part retains

a minimal residual credit risk reflecting the possibility that the insurer itself can become insolvent. However, given the strong financial position of international credit insurance providers like Atradius, the risk is negligible. In addition, using a single POD of the insurer can simplify the ECL calculation process as the number of buyer segments can be decreased (e.g. split good vs. bad rating may no longer be needed).

Debt collection

services can vastly increase the efficiency of debt recovery processes, resulting in improved expected recovery rates from problematic buyers and thus a decrease in the LGD and the total ECL.

Example 4 in the Appendix demonstrates the potential effect of credit insurance and debt collection services on the ECL provisions.

Credit Risk Information

As discussed earlier in the article, availability of historical credit risk information is important especially for:

- Determination of relevant buyer segments with similar loss patterns

- Determination of loss rates for buyers in each of the segments

Going back in time to collect information about past non-performances and retrospectively looking for drivers of such behaviour is not a trivial task and requires time, effort, special technology and a specific skillset. As the global footprint of a non-financial corporate increases, so does the complexity involved in maintaining and matching the individual buyer records and the cost of performing these activities. External credit risk information coming from a globally respected and trustworthy credit management institution like Atradius, together with robust documentation about the methodology can vastly increase the auditability and transparency of the corporate's ECL methodology. Furthermore, it can improve the consistency and comparability of the applied credit information across different international markets in which the corporate operates. In conclusion, by leveraging the financial strength and expertise of an external partner, non-financial corporates can significantly decrease the amount of credit risk faced in their receivables and can control the financial impact of IFRS9.

How Atradius can help

Atradius credit insurance, buyer rating information and collection solutions can help businesses reduce the costs and workload associated with IFRS9 requirements. Atradius' buyer information and state-of-the-art credit management tools that provide overviews and portfolio analysis can help businesses manage their ECL requirements while the credit insurance protection and collection services can help reduce their debt provisions.

As a leading international credit insurer and collection agency, Atradius has a presence in more than 50 countries across the world and can provide its customers with information about the creditworthiness of more than 240 million companies worldwide. With a local presence and knowledge of markets across the world, Atradius is close to its customers and their buyers and equipped to provide the best solutions tailored to local needs.

As a specialist in tailor-made credit management and debt collection solutions Atradius can prepare an offer to best fit your needs and challenges. Contact us and find out how Atradius can help your business.

Appendix

Please note that the examples presented below are for illustrative purposes only. Numbers applied have been generalised and selected to increase simplicity of the examples.

Example 1:
Current impairment methodology and the calculation of provisioning rates

In figure below we show a simple provisioning calculation (Provisioning rate = POD * LGD) based on historical data. For amounts undue the provisions are 0.

When determining the provisioning rates, the chance of bankruptcy (POD) increases with the increasing overdue status of a receivable. The LGD generally remains unaffected[4] as it is mainly determined by the credit management policy of the non-financial corporate and by the industry & regional distribution of its buyers.

Days past due	Trade Receivables	POD	LGD	Provisioning rate	Provisions
Amount not past due	700	N/A	N/A	0.00%	0
Past due 0-90 days	160	12.50%	60.00%	7.50%	12
Past due 90-180 days	100	50.00%	60.00%	30.00%	30
Past due more than 180 days	40	70.00%	60.00%	42.00%	17
Total (mln EUR)	1,000				59

Example 2:
Provisions for receivables not past due under IFRS9

In the simplified calculation below the ECL provisioning rate is also calculated on amounts not yet due (assuming 1.2% POD for amounts not past due).

Days past due	Trade Receivables	Provisioning rate	Provisions
Amount not past due	700	1.20%	8
Past due 0-90 days	160	7.50%	12
Past due 90-180 days	100	30.00%	30
Past due more than 180 days	40	42.00%	17
Total (mln EUR)	1,000		67

[4] For simplicity purposes, any correlation of LGD with POD / Days Past Due has been ignored.

Example 3:
Provisioning matrix for receivables grouped into segments

In the example below the receivable portfolio has been split into 4 segments according to two dimensions[5]:

1. Credit rating of the buyer (where good rating results in low POD, bad rating in higher POD)

2. Debt collection efficiency in the different regions, in this example Western Europe and China (high collection efficiency results in low LGD, and lower efficiency in higher LGD)

Good Credit Rating - Western Europe

Days past due	POD	LGD	ECL Provisioning rate
Amount not past due	0.80%	50.00%	0.40%
Past due 0-90 days	5.00%	50.00%	2.50%
Past due 90-180 days	20.00%	50.00%	10.00%
Past due more than 180 days	60.00%	50.00%	30.00%

Good Credit Rating - China

Days past due	POD	LGD	ECL Provisioning rate
Amount not past due	1.50%	70.00%	1.10%
Past due 0-90 days	7.00%	70.00%	4.90%
Past due 90-180 days	25.00%	70.00%	17.50%
Past due more than 180 days	65.00%	70.00%	45.50%

Bad Credit Rating - Western Europe

Days past due	POD	LGD	ECL Provisioning rate
Amount not past due	2.00%	50.00%	1.00%
Past due 0-90 days	12.00%	50.00%	6.00%
Past due 90-180 days	35.00%	50.00%	17.50%
Past due more than 180 days	80.00%	50.00%	40.00%

Bad Credit Rating - China

Days past due	POD	LGD	ECL Provisioning rate
Amount not past due	2.50%	70.00%	1.80%
Past due 0-90 days	15.00%	70.00%	10.50%
Past due 90-180 days	40.00%	70.00%	28.00%
Past due more than 180 days	90.00%	70.00%	63.00%

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[5] IFRS9 does not define the number of segments to be used or how they should be derived.

Example 4:
Impact of credit insurance and collection services on ECL provisions

In the example below, we illustrate the impact of credit insurance and debt collection services on the POD and LGD parameters of ECL calculations on one of the IFRS9 segment matrices from example 3 – Good credit rating – Western Europe.

Parameters taken into account:

- Insured percentage: 90%; 10% of the receivable presents the retained risk for the buyer (uninsured part).

- LGD when using collection services to recover debts: 29% (taking into account the average collection recovery rate of 71%).

The impact of credit insurance and collection services on the ECL provisions is demonstrated in the tables below.

Good Credit Rating - Western Europe
(ECL calculation without credit insurance and collection services)

Days past due	Trade Receivables	POD	LGD	ECL rate	ECL provisions
Amount not past due	350	0.80%	50.00%	0.40%	1.40
Past due 0-90 days	80	5.00%	50.00%	2.50%	2.00
Past due 90-180 days	50	20.00%	50.00%	10.00%	5.00
Past due more than 180 days	20	60.00%	50.00%	30.00%	6.00
Total (mln EUR)	500				14.40

Total ECL provisions without credit insurance and collection services: EUR 14.40 mln

Good credit rating – Western Europe with credit insurance and debt collection services:
A) Insured part - 90% (based on the POD (0.04%) of the insurer and LGD (29%) of the debt collection agency)

Days past due	Trade Receivables	POD	LGD	ECL rate	ECL provisions
Amount not past due	315	0.04%	29.00%	0.01%	0.04
Past due 0-90 days	72	0.04%	29.00%	0.01%	0.01
Past due 90-180 days	45	0.04%	29.00%	0.01%	0.01
Past due more than 180 days	18	0.04%	29.00%	0.01%	0.00
Total (mln EUR)	450				0.05

Good credit rating – Western Europe with credit insurance and debt collection services:
B) Uninsured part - 10% (based the POD of buyers and LGD (29%) of the debt collection agency)

Days past due	Trade Receivables	POD	LGD	ECL rate	ECL provisions
Amount not past due	35	0.80%	29.00%	0.23%	0.08
Past due 0-90 days	8	5.00%	29.00%	1.45%	0.12
Past due 90-180 days	5	20.00%	29.00%	5.80%	0.29
Past due more than 180 days	2	60.00%	29.00%	17.40%	0.35
Total (mln EUR)	50				0.84

Total ECL provisions (A+B) with credit insurance and collection services: EUR 0.89 mln

As demonstrated in figures above, the ECL provisions
have decreased by 94% when including credit insurance and
collection services.

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