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IFRS 9 & COVID-19

Catalysts for Digital Transformation

How digitisation enables institutions to drastically improve their recovery rates, successfully comply with the new International Financial Reporting Standards (IFRS 9) requirements, and meet the challenges of a post-COVID-19 economy with confidence.

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Key Takeaway

- Under recent IFRS 9 requirements, institutions must account for expected credit losses (ECLs) in the future. Therefore, forward-thinking financial reporting has become critical in the wake of COVID-19.
- Digitisation allows institutions to appropriately categorise their assets, reduce the likelihood that performing loans become under- or non-performing, and allows them to maintain greater cash reserves — meaning they can offer more loans going forward.

The Global Economy in 2021

The global economy has been decimated by the impact of COVID-19. Government-mandated shutdowns have seen innumerable businesses close their doors for good. Furloughs and enforced layoffs mean that millions of people have lost their jobs.

However, in Europe, the full economic impact of COVID-19 is yet to be fully felt. EU governments responded to the crisis with expansive monetary and fiscal policies, for example, by introducing widespread loan moratoria.

This has offset at least some of the initial pain—but bad debts cannot be put on ice forever. According to the World Bank, we are slipping into the 'Quiet financial crisis'. They state: "Specifically, financial institutions around the world will continue to face a marked rise in non-performing loans (NPLs) for some time."

It has been reported that banks under the European Central Bank (ECB's) supervision had NPLs amounting to roughly €550 billion as of mid-2020. To put that into perspective, this represented almost 3% of their total loans.

€550 billion might not seem so bad — especially when you consider the fact that there was a €1 trillion peak in 2016. However, such optimism is short-sighted.

As the European Central Bank states: "The economic crisis caused by the coronavirus pandemic is likely to trigger a sharp increase in non-performing loans: under a severe but plausible scenario they could reach levels as high as €1.4 trillion by the end of 2022."

But there are more factors at play. Not only has COVID-19 meant a global tightening of the purse strings (with organisations slowing down spending due to the economic impact of the pandemic), but IFRS 9 requirements also mean that rising NPL volume will have a significant impact on financial reporting. Unsurprisingly, this will profoundly impact institutions' bottom lines and have broad implications in the context of IFRS 9.

As IFRS 9 requires early recognition of impairment losses, entities must make weighted calculations that predict how likely it is that a loan will become permanently devalued.

With impairment assets set to skyrocket in the aftermath of COVID-19, these IFRS 9 requirements pose a substantial challenge to the available capital of institutions. It has therefore never been more important to recover outstanding debts as quickly and cost-effectively as possible.

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Forward-thinking organisations are already leveraging digital solutions to encourage faster repayments, to gain data-driven insights into the default probability, and to maintain better visibility and tighter controls over their total loan portfolio.

This brings with it a multitude of benefits. Most importantly, however, it means that innovative organisations can:

1. Increase their recovery rates, reducing the likelihood of loan assets being classified as underperforming or non-performing loans;
2. Therefore, reducing the expected credit losses (ECLs) that they report, meaning less money has to be set aside for reserve requirements.

This whitepaper examines how digital transformation enables organisations to increase their recovery rate to mitigate the effects of COVID-19 on financial reporting, particularly with regards to IFRS 9.

A Brief Introduction to IFRS

IFRS 9 sought to reinvent the way in which financial instruments were reported. It came into effect on January 1st 2018, replacing its much-criticised predecessor, International Account Standards (IAS) 39.

IAS 39 was overtly retrospective, using an incurred loss impairment model to inform banks and financial institutions on what needed to be reported. It was derided by some as being "too complex, [and] inconsistent with the way entities manage their businesses and risks, and defers the recognition of credit losses on loans and receivables until too late in the credit cycle".

This meant that provisioning requirements were often "too little, too late". Additionally, it could be argued that reporting under IAS 39 was not truly representative of an organisation's finances and left too much room for interpretation.

IFRS 9, on the other hand, is forward-facing with an expected loss impairment model. It completely redefined how banks value loans (from incurred to expected), as well as how they calculate credit loss provisions. McKinsey labelled it "A silent revolution", arguing that it heralded the most important update yet to financial reporting within banking.

IFRS 9 completely redefined how banks value loans as well as how they calculate credit loss provisions

As banks and financial institutions already knew, IFRS 9 requirements have meant that since 2018, they have been required to account for expected losses from the first instance that the loans appear on their books.

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The precise measurements that are used depend on the individual asset's classification. Under IFRS 9 all assets are initially measured at fair value plus or minus, which is consistent with IAS 39. However, if certain conditions are met, IFRS 9 requires institutions to undertake two preliminary tests in order to further classify their debt instruments:

- **Business model test:**
  The model an organisation adopts determines the classification (fair value vs amortised) of a financial instrument. For example, is the entity's business model geared around holding assets so that they can collect cash flows? Or do they both collect cash flows as well as selling assets (i.e. selling off bad debts)? In the case of the latter, the organisation would adopt a "hold & sell" business model, which enables them to report simple debt at fair value on their balance sheet, protecting them from the volatility from changes in fair value being presented on income statements.

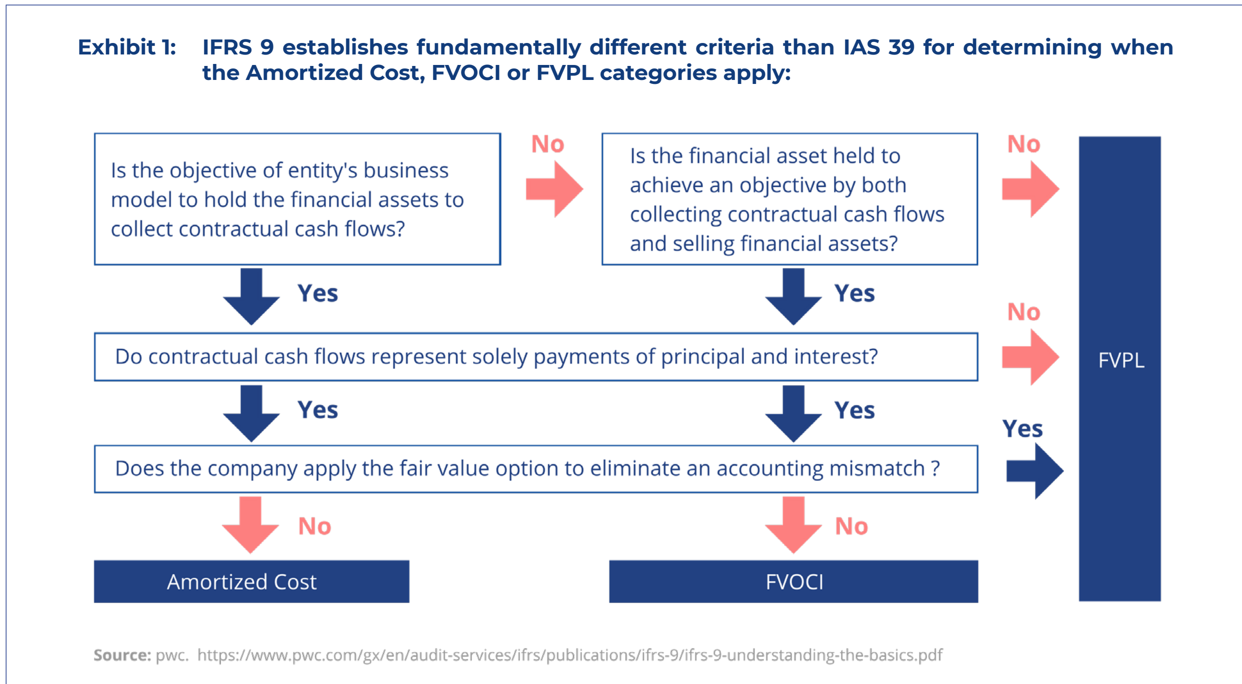
- **The Solely Payments of Principal and Interest (SPPI) test:**
  This seeks to examine whether or not the contractual cash flows of an asset solely relate to: "payments of principal and interest ("SPPI") on the principal amounts outstanding". This is used to determine if a debt instrument can be classified as simple debt, which necessitates the second step of classification.

Once a business has answered these two tests, they can then identify which specific category applies—before reporting their assets appropriately. Debt instruments under IFRS 9 can be classified in the following ways:

1. Financial assets at fair value through profit or loss (FVPL / FVTPL)
2. Financial assets at fair value through other comprehensive income (FVOCI / FVTOCI))
3. Amortised cost

If a debt instrument is classified as FVOCI/FVTOCI, it can be classified as "simple debt" and as stated earlier, must be included within an organisation's ECL Model. It must also be designated as such upon initial recognition.

Exhibit 1: IFRS 9 establishes fundamentally different criteria than IAS 39 for determining when the Amortized Cost, FVOCI or FVPL categories apply:



Source: pwc. https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-9/ifrs-9-understanding-the-basics.pdf

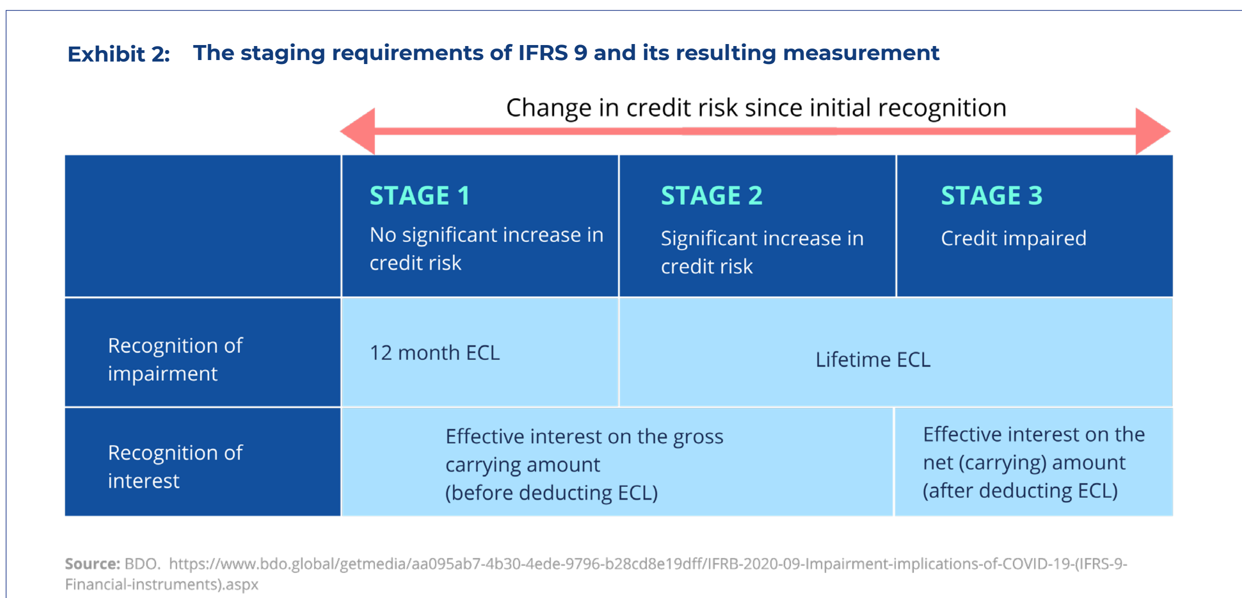
IFRS 9 has therefore introduced a new 'General' approach for impairment within an organisation's ECL Model. In short, assets (such as simple debt, like a loan or bond) can be classified in three distinct stages (or 'buckets').

Stage 1: Also known as "performing loans", these occur when a credit risk on a financial instrument has not significantly increased since its initial recognition. In this case, institutions are required to report a 12-month expected credit loss (ECL) at their reporting date. This should take into account any expected losses that may occur from default events that might potentially occur within the following 12 months.

Stage 2: Stage 2 includes all "underperforming loans". This would include any instances where the credit risk on a financial instrument has considerably increased since it was first recognised. For stage 2 assets, institutions must provide a lifetime ECL. This relates to the possibility of expected credit losses incurring throughout any stage of the asset's life. Interest revenue must also be calculated on the gross carrying amount, defined as: "the amortised cost of a financial asset before adjusting for any loss allowance".

Stage 3: Classed as credit-impaired—or non-performing—stage 3 financial assets require interest revenue to be calculated based on the amortised cost. In other words, while Stages 1 and 2 require effective interest on the gross carrying amount (before deducting ECL), Stage 3 requires effective interest on the net (carrying) amount (after deducting ECL).

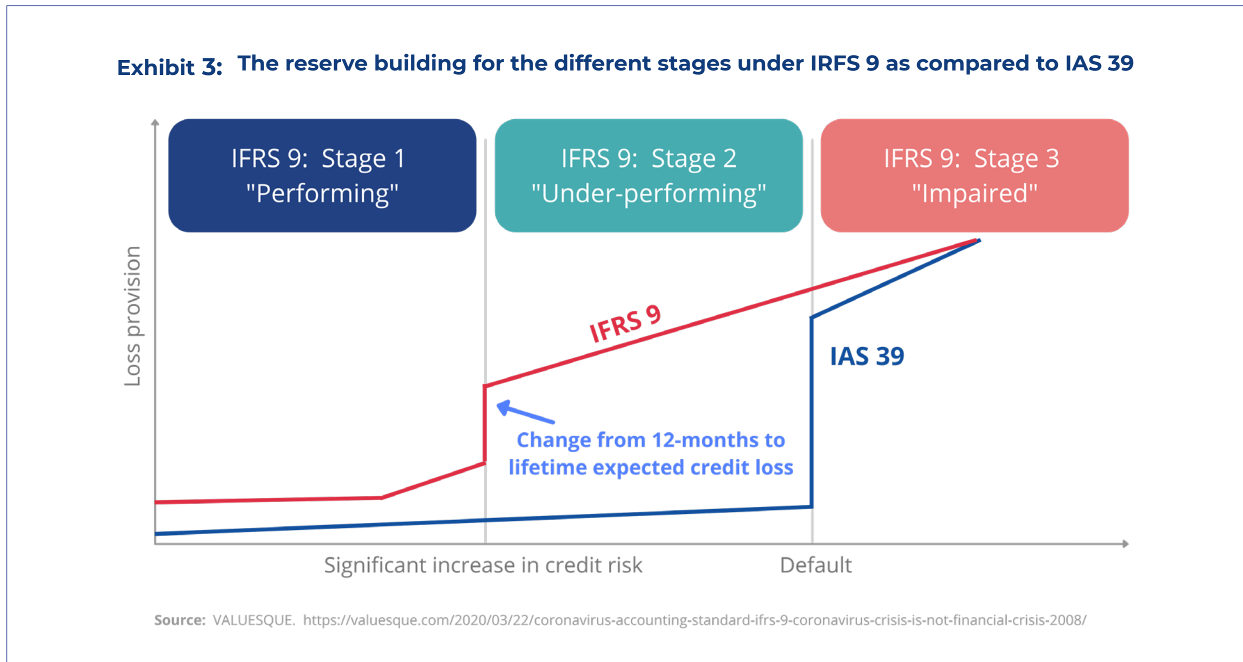
Exhibit 2: The staging requirements of IFRS 9 and its resulting measurement



Change in credit risk since initial recognition

	STAGE 1 No significant increase in credit risk	STAGE 2 Significant increase in credit risk	STAGE 3 Credit impaired
Recognition of impairment	12 month ECL	Lifetime ECL	
Recognition of interest	Effective interest on the gross carrying amount (before deducting ECL)		Effective interest on the net (carrying) amount (after deducting ECL)

Source: BDO. https://www.bdo.global/getmedia/aa095ab7-4b30-4ede-9796-b28cd8e19dff/IFRB-2020-09-Impairment-implications-of-COVID-19-(IFRS-9-Financial-instruments).aspx



How COVID-19 has Impacted IFRS 9 Compliance

ECL requirements stipulated in IFRS 9 will significantly impact lenders, consumers and the wider economy at large

Just as both financial institutions and non-financial institutions (NFIs) have begun to get to grips with IFRS 9, COVID-19 struck. Alongside the pandemic's wider impact on society, it looks set to fundamentally shift the way that institutions handle their financial reporting obligations for years to come.

In fact, according to BDO, "The effects of COVID-19 will require entities to adjust their assumptions and systems that interact with the measurement of expected credit losses (ECLs)."

IFRS 9 requires more overall transparency and is therefore viewed as a net positive for accurate reporting. However, it also mandates reserve requirements to cover expected credit losses (ECLs) and therefore allows for less available capital for lending.

Further, this implies there will be less money for macroeconomic recovery due to lower lending volume. Therefore, the ECL requirements stipulated in IFRS 9 will significantly impact lenders (banks, financial institutions, and NFIs), consumers and the wider economy at large.

Not only does IFRS 9 mandate institutions to restrict lending to maintain adequate capital reserves, it also makes the entire process of financial reporting undeniably more nuanced. Even though IFRS 9 was designed to create transparency and lead to more accurate reporting, it will take a while before this becomes a simple process.

There is no single formula to calculate 'Expected Credit Losses'. Nobody can predict the future—not even multinational banking corporations that prop up the global economy.

This is especially true in the aftermath of COVID-19. Imagine this scenario: a bank has just compiled its year-end financial statements for 31st March 2021. This outlines its loan portfolio, i.e. financial assets at amortised cost, with corresponding ECL calculations.

On April 10th, a new local government report was released detailing the total impact of COVID-19 on regional unemployment. It presents a bleak outlook—far bleaker than the outlook the bank adopted when calculating its ECL. It is clear that COVID-19 will have far more of an effect on the loan portfolio than initially thought.

Institutions in this scenario may well feel stuck between a rock and a hard place. The report was published after the period ended, but prior to the statements being fully completed. Now that the bank knows the full effects of COVID-19 on local employment, should it revise its ECL calculations?

The answer here would obviously be yes—but it raises a key issue: IFRS 9 compliance has just become significantly more dynamic. Institutions must quickly react to fast-changing times, rapidly getting up to speed with new information that might have an impact on their IFRS 9 reporting obligations. They need to be more agile and flexible and provide a level of granularity in their reporting like never before.

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So how can institutions stay on top of all key information when making ECL calculations? How can they ensure debts are repaid as quickly as possible, reducing the likelihood that Stage 1 assets will become Stage 2 or even Stage 3 assets?

By digitising their collections process and wider credit processes as a whole. Forward-thinking banks, financial institutions and NFIs are already leveraging digitisation to greatly ease the pressures of IFRS 9.

Digitising collections processes will enable organisations to have actionable, accurate data about their outstanding accounts. It will provide them with the tools they need to improve the speed and amount of recovery at scale.

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Therefore, in theory, their overall expected credit losses that need to be reported will decrease. This will in turn reduce their required cash reserves, eventually culminating in them being able to offer more loans.

How Digitisation Eases the Workload from IFRS 9 Requirements

IFRS 9 is more principles-based than its predecessor. It requires significantly more contextual judgments in its application—for instance, when calculating if a loan is performing, underperforming, or non-performing.

It was established this way to enable organisations to comply with the new reporting standards while enabling them to create ECL models that are unique and specific to their individual organisation. Rather than hard and fast rules about what reporting must happen, it is “the principle of the thing” that matters.

It is therefore essential that organisations have the best operational processes that enable categorising their outstanding accounts plus classifying in which stage these assets currently stand at scale.

Adopting a data-driven, digital-first approach will arm institutions with all they need to establish best-in-class operations and asset classification. Software will provide detailed insights into their current financial risks and credit expectations, allowing them to establish better ECL models.

In turn, this means that they can likely project lower expected credit losses, which implies less cash necessary in reserve. This capital can then be lent out—in other words, used to generate revenue—instead of staying under lock and key in the event that an asset does eventually become impaired.

To summarise, by embracing digitisation, institutions can:

1. More easily recognise high-risk assets;
2. Make accurate, data-driven future risk projections;
3. Quickly recover outstanding debts/NPLs, increasing overall operational efficacy to reduce potential and real losses;
4. Better steer customer outcomes.

Let us now examine the precise ways in which digitisation assists in reducing the impairment of financial assets and accelerates recovery rates.

Reducing the impairment of financial assets and accelerating recovery rates

IFRS 9 implies that both financial institutions & NFIs need to recover debts faster in order to limit increases in their expected credit losses and decrease the likelihood their assets fall into stage 2 or 3, anything past 30 DPD.

Lenders can recover debts faster by digitising the complete credit lifecycle and accounts receivable (A/R) processes through account-level management, customer self-service, and AI/ML-driven personalisation.

Digital transformation will:

1. Reduce their required reserve capital for expected credit losses
2. Increase the available loan volume that they can give out

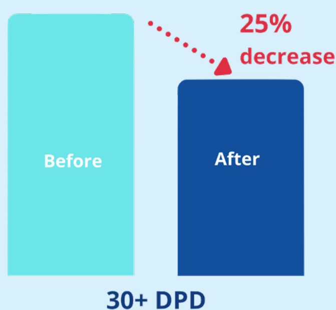
A quick example of the savings in required reserve capital when implementing a debt collection software.

Assuming a Phase 1 default risk of 20% plus an average loss of 60%

If an organisation can improve debt recovered by 25% in Stage 1, it can reduce the amount of reserve requirements in Stage 2 by 25% - allowing it to use the saved amount to offer more loans into the market.

(receeve clients generally sees larger improvement gains)

Capital Reserve Requirements under IFRS 9



Using data-driven account-level insights, collections departments can personalise their outreach—tailoring messages according to what resonates with each individual account. They can contact past-due customers on their preferred channels, using the tone of voice that works best for them and at a time that suits the customer.

Digitally-empowered institutions provide past-due customers with a range of potential payment methods to suit their own particular preferences. Some may prefer self-service options, while others would prefer to handle payments over live chat with an agent.

This ultimately increases the likelihood that customers will pay up in full sooner rather than later. It also greatly decreases any instances of "reactance", where a customer's need for agency is violated by having terms imposed on them (and so they refuse to pay in order to assert a sense of control).

Indeed, by using AI/ML-driven personalisation, self-service customer portals, and software-driven account-level management, finance professionals can accelerate their rate of recovery by as much as 30% in the first 2 weeks within 30DPD.

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Of course, dunning strategies must be tweaked and refined on an ongoing basis depending on a past-due customer's response (or lack of response).

Digital communication KPIs can be revelatory in this regard. A customer might have initially expressed a preference for conversing over email. However, when an agent digs into their account, they see that none of the 3 emails that your company has sent out has been opened.

As a result, the agent should consider discontinuing email outreach messages and instead opting for another alternative (like SMS messages).

Exhibit 4: Digital communication KPIs

Total email delivery rates

This total shows the percentage of E-Mails that have been delivered.

Email bounce rate

This total shows the percentage of emails that haven't been delivered.

Email open rates

This shows the percentage of emails that have been opened by a customer.

Email click-through rates

This shows the percentage or number of customers who have clicked a link or a call to action button on an email.

Traffic by source or channel

This metric shows where customers have come from – i.e. they've arrived on a payment landing page via email, SMS or a link included on a letter (direct visitors).

Landing page views

This figure shows how many customers visited the payment landing page.

Landing page conversions

This figure shows how many customers made a payment on the payment landing page.

Response time

This indicates how quickly it takes a customer to view an email or to make a payment.

Such detailed account-level measurement allows agents to refine their outreach strategy. By recovering older debts faster, institutions can better influence which stage of impairment (within the ECL model) their accounts fall under. Of course the best case scenario is all loans stay in stage 1 (under 30 DPD) rather than stage 2 or 3—higher stages require more expected credit loss to be reported over a longer timeframe (lifetime ECL vs 12 month ECL).

By recovering older debts faster, institutions can better influence which stage of impairment (within the ECL model) their accounts fall under

In fact, insights provided by digital tools help inform the entire credit lifecycle by giving real and actionable insight into account-level credit risk.

If a customer has not opened any of your dunning emails, they could be deemed to be fairly high-risk. This means that they warrant attention, fast—or else the assets connected to their account may have to be reported as under or non-performing.

Alternatively, perhaps they have opened your emails and even clicked through on a payment landing page. They still have not repaid what they owe, however. You eventually manage to get in touch with them and they explain that they are suffering temporary cash flow issues. With digital tools, it would be easy to establish an instalment plan and record this repayment method quickly, further decreasing the likelihood that this account would be under or non-performing.

Lastly, you might dig into another customer profile and see that they have made all pre-planned repayments up until this date. The account's past payment history may paint a contradictory picture to their current consistent payments, and with access to this information the risk around this account could be adjusted accordingly.

Digital tools providing account-level-management capabilities allow finance professionals to be as granular or as expansive as needed. Institutions can quickly gain insights into their overall loan portfolio performance, or drill down into the details relating to one particular past-due customer in a holistic, centralised platform.

Empowering collections teams

Digitisation does not just make lenders' financial reporting more accurate — it also makes their collections team vastly more efficient, as outlined above.

Increasing visibility at the account level eases the workload of your team who are working diligently to meet the recovery requirements demanded under IFRS 9 and COVID-19. Analysts can access the wealth of data at their fingertips to rapidly identify Stage 1 assets that are at risk of falling into Stage 2 or Stage 3. These past-due customers can then be prioritised, with collections managers quickly devising the ideal outreach strategy based on the customer's prior behaviour and preferences.

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COVID-19, IFRS 9, and NFIs

It is worth highlighting that while IFRS 9 affects financial institutions and banks most heavily, it is not limited in scope to those businesses alone.

Non-financial institutions (NFIs) must pay close attention to the requirements stipulated in IFRS 9, and have a strategy for complying with its standards going forward. In the wake of COVID-19, this is especially important.

However, the extent of IFRS 9 requirements on an NFI depends on the nature of the entity's financial assets. Therefore, NFIs must first know how their financial assets are to be measured and categorised under the first requirement of IFRS 9 — for example insurers also need to be aware of all IFRS 17 requirements.

Insurance companies must be mindful of the types of financial instruments they report — especially when it comes to debt versus equity instruments.

Equity instruments, like stocks, are always reported at fair value. Debt instruments (bonds and loans), on the other hand, must be pushed through the two step test mentioned above in order to determine if they are fair value or amortised.

Given that debt instruments can often form the majority of financial instruments within an insurance organisation, it is crucial that these institutions pay close attention to their IFRS 9 requirements. Indeed, if a debt instrument is classified as a "simple debt", an organisation must recognise and proactively account for expected credit loss — just like a financial institution.

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In essence, it is equally important for NFIs with diverse assets to digitise their financial operations as financial institutions, and for precisely the same reasons.

Conclusion

COVID-19 and IFRS 9 have both had a significant impact on the financial sector. Each has required institutions to make realistic and accurate predictions in an increasingly unpredictable world. And, the economic impacts of both can be greatly mitigated through the adoption of digital collections tools.

Innovative Banks, financial institutions, and NFIs leverage digital tools to:

1. Understand their customers' behaviour
2. Recover debts quicker and more cost-effectively than before;
3. Make accurate, data-driven predictions — not only enabling more precise outreach to high-risk past-due customers, but also ensuring more accurate expected credit losses be reported;
4. Ease the workload on their collections team, allowing them to focus on deriving targeted outreach strategies that resonate with individual past-due customers.

As a result, entire loan portfolio data is visible and updated on an ongoing basis, providing a reliable reflection of an institution's financial health. Agents can dive into a past-due customer's data as and when needed, understanding the complete picture regarding all of their outstanding debts and identifying those customers that require extra attention.

Behavioural analytics will outline the best methods for ensuring repayment. The content of outreach messages, frequency with which they are sent out, and channels used can be personalised according to each individual's preferences. All of these analytics can also be optimised automatically using built-in artificial intelligence to save time and money. It can even reduce the required headcount demanded by traditional collections departments. Headcount is currently the overwhelming highest expense within collections, so enabling reductions to this expense will have immediate positive effects on an organisation's bottom line.

Digital communication KPIs will indicate whether a strategy is actually working, reporting as an example, whether a past-due customer has opened outreach emails or clicked through on self-service payment links sent via SMS.

By leveraging digital technologies and data-driven insights, companies can reduce their impaired assets by improving recovery rates, in turn, reducing the expected credit losses they must project. They will ensure that as few assets as possible have to be classified as Stage 2 or Stage 3.

By leveraging digital technologies and data-driven insights, companies can reduce their impaired assets by improving recovery rates, in turn, reducing the ECLs they must project

Consequently, they will have to allocate less capital to meet their reserve requirements. This capital can be lent out, generating additional revenue instead of collecting dust in a bank account to cover losses that may or may not ever occur.

There has never been a better time for institutions to digitise their collections processes. But make no mistake, digitisation is not merely a nice-to-have—it is an imperative.

Of course, it is impossible for institutions to prevent all impairment losses. They must, however, do all in their power to reduce their reported losses as much as possible. Only digitisation provides institutions with a way to achieve this at scale.

Prepare for IFRS 9 requirements in the aftermath of COVID-19

If you're ready to embrace digital transformation, ensuring complete IFRS 9 compliance while reducing reported losses, then get in touch with our team at receeve today.

Our revolutionary platform empowers finance and collections leaders to embrace data-driven decision-making at all times. It enables next-level personalisation, allowing institutions to provide past-due customers with a range of repayment options.

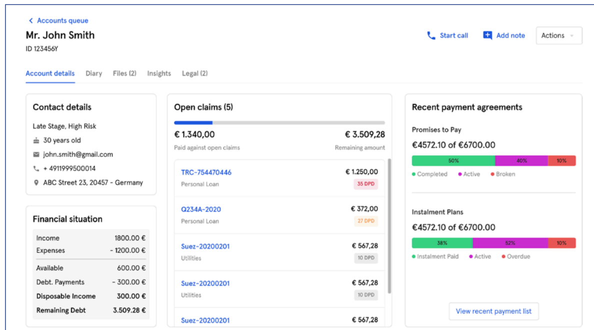
It offers total visibility, helping collections departments prioritise their attention and direct resources to where they are most needed. This maximises institutions' cash flow and liquidity, while also minimising reporting losses where possible.

Even better, our platform leverages AI to improve on an ongoing basis — learning from previous recovery implementations to fine-tune its own performance going forward.

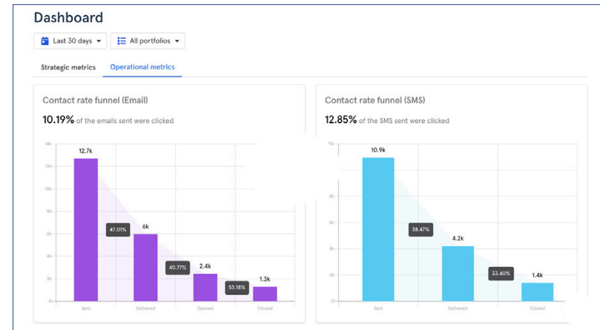
To find out more, visit receeve.com

Our Platform Features

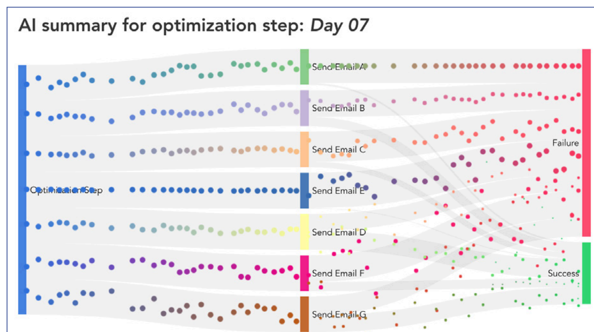
Important information is displayed for you to immediately grasp the context of the debtor during the conversation



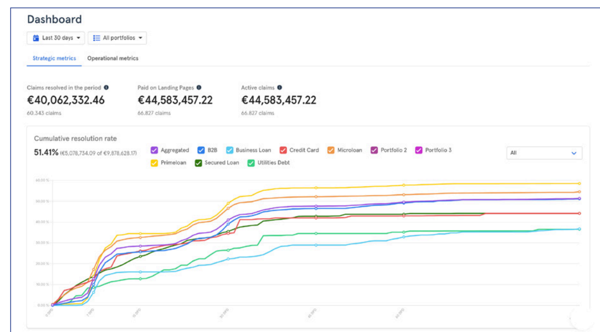
You can easily track customer behaviour via our insightful report and choose your best digital collections strategy



Our software analyses the effectiveness of each messaging and optimises the processes automatically



The performance of your collections rates are shown on the dashboard for you to optimise your approaches



If you want to learn more about leveraging AI to automate collections processes, improve cash flow and create a positive customer journey, schedule a demo with us today.

receeve is a fully customizable All-in-One Platform for Collections & Recovery. We simplify the growing complexity of data and systems and empower in-house teams to easily automate processes, engage customers and apply 360° insights to maximize recovery and minimize risk across every stage of credit management - from pre-delinquency to portfolio assignment or sale.

One Platform. A perfect balance of ease-of-use and power, receeve's cloud-native, no-code platform is fast to deploy, simple to manage and easy to customize and expand. Bring together intelligence, strategy and operations in one place.

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