IFRS 9 Implementation – How far along are you already?

IFRS 9 will become effective regarding the recognition of financial instruments on 1 January 2019. The replacement of the previous standard IAS 39 contains numerous measures, which corporate groups are currently implementing at full speed. Two and a half months before the "go live" date, it is time to take stock.

Which key measures and actions should already have been successfully implemented in connection with the conversion to IFRS 9?

Let’s first take a look at the project phase classification and evaluation. At this stage, management should have created appropriate portfolios of financial instruments and clearly defined the existing business models. In addition to clarifying special issues, such as the allocation of financial instruments in factoring, it goes without saying that adequate backtesting routines must be implemented to monitor the correct allocation to the business models. This is also the time to examine whether the requirement to meet the contractual cashflow criteria (SPPI) of the financial instruments has been fulfilled and documented. Furthermore, an appropriate design of controls and processes must be used to ensure that the cashflow criterion is properly reviewed at contract level also in the future.

With regard to the impairment project phase, most companies are still in the midst of finding and developing a model. As the deadline for a global roll-out of the new impairment provisions is approaching fast, at least the following steps should have been completed by now:

- Identification of all financial instruments in the impairment scope of IFRS 9
- Allocation of financial instruments to the General, Simplified or POCI approach
- Definition of significant increase in credit risk, event of default, cash shortfall and low credit risk
- Modelling of the Simplified and General Approach
- Data analysis of historical defaults or current market data on credit risk and forward-looking information
- Calculation of the impairment effects resulting from the conversion to the new expected credit loss model

In contrast, it is much easier for companies to implement the conversion measures in the hedge accounting project phase. A high-performance Treasury Management Systems (TMS) should be able to differentiate between spot and forward designations, to calculate cost of hedging components – in particular currency basis spreads – thus ensuring appropriate accounting for cash flow hedges and cost of hedging reserves. The definition of an effective hedging relationship in line with the respective risk management strategy should have been implemented and the company has defined what it considers to be a small time window for the inception of an underlying transaction.
And now, let’s take a look at the last two project phases disclosures and transition. In particular the disclosures project phase places significant demands on companies’ data availability and their financial reporting. At this point in the conversion project, the company should at least have identified which changes will occur in the Notes, whether the necessary data for the disclosure of the required information already exist in the reporting systems, and which steps will be necessary to make sure appropriate reporting functionalities exist by the “go live” date. What then remains is the Transition phase. At present, the focus is on the implementing measures for data archiving and data migration; here, the purely technical conversion component should not be underestimated in terms of its complexity. The necessary adjustment measures should by now have been identified in the standard chart of accounts and revising of the Group Reporting Packages should be in the final stages.

Two and a half months remain to tick all the boxes – let’s do it!
The system landscapes of many international companies often look very heterogeneous, usually as a result of strong operational growth.

Despite the many decentralized corporate units, companies usually strive to streamline and standardize their IT environment for strategic reasons. The goal is to become more cost-efficient and enable enterprise-wide transparency by reducing the number of interfaces and standardizing processes in the central system. This desire for transparency generally arises in Financial Accounting – and especially in Treasury – in order to meet the compliance and control as well as external regulatory requirements. In view of this background, the trend towards setting up central platforms in Treasury to replace the globally dispersed stand-alone solutions is an understandable move that bundles all risks that need to be managed. The advantages are obvious: just compare the compliance and efficiency levels of a dozen local electronic banking solutions to those of a central solution for global payment transactions with its standardized processes, formats and bank interfaces.

From theory to practice
So much for the theory of a standardized central system solution for corporate treasury based on uniform processes and technology. For globally active companies that need to master a project setting up a central treasury architecture, carrying out a global implementation project is far from trivial. The breadth of technical aspects that need to be addressed automatically lead to a very heterogeneous requirements profile; they range from day-to-day liquidity management issues to detailed treasury accounting issues, the consideration of local specificities in the individual national subsidiaries, such as differing regulatory requirements, the variety of currency exposures and liquidity flows or, for example, country-specific factors in payment transactions. The project team thus not only faces a number of technical challenges but also – and especially – conceptual ones. In addition, there is no panacea that sufficiently addresses these particularities to provide planning security. This is the main reason why many IT projects – not only in Treasury – tend to spin out of control sooner or later.

The straw that most managers clutch at is the magic word standardization. Mushrooming Treasury IT projects’ technical aspects, processes, system functionalities, project activities are all tamed by basing them on an imaginary standard. The only way to unleash the advantages of a centralized, global Treasury platform is by introducing company-specific process templates for the essential Treasury processes for the standard functions predefined in the Treasury Management System and to adapt them to the company’s own requirements. In this context it is crucial that the idea of standardization runs like a leitmotiv through all project activities. It is not cost-efficient to use process templates, leaving Treasury system settings in the standard configuration, but then later having to prepare training documents and test case catalogs from scratch. The use of standard templates must therefore be carried out over the entire project’s duration and all project steps. This begins with previously defined project plans or the scoping template for the precise specification of requirements and continues with best-practice templates for concepts and blueprints and ends with Treasury-specific technical
specifications (such as templates for the TMS rules for recognizing and valuing items) or test case catalogs.

**The balancing act between success and failure**
The advantages of standardization are obvious as it significantly increases the probability of a predictable and comparatively faster and cheaper system implementation project. Whether the project will be a success in the end depends on how well the system balances between standardization and local specificities. It should therefore not be forgotten that the use of templates naturally entails a number of risks: defining procedures and system functions without sufficient or timely involvement of local treasury process experts, or using only the system manufacturer’s specifications so that individual business-critical Treasury processes ultimately cannot be mapped in the TMS or can only be integrated in a convoluted manner, or that old local solutions exist in parallel with the newly implemented ones. Whenever standardization is strived for, the solution must be sufficiently flexible to accommodate all technical requirements. Functional compromises should remain the exception.

Admittedly, projects to build global treasury platforms will always be heterogeneous and complex. In this context, standardization is a means of reducing complexity that in combination with other project approaches such as the use of agile methods can significantly increase the project’s probability of success. However, especially in Treasury with its wide range of specialist topics and local specifics, it is important to avoid the other extreme – the ”standardization trap”. Many companies aim at reducing the duration and cost of implementing a Treasury system by using the plug-and-play approach, completely avoiding any adjustments to processes and system functions. Often, system modifications are indeed unnecessary. Relying on an often-imaginary standard, however, is not the right approach either, because the one-size-fits-all approach is indeed fictional. Rather, it should be called ”one size fits some”.

**So what now?**
As soon as the initial conception of a system architecture for Treasury has been completed and one or several systems have been chosen, the platform is built by using the selected modules, thus defining the company-specific standardization. There is an infinite number of templates and building instructions to choose from, which can then be adapted to individual needs. Yet it is comparable to a Lego set: just because you’ve got the bricks, doesn’t necessarily mean you know what kind of house you should build.
It is undisputed that treasurers like to call themselves risk managers, given the fact that they are dealing with risks related to foreign currencies, interest rates and liquidity as an important part of the core business. But what about credit risk management? Does this automatically mean that credit risk also belongs to the generally accepted Treasury landscape? Or would it be better consigned to the realm of operational controlling?

In its “Position Paper on the Definition of Treasury” of June 2017, the Association of German Treasurers takes a clear stance on this, seeing the tasks of managing financial risks decidedly falling into Treasury’s responsibility. This also includes customer credit risk as well as any related processes and tasks, such as creditworthiness assessments. In practice, this trend towards a stronger focus on credit risk issues has been apparent for some time now. For some companies, credit risk has already assumed a significance similar to managing forex and interest rate risks. This is partly due to the following reasons:

- **Increasing regulatory requirements**
  One of the main causes of the banking and financial crisis was the flawed valuation and inadequate monitoring of credit risk in the banks’ trading books. The regulators learnt from this, which is why IFRS 9, a new accounting standard for financial instruments, will come into force in 2018. It will also entail significant changes in how corporate credit risk positions are handled.

- **Benefit for further treasury processes, e.g. liquidity management**
  The quality of the planning regarding incoming payments for outstanding receivables combined with the corresponding payment behavior of customers is valuable information for professional liquidity planning. A precise understanding of customer payment history provides valuable information for improving the planning quality.

- **Changes in the IT landscape and availability of new technologies**
  Increasingly powerful systems are enabling an ever more professional credit risk management. The consolidation and use of Group-wide credit risk data is at the top of the task list – and Treasury already has sound experience in this type of thing from other processes, such as FX exposures or liquidity planning. Modern database and analysis technologies can provide new insights into risk factors and control mechanisms. This makes forecasts more accurate; combined with system-generated recommended actions and decisions, such innovations pave the way to Treasury 4.0.
However, who is ultimately responsible for credit risk is up to the respective Treasury department. In the following, we will present two aspects that are currently being widely discussed:

**Organizing credit risk management (centralized vs. decentralized)**

Due to the increasing importance of credit risk, the market frequently raises the issue of how the credit risk management function should be integrated structurally. Which activities are ideally carried out at subsidiary level and which ones should be managed by a central corporate function?

Despite the global trend towards centralization in various finance functions, subsidiaries and sales units display a strong sense of ownership. In fact, most areas of credit risk management are both centralized and local. Group Treasury or the central credit risk department should address all tasks relating to classic Treasury Management, i.e. strategy and governance (procedural or technical), aggregation of risks and limit systems, the use of IT systems as well as the development and making available of models used to calculate credit decision processes. Local units, on the other hand, are responsible for issues in which they benefit from direct contact with debtors, such as dunning, operative receivables management, individual value adjustments, factoring and updating creditworthiness information.

**Scoring as a quality factor**

Some of the most important activities in credit risk management revolve around the topic of scoring. Scoring simply means awarding points; in the context of credit risk, this means quantifying customer information to assess creditworthiness. It is therefore a question of quantifying various customer characteristics on a number scale to generate an objective "creditworthiness matrix" for the performance-relevant credit decisions and processes. While in the past only a minority of companies had implemented their own scoring models (instead of using external information as the basis for the credit decision), this approach is currently changing.

The scoring process is usually divided into three stages:

1. **Risk aggregation**: many sources of information may be taken into account for scoring (e.g. analysis of internal historical data, external credit reports, CDS spreads, country-specific and sector-specific trends). Each company has its own composition of information sources, as not every source offers added value regarding credit information for that specific company. However, it is important to actually include the relevant sources of information in the risk aggregation.

2. **Risk weighting**: The identified credit information must be weighted accordingly. For example, it is advisable to weight quantitative data higher than qualitative information, or to decrease the weighting of historical data depending on how recent it is.

3. **Risk classification**: The risk weighting results in a "credit score". However, this must be correctly interpreted and classified so that it can be mapped to a customer creditworthiness matrix and can therefore be used for credit or limit decisions and also becomes useful for calculating loss rates.

As already indicated, credit risk management has also become more of a focus in balance sheet management. IFRS 9 requires a credit risk-based measurement of trade receivables. A major innovation is that receivables are no longer valued according to the "Incurred Loss Model" (based on the past) but rather according to the (forward-looking) "Expected Loss Model". Comprehensive scoring and a correct transfer of the information into a credit rating matrix is also essential for this purpose.

Scoring is certainly not a new development in credit risk management. However, it is in constant flux, as the availability of scoring-relevant information and systems for evaluating this data are becoming more numerous. On the one hand, this calls for an increase in legal requirements for scoring models and on the other hand, it gives rise to pressure within the respective industry to implement competitive assessment methods. Only an exact risk assessment allows the consideration of bad-debt risk in price calculations – and Treasury has the expertise, methods and tools to implement this as far as risk assessment is concerned.
Conclusion
Credit risk management is twice as significant for Treasury as for other departments. On the one hand, regulatory standards require the implementation of credit risk-based models for accounting purposes. On the other hand, taking full advantage of the potential in already existing credit risk areas is an extremely exciting topic with very good prospects of success: here the proverbial "cash is king" applies, be it to improve the company’s position through precise scoring or to implement efficient credit risk management to reduce bad debt losses.