Atradius

Managing risk, enabling trade

Ten years ago, the world watched as companies considered too established to fail, did so, with aplomb. One decade on, the fallout from the 2008 'credit crunch' is still felt the world over. No surprise then, that much has been done to ensure that the financial impact on businesses of any future financial crisis is mitigated. New regulations and legislation have been put in place to help companies prepare for and manage bad debts whether they be sudden and unexpected, or predictable.

One such measure is IFRS 9, a new regulation for companies that report using IFRS accounting standards, which comes into force in January 2018. IFRS 9, besides other areas, encourages businesses to adopt processes, standards and models that more accurately calculate and provision for potential future trade credit losses.

The objective behind the new regulation is simple. To upgrade the trade credit risk provisioning process by requiring companies to comply with a new set of credit impairment principles. Businesses will need to have greater insight into the insolvency risk posed by their buyers and provision accordingly. In real terms, the idea is that as a result, trade credit risk will be more accurately and more transparently represented on a company's Balance Sheet than ever before.

What do businesses need to put in place?

The regulation introduces an upgrade of the current trade credit risk provisioning by moving from the 'incurred loss' model to the 'expected trade credit losses' model (ECL).

Under the incurred loss model companies often make no provisions at all for receivables that are not yet overdue. IFRS 9 is meant to ensure that the trade credit risk that is inherent in every single receivable is accounted and provisioned for, even if expected losses are low.

So, what do these new requirements demand? In simple terms, many businesses will need to modify their current trade credit information systems and processes in order to facilitate debt provision changes. For financial institutions, this will prove particularly challenging due to their substantial exposure to trade credit risk. For non-financial organisations, it's significantly less complicated and is something that your trade credit insurer can really help with.

Andreas Tesch, CMO of leading global trade credit insurer Atradius, explains:

> *"To date, many companies have relied on a 'trigger event' such as an invoice becoming overdue, before making a bad debt reserve for the particular buyer. Historically, this has been deemed perfectly acceptable practice – however, the new regulation will require businesses to provision based on the overall level of credit risk in the receivables portfolio from January 2018 onwards, and not just based on the overdue ones."*

For businesses seeking a clear, simple route forward on IFRS 9, one which streamlines process and alleviates the need to make choices from a multitude available, partnering with a trade credit insurer and collections agency has obvious advantages

"Companies will need to take into account all of their receivables and all of their buyers when calculating their expected trade credit loss. So, insight into the likelihood of your buyer defaulting on payment and the health of your overall portfolio, becomes vital. We have a wealth of information and expertise at our fingertips, that will help companies to do this."

Let's look at some of the things businesses currently face in order to become IFRS 9 compliant.

The challenges

One of the biggest challenges faced by financial and non-financial organisations alike is that this regulation is 'principle based'. It doesn't provide clear definitions or processes to follow, in order to be compliant. And whilst there is a positive in that this gives companies flexibility to establish what they deem to be the best route for their particular organisation, there also exists the downside that a multitude of decisions need to be made regarding the methodologies to be put in place, requiring significant time and resources in order to build the model that still needs to be approved by auditors.

The next major challenge facing finance teams will be to obtain the right kind of data. There are a number of facets a business will examine in order to determine buyer quality. Probability of default information and loss given default details will become important, along with other external risk factors such as macroeconomic developments. Data analysis will need to be consistent across regions while still considering sector specific factors and ensuring transparency and auditability of the underlying processes.

Once data requirements are in place, the third challenge is determining how to model all of the trade credit risk parameters needed for the calculations of ECL (ie. the bad debt reserves). The business has a number of modelling approaches to choose from, each potentially leading to different values for the ECL estimates. The calculations used in the model are likely to include segmentation by geography, sector, product type or customer rating, will have to be auditable and will need to provide all the details required for making IFRS 9 disclosures.

The final hurdle is then to embed this as a process across the organisation so that it quickly becomes 'business as usual' without creating entire internal 'mini industries' in order to meet the requirements. In a global organisation with thousands of customers, potentially spread across diverse sectors and segments, this part is potentially the most critical, as it could prove both costly and damaging if unwieldy or inefficient processes are implemented.

The solutions

Putting measures in place in order to comply with IFRS 9 can be complex: but it needn't be the case.

Atradius CMO, Andreas Tesch, explains how trade credit insurance and outsourced collections can help businesses address the bad debt provisioning challenges of IFRS 9.

> *"We talk daily to Financial Directors the world over and IFRS 9 needn't be as much of a hurdle as businesses might suppose. We are here to help and our customers are positioned to benefit from three key parts of our offering. Trade credit insurance, debt collections and business intelligence can play a role in terms of robust reporting, forecasting and provisioning."*

Here's how.

Trade credit insurance: less risk, more value

Trade credit insured businesses enjoy the benefits of reduced risk via insurance and buyer ratings delivering the necessary buyer information for calculation of expected trade credit losses under IFRS 9. The combination saves the company time – in most cases Atradius Credit Insurance customers can get a rating on their buyer in minutes through the Atradius Atrium customer portal – and can reduce the capital tied up in reserves as the amount at risk can be significantly reduced by the insurance.

Reduced bad debt reserve requirements

Trade credit insurance alone means that a business's debt provisions can be lower as the risk is transferred to the insurer, instantly putting a business in a stronger position. But there is also a clear additional benefit in partnering with a trade credit insurer for debt collection - which is something Atradius also offers as standard to trade credit insurance policyholders and as a stand-alone service for non-insured businesses. Being able to demonstrate strong success rates in your historical debt collections reduces 'loss given default' levels and subsequently the bad debt reserve requirement. So a business's position is strengthened considerably with an effective debt collection solution in place, once again, helping lower bad debt reserve requirements.

Business intelligence, the way you need it

This is perhaps the biggest hurdle for many companies faced with putting measures in place. Geography, diverse providers and methodologies, inconsistent models – they can all create a headache for the most prudent Financial Director struggling with multiple data sets based on a number of different parameters. Atradius's Buyer Ratings provide a snapshot of the likelihood of a buyer going into default.

This simple measurement tool is embedded in Atradius's trade credit insurance policy offering, and can be used to help businesses meet their IFRS 9 requirements, i.e. as one of the factors used in calculation of the expected trade credit loss. With real time intelligence on around 240 million businesses around the globe, there is a clear benefit to integrating Atradius solutions into a business's knowledge and reporting, rather than attempting to go it alone.

Conclusion

For businesses seeking a clear, simple route forward on IFRS 9, one which streamlines process and alleviates the need to make choices from a multitude available, partnering with a trade credit insurer and collections agency has obvious advantages. Ultimately, these solutions could result in a major improvement in expected trade credit loss methodology and can have a positive impact on P&L volatility. There is also a benefit to having an independent external source, as it, increases the robustness of the entire process.

Andreas Tesch summarises:

> *"For finance teams faced with selecting from an abundance of models, methodologies and providers around the globe, our message is clear: talk to us first. We have what you need. The beauty of what we can offer is that we have the information required at our fingertips, ready for businesses to use in their own systems. We'll work with you to reduce complexity from the entire process, lower your provisioning requirements, save you time, and most importantly, give you one less thing to worry about."*

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