KPMG

Customer Credit Risk Management

From the static risk view to a driver-based risk management

Finance- and Treasury Management Switzerland

Customer credit risk management consists of a rather static operational processing of credit limit decisions – at least, that is how companies have traditionally been implementing it this far.

However, with the technical possibilities currently enabling a flexible KPI reporting on credit risk, measures can also be targeted for balanced and dynamic risk management. The decisive factors for this are a clean and comprehensive database and the right analytical tools.

Reporting only the status quo means stagnation

The daily routine of a credit manager is characterized by the appraisal of existing high-risk customers or the risk assessment of new customers. The whole process often takes place on the basis of individual considerations, taking into account external ratings, payment behavior and open items. Genuine risk management is carried out only when a trigger event occurs, such as a system message that a customer is on the brink of exceeding a previously defined credit limit.

Current standard software adequately maps this information need, for example, in the form of scorecards, which graphically present the development of payment behavior, the industry and external ratings. This can then be used to quickly and intuitively carry out customer risk assessments.

This form of reporting provides answers to operational questions, such as the ratio of the credit line granted to the exposure incurred by major customers. However, such evaluations are often static and primarily only of immediate use on a granular level in the day-to-day business of credit management. On the other hand, ad-hoc reports for Management are often time-consuming and have to be implemented together with IT and departmental resources, posing real challenges in the daily work of a credit manager.

This begs the question: how else could this be solved? What other information could be extracted from aggregated master data, receivables and accounts receivable accounting? And how could this information be used?

For example, instead of using customer scorecards, a skillful aggregation and visualization of data would make it possible to look at global exposure. Detailed management reports at different levels of aggregation are not an unrealistic vision of the future if using data analytics.

What could such a use case look like?

- Flexible selection of the exposure modules (open items, purchase orders, outstanding deliveries and collateral) for a differentiated view

- Calculation of the exposure at risk (cumulative exposure less the sum of the collateralized exposure)
- Consideration of possibilities at different aggregation levels (e.g. corporate exposure vs. entity exposure)
- Creation of a future exposure forecasts using predictive analytics methods
- If the forecast exposure is in a foreign currency, it would be possible to look at forecast FX rates by directly integrating market data

Various background (monitoring) bots could be used to optimize the process of creating reports. These bots could generate automated standard reports on the one hand, and on the other hand alarm the responsible functions and trigger a defined risk management process if, for instance, payment behaviors, industry developments or customer rating were to deteriorate. Tangible proposals to reduce risk could be sent directly to the credit manager, who could use this detailed and targeted information to make a sound decision.

How analytics can help answer important questions

Data analytics is being used by pretty much in every area of the company. New technologies in the field of data processing and data analytics are already opening up opportunities and possibilities in corporate management. But what do these opportunities look like in the area of customer credit risk management? To begin with, we identified three basic questions that can be answered using analytical methods:

1. **What is the group-wide exposure-at-risk?**
   Is the existing hedging strategy the right one? Is the risk appetite appropriate in view of the market situation? Or are opportunity costs possibly incurred due to incorrect risk assessments, which leads to "missed" contracts and thus lost revenue? Today, such questions are often answered based on gut feelings. By determining the exposure-at-risk at Group level, in combination with sector and country developments, it is possible to create a sound basis for decision-making.
2. **How precise are my accounting value adjustments?**
   Have balance sheet profits been reduced by excessively high write-downs of outstanding receivables? Especially with the introduction of IFRS 9, value adjustment rates in accounting are currently a much discussed topic. Here, too, depreciation rates are often estimated on the basis of many years of experience, but are difficult to reconstruct empirically. This is primarily due to receivables that have already been written off: here, the numbers of the accounts receivable and the payments still received after the write-off (= extraordinary income) at times significantly differ from each other. The resulting lack of transparency then complicates credit management.
3. **How does the (group-wide) receivables portfolio develop over time?**
   Does the portfolio tend to become younger (or is it aging)? Why is this? Is there a major growth in creditworthy customers? Or has the payment behavior of existing customers improved? Questions such as these frequently arise when defining a global strategy in receivables management, on the basis of which decisions must be made regarding collateral, target payment standards or the handling of payment agreements.

   We can see from these three examples that the variety and complexity of such questions has generally increased. However, because the use of data analytics technologies is so flexible, it also facilitates the implementation and handling of appropriate instruments for answering precisely these questions, thus creating new bases for decision-making at management level.

So what are the benefits?

What is certain is that Management's need for transparency and information is also increasing when it comes to more detailed questions; these can only be answered with the appropriate tools. The catchphrase is therefore: driver-based control when dealing with credit management decisions. This does not mean taking a global standard measure (e.g. "reduce all payment terms by 10%"), but deriving the most effective and efficient measures possible from reporting (e.g. "reduce payment terms by 10% for customers who tend to settle open items before payment targets").

Differentiated action is only possible with a precise, complete and correct information base as a starting point for decision-making. This is the only way to cultivate a targeted market development. Obtaining effective and efficient measures tailored to the achievement of objectives instead of global "one-size-fits-all" activities thus becomes the norm.

Apart from making the decision-making process of credit management much more agile, analytics also enable the validation and ultimately the optimization of the group-wide hedging strategy for open items by providing insights into local exposures and collateral. For example, it is possible to cut costs when collateralizing receivables (cost-optimized factoring, etc.) and to make synergy effects visible across countries.

Multi-dimensional transparency in reporting and closer, automated (bot-supported) monitoring will lead to better information and decision-making bases that enable faster, more targeted action in crises, thus proactively preventing loan defaults. The result is not only a permanent reduction in losses due to defaults but also a potential increase in turnover, as (new) customer risks can be better assessed at the time when contracts are concluded.

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Is your banking partner still the perfect match?

Why lifelong loyalty is not always the right way

Finance- and Treasury Management Switzerland

Treasury and its banks often appear to be an inseparable relationship. Since the partnership has frequently grown over years, many companies are slow in realizing that they have since outgrown it and that their bank partner(s) no longer fit(s) corporate strategy.

In the following, we will highlight why you should regularly analyze your banking relationship and the services offered, which factors you should keep in mind and which banking strategy is recommended for your company.

A decisive relationship

Your banking partner (or often, your various banking partners) is a key component of the company and greatly influences day-to-day business, especially regarding cash management. However, the significance of the relationship goes far beyond this. A company's possible strategic orientation and future development also depend to a large extent on its banking relationship and access to the capital markets. For instance, a banking partner's support is indispensable when it comes to financing acquisitions or other expansion projects. On the operational side, a bank's geographical presence and coverage of local requirements are important elements. Since regulatory requirements in many countries require a physical presence of the bank for tax or salary payments, your banking partner must have a suitable branch network to ensure smooth business operations. One question you should therefore regularly ask yourself is: "Can my banking partner support my company's next strategic steps, or is this relationship already at its limit?"

An analysis should be based on a detailed recording of all local and global requirements, and corresponding prioritization. Which aspect should be prioritized first? Transparency on liquidity, the centralization of liquidity (and thus its availability) or simply interest rate optimization?

Cash management in particular is highly dependent on the individual service and performance of the respective bank. A wide range of requirements (which subsidiaries also expect of banking services beyond cash management) should be considered: guarantees, financing instruments and payment transactions with their various payment types and formats, etc.

Such an analysis should be performed at an early stage in order to identify any banking service gaps early on and, thus, to avoid the potential hindering of attainment of strategic goals.

A common problem we have recently observed is the following: As part of a bank rationalization process, an international company had selected a small number of banks to support further expansion.

Due to their client's organic growth and changes in the local business model, the bank(s) were quickly faced with a number of new challenges. The global partner bank could not fulfil a number of new requirements, such as the required branch network, cash withdrawal solutions or local corporate credit cards. While it would have been possible to find solutions to individual problems, the overall number of issues no longer justified continuing the relationship, which is why new local banks had to be selected. The original idea of a single-bank approach thus had to be abandoned.

Rationalization and back: Multi-banking

Following the long-lasting trend towards rationalizing banking relationships, we now observe that many international companies are moving towards so-called multi-banking, where several banking partners are used, depending on countries and local requirements. Multi-banking is not a completely new approach, but the reasons for companies to opt for this strategy are now very different from ten years ago.

Contrary to what many would suspect, the reason for this is not risk management (especially in view of the financial crisis), and thus risk mitigation, but rather the fact that large global banks cannot meet all local requirements, despite advertising extensive networks of local banks with which they cooperate.

The promise was that these local partners (or large partner banks) would meet all conceivable local requirements. Unfortunately, reality is often different. Regardless of whether the corporation is dealing with a single bank or multiple banking partners, individual negotiations and contracts must in most cases be managed singly. For example, the Know Your Customer (KYC) process demands varying levels of effort, depending on the country in which the bank is located. KYC requirements have made opening a new corporate account a long and complex process. Banks need an average of one month (rule of thumb) to complete the onboarding process. In addition to the time factor, customers are also asked to provide unimaginable amounts of information and data. Interestingly, the scope and content of the information to be provided varies from institution to institution - and even within an institution - from one European country to another. The reasons for this are central bank policies in the respective country, on the one hand, and the bank's own compliance requirements, on the other hand. If, for example, you have an account with a renowned European bank in both Germany and the Netherlands, the managing director will still have to appear in person in order to open another account in Belgium, for example.

Even the connection to the banking portals within the same banking group can often only be implemented with great difficulty. In addition, different online banking systems are often in use, depending on the country.

In scenarios such as the one described above, we do not see any advantage in a single-bank approach in view of the complexity involved and therefore advise against it.

Single-bank approach is not the future

In order to find the right banking partner(s), the first step must therefore be to clarify one's own objectives and strategic plans. However, treasurers often hesitate to carry out a detailed analysis of local requirements involving cash withdrawals, credit cards, the branch network, local payments, card terminals, legal issues, etc. For many, it seems more important (especially under time pressure) to make "rapid" progress in order to be able to present management with tangible progress in the implementation process.

In the example given above, long after the strategic bank had been selected and implementation was in full swing, the corporation realized that the selected banking partner could not support all local requirements (such as branches in peripheral areas). The firm's subsidiaries understandably had reason to reject head office's proposed solutions and did so accordingly.

As a result, the solution that was finally implemented became significantly more expensive than planned. Earlier involvement of local units would have facilitated both identification of specific local requirements and ensured the buy-in and support of the local units.

Conclusion

A single-bank approach is a bit of a pipe dream and remains elusive if it conflicts with business needs. A multi-bank approach entails considerable implementation efforts. As a result, operating expenses are higher if a company wants to ensure efficient and central liquidity management, even if operational processes can almost be completely automated with the corresponding system support.

In the end only one thing counts, namely that a company's subsidiaries can run their business efficiently. This does not exclude central managerial responsibility, the central appointment of a banking partner, or the central provision of systems. On the contrary, they guarantee compliance and efficiency.

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