



Fault Lines in Finance

Is Geopolitics on Your Credit Risk Radar?

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Abstract

The world is shifting – from a global pandemic to a full-blown military conflict in Europe that questions the international order we’ve known since World War 2. Both phenomena have greatly impacted businesses worldwide in their own way: Uprooting our assumptions, contributing to inflation, and disrupting supply chains. The shift is also impacting the world of corporate financing and liquidity. High prices on the one hand and tightening monetary policy on the other, are increasing the risk for customer payment default and higher DSO.

When political and economic instability meet the office of the credit and risk manager, they need to be ready to navigate the fault lines in finance. In this article, we will explore how current geopolitical escalations, supply chain disruptions and inflation impact corporate finance and what credit and risk managers can do to control the impact on their business.

From Invasion to Inflation – Making Sense of the Current Multifaceted Risk Landscape

In a highly dynamic world economy with fluctuating risk, credit and risk managers must factor in all kinds of market volatilities, while also processing credit limit applications for individual customers. They have to determine how this volatility could possibly affect their organizations' customer debt portfolio and financial stability and analyze the available data to control the impact of these interconnected risk factors. How effectively they perform their analysis will determine the success of their organization as a whole in uncertain times. To estimate how current market instabilities pose risk for corporate finance, we want to look closer at sanctions, supply chain disruptions and inflation, and how they influence each other.

Sanctions and Trade Volatility

Geopolitics is back – and it is affecting trade and markets globally. After the recent Russian invasion of Ukraine, Western countries initiated a series of economic and financial sanctions. These sanctions include: A ban on secondary trade in Russian government bonds, limits on key Russian banks, prohibiting the export of critical technology to Russia, and freezing the assets of Russians oligarchs. The list of sanctions is growing longer by the day and by now, sanctions against the Central Bank of Russia (CBR) have become a central focus area. It is now nearly impossible for the CBR to obtain access to its foreign reserves, of which a sizable share is held in other countries and currencies – mostly dollars, euros and pounds. This makes Russia's currency (the ruble) vulnerable to collapse, which could trigger a run on their domestic banks.

For now, the sanctions deliberately try to carve-out energy-related transactions, hoping to avoid further swings in energy prices and keeping oil and gas flowing from Russia to the West – although bans are being discussed even here. Nevertheless, the prices of oil and natural gas have increased further, staying in line with “safe” currencies, like the US dollar which rose in value. Financial markets have reacted harshly to the military attack, and it is possible that there will be further international fallout due to further sanctions and counter-sanctions. To date, S&P has downgraded Russian sovereign debt to junk status. Equity trading is suspended on the Moscow Exchange and capital control has been implemented, meaning that Russians are unable to send money abroad and cannot service debt that is held in foreign currency. On top of that, most Russian banks lost access to the financial messaging system SWIFT, which is essential for international trade and currency movements across borders. It is questionable whether Russian banks and businesses will be able to fulfill their obligations, or if they will default on their debt. Even though trade between the US and Russia, for example, is rather low compared to other countries and markets, oil imports from Russia and affected supply chains will likely result in new price hikes, which could pose risk for global corporates as well.

The Disruptions of Global Supply Chains

The pandemic has already put supply chains under extreme strain due to the initial collapse and subsequent surge in consumer demand. This triggered a significant scarcity of different manufacturing components, followed by order backlogs, delays in shipping and delivery, and rising costs for transportation and consumer goods. The US and EU are currently the most exposed to supply chain risk, according to the Statista Supply Chain Index, yet all regions are

affected. This makes clear that the level of disruption globally remains high. The Supply Chain Vulnerability Index by GlobalData even identifies the US as the nation most vulnerable to supply chain instability worldwide. According to global credit insurer Euler Hermes, global disruptions will most likely remain high throughout 2022.

The dramatic disruption caused by the pandemic goes hand in hand with a greater paradigm shift in supply chain management: In the past, government policies were focused purely on measures that facilitate trade, but lately there has been a surge in protectionism. Systemic confrontations between western democracies and powerful authoritarian polities in the East (China and Russia) are on the rise, and they can unpredictably impact trade and business reliability. Cost – shipping items as cheaply as possible – is not the only concern for businesses anymore. Other considerations are increasingly coming into play. And it is uncertain how technology – digital transformation, automation, artificial intelligence and robotics – will change logistic management in the future.

Skyrocketing Inflation and Tightening Monetary Policy

Currently, we see geopolitical tensions taking the form of military conflicts and sanctions that will possibly result in shortages of certain goods. When these tensions come together with a still fluctuating demand that impacts supply chains as well, it will drive up prices and create levels of inflation we have not seen in the US in the last 40 years. By December 2021 US inflation, as measured by the US consumer price index (CPI), had reached an all-time high of 7.0% (up by 5.6 percentage points since January 2021) – with 2.2 percentage points stemming from energy inflation, making up around one-third of the United States headline inflation in that month.

Global credit insurer Euler Hermes estimates that inflation will remain above 2% until late 2023. If commodity prices, wages and interest rates keep rising, specific sectoral risk could increase as well in industries such as construction, power, metals and transport. Food manufacturing, chemicals and automotive would also be at risk because of their reliance on metal and other raw material components. As the central banks raise interest rates, this will translate into gradually increased financing costs for corporates, which could possibly lead to liquidity and profitability crunches, depending on the organizations' debt structure and interest expenses.

Looking ahead, the current escalation between Russia, Ukraine and the West can further exacerbate inflationary pressure due to another surge in energy prices and disrupted supply chains for energy, food and critical minerals.

Controlling the Impact: What Credit and Risk Managers Can Do

As laid out above in detail, geopolitical tensions, supply chain disruptions and inflation are interconnected and strongly influence one another. Next to refinancing problems, corporate cash flow risks will come from late payments or defaults in their debt portfolio due to customers who are affected by these instabilities. Just like the pandemic before, all of these factors will destabilize the global economy and trigger uncertainty and supply chain disruptions due to trade restrictions and shortages. Further, hikes of inflation will threaten businesses that have nothing to

do, for instance, with the war in Ukraine. The biggest risk will be for companies that experience severe supply chain disruptions or that cannot afford the rising prices for raw materials or other goods. These companies will be at risk of insolvency – or at least will be more likely to default on their payment obligations to their suppliers. Every credit and risk manager needs to keep this in mind. Even if you deem your business to be safe because you are not affected by sanctions or because you can absorb the effect of inflation, your customers might be in a much different position. Their supply chains could be breaking down, or they might feel the impact of sanction-related compliance risk. Some customers might even have to suspend payments to their business partners altogether because of liquidity squeezes.

Therefore, credit managers need to make sure, on a daily basis, that the customer's credit limit is still in line with the actual default risk and check whether new data or developments suggest otherwise. Risk managers will need to evaluate how financial, sectoral, economical and political risks will affect their business on different levels. Compliance managers, on the other hand, will have to make sure that all business relations are in line with corporate compliance policies, by rigorously screening and analyzing their clients and business partners. They will need to regularly ensure that no one is phased by the latest round of sanctions or other punitive measures, especially in a dynamic situation like we have right now. So, what can experts in credit and risk management do to weather the storm?

Secure Your Receivables with Credit Insurances

Aside from regular credit and compliance due diligence practices, a strong trade credit insurance is a very effective instrument to mitigate trade and cash flow risk. Credit insurances compensate you in case of payment default and bad debt. This insurance improves the ratio of corporate working capital ratio and financial stability, reducing cash flow volatility and improving your position towards finance institutes and shareholders. How does this work? Generally speaking, the credit insurer analyzes the creditworthiness and financial strength of your insurable customer portfolio. They are assigned certain credit limits which make up the indemnifiable amount in case of default. Your credit risk is covered to a certain limit, which allows you to continue to safely carry on trading with your customers. In addition, credit insurers provide you with solvency and financial stability data, which can help you adjust your credit decisions – a truly valuable service in times of high economic and financial volatility.

Factoring Insurance for Receivables

Another option to avoid debt default is to put up an agreement with a third-party company to obtain your receivables – namely factoring insurance for receivables. This can be set up for selected positions in your debt portfolio and isolated instances or be done on an ongoing basis. The idea is simple: A factoring institute will purchase your receivables, usually at a reduced amount of the invoices' face value, enabling you to outsource your credit risk. The cash is provided in advance, typically ranging from 70% to 90% of the receivables' original value. Once the debt is collected by the factoring institute, the factor returns the balance, excluding their service fee. These fees can range from 1% to 10%, depending on various components. Factoring provides your company with immediate liquidity, while the factoring institute assumes full risk

of loss within an agreed limit. It offers effective protection against payment defaults, which can add security in times of high trade and market instability.

Process Agility and Deep Automation

Whether you are managing credit insurances or doing factoring, compliance screening or regular credit due diligence using manual processes will make it difficult for your business to react to market risk in real-time. Your processes will need to be agile and up-to-speed to be able to perform effectively in unstable market conditions. Your processes should be standardized as much as possible, so that tasks are done the same way across the entire organization. Standardization leads to better quality, comparability and auditability. It also makes credit and risk decisions more effective on a global scale. It avoids *ad-hoc* decision-making and ensures that credit limits and risk control measures are based on a coherent corporate policy that every credit and risk manager can follow.

Even a highly standardized process, however, will not serve you well if there are external shocks and your processes remain completely manual. Process agility can only be achieved by implementing a certain level of automation. Once automation is in place, you can focus on data analysis, insight and informed decision-making rather than, for instance, calculating a risk score by manually copy-pasting data from credit insurers, compliance list providers or credit reference agencies into Excel spreadsheets. These back-office processes need to run smoothly and automatically so you can retrieve information with the click of a button when you need it. Luckily, technologies such as robotic process automation (RPA) can easily automate a majority of rule-based processes (e.g., credit data sourcing). Artificial intelligence (AI) and machine learning (ML) can make decision-making even more accurate and precise. These technologies can factor in past experience and historic data to deliver greater insights and predict potential developments. All of this helps you focus on what is really important and allows quick reaction to changing risk landscapes.

Get Your Data on Point with a Single Source of Truth

Information is of the essence in a dynamic and quickly changing risk environment. You need real-time information on what is happening. For credit managers, this means broadening the scope of the data that is reviewed. You will need both internal data, such as payment history, behavior and experience information, as well as external data from credit rating agencies. Integrate financial analysis, credit insurances, credit securities and collateral management into your decision-making process as well. Ensure that your risk and compliance managers have real-time access to blacklists and sanction lists to identify politically exposed persons (PEP).

With more manual process being automated, such as data sourcing, we see credit and risk managers becoming true data scientists. They will be able to pull a broad range of business information from different sources to gain an accurate picture of possible risk. Centralized solutions will enable global organizations to provide every user with access to the same information throughout the organization. This will make collaboration much easier for global teams if they have a centralized system for credit and risk data evaluation. Centralization is also necessary to ensure the same level of quality in credit decisions throughout the organization.

A centralized credit and risk management system enables companies to manage global portfolios, monitor credit and compliance risk, and respond quickly in case of status changes. It is also ensuring that organizations have the time and information they need to mitigate risk and align internal communications.

Conclusion

Risk, in all its dimensions, can be very unpredictable. From the pandemic that began in 2020 and the supply chain interruptions it triggered, to the recent inflation rate hikes and the impact of international political destabilization on trade and markets – credit and risk managers need to be prepared to manage risk during turbulent times. Even if your company does not hold Russian government bonds, conduct business with Russian banks or have Russian or Belarusian customers – your customers might. Your customer supply chains might be affected by sanctions or higher oil and gas prices. Shares of a company in your customer portfolio might be held by a Russian oligarch. And even if that is not the case, inflation caused by supply chain disruptions can cause problems in your debt portfolio if your customers are unable to pay, while tightening monetary policies can negatively impact your company's ability to re-finance. In summary: Your liquidity could be reduced, and your own financial stability could be endangered.

Credit managers need to keep an eye on the big picture to estimate how market trends could impact their business. Navigating in a multifaceted risk environment that can change significantly depending on markets, regions and verticals, shows the complexity that global credit and risk managers face today. The steps they take to make sense out of vast volumes of data and detect the fault lines in finance will determine how successful credit and risk managers will be in preventing disaster by keeping the daily business flowing and by controlling risk. Processes, enabled by technology, are more agile and resilient, which can help credit and risk managers react quickly to changing risk landscapes. With the right tools, data and process design, they can analyze individual customer risk profiles and process limit applications quickly to support profitable sales and protect their business.

About the Author

Johannes Schmidt is a subject-matter expert on AR Automation at Serrala. He has several years of experience in researching and analyzing market developments and technology trends and presenting them in articles and thought leadership pieces. Areas of expertise include the entire receivables management lifecycle, including credit management, invoicing, and billing, collections, and disputes, as well as cash application.