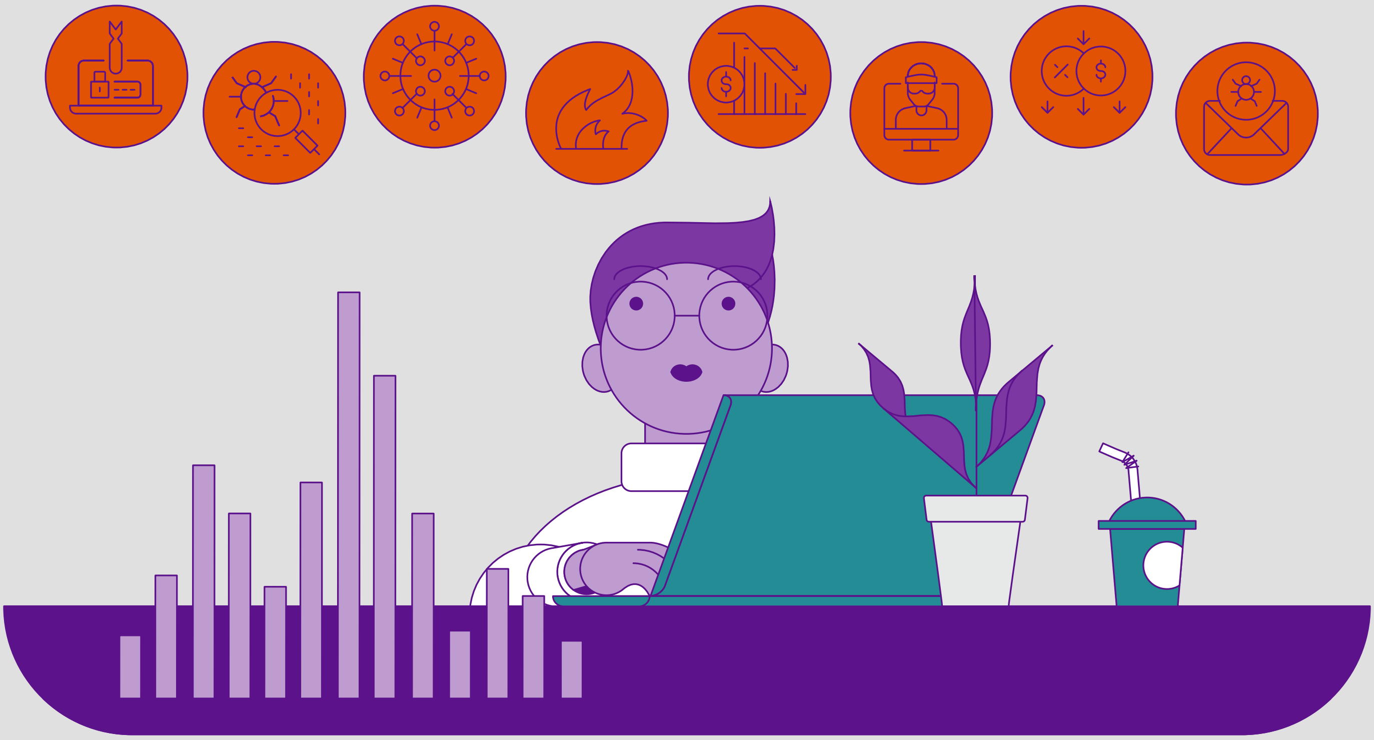
Raconteur

A new approach to credit risk management



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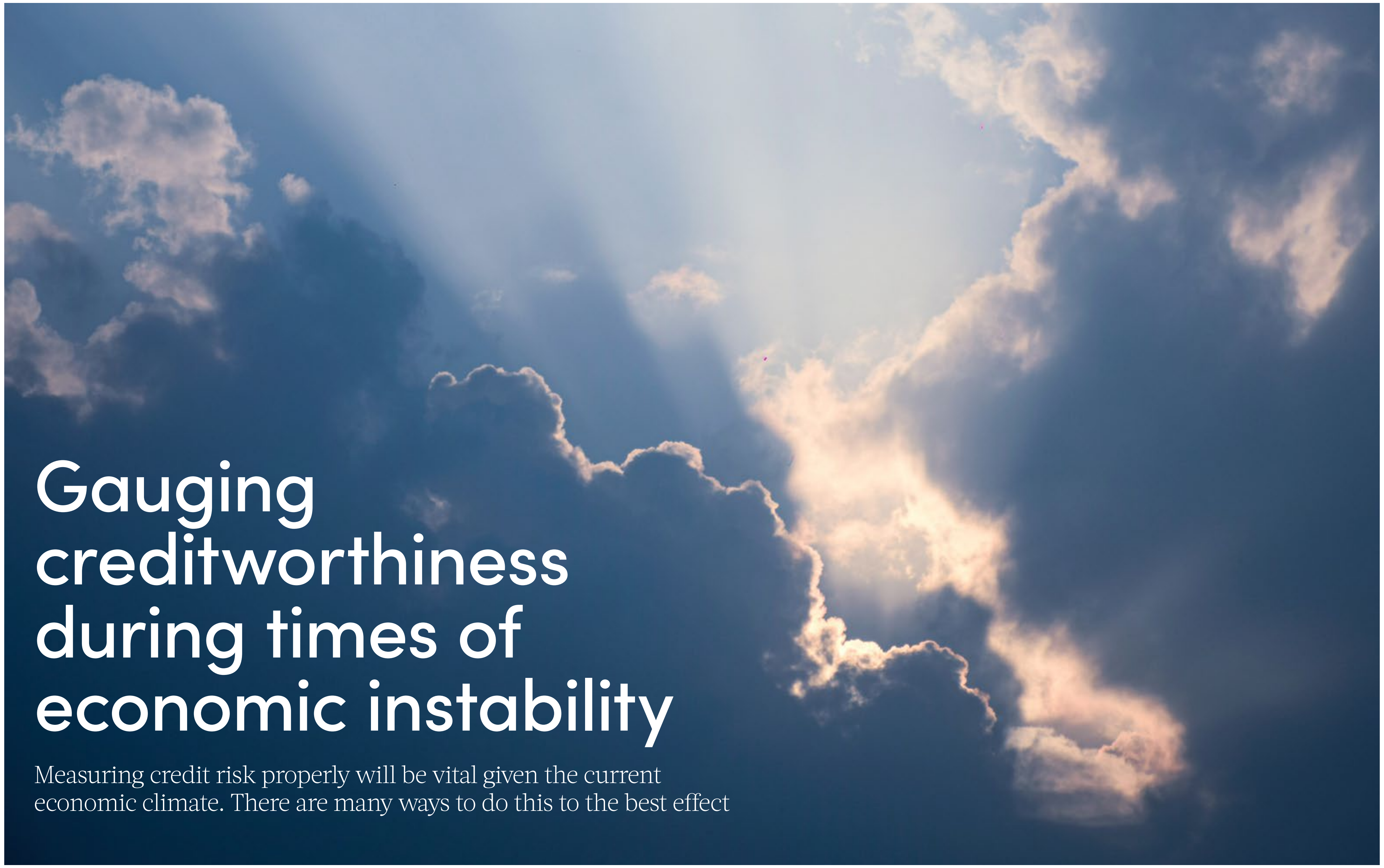


Gauging creditworthiness during times of economic instability

Measuring credit risk properly will be vital given the current economic climate. There are many ways to do this to the best effect

Daniel Thomas

As dark clouds remain over the UK economy, companies are under growing pressure to ensure the creditworthiness of their customers and suppliers. A large and sudden bad debt or even a significant delay in payment can lead to the failure of a company in a worst-case scenario.

Such an outcome would be particularly unfortunate if it could have been avoided by a thorough credit risk assessment of the counterparty. Yet it seems that a growing number of UK companies are likely to fall into difficulty if the economy slows down as forecast.

Gareth Harris is a restructuring advisory partner at audit, tax and consulting firm RSM UK. He says that firms need to act now to ensure their credit risk processes are sufficiently rigorous.

"Ensuring you get paid for the work you do and the value you add is important at any time, but never more so than it is now," he says. "Measuring risk properly can be time-consuming, so it needs to be done proportionally and in line with potential exposure."

The problem, he says, is that companies too often fail to take a rounded approach to assessing credit risk, relying instead on limited sources of information. They may also be blinded by the promise of a large profitable contract or piece of work, or over-reliant on credit scores which, while useful, can be lagging indicators as they are based on historic information.

Instead, he urges companies to draw on all sources of information to create a broader picture of a company or supplier. That might include going through blogs and social media for comments that may indicate risks and asking other people in your business or contact network for their opinions.

"A credit assessment shouldn't just be a one-off assessment, for instance when a new contract is signed," he adds. "It should be an ongoing process because circumstances can change rapidly."

> Measuring risk properly can be time-consuming, so it needs to be done proportionally and in line with potential exposure

There are many companies which can help firms assess credit risk or manage cashflow more effectively, many using technology to do so. For example, Asset manager Janus Henderson tracks the credit risk of listed companies using a Red-Amber-Green traffic light system. In October 2022, all three of the key indicators it monitors were flashing red, signalling that the global outlook for corporate earnings and cashflow was likely to deteriorate. In a situation like this, access to capital for borrowers will tighten and debt defaults will start to tick up.

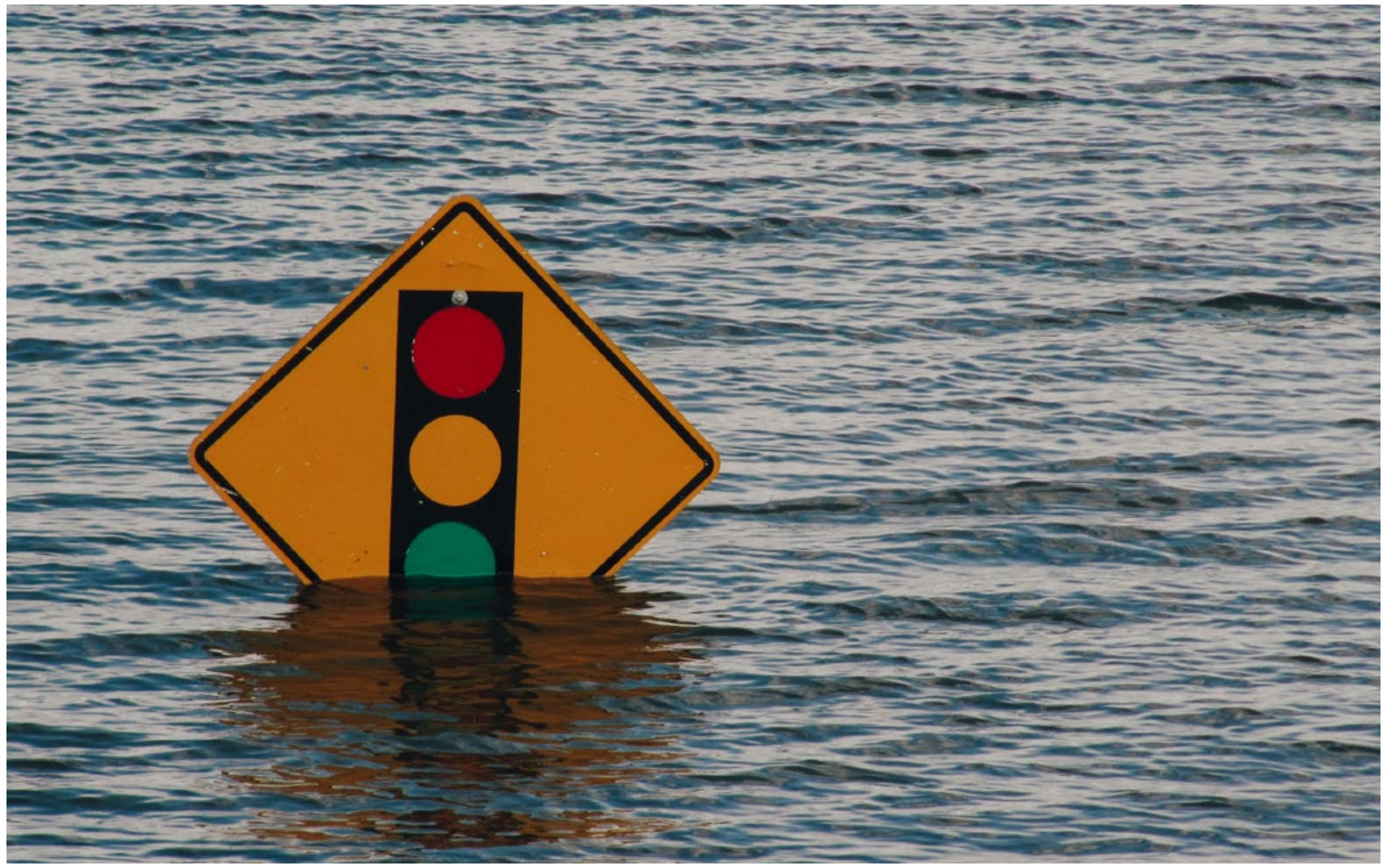
The Chartered Institute of Credit Management advises firms to keep a close eye on cashflow as the economic waters get choppier.

That might mean converting unbilled revenue into cash, tightening spending controls and scaling back projects that require substantial financial investment but only offer long-term returns.

"Other things businesses can continue to focus on include keeping an eye on foreign exchange impacts, stress-testing subsidiary balance sheets to identify any downturn risks and reducing work on accounts that are considered at most risk and where margins are lowest," says its chief executive, Sue Chapple.

The Federation of Small Businesses (FSB), meanwhile, says firms should spread risks wherever feasible and consider retaining title clauses in contracts so that if the worst happens, they can at least reclaim products that were supplied but not paid for.

"Maintaining honest and open relationships with counterparties is also helpful," says FSB national chair Martin McTague. "If one side hits a rocky patch, they may be able to get through it in better shape if their supply chain and/or customers are aware of the issue and are willing to extend forbearance to help them stay afloat."



The biggest credit risk factors for organisations

Cyber attacks, geopolitical upheaval and climate change pose the greatest threats to a company's financial health

Alex Wright

Credit risk has risen to the top of the agenda for many businesses because of the current economic and inflationary environment.

The global shockwaves of the ongoing war in Ukraine, the impact of the Covid-19 pandemic, the increase in cyber attacks, and Brexit have made it exceptionally difficult for firms to assess the risks of doing business with another organisation.

Given the global interdependency of many businesses, an organisation's financial health and creditworthiness can change in almost the blink of an eye. These are the top three factors affecting a company's credit status to look out for now.

1 Cyber attacks

Cyber breaches have increased in frequency and severity over the past decade. This is primarily driven by a surge in ransomware attacks, which were up 105% in 2021, according to SonicWall Threat Intelligence. Such attacks can cause significant financial and reputational damage to the target.

They are costly, in terms of the investment that firms must spend on cybersecurity solutions in a bid to fend off such attacks. If a breach does occur, the bill to contain and remediate the damage, including fines and penalties, can be high. Then there's the expense of cyber insurance to protect against such attacks.

But by developing a robust risk management strategy, businesses can more effectively use their resources, rein in costs and protect liquidity. That requires an awareness of the latest cyber threats and having the appropriate security measures in place to deal with them. It is also crucial to have watertight business continuity and disaster recovery plans.

"Understand what your cyber risks are, prioritise them, create the right engagement, model and financial planning into what good resiliency looks like, and deploy the right tools and technology to support that activity to create an effective defence," says Naveen Vasudeva, founder and CEO of The CyberTree Paradox. "The key here is to ensure liquidity in the business."

105%

increase in ransomware attacks in 2021, with 20 attacks being attempted every second

Sonicwall Threat Intelligence, 2022

2 Geopolitical upheaval

The world has become increasingly geopolitically unstable in recent times, most notably because of the Ukraine conflict. The sanctions imposed by the West on Russia and Belarus have made it far more difficult to do business in those countries, while key trade routes and the supply of core commodities such as wheat have been severely disrupted, and food and energy prices have spiked.

This has had the effect of increasing funding costs and restricting capital flow for firms as central banks tighten their monetary policies and raise interest rates to try to curb inflation. The result is that companies are far more vulnerable to the risk of defaulting.

While such geopolitical risk is largely outside an organisation's control, there are steps it can take to mitigate the problem. Chief among them is minimising their day sales outstanding and ensuring they offer credit in a safe, sustainable and supported way.

"All businesses selling to others should consider their options for protecting themselves against credit risk, such as working with an external trade credit provider or taking out invoice insurance," says Louis Carbonnier, co-founder and co-CEO of Hokodo. "The converse is also true – businesses should ensure they work with suppliers and partners who are stable and financially sound."

> "All businesses selling to others should consider their options for protecting themselves against credit risk

3 Climate change

Climate change has also accelerated as global temperatures have risen exponentially over the past decade. The financial consequences of this extreme weather pattern shift for businesses can be far-reaching.

The losses incurred by extreme weather events, both in terms of physical property damage and business interruption, can be significant. Then there is the investment required to meet net-zero targets and environmental, social and governance standards that organisations are held to by governments and shareholders, and the subsequent penalties and fines they will incur for failing to comply.

As part of their overall internal control strategy, companies need to have a risk management framework to address climate change that extends across all business units, including control functions. The framework should encompass financial and non-financial risks, and on- and off-balance sheet risks, including current and future exposures.

Firms must also ensure their boards focus on climate change risks and that their strategic plans and business models embed these exposures into their risk management frameworks and capital allocation. Additionally, they must carry out periodic scenario analyses and stress tests to assess their resilience to such risks, and leverage technology, data and talent to manage the risks.

All three of these factors pose significant credit risk challenges for organisations. But by adopting a common sense and pragmatic approach to dealing with them, their potentially wide-reaching and damaging effects can be successfully mitigated. ●

COMMERCIAL FEATURE

The benefits of an integrated risk assessment approach

Why do businesses need to adopt a more holistic and data-driven risk management strategy?

Alex Wright

Increased awareness of the risks of doing business with another company in the current environment, has forced credit risk experts to seek more robust information to assess the host of factors that can potentially impact their trading with other firms.

"In the post-pandemic world, trade patterns are shifting, as is creditworthiness across geographies, sectors, and individual businesses. These changes are forcing credit risk experts to adapt to a new environment where the traditional approach to fundamental financial analysis just isn't enough. In order to navigate this new environment, credit risk experts need to adopt an integrated approach to risk management," says, Carolina Azar, senior director at Moody's Analytics, a firm dedicated to integrated risk assessment.

That's evidenced by the fact that, according to the most recent Deloitte Global Risk Management Survey, 62% of respondents believe that credit risk measurement will be an extremely or very high priority, citing it as the risk that would increase the most over the next two years.

There are many past examples of global businesses across different sectors that have failed to detect the early warning signals and, as a result, defaulted, gone bankrupt or were forced to restructure. That's why organisations need to adopt an integrated and data-driven approach to risk assessment models.

Given the recent rise in corporate default risk, a starting point should be to use early warning tools and data to identify and understand the credit risks affecting the business, thus leading to better decisions. Traditionally, organisations have relied on their own assessments of financial statements, ratings, quantitative models and market information. "Environments change too quickly to rely on assessment of financial statements alone, as we saw from the global financial crisis, pandemic and current geopolitical unrest. Firms need to adapt their strategies and integrate robust and actionable data," says David Hamilton, managing director, head of market insights, at Moody's Analytics.

Digital transformation is a process that puts data at the centre, combining high quality, timely third-party and a firm's own data with analytical tools that turn data into key risk metrics that help assess the overall risk across the portfolio. Technological tools have empowered organisations to build their own internal systems and helped them evolve their digital transformation for credit risk management, from a traditional financial risk oriented approach to an agile integrated risk assessment approach. "Thus, internal data is enriched with third-party external data, workflow tools and analytics acquired from companies like Moody's Analytics," Azar says.

> "Firms need to adapt their strategies and integrate robust and actionable data

That transition to embrace third-party data and analytics has only been accelerated by such a complex risk landscape. "It is unlikely governments will step in to provide emergency support as they did during the global financial crisis," says Hamilton. Additionally, the prices of traded financial assets or macroeconomic indicators do not clearly indicate when and which exposures to worry about."

"We advise our customers that now is the time to prepare for this eventuality by investing more strategically in early warning systems for credit risk," says Hamilton. "Our early warning data and analytics can help corporates prioritise at-risk exposures, differentiate heightened risk due to idiosyncratic factors and identify new business opportunities. Using our forecasting and scenario analysis tools can also provide another view of the potential effects on credit risk that different economic scenarios might have."

Eefje van Craen, director at Moody's Analytics adds: "The key is to combine unique data sources and methodologies to turn data into actionable insight and metrics that help organisations quantify their exposure and mitigate risk."

This is achieved by gathering insightful information from experts across a range of risk domains, from fundamental credit risk and macroeconomic views to emerging risks such as climate change; environmental, social and governance; supply chain; and cyber.

The problem with traditional methods is that they tend to quantify risks into silos rather than taking a holistic view, using domain-specific data, time horizons and metrics.

In contrast, an integrated risk assessment approach allows firms to compare risks on a like-for-like basis and take into account how they are interconnected, both from a macro- and microeconomic perspective. This approach considers data across all domains, quantifies how risks get mitigated or amplified between each other, and provides insights into exposures to systemic and idiosyncratic shocks of different types and severity.

62%

of execs believe that credit risk measurement will be an extremely or very high priority over the next two years

Deloitte, 2021

"Payment and spend behaviour is an important metric into taking a more proactive approach," says van Craen. "We collect A/R data from US and Canadian entities and are expanding the practice to the rest of the world. This data is important to organisations, and this data helps us make inferences about payment behaviour to turn into metrics."

Integration of data also helps identify risks and opportunities that emerge from the synergies behind trends and co-movements, that would otherwise be ignored when looking at risk factors in isolation.

As a global player, Moody's Analytics is at the forefront of integrated risk assessment, empowering organisations to make better decisions with a unique set of solutions that combine data, analytical tools and insights. By affording greater transparency, more informed decisions and fair access to information, this opens the door to shared progress for all.

How Moody's Analytics can support digital transformation and reduce credit risk

Eefje van Craen, director, Moody's Analytics

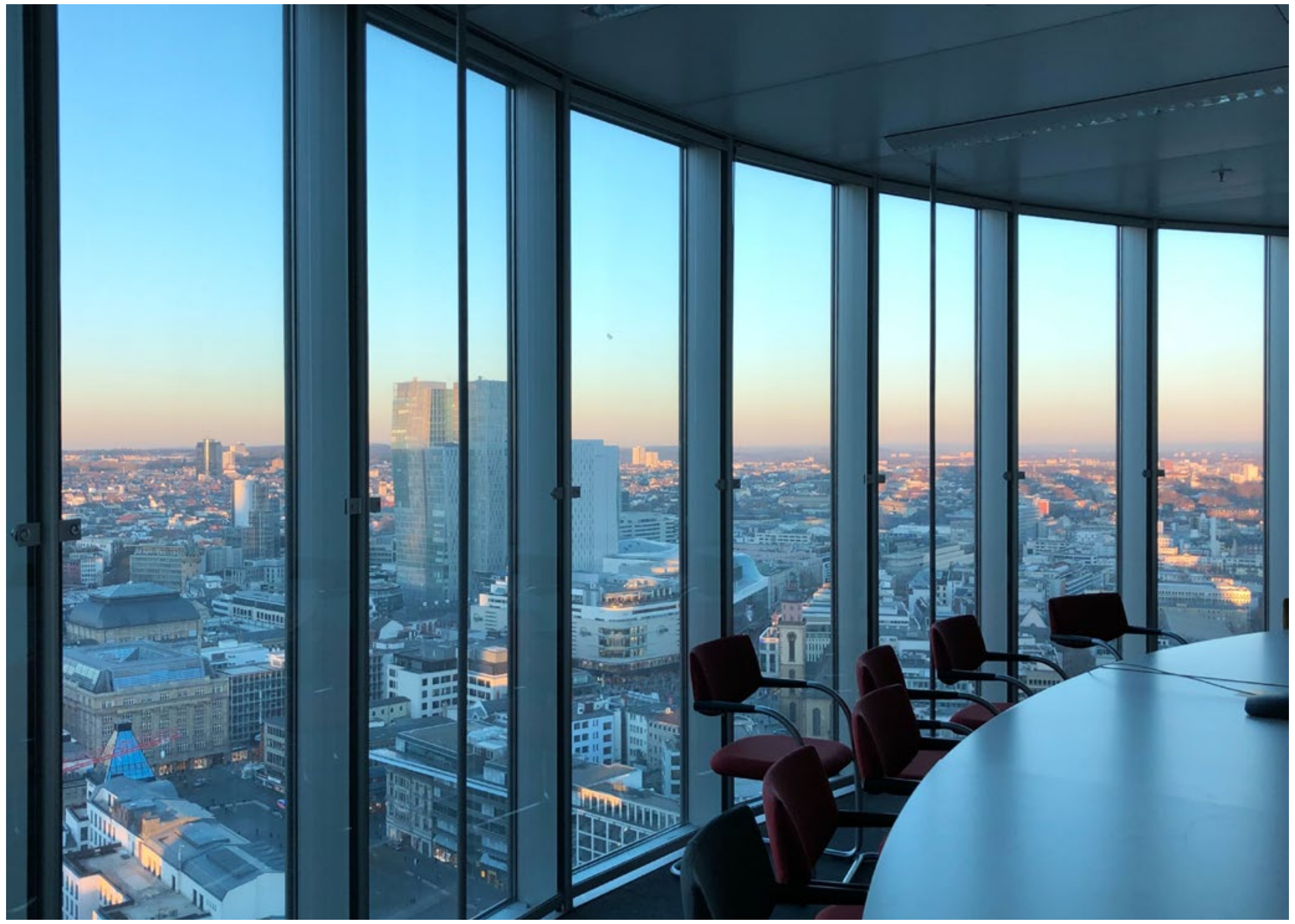
Within Moody's Analytics, innovation is key as technology and computing power change business processes and data becomes increasingly critical to finding opportunities for growth and assessing a range of risks. We can support our customers' digital transformation and automation by applying the most relevant modern technologies to support analytical processes and deliver our data and expertise.

Our expertise and resources also help companies automate and digitise their processes. This in turn with our added layer of analytical tools help deliver meaningful solutions to organisations. Through a combination of enhanced data sets, such as the world's largest collection of private credit risk data, and machine learning capabilities, we offer solutions that bring valuable insight faster than ever before.

Carolina Azar, senior director, Moody's Analytics

We leverage artificial intelligence and machine learning for financial spreading and use trusted, global news sources for credit sentiment analysis. Transforming real time information into early risk warnings or red flags, has helped our clients get ahead of the financial cycle.

Licensing multiple data sets is not the biggest hurdle. Standardising, connecting and transforming diverse data sets into meaningful insights is. As organisations continue to deal with uncertainties and vulnerabilities, we'll continue to educate them about the importance of being proactive instead of reactive when managing risk. Helping them become more agile is key to a successful relationship.



Risky business: why boards need a better grasp of credit control

It's crucial to put credit risk departments at the core of business strategy, yet too often they are sidelined

Daniel Thomas

The economic climate makes it even more vital to accurately assess the creditworthiness of clients and customers. Yet credit risk management is not always prioritised as highly as it needs to be, leaving many firms exposed to risks such as late payments and bad debts, which can create liquidity issues.

This is partly due to the difficulties of effective risk assessment, which requires resources and expertise that smaller firms often lack. It is also about embedding the right culture across an organisation, which can be equally challenging, says Gareth Harris, a restructuring advisory partner at audit, tax and consulting firm RSM UK.

"Businesses that are dominated by a strong sales culture sometimes don't give it the prominence it deserves, as the focus is on the deal rather than the counterparty risk," he says. "Credit risk is also sometimes delegated to junior levels in an organisation, but it needs to be considered at board level."

Take positive action

To create an effective credit risk management culture, a firm must establish a system to identify, assess and manage exposure to risk. They then must cascade it through the organisation, with engagement from employees at all levels.

That may involve educating teams about key accounting concepts such as margin, cashflow and profit, while putting clearly defined and well-communicated processes and procedures in place. It will also require collaboration between teams that might not have worked together before, so that customers can be monitored properly, competitive advantage can be balanced against risk and negative information acted on swiftly.

Fusion Accountants, a British accountancy practice, recommends that businesses start by defining a credit policy which sets out how the organisation plans to approach issues such as risk, cashflow management and late payments. Some may opt for a generous approach to entice customers, it says, while others prefer to keep a tight rein on cash to ensure that they always have sufficient liquidity.

"Whatever approach you decide is right for your business, the important thing is to make sure you actively choose it, communicate with your staff and then apply it in practice," the firm wrote in a recent company blog.

"Possibly the worst thing you can do is ignore the whole topic of credit control and just hope that your customers will be nice enough to pay."

Credit control departments must be prepared to be flexible when needs must, remembering that each customer or counterparty should be assessed on an individual basis. The right accounting and risk management platforms will make the job easier, with outside consultancy support brought in where necessary.

Strategies and firm policies

The credit control function must have the strategies and expertise in place to fulfil its central role of protecting the business from liquidity crises. Detailed financial forecasting, proactive working relationships with suppliers, robust protections in contracts and taking out credit insurance on large (and therefore riskier) accounts are just some of the tools available.

59%

of businesses reported suppliers had ended relationships with them due to repeated late payments

67%

warned there could be a "cashflow crisis" if firms continued to pay suppliers late

Ivalua, 2022

Departments should also have a firm policy on late payments. 2022 research from Ivalua, a spending management platform, suggested that more than a third of UK businesses had to extend payment terms for suppliers in the 12 months prior to the research, due to the impact of Covid, Brexit and rising energy costs.

It also found that 59% of businesses reported suppliers had ended relationships with them due to repeated late payments, while 67% warned there could be a "cashflow crisis" if firms continued to pay suppliers late.

"You pay your accounts on time and so should your customers. But so many people in business find it difficult to ask customers to pay what they owe," says Fusion. "As your credit control function matures, you will get to know which of your customers responds to what type of approach."

Harris says many firms will need to shift their mindset about credit risk to give it the priority it deserves. He observes that change takes time but thinks that firms would do well to start overhauling their processes now, as inflation soars, demand in the economy weakens and an expected rise in defaults looms.

The risks of inaction are all too clear: bad debts, slow payments and hidden losses that risk bringing a company down when they are finally uncovered.

"Sometimes it takes a rather painful – and hopefully not fatal – financial loss to put credit risk firmly on the board's agenda," says Harris. "Putting it on the regular board agenda is a starting point and inviting the credit controller to take part in that agenda item can also help."

> Possibly the worst thing you can do is ignore the whole topic of credit control and just hope that your customers will be nice enough to pay