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28th March 2022

To whom it may concern,

RE: Risk Alert – building and testing financial resilience to withstand heightened economic volatility

I am writing to you further to the risk alert I issued on the 1st of February 2022 relating to the onset of military conflict between Russia and Ukraine. The objective of this letter is to share practical insights and recommendations to support your firm's financial resilience preparations, as the UK economy enters a period of heightened volatility, with the potential for corporate financial risks to be made worse by the manifestation and severe threat level of other material non-financial risks.

You will be well versed in guiding businesses through economic cycles, not least with memories of the worst economic decline in over 300 years led by the onset of the COVID-19 pandemic still fresh in one's memory. You will also have experienced the vulnerabilities exposed through bias in the use of historical models to assess financial risks during downcycles, often based on the presumption of pattern similarity between cycles. In an environment where business models are being transformed by geopolitical forces, innovative and disruptive technologies, and new industries whose economic behaviours and impact are not accounted for in historical models (e.g., the "gig economy" and the multi-trillion-dollar technology industry), overreliance on historical models to predict future financial risks could lead to unexpected financial difficulty as firms adapt to unique and changing external circumstances. This is particularly true in the context of the current stressed operating environment presenting uncontrollable external risks which could add the potential severity of financial risks facing firms in the months and quarters ahead.

Since the 2007/08 Global Financial Crisis (the "GFC"), the Bank of England (the "Bank") has broadly maintained an exceptionally loose monetary policy stance, leading to a prolonged period of ultra-low base interest rates and Bank asset purchases totalling £875 billion in the last 13 years. The Bank's decision to maintain the status-quo of loose monetary policy against escalating inflationary risks throughout 2021 has placed the Bank in an unfortunate position of having to make rapid and aggressive adjustments in monetary policy to counter persistent above-target inflationary risk.

The Bank's inevitable tightening of monetary policy and the potential impact such tightening could have on markets and underlying economic performance underpins the growing importance for firms to build and test their financial resilience through forward-looking practices of risk management. Further complicating matters is the level of stress in the external environment with multiple elevated non-financial risks already harming the functioning of global markets. The combination of severe financial and non-financial risks could collide and lead to extreme impacts. It is vital firms incorporate these factors into financial risk forecasting and planning to accurately determine the level of financial resilience required to withstand the gradual build-up of volatility in the marketplace.

Advancing financial risk models to incorporate new market realities

Financial risk forecasting and planning models must advance from previous cycles to incorporate considerations of new and emerging non-financial risks that have the propensity to affect the severity, response to or recovery from an anticipated economic deceleration. Examples include:

- **The risk of further stress on commodity prices and supply for natural resources as the full-scale impact of targeted economic and corporate sanctions on Russia becomes clearer.** Firms should have already established and assessed the financial and non-financial risks across a range of plausible scenarios resulting from Russia's invasion of Ukraine, including the instigation of secondary risks, such as national protectionist policies for critical supply chain materials and retaliatory risks targeting critical economic sectors across western economies. For more information, please reference the risk alert issued to you on the 1st of February 2022.
- **The risk of prolonged higher inflation leading to material changes in consumer and business behaviours.** The UK is experiencing a cost-of-living crisis not seen in a generation, with consumer inflation expected to reach 8% this spring, with further upside risks suggesting inflation forecasts of 10% by late 2022.¹ The severity of the UK's cost-of-living crisis is becoming apparent for government officials and businesses across the nation, as the public contend with a mix of tax increases and price rises across every line item of day-to-day living. The COVID-19 pandemic demonstrated the pace at which consumer behaviours can adapt to changes in circumstances. As consumers prepare for and adapt to the worst effects of the cost-of-living crisis, firms should consider the risks associated with changes in consumer and business sentiment and the impact of such changes on their business models.
- **The risk of escalating trade tensions between the US, Europe and China impacting the orderly functioning of highly interconnected industries and supply chains.** Trade tensions have continued to escalate at accelerating speed as economic and political influence has transitioned east. These tensions have been demonstrated in recent years, such as in 2006 when China applied export controls and duties on rare earth metals leading to a 40% supply reduction in 2010 and a sixfold price increase for manufacturers (at a time of severe economic vulnerability as the world recovered from the GFC). The COVID-19 pandemic also exposed global trade vulnerabilities as vaccine distribution was geographically concentrated which gave rise to certain production countries stockpiling vaccines, as well as critical ingredients, causing vaccine shortages and disparity in the rate-of-vaccination around the world.
- **Capital allocation for environmental, social and governance programmes.** Contributing to resolving environmental, social and governance issues (commonly referred to as "ESG") has become an important topic for board members in recent years. A survey conducted by PricewaterhouseCoopers in July 2021 identified 81% of firms have an ESG programme in place. As the UK economy enters a period of economic volatility, firms must delicately balance capital allocation across a growing portfolio of stakeholder interests to deliver a range of financial and non-financial benefits. Internal conflicts and declining investment capital could test the ability of firms to demonstrate a continued commitment to addressing ESG issues during times of difficulty. It is important firms address potential delays or disruption to pre-existing ESG commitments by adopting reputation management practices to effectively manage stakeholder expectations and minimise potential reputational harm.

Preparing financial resilience

The current operating environment presents a multitude of risks to the financial resilience of firms across industries. In the case of two or more of these risks combining, the rate and severity of financial harm could become severe. Firms should expand the use of historical financial risk forecasting and planning models to widen the assessment of financial resilience and determine priority actions required to protect the firm's short -and long-term financial interests. Given the change in economic sentiment already underway, applying forward-looking and pre-emptive risk management actions, such as the suggested items below, will help prepare your firm to weather the changing economic risk profile.

- Define a range of probable and extreme but plausible scenarios of economic volatility and evaluate how such scenarios could lead to changes in consumer and business behaviours.
- For each scenario, identify and assess supply and demand pressures across your firm's end-to-end value chain for important products and services (from supply origin to end customer), such as customers requiring changes to pay terms, reducing order volumes, or critical suppliers entering most favoured customer arrangements with competitors as a result of reduced supply capacity or geopolitical pressures.

¹ Reference the Bank of England, <https://www.bankofengland.co.uk/knowledgebank/will-inflation-in-the-uk-keep-rising>

- iii. Identify and monitor the creditworthiness of critical customers, partners, distributors and other critical third parties (e.g., suppliers) in the end-to-end value chain, with an emphasis on highly concentrated entities across buy or sell side channels. For highly concentrated suppliers, consider a review of exit plans and contingency supplier arrangements to verify the feasibility of alternative arrangements to recover the supply of products and services within impact tolerances or recovery time objectives. The loss of a highly concentrated sole or single source supplier, including material outsourcing arrangements, can lead to sudden and material changes in a firm's risk profile, with the potential to exceed risk capacity where there are no readily alternative contingency arrangements for critical goods and services.
- iv. Define and assess capital allocation priorities to protect pre-existing financial commitments and maintain capital availability to invest in strategic initiatives critical to your firm's future competitiveness and value-creation. The board of directors should set financial management expectations for each applied scenario, such as protecting dividend payments, mitigating debt deterioration, maintaining positive cash flows, inventory efficiency, and/or continued delivery against ESG commitments already made to markets.
- v. Model the demand and potential impacts of strategic investments on your firm's credit and liquidity risk profile against the mitigation and recovery of financial and non-financial risks identified in the end-to-end value chain (reference item ii. above). This includes the effect of higher inflation on operating costs and the dependency on debt markets to maintain liquidity and/or fund strategic initiatives on your firm's credit profile. Link capital commitments to programme tollgates promoting early and continuous decision-making of whether to pivot or persevere as internal and external circumstances change.
- vi. Assess the effect of changes in consumer and/or business behaviour, including the emergence of new, or strengthening of existing, competitors and the consequence of such changes on your firm's business model.
- vii. Review your firm's risk appetite framework to assess whether financial risk thresholds are set according to the forecasted impacts against each scenario. The board should consider the firm's capacity for risk relative to the firm's ability to deliver expectations committed to firm-wide stakeholders. Risk appetite thresholds should be set sufficiently to promote early board engagement where escalating risk levels threaten the firm's ability to meet such commitments.

Navigating a period of economic volatility will not be new to you. The conjunction of multiple and potentially severe financial and non-financial risks presents an increasingly complex environment for board members and executives. As we adapt to living in an era defined by going from one crisis to another, enhancing the use and relevance of historical financial risk models will equip your firm's financial resilience preparations to withstand a range of harmful, uncontrollable, and potentially severe changes in external conditions.

I hope you find the recommendations in this letter useful. If you would like to discuss any of the recommendations in more detail, please do not hesitate to request your assistant to contact me by phoning 07444-788-545.

Yours sincerely,

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