#### The Credit and Financial Management Review

The Journal for Credit and Financial Executives

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- Tariffs, Supply Chain Risk, and the Career Opportunity for Credit Leaders
- The Federal Reserve and the Impending Debt Crisis: Will the Tools Still Work?
- Flexible Covenants and Private Capital: Credit
   Strategy in a Looser Lending Environment
- Under Pressure: When Creditor Pressure Impairs the Applicability of the Objective 'Ordinary Course of Business' Defense
- Al is Not a Tool: The Truth About Artificial Intelligence in O2C Processes and Beyond



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#### Tariffs, Supply Chain Risk, and the Career Opportunity for Credit Leaders

By: Melanie Albert, VP of Customer Success, Credit Pulse

#### Abstract

Tariffs don't stop at the port of entry. And they don't just add a percentage point to imported goods before quietly disappearing. They ripple outward, reshaping the economics of entire industries, altering pricing strategies, testing customer loyalty, and ultimately landing on the desks of credit professionals who see the fallout in real time. This is the perfect opportunity for credit leaders to learn how to put themselves in the position of successfully managing supply chain volatility.

When tariffs hit, companies respond in very different ways. Some fold the additional costs into existing SKUs, effectively bundling them with higher prices. Others create new line items so they can track and justify the increases transparently. A few try to absorb the costs outright, hoping not to lose market share. But most push costs downstream to distributors, retailers, and eventually, the consumer.

Every one of those decisions creates a new set of pressures along the supply chain. Suppliers face higher raw material costs. Distributors have to explain sudden changes to their customers. Retailers must decide whether to swallow the margin hit or risk passing it along in a competitive market. By the time the effects show up in accounts receivable, the ripple has already passed through several layers. Late payments become more common. Credit terms get stretched. Margins erode. A single tariff can turn into a full-scale liquidity challenge.

What's often missed in boardrooms and pricing strategy sessions is that credit teams are among the first to see these ripple effects. They notice when customers suddenly request extended terms or miss a payment. They spot changes in buying behavior, like reduced order volumes, smaller average ticket sizes, and unexpected surges followed by dry spells. They see early signals of distress that don't always appear in financial statements until months later.

This vantage point creates a unique opportunity. Tariffs may start as a trade or procurement problem, but they inevitably end as a credit and cash flow problem. And that means credit leaders are perfectly positioned to connect the dots between supply chain disruption and financial risk.

#### The Expanding Scope of Credit

For decades, credit management has focused on one side of the equation: the customer. Teams have built expertise in assessing buyer risk, monitoring payment performance, and managing collections. But today, the lines between credit and procurement are blurring. Companies are running leaner. Procurement teams are smaller. Risk management is often spread thin.

The result is role collision. Credit managers are being asked questions that go beyond the customer: How reliable are our suppliers? What happens if one of them collapses under tariff pressure? Are we exposed to a second- or third-tier vendor we've never even spoken to?

Credit leaders are discovering that they're not just managing receivables, but also managing resilience. The ability to connect vendor health with customer viability, and to see how shocks like tariffs travel in both directions, is fast becoming table stakes.

#### Tariffs as a Case Study in Ripple Effects

Consider a manufacturer relying on imported steel from Canada. When tariffs drive up input costs, the supplier raises prices. The manufacturer passes those costs via existing SKUs, but distributors resist, unwilling to absorb the higher prices. Distributors pass the pain further downstream, but retailers balk, facing consumers already squeezed by inflation.

Somewhere in that chain, the weakest link snaps. Maybe it's a small distributor who can't absorb the added carrying cost. Maybe it's a retailer with thin margins that suddenly finds its credit line overextended. Whoever it is, the impact shows up as an unpaid invoice.

Credit teams that are monitoring exposures systematically can spot which customers or suppliers are most vulnerable. Without that tracking, the failure looks like it came out of nowhere. In reality, the signals were there from the start.

#### From "Back Office" to Strategic Advisor

This is where the career growth opportunity lies. For years, credit has been viewed as a back-office function: necessary, risk-averse, and sometimes seen as an obstacle to sales. But the world has shifted. Boards and CFOs are prioritizing resilience. They want to know not just if the company can make a sale, but whether that sale is sustainable in a volatile environment.

Credit leaders already hold the keys to so much of this visibility. They see real-time payment behavior. They know which customers are slowing down, which are accelerating, and which are masking deeper issues with temporary cash infusions. When credit professionals expand their lens to include suppliers and broader supply chain risks, they transform from gatekeepers of receivables into strategic advisors on resilience.

Titles are beginning to evolve as a result. We're seeing roles emerge that combine credit, supply chain, and enterprise risk into unified positions. What used to be "Credit Manager" is increasingly looking like "Director of Credit & Supply Chain Risk" or even "VP of Risk".

#### The Tools That Make It Possible

This expansion of responsibility doesn't mean credit professionals need to start from scratch. In fact, many of the tools they already use can be extended naturally into supply chain oversight.

- Digital credit applications that once streamlined customer onboarding can be adapted for vendor vetting, ensuring that suppliers meet financial stability thresholds before they become critical dependencies.
- Predictive analytics used to flag early signs of customer distress can just as easily monitor suppliers for bankruptcy risk, payment delays, or declining health scores.
- Systematic tracking, or monitoring exposures across customers, suppliers, and even second- and third-tier relationships, to turn reactive firefighting into proactive risk management.
- Cross-functional dashboards that link credit, procurement, and finance data create a single view of where vulnerabilities sit and how they might spread.



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None of this replaces human judgment. If anything, it makes the human role more important. Technology can surface patterns, but it takes a credit leader's experience to decide which risks are material, which can be managed, and which require escalation to the executive team.

#### **Real-World Implications**

The most compelling proof of this expanded role comes from real-world examples.

A building materials supplier recently faced supplier defaults due to tariff-induced cost pressures. Because their credit team had already extended monitoring into the vendor base, they spotted warning signs early and identified alternate suppliers before operations were disrupted.

A food distributor exposed to Canada and Mexico import tariffs used credit analytics to model "what if" scenarios. By simulating different tariff levels, they showed the CFO how exposure would change under multiple outcomes. That analysis earned the credit leader a direct reporting line into the executive team. And under CUSMA, only certain food categories fall under tariffs, making credit analytics essential to identify which exposures truly matter.

In retail, one company's decision to pass tariffs directly into SKUs slowed sales dramatically. Customers bought less, retailers stalled orders, and the credit team's AR monitoring flagged risk before DSO spiked. Their proactive tightening of terms saved millions in potential losses.

Each of these stories highlights the same truth: tariffs may be the trigger, but the career-defining opportunity comes from connecting the dots across the chain.

#### A New Playbook for Credit Leaders

The emerging playbook looks very different from the one credit professionals inherited. It's no longer about managing collections efficiently or enforcing terms rigidly. It's about building resilience into the entire system. That means:

- Tracking exposures systematically across customers, suppliers, and beyond.
- Using predictive analytics to spot early signals of distress before they hit statements.
- Collaborating cross-functionally with procurement, finance, and operations.
- Positioning credit as a partner in growth, not just in risk mitigation.

Tariffs are just one example. Geopolitical instability, climate events, cyberattacks. These shocks all ripple through supply chains in similar ways. Credit leaders who understand the mechanics of these ripple effects are in the best position to guide companies through them.

#### The Opportunity in Front of Us

For some, this evolution may feel daunting. For others, it's the chance of a career. At no other point in recent memory have credit professionals been this close to the center of strategic decision-making. The very skills that once defined the role—analytical rigor, risk awareness,

data-driven decisioning—are now the same skills boards and executives are demanding to manage supply chain volatility.

The companies that embrace this shift will not only protect themselves against tariff shocks but also build resilience into their DNA. The professionals who embrace it will move from being seen as cost controllers to being recognized as builders of enterprise value.

Systematic tracking is no longer optional. And those who master it are writing the next chapter of credit leadership. One where the role extends far beyond receivables and into the very heart of global resilience.

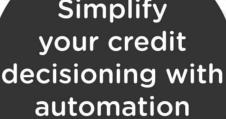
#### About the author:

As VP of Customer Success at Credit Pulse, Melanie leverages her background in scaling customer experience to help finance leaders modernize credit practices. As a founding leader at several hypergrowth startups, she has built strategies that unite technology, process, and people. Today, she partners with credit and finance teams to transform risk assessment with AI-driven insights, reducing bad debt and unlocking growth.



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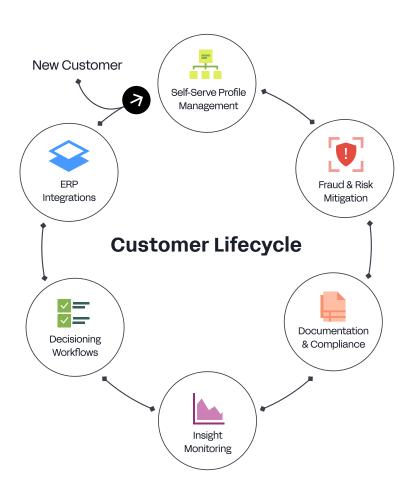
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## The Federal Reserve and the Impending Debt Crisis: Will the Tools Still Work?

By: Steven C. Isberg, PhD
Senior Fellow, Credit Research Foundation

#### Abstract

The Federal Reserve has taken on the dual challenge of engaging in policy to manage and control inflation while at the same time enabling economic growth by keying on the labor markets. Its traditional tools include interest rates and the management of bank reserves. Interest rate increases are typically used to bring down rising rates of inflation. Decreases are employed to enable business investment, development, hiring, and therefore economic growth. Creation and injection of reserves into the banking system represents an additional tool for facilitating economic growth. Reserve contraction can be used as an additional tool to fight inflation. Recent events have shown that the effectiveness of these tools may be diminishing. What does this mean as we attempt to move forward as an economy?

#### How the Tools are Designed to Work

The basic functions of Federal Reserve monetary tools are easier to understand in the context of a concept known as the quantity theory of money. It is based on the following simple equation:

$$M*V = P*Q$$

where: M = the money supply; V = the "velocity" of the money supply; P = the level of general prices in the economy; and Q = the output level of the economy. M\*V and P\*Q are also theorized to represent the value of the output, or GDP of the economy.

The use of Federal Reserve tools is based on the idea that it is desirable to maximize the value of the economic output level (P\*Q) in such a way that the economy tends toward full employment (maximum Q) without pure price inflation (rising P with no increase in Q). In an economy operating at a level below full employment (below max Q), the Federal Reserve may engage in policy to increase the creation and circulation of money (M\*V). Theory maintains that the money supply can be managed by policy designed to influence bank lending activities.

Bank and other forms of lending are hypothesized to enable economic growth by seeding business investment opportunities. Providing access to capital leads to the foundation of businesses that then hire employees, thus increasing income levels, funding consumption and enhancing overall economic growth. Within a "fractional reserve" banking system, loan dollars can create additional dollars, thus increasing the overall money supply.<sup>1</sup>

The discount rate is one of the tools used by the Fed to manage the money supply. The discount rate is the interest rate charged to banks when they borrow reserves from the Fed. Decreasing this rate is expansionary as it increases amounts that banks borrow from the Fed and then make available as loans, increasing the money supply and facilitating growth. The reserves borrowed by the banks are created (out of nothing) by the Fed itself. Increasing the discount rate is contractionary: reducing amounts borrowed by banks and thus slowing loan volume in the general funds markets. This is done to cool down an economy considered to be producing at maximum output levels where increased money supply has resulted in inflation.

The other tool may be referred to as open market operations, where the Fed intervenes by either buying or selling government and other bonds, influencing market interest rates and overall liquidity by either increasing or decreasing supply in the funds markets. The Fed can, once again, create its own reserves and use them to purchase bonds in the open markets, thus increasing the supply of funds. The outcome of this behavior would be to increase the quantity of reserves in the banking system and facilitate lending at lower rates, which will multiply into a larger money supply to seed economic growth. It can also sell bonds out of its own portfolio and thus reduce the supply of funds in the market. The outcome of this action would be to reduce the

<sup>&</sup>lt;sup>1</sup> In a fractional reserve system, banks need only to hold a small percentage of deposit money against their loan portfolios. A \$1.0 million business loan will result in additional deposits coming back to the banks when that money is invested in the business and paid to employees. The banks may then make more loans out of those deposits, creating additional money supply in the process. The more loans made, the more money is created. The Federal Reserve can initiate this process by lending directly to the banks.

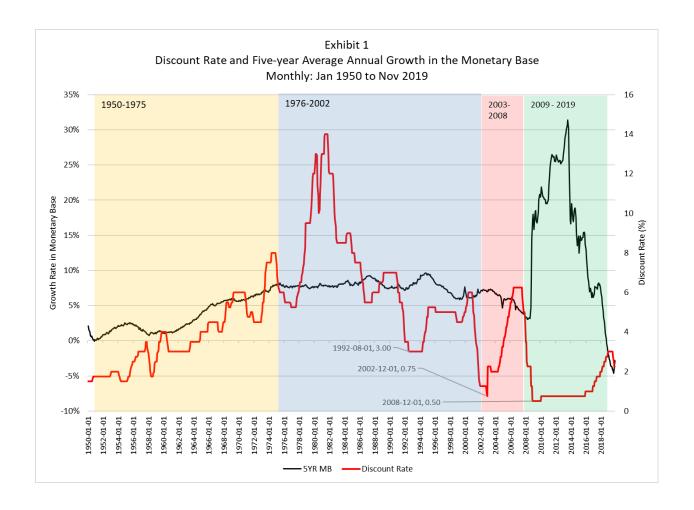
quantity of reserves in the banking system, thus increasing interest rates and reducing loan volume in the markets, which is intended to reduce inflation caused by the excess money in the system.

In simple terms, expansionary monetary policy by the Fed will include either lowering interest (discount rates), increasing reserves, or doing both. Contractionary policy will involve either increasing rates, reducing reserves, or doing both. Historically, it is possible to see periods of time when the Fed was engaged in expansionary and contractionary policy. It is also possible to see, however, that there were times at which some elements of Fed behavior were expansionary, while at the same time others were contractionary. Such patterns can be seen at various times going back 100 years.

#### History of the Tools and Their Impact Prior to the COVID Pandemic

The use and effectiveness of Federal Reserve monetary policy tools in the Post-World War II economy (1950-present) can be examined within four distinct time periods. These are shown in Exhibit 1.<sup>2</sup> In the 25 years beginning in 1950, the growth rate in reserves gradually increased, implying an expansionary policy. At the same time, the discount rate also tended to increase, which would have a contractionary effect on growth. From the mid-1970s to the end of the 20<sup>th</sup> century, reserve growth rates tended to be more stable, while interest rates were increased or decreased in response to changes in the rate of inflation (additional discussion follows). The first two decades of the 21<sup>st</sup> century have been different in the fact that reserve growth and interest rates moved in opposite directions. Prior to the credit market collapse of 2008, interest rates were increased and the rate of growth in reserves slowed down, implying a contractionary policy. Following the crash, interest rates were substantially reduced, and reserves were poured into the banking system to keep it from collapsing due to a lack of liquidity.

<sup>&</sup>lt;sup>2</sup> Data: Federal Reserve Bank of St. Louis Economic Data



Going a bit further back in time adds some insights as to the impact of policy in relation to the underlying political economic conditions driving domestic and global socioeconomic events. As shown in Exhibit 2,<sup>3</sup> the period including both the Great Depression and the Second World War, 1930-1946, was characterized by increasing growth in monetary reserves and falling market interest rates, as measured by the Moody's AAA bond rate.<sup>4</sup> Creation of liquidity in the form of reserves increased the supply of money available to fund projects related to President Roosevelt's New Deal in the early 1930s and military spending during the Second World War. Following the war, the reserve growth rates returned to their pre-depression levels and the AAA rate stabilized at about 3.0%. While reserve growth increased over the course of the 1950s and 60s, interest rates also rose, along with the discount rate increases shown in Exhibit 1. As we will see, inflation also increased in two different cycles between 1955 and 1971.

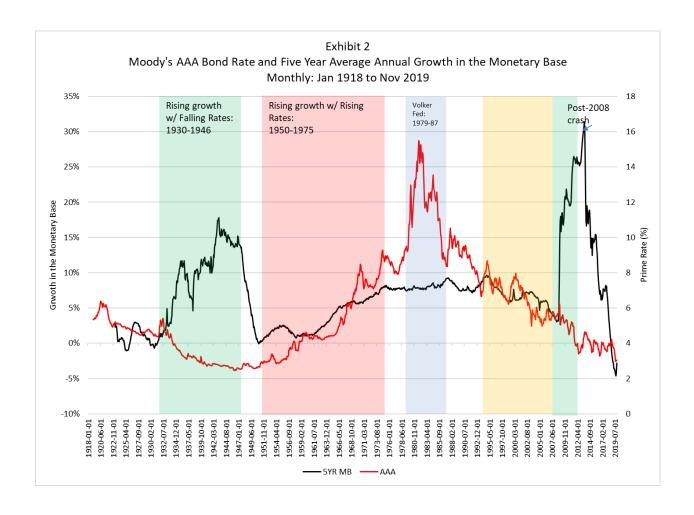
By the mid-1970s, annual growth in monetary reserves stabilized between 6.0 and 7.0%. The underlying behavior of the Fed changed dramatically, however, during the chairmanship of Paul Volker, who aggressively employed interest rate increases to reduce inflation. This led to long-

<sup>&</sup>lt;sup>3</sup> Data: Federal Reserve Bank of St. Louis Economic Data

<sup>&</sup>lt;sup>4</sup> The Moody's AAA rate is used here based on the availability of data and the fact that it is correlated with the discount rate.

term declines in both interest and inflation rates until the financial markets collapsed in 2008. It is interesting to note, however, that the growth in monetary reserves also slowed down between 1995 and that same year (2008). More will be said about this later.

The credit market collapse of 2008 represents a significant break point in financial economic history. In an unprecedented move, the Federal Reserve issued trillions of dollars in new monetary reserves and lowered rates to near zero to bail out a failed banking system.<sup>5</sup> Although by 2015, it was once again raising the discount rate and reducing the rate of growth in reserves, and the markets seem to have become dependent on those higher reserve balances (i.e., cash) to remain liquid and stable. This addiction to cash mixed with extreme expansionary financial policy during the COVID pandemic may have pushed the markets over the edge regarding the supply of reserves and actual money needed to maintain liquidity. As will be discussed below, this creates significant tension between the Fed's mission to control inflation, ensure financial market stability, and accommodate economic growth.



<sup>&</sup>lt;sup>5</sup> United States Congress, Joint Economic Committee, Joint Economic Committee Republicans, "Breaking the Conventional Mold: Monetary Policy Actions Since the 2008 Financial Crisis," 8 December 2016





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Adding an analysis of inflation rates offers additional understanding to both the logic and impact of Federal Reserve policy behavior. As can be seen in Exhibit 3, the period between 1950 and the early 1970s was characterized by increasing growth rates in monetary reserves and increases in both the discount rate and the rate of inflation. While higher discount rates would be intended to slow the rate of inflation, its impact may have been offset by increases in the growth rate of reserves entering the financial markets. It is important to note that, during that period, the global financial system was functioning under the Bretton Woods agreement of 1944, and the U.S. dollar was still valued using a gold standard. As foreign nations sought to hold dollars in reserve against their own currencies, the demand for dollars would increase, which would tend to push interest rates to higher levels. Foreign purchases of dollar-denominated bonds would also push additional funds into the markets, fueling loan growth and potentially seeding inflation.

In response to the increasing difficulty of managing the supply and demand for dollars in such a way as to maintain the dollar value of \$35 per ounce of gold in the open markets, President Nixon took the U.S. dollar off the gold standard in 1971.<sup>8</sup> Two years later, the OPEC oil embargo caused energy prices to skyrocket, adding additional pressure on prices and fueling double digit rates of inflation by the mid-to-late 1970s. New Federal Reserve Chair Paul Volker, who took office in August 1979, decided that inflation should be the primary target of the Fed, and responded by increasing the discount rate to 14% by the early 1980s.<sup>9</sup> At the same time, growth in reserves was maintained at rates ranging between 6.0 and 9.0%. As inflation rates came down, the discount rate was reduced. By the mid-1990s inflation had fallen close to the Fed's preferred target rate of 2.0%. Rising discount rates and falling growth rates in reserves, however, preceded the collapse of the credit markets in 2008. While there were many other factors associated with the collapse, the implicitly contractionary Fed policy, whether intentional or not, may have influenced the severity of the collapse.<sup>10</sup>

The federal government's response to the collapse was to request that the Fed infuse vast quantities of reserves to bail out the failed banks. <sup>11</sup> It did so by creating the reserves and using them to purchase undervalued bonds from the banks, thus restoring their asset values. Following the initial round of reserve infusions under the TARP legislation, <sup>12</sup> the Fed continued to add reserves to the banking system through a three-stage program of quantitative easing from 2009 to 2014. As you can see in Exhibit 3, the five-year average annual growth rate in reserves reached

<sup>&</sup>lt;sup>6</sup> Data: Federal Reserve Bank of St. Louis Economic Data

<sup>&</sup>lt;sup>7</sup> Federal Reserve History, "Creation of the Bretton Woods System: July 1944," https://www.federalreservehistory.org/essays/bretton-woods-created#:~:text=The%20United%20States%20had%20the.the%20dollar's%20com

<sup>&</sup>lt;u>created#:~:text=The%20United%20States%20had%20the.the%20dollar's%20convertibility%20to%20gold</u>

8 Federal Reserve History, "Nixon Ends Convertibility of U.S. Dollars to Gold and Announces Wage/Price

Controls: August 1971," https://www.federalreservehistory.org/essays/gold-convertibility-ends 

<sup>9</sup> Poole, William, "Volker's Handling of the Great Inflation Taught Us Much," President's Message, Federal

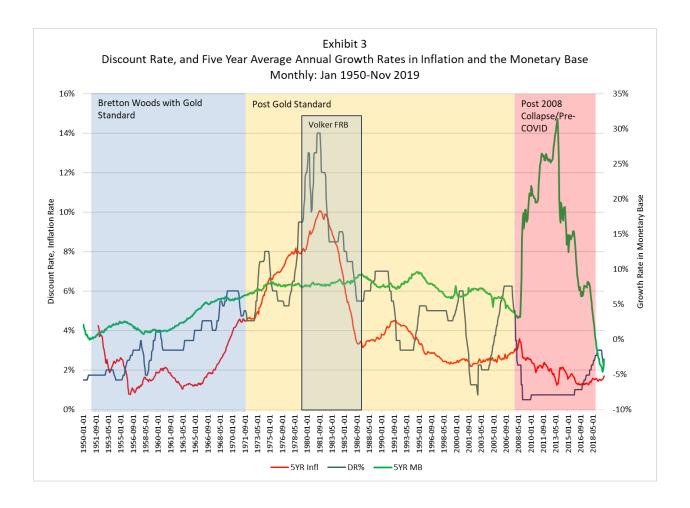
Poole, William, "Volker's Handling of the Great Inflation Taught Us Much," President's Message, Federal Reserve Bank of St. Louis, 1 January 2005

While the credit bubble of 2003-06 was building up, it can be seen in Exhibit 3 that the Fed was engaging in contractionary policies: discount rates were increasing, and monetary reserve growth was decreasing.
 This was done by way of the Emergency Economic Stabilization Act of 2008, passed by Congress on 3 October, 2008.

<sup>&</sup>lt;sup>12</sup> The Troubled Asset Relief Program that authorized the Fed to purchase \$800 MMM of bonds from various financial institutions and infuse cash to others.

the unprecedented rate of over 30% by the end of the third round of reserve infusions. Even so, the rate of inflation remained well below the target rate of 2.0%.

As the economy recovered from the credit market collapse and subsequent recession, the primary concern of the Fed was whether the reserve infusion would eventually lead to inflation. As a result, they ended the infusions in early 2014 and began to decrease the level of reserves by taking them out of the system. At the same time, increases in the discount rate place additional contractionary pressure on the economy, keeping the rate of inflation at lower levels, but also cutting off growth opportunities. This was the situation leading into 2020, when the COVID pandemic changed everything.



<sup>&</sup>lt;sup>13</sup> Thornton, Daniel, "Requiem for QE," Policy Analysis No. 873, CATO Institute, 17 November 2015

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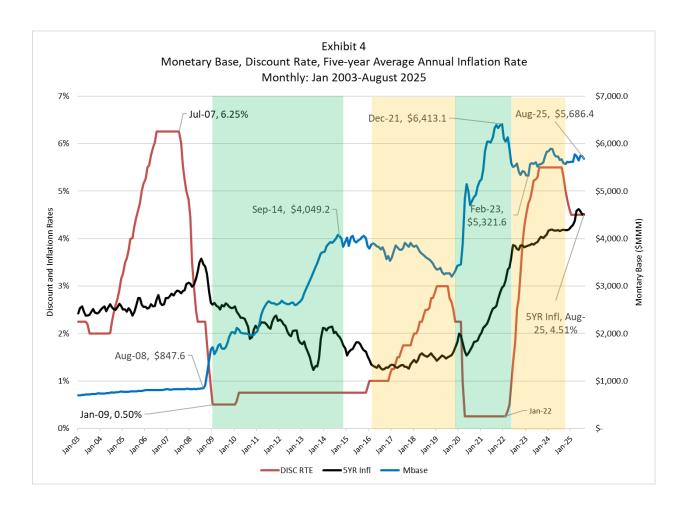
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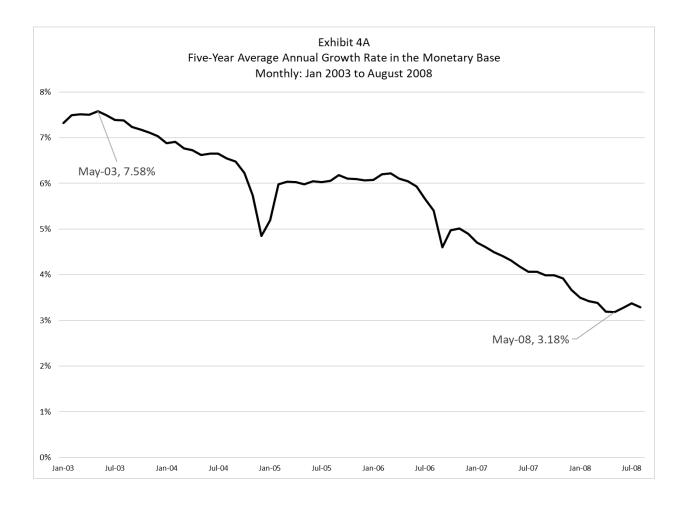
#### Monetization, the Attempted Return to Discipline, and the Pandemic

To fully understand the impact of the pandemic on money, interest rates and inflation, it is important to realize that the Fed's response to the financial market collapse of 2008 represents a significant structural shift in policy that moved further away from monetary discipline and closer to the monetization of the financial markets and economy. The story of what has happened since then is told in Exhibit 4.<sup>14</sup>

Prior to the market meltdown in 2008, several things are clear. First, the Fed was increasing its discount rate, which reached the rate of 6.25% in July 2007. This was accompanied by an increase in the rate of inflation over the same time-period. While not clearly perceptible in Exhibit 4, it is easy to see in Exhibit 4A that the rate of growth in monetary reserves steadily decreased in the five years between May 2003 and May 2008. The combined effect of increasing discount rates and declining reserve growth amounted to monetary tightening. The degree to which this influenced the market meltdown in 2008 is problematic. The response following the collapse was a major breakpoint in financial economic history, creating the context for the conflict that the Fed faces today.



<sup>&</sup>lt;sup>14</sup> Data: Federal Reserve Bank of St. Louis Economic Data



The first step into the period of monetization flowed out of the Troubled Asset Relief Program (TARP) which was initiated by the Emergency Economic Stabilization Act of 2008. The act authorized the Fed to issue \$700 MMM in reserves to be used to replace low valued assets on bank balance sheets, thus restoring solvency to the banking system. In addition to suffering from declining mortgage-backed security values, banks experienced billions in losses from unsecured credit related to derivative positions. The chain of defaults reverberated through the system, eliminating its liquidity virtually overnight.

When the credit markets collapsed in the early 1930s neither the Fed nor the government intervened, and many banks failed. The failure resulted in a loss of almost 20% of the deposits in the banking system. <sup>15</sup> As prices later collapsed, the economy fell into the Great Depression. Part of the motivation of the Fed's actions following the collapse of 2008 was to avoid a repeat of the same outcome.

<sup>&</sup>lt;sup>15</sup> DeSilver, Drew, "Most U.S. Bank Failures Have Come in Big Waves," Pew Research Center, 11 April 2023, <a href="https://www.pewresearch.org/short-reads/2023/04/11/most-u-s-bank-failures-have-come-in-a-few-big-waves/">https://www.pewresearch.org/short-reads/2023/04/11/most-u-s-bank-failures-have-come-in-a-few-big-waves/</a>

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Following the TARP funding, the Fed engaged in a three-stage program of quantitative easing, infusing just over \$3.2 trillion in reserves through the end of 2014. At the same time, the discount rate, which plummeted after the collapse, remained at a rate of 0.75% through the end of 2015. The fact that the infusion of such a large level of reserves coupled with that low of a discount rate did not result in rampant inflation is testimony to the brokenness in the economy following the credit market collapse. Even so, the Fed was aware that the presence of that much cash in a low-rate environment could be inflationary.

Beginning in January 2016, the Fed began to both reduce the level of reserves in the system along with increasing the discount rate. Despite this tightening, the inflation began to gradually increase into the year 2019. It appears that between 2016 and 2019, the Fed was attempting to return to some form of monetary discipline as the economy recovered from the collapse of 2008. As can be seen in Exhibit 4, growth in the monetary base began to slow and the discount rate was increased in steps by 225 basis points, up to a level of 3.0%, where it stayed until the onset of the pandemic.

It is important to note at this point that the Fed's response to the credit market collapse was a massive infusion of reserves in four different stages over five full years. Despite these huge infusions, inflation was negligible. This suggests that the impact of the infusions was to keep prices from collapsing, as they did after the financial market collapse in the 1930s. Keeping prices from collapsing most likely avoided a much more significant recession if not depression following the credit market collapse in 2008.

As the economy came out of a five-year recovery period, it is also evident that inflationary pressure began to resume. This can be clearly seen in Exhibit 4, as the inflation rate increased even as interest rates increased and growth in the monetary base slowed.

While the credit market collapse created a demand-side impact on prices, the pandemic had the opposite effect. The shutdown that accompanied the onset of the pandemic resulted in a *rapid decrease in the supply* of many products. <sup>16</sup> The Federal government stepped in and borrowed against the two Fed infusions of monetary reserves and distributed that money directly to companies in the form of payroll protection loans and individuals as income support. There was little oversight regarding the distribution of these loans, and it is highly likely that many companies receiving such loans were still generating revenue and able to pay employees out of their own cash flows. <sup>17</sup>

The Fed finally stepped in to engage in policy action designed to attack the high rates of inflation in early 2022. As can be seen in Exhibit 4, this included raising the discount rate to 5.50% and reducing the level of the monetary base. By February 2023, the monetary base had fallen from \$6.4 trillion down to \$5.3 trillion. Within a month, several large banks failed, signaling weakness in the financial system. While keeping the discount rates level, the Fed allowed the

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 <sup>&</sup>lt;sup>16</sup> Bai, Xiwen, et. al.; "The Causal Effects of Global Supply Chain Disruptions on Macroeconomic Outcomes: Evidence and Theory," National Bureau of Economic Research Working Paper 32098, February 2024
 <sup>17</sup> Furdek, Rebecca, and Kyle Gilster; "Mid-Year Update: PPP Investigations Continue as DOJ Enforcement Priority," Husch Blackwell, 18 August 2025,

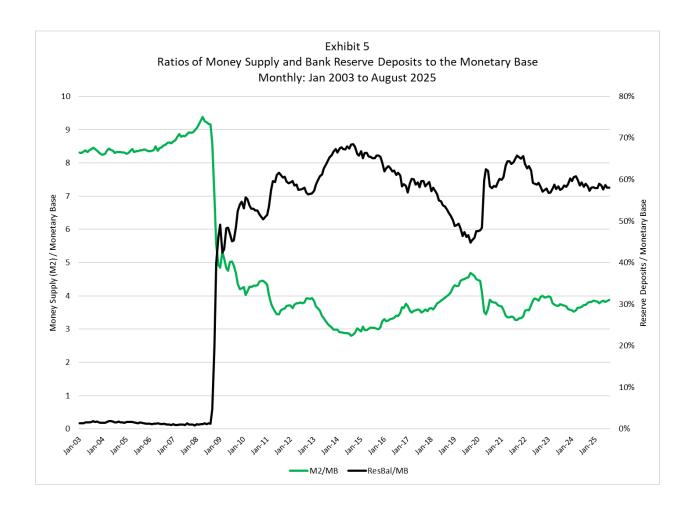
<sup>&</sup>lt;sup>18</sup> Choi, Candace; "The Banking Crisis: A Timeline of Key Events," Wall Street Journal, 11 May 2023

monetary base to grow, infusing more reserves into the banking system. Whether this averted a larger set of failures in the banking system is an interesting question.

Despite the high discount rates and reduction in monetary reserves, relatively high inflation persists. The Fed has, as of this writing, reduced the discount rate once, and is considering further reductions before the end of 2025. It does, however, continue to be reluctant to reduce rates given the persistence of inflation well above its policy targets.

#### What Has Changed Since 2008?

The financial market collapse of 2008 seems to have led to a systemic change in the behavior of the relationship between monetary reserves and money creation. This is at least in part due to restrictions on lending activities place on the banks following the collapse. One of the most notable changes is the increase in the percentage of the monetary base that is held by banks in the form of reserve balance deposits in their accounts with the Federal Reserve. The holding of these balances reduces the money creating ability of the banking system by reducing reserves available for lending activities. As bank lending creates additional money supply, neither money supply creation nor reduction will result from changes in the monetary base if, in fact, a significant percentage of that base is being held in the form of reserve deposits. This can be clearly seen in Exhibit 5. As bank reserve balances increase as a percentage of the monetary base, the ratio of the money supply (M2) falls relative to the monetary base. Banks' holding of greater reserve balances reduces the bank lending multiplier. Each dollar increase in the monetary base will lead to less money creation than in the past. Prior to the collapse, the money supply was about 9.3 times the monetary base. As of August 2025, it was 3.9 times the monetary base. This is due to the changes in bank lending practices and behaviors.



This pattern holds up when comparing the ratios of reserve balances and total debt to the monetary base. As can be seen in Exhibit 5A, as reserve balances relative to the monetary base rise and fall, the total debt value relative to the monetary base does the opposite. As banks hold an increasing percentage of the monetary base in their reserve balances, the ratio of total debt to the monetary base declines, and *vice versa*. Even though banks may be restricted in their lending behavior, debt capital is being provided in the funds markets.



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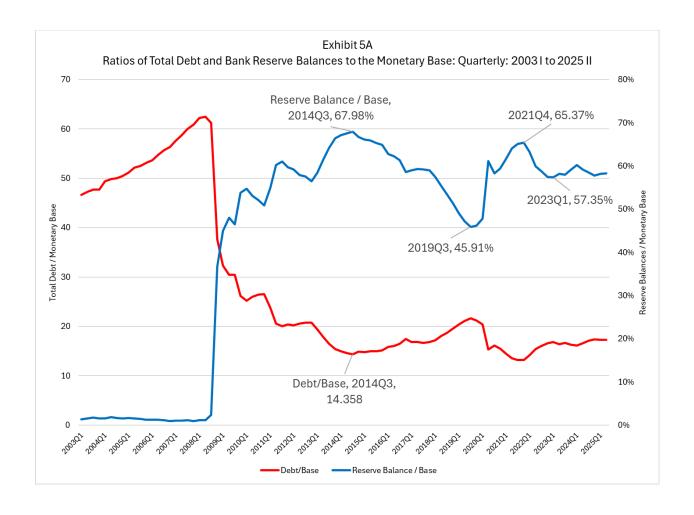
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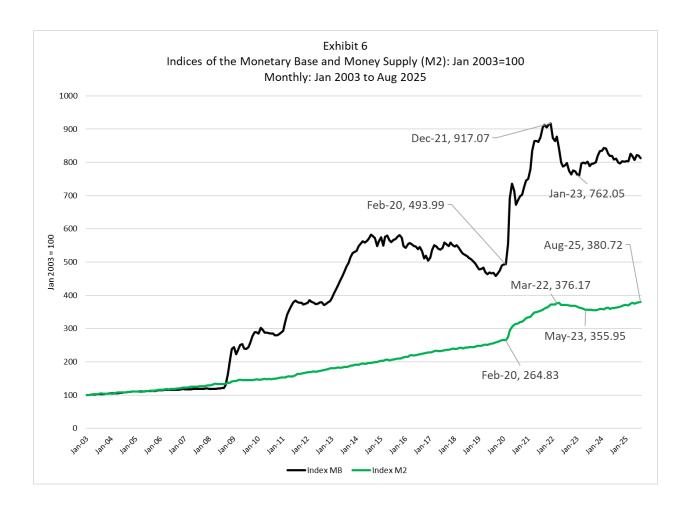
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#### What Changed During and After the Pandemic?

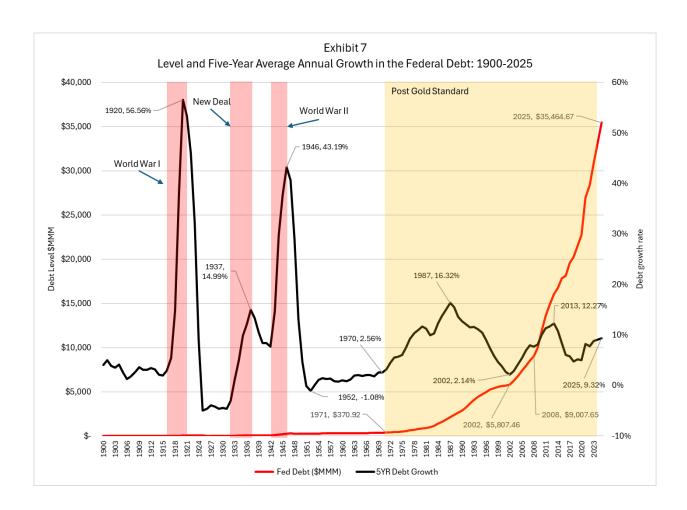
The combined impact of financial and government policy during the pandemic ended up in the creation of additional money supply beyond that which would occur by way of increased bank lending. The story can be seen developing in Exhibit 6. Prior to the market collapse of 2008, the indices of monetary reserves and money supply grow roughly together. Between 2008 and February 2020, it is also clear that increases and decreases in monetary reserves had little impact on the growth in the money supply (M2), which was relatively stable over that time-period. Reserves issued during the pandemic, however, did translate into significant increases in the money supply. The index of reserves increased from 494 to 917 between February 2020 and December 2021. At the same time, the index of money supply increased from 265 to 376 (as of March 2022), a much faster rate of increase than had been seen in the prior ten years. This did not happen because bank lending increased. Rather, the additional money was created by direct lending and spending by the federal government and other private non-bank lenders. The total amount of this spending was over \$3.0 trillion for the years 2020 and 2021. It included a variety of different benefit programs. For example, the paycheck protection program (PPP) issued approximately \$800 billion in loans, over 92% of which were forgiven. Another \$931 billion in stimulus checks were issued to American families; \$666 billion was added to enhance and extend unemployment benefits. Between March 2020 and December 2021, the Federal Reserve created

just over \$2.5 trillion in new monetary reserves. Over that same time-period, the money supply increased by over \$5.6 trillion. The difference is essentially explained and accounted for by government spending on pandemic relief programs. It accomplished this by running deficits of \$3.13 and \$2.77 trillion in 2020 and 2021, respectively, for a total of \$5.9 trillion. The federal government virtually monetized its own debt into spending programs to sustain the economy during the pandemic. As it turns out, in addition to whatever economic value was created (or sustained), the cost was the rampant inflation that persists in the economy and which the Fed does not seem to be able to obviate.



#### The Consequences of the Lack of Monetary Discipline

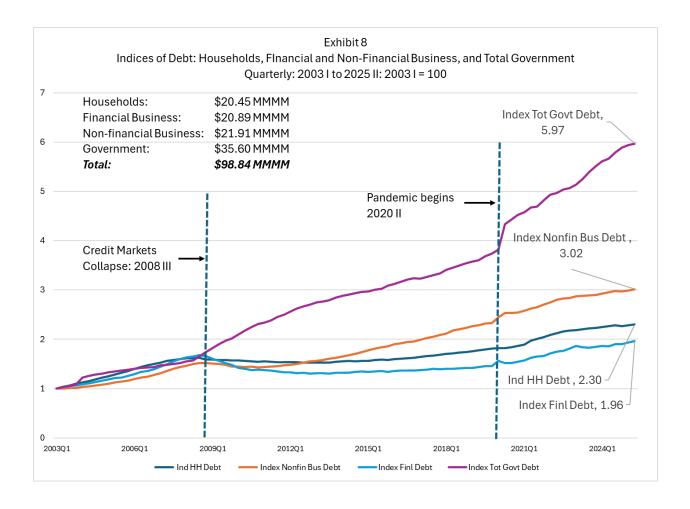
Since the end of the gold standard, federal government debt has ballooned and now sits at over \$35 trillion. As can be seen in Exhibit 7, the federal government borrowed heavily during the crisis periods of the two world wars and the Great Depression. Following World War II, however, the rate of growth in the federal debt declined. By 1970, the five-year average annual rate of growth was 2.56%. By 1987, that had risen to 16.32%, as deficit spending during the Reagan administration began a period leading to today, during which there have been only three years in which the federal government has run a budget surplus. The impact of these surpluses is evident in the fact that the five-year average growth in the federal debt was only 2.14% in 2002, at which point the total debt was \$5.8 trillion. Since then, the debt has increased by a factor of over six times. As of 2025, the rate of growth has fallen to 9.32%, but given the size of the base, annual increases in the federal debt have been huge, to say the least. The unsustainability of this behavior is becoming less of a question and more of a certainty.



#### The Current National Debt Situation

As of this writing, borrowers in the U.S. are on the hook for almost \$99 trillion. This includes \$20.45 trillion for households; \$20.89 trillion for financial business; \$22.91 trillion for non-financial business, and \$35.60 trillion for government. This is leading to excessive debt service costs which steadily contribute to the continuing problem of income redistribution and increase the likelihood of financial distress and/or default.

Debt behavior across the different sectors has changed substantially since 2008. As can be seen in Exhibit 8, which provides indices of total debt for the four borrowing sectors of the economy going back to 2003, the rate of increase in borrowing across those sectors was similar in the five years preceding 2008. Between 2008 and the pandemic, the rate of borrowing increased substantially for the federal government, followed by non-financial business entities. Borrowing by households and financial businesses slightly declined and was reaching its 2008 levels by the beginning of the pandemic. Since the pandemic, rates of growth in all sectors have increased, led by government and non-financial business. Non-financial business debt has tripled since 2003. Much of this debt has been used to consolidate industries and fund private equity transactions. This increases the underlying systemic risk in the debt markets.





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In 2008, the Fed with the backing of the Federal government stepped in and bailed out the banking system when its members began to default on their short-term debt commitments, thus threatening to collapse the industry and the economy. Tighter lending restrictions on the banks changed the structure of the debt markets in such a way as to increase the amount of private non-bank borrowing *and lending*. There are concerns that the next wave of defaults will originate either in the federal government or non-bank financial business sectors. The Fed monetized bad bank debt in 2008. The Fed could monetize government debt in the event of a default in that sector. Will the Fed go so far as to monetize private non-financial debt if there is a major meltdown in that sector of the lending markets?

#### What Now?

There is no real simple explanation as to how we arrived at the current situation. It was an emergent outcome of economic and political behavior in which individuals and agencies made decisions based on the perception of what benefitted their own positions and/or advanced what they believed to be the best policies for ensuring economic growth and, in some cases, a distribution of income and wealth in line with some standard of fairness. Let's consider some of the key elements involved in its evolutionary process to date. As you will see, they all interact with each other.

- *Financial market collapses and crises*: The financial markets collapsed in 1929-33 and again in 2008. The first collapse brought about a wave of government policy intervention, particularly the Glass-Steagle Act with governed banking until its repeal in 1998. What the first collapse lacked, the second included, and that was a bailout of the banks and other businesses when the markets became totally illiquid virtually overnight. The bailout avoided what might have been a repeat of the Great Depression of the 1930s. It was also accompanied by new bank regulatory restructuring in the form of the Dodd-Frank bill. This increased bank capital requirements and put some reins on high-risk lending practices pursued before the collapse. That point also, however, marked the beginning of an era of monetization, to be discussed further below.
- War and other geopolitical tension: U.S. federal government borrowing and spending skyrocketed during both the First and Second World Wars. While not nearly as pronounced, it was renewed in the 1980s as the Reagan administration cut taxes and then went on to borrow and spend on defense. This led to the end of the breakup of the Soviet Union and the end of the Cold War in the early 1990s. As of now, global geopolitical tension appears to be on the increase. The likelihood that major global powers may be drawn into military conflict is at its highest level since the end of the Cold War. It needs to be cooled down.
- Lack of monetary discipline: Up until 1971, the value of the U.S. dollar was managed in such a way that maintained a gold price of \$35 per ounce. This provided a certain degree of discipline in the sense that dramatic increases or decreases in the supply of dollars would impact the ability to maintain that fixed exchange rate. The U.S. dollar also (and continues to) served as the global reserve currency. Removing the dollar from the gold standard essentially converted the global financial system into one predicated on the use of fiat money. There have been virtually no restrictions on the money-creating ability of the Federal Reserve since then. It has used this ability to monetize Federal debt, bail out

- a failed banking system, and enable an economic support and stimulus program during the pandemic. Adherence to a gold standard would have made this impossible. At the same time, other nations have been able to create fiat money to a similar degree. This has been enabled in part by the creation of U.S. dollars, which are subsequently held by foreign nations as reserves against their own currencies. The greater the availability of dollars in the foreign exchange markets, the easier it is for these governments to create additional money of their own.
- Excessive government borrowing: The availability of monetary reserves created (out of nothing) by the Fed has enabled the federal government to maintain a pattern of deficit spending consistently since the dollar went off the gold standard in 1971. Despite this high rate of money creation and government borrowing, the U.S. dollar has held its value relative to other global currencies.
- The dollar as the global reserve currency: A big part of the reason for the above is the demand for the dollar as the global reserve currency. Foreign investors hold almost 30% of U.S. government issued debt. This has served to both keep interest rates low and the value of the dollar high in the global markets. This result would most likely not persist were the dollar not the global reserve currency.
- Shift in corporate finance to debt over equity financing (increase in non-financial business debt): Non-financial companies have used greater amounts of debt to fund distributions to shareholders (i.e., equity repurchases) and acquire other companies. These debt-funded distributions have served to consolidate control over equity to smaller groups of investors. Debt-funded acquisitions, by both public and private entities, have consolidated many industries into a smaller number of larger competitors, thus further concentrating the control of capital into a smaller group. Such consolidation concentrates risk as it concentrates ownership and control over assets. We hence now occupy a position of greater leverage and risk.
- Offshoring business manufacturing and service activities: The combination of readily accessible debt and technology development has accelerated the rate at which manufacturing and service activities have been moved offshore, resulting in job transfer and loss to the American economy.
- Increased household debt: Consumers have for a long time used credit to fund purchases. Rather than paying interest on debt that has funded an investment that generates a return, consumers are borrowing to pay for goods and services that will depreciate down to a value of zero as they are consumed. This has contributed to the redistribution of income in that interest payments convey from the borrowers to the lenders. As the lenders have also consolidated over time, this is contributing to the concentration of wealth into a smaller group of elite investors.
- restrictions on bank lending has been filled by a variety of non-bank financial entities. These institutions are lending investor money, yet they are not subject to the same regulations as the banks. Unlike bank deposit money, investor money in this sector is not insured. We are already seeing cracks in this sector as of this writing. One situation involves loans made to Western Alliance Bancorporation to the Point Bonita Capital trade finance fund owned by Jeffries Financial. Western Alliance is now exposed to risk originating with bad factoring loans by Point Bonita to First Brands, an auto industry supplier now in bankruptcy. This situation is being compounded by the possible presence

of previously unseen off-balance sheet liabilities and potential fraud. As a major lender to Point Bonita, Western Alliance is now exposed to this underlying risk. This is not dissimilar to what precipitated the 2008 financial crisis, when unaccounted counterparty risk impacted lending and derivative portfolios in the banking system.

The net effects of the above outcomes have been to increase the overall amount of leverage carried by the U.S. economy. This increases the burden of debt service payments. It reduces the ability of the government to spend on viable programs that contribute to the general welfare and/or security of the nation. It depletes consumer income and redistributes it to a concentrated group of investors. It has been combined with a long-term trend of industry and economic consolidation, concentrating the amount and control of capital into the hands of a smaller group of companies and individuals. As a result, the degree of systemic and unavoidable risk present in the economy is increased.<sup>19</sup> Defaults at the consumer, business, and government levels could easily crash the economy in its current state.

Another impact of these outcomes is a reduction in the effectiveness of the Fed's tools to control inflation. As the Fed increased discount rates and reduced both monetary reserves and the money supply in 2022 and 2023, inflation rates began to slow down. Just over one year into the action, however, the banking system showed some instability, after which interest rates remained at their high levels but the Fed infused reserves back into the system, reversing the decline in the money supply. The Fed is currently reluctant to reduce rates by a significant amount due to fear of the resurgence of inflation. To bring inflation down even further, the Fed may need higher interest rates and/or reductions in monetary growth. It is more likely now to test the former rather than the latter. The economy seems to have become dependent on the existence of a certain amount of and growth in the money supply, and the Fed may not alter it.

#### **Current Administration Policy**

The current presidential administration has engaged in a variety of policies designed to restore growth to the American economy. It has also suggested that its policies will reverse federal deficits and enable paydowns of the federal debt. One of these policies includes a significant income tax cut. This in and of itself will make it more difficult to reduce the federal spending deficit to the point where it generates a surplus necessary to begin bringing the accumulated debt level down (at all). The tax cut bill included additional spending, however, that is estimated to lead to a \$4.1 trillion increase in the government debt by 2030.<sup>20</sup>

The administration intends to make up for the revenue shortfall by enacting tariffs on imported goods. The second purpose of the tariffs is intended to bring manufacturing and other business back to the U.S. From a revenue perspective, it is important to remember that tariffs are among the most regressive of all taxes. The burden of tariffs disproportionately falls on lower income groups, as the tariffs are related to consumption rather than income. A variety of historical

<sup>&</sup>lt;sup>19</sup> Vitali, Stefania, et. al; The Network of global Corporate Control, *PLOS One*, vol. 6 no. 10, October 2011

<sup>&</sup>lt;sup>20</sup> Congressional Budget Office, "Effects on Deficits and the Debt of Public Law 119-21 and of Making Certain Tax Policies in the Act Permanent," 4 August 2025

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studies have shown that tariffs fail to restore domestic business. Rather, they may be highly inflationary and protect less productive domestic business from competitive pressures.<sup>21</sup>

There is, thus far, little evidence that the administration's economic program is going to succeed in growing the economy and reducing debt levels. The levying of tariffs has been somewhat haphazard. Tariffs on imports from China are still on hold. Even if fully enacted, it will take months to discern their impact on government revenue and inflation. Tariffs represent a direct burden on consumers, who will reallocate their expenditures based on "needs" more than "wants" when income becomes constrained. They will have disparate impacts on different groups of consumers and therefore within certain industries, especially any consumer goods or service industry.

Many companies have committed trillions of investment dollars into the U.S. economy. Much of this investment capital is focused on technology development and consumer durables manufacturing. Most of the spending will take place over the next three to five years. Low levels of domestic investment in manufacturing activities due to offshoring and consolidation have slowed U.S. economic growth. As these investments materialize into actual capital spending on facilities and equipment, it should have a positive effect on the employment markets. Even so, the ratio of employment to output in manufacturing has declined over the years due to the implementation of technology in various processes. Job creation will be somewhat problematic. Additional tax revenue from higher levels of general business activity, however, could help reduce government deficits, enabling it to chip away at accumulated debt levels.

#### What Needs to Change?

Several changes may serve to initiate movement toward a solution to this cumulative problem of slow economic growth and mounting debt levels. *First, we need to return to some form of monetary discipline*. Allowing the uninhibited creation of fiat money has led to long-term indebtedness and additional inflation, the latter of which has served as a tax on consumers. The inflation has acted as a tax on consumers, who are funding those who benefit from the creation of fiat money. These include borrowers like the federal government who will pay off loans with inflated dollars and lenders to whom interest is paid. It has widened the income and wealth gaps since the 1970s.

Second: we need to align government spending with tax revenue. To pay down the government debt, we will need to begin to run surpluses rather than deficits. Both spending cuts and tax increases need to be gradual and managed to avoid traumatic impact to the economy. The accumulated level of government debt needs to be reduced. It can only happen with such a realignment.

Third: we need to reduce if not eliminate the rate at which the economy is consolidating and invest more in the domestic economy. Consolidation has led to the offshoring and eliminating of jobs, accelerated the rate at which income and wealth are being redistributed, and increased

<sup>&</sup>lt;sup>21</sup> See for example: Furceri, Davide, et. al.; Are Tariffs Bad for Growth? Yes, Say Five Decades of Data from 150 Countries, *Journal of Policy Modeling*: vol. 42 Issue 4, July-August 2020.

the degree of systemic risk in the economy. The principal source of capital funding consolidation is debt. Perhaps it will be necessary to treat interest payments on consolidating debt in a similar fashion to dividends and stock repurchases – in other words, as taxable income to recipients. Up to now, taxpayers have been subsidizing these consolidating transactions through the tax deductibility of debt interest payments.

Along with reducing consolidation, it will be important for companies to continue to invest directly in the domestic economy. The multiplier value of investment spending (the rate at which dollars invested leads to increases in overall output and growth) is much higher than that for consumer and government spending.

Fourth: we need to create pathways to employment in line with the needs of the future rather than the past economy. Technology has been a driving factor in restructuring the labor markets. There are currently gaps in the employment markets caused by mismatches between employer needs and labor force skills. Further, an entire generation of vocational workers will be aging out of the labor force over the next five-to-ten years, and there is no apparent pipeline of replacements ready to perform that work. This represents an opportunity for new programs both within the framework of the existing education system and by way of institutions that currently do not exist.

Fifth: we need to establish trading and geopolitical partnerships that make sense from an economic and security standpoint. Trade and national security interests are inextricably linked, yet recent trade negotiations have often been characterized by acrimony. Tariffs are a weapon to be employed in a trade war. As previously referenced, they tend to harm rather than promote economic growth on either side. Trading partners who share national security interests need to work out relationships that are mutually beneficial at both levels. Continuing trade warfare will only destroy value and compromise security interests of the participants.

#### Implications for Credit Management

For credit managers and executives, the major impact of these events and changes has been to put greater emphasis on the criticality of applying best practices in the development and implementation of your credit policies. The fundamental tenets of sound credit and risk management have never been of greater importance than now. These apply to both the internal management of your own company's balance sheet and your continued assessment and monitoring of your customers' businesses. The following policies and practices are recommended:

- *Increase liquidity and reduce leverage on your balance sheet.* In a financial crisis, cash is king and there are no queens, princes, lords, or ladies.
- Closely monitor customer balance sheet for short- and long-term liquidity: make sure you have a complete understanding of your customers' payment obligations over the short and long terms. Be sure that you are aware of the sources of potential liquidity on which your customers may draw. Bank lines of credit, for example, may not be available in a liquidity crisis, as we saw in 2008.

- Go further upstream and downstream in the analysis of factors that affect your business given your position in the value chain. You will need to be fully aware of the business and financial risk of suppliers and providers upstream, and of your customers and their customers downstream. Make sure you have a clear understanding of both the complexity and nuances of these interactions.
- Spread out your banking relationships so that you will have access to liquidity in the event of a shortage. Spreading out your access to capital is a good way to hedge the risks of cash flow shortages in a liquidity crisis. Concentrating your banking relationships may increase your exposure to both short and long run risk.
- Increase credit monitoring, especially for industries in which tariffs are a significant factor. Increase the frequency with which your dashboards are updated and closely track the performance of your receivables portfolio so that you can detect the early warning signs of financial distress. Pay particularly close attention to macroeconomic factors that may have a delayed impact on your customers' ability to pay.
- Organize and manage your credit portfolio based on your customer's exposure to both upstream and downstream sources of risk. Be sure you completely understand those sources of risk and where they are positioned. As you have conducted an analysis of your own position in the value chain, do the same for your customers and for their customers. As in prior crises, be aware that you may end up representing the only source of available capital for your customers in the short run. Understanding their liquidity and managing your own will help you fulfill this role and stay in business.
- Advocate for sensible trade policy within your industry. Use whatever political leverage you have to influence Congress and the administration to enact and enable trade policies that accommodate growth and minimize risk across your value chains.

As we have seen in the past, financial crises may arise with lightening speed. The concentration of capital and control of assets within a complex and interconnected global economy has led to significant increases in systemic risk that, in many respects, cannot be avoided. As a final recommendation, make sure you have an economic "disaster plan" in place so that you may be able to ride out any storm that forms in the financial and economic markets. Questions in forming the disaster plan include:

- Where are the risks in our supply chain? How do we mitigate those risks?
- Should we keep an extra quantity of inventory/supplies on hand to deal with a shortage? How much should we hold and at what cost?
- Do we have adequate levels of liquidity? Do we have additional sources of liquidity? To how much liquidity do we have access? Should we hold more?
- Do we have a sound plan for cash flow management if different scenarios materialize? Can we model those scenarios?
- What can we do to support our customers' businesses through the disaster?
- What resources do we have for supporting our people in the event of such a disaster? Can we maintain team cohesiveness? Can we maintain morale? Can we financially support them?

We can draw upon some of the lessons of the collapse of 2008 and the pandemic in making these plans. Like battlefield generals, however, we want to make sure that we are ready for the next war rather than the last one.

#### About the author

Dr. Steven Isberg is currently Senior Fellow at the Credit Research Foundation and Associate Professor and Chair of the Department of Accounting at Towson University in Towson, Maryland. Steve has been working with CRF since 1994 in his capacity as research fellow and in the development and delivery of a wide variety of our professional training and education programs. Steve has been a part of a number of key CRF research initiatives over the years, including The Future of Credit Studies; the Compensation Studies; Shared Services; and now CECL. Steve has almost 40 years of experience teaching at the college level, where he specializes in the areas of accounting, financial statements analysis and valuation, and financial economic history.



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## Flexible Covenants and Private Capital: Credit Strategy in a Looser Lending Environment

By: Chris Woodard, CMO & Co-Founder, Handle.com

#### Abstract

The private credit market's explosive growth has popularized covenant-lite loans, eliminating traditional financial covenants that once served as crucial early distress signals. This transformation fundamentally redistributes risk, leaving trade credit professionals dangerously exposed without the indirect protection of bank monitoring. This analysis examines the practical implications of this looser lending environment, identifying critical blind spots for suppliers. It provides actionable frameworks for credit teams to adapt by developing proactive, internal monitoring systems. Success now requires using operational data, strategic term-setting, and enhanced diligence to protect cash flow when traditional lender safeguards are absent.

Private credit markets have grown from \$46 billion to over \$1 trillion since 2000, fundamentally reshaping corporate lending through covenant-lite structures that eliminate traditional financial maintenance requirements. This transformation redistributes credit risk throughout the lending ecosystem, creating both opportunities and blind spots for trade credit professionals. While covenant-lite loans now comprise over 90% of leveraged lending, their reduced early warning mechanisms force trade creditors to develop alternative monitoring systems. This analysis examines how flexible covenants affect credit exposure assessment, risk distribution among stakeholders, and traditional monitoring approaches. Using recent market data from leading credit research organizations, the article provides practical frameworks for adapting credit strategy in an environment where traditional covenant triggers no longer provide early distress signals. Trade credit teams must balance the commercial benefits of customers' financing flexibility against increased monitoring requirements and delayed intervention capabilities inherent in covenant-lite structures.

The private credit market has experienced explosive growth over the past decade, emerging from a niche financing alternative to a dominant force reshaping corporate lending. From \$46 billion in 2000 to roughly \$1 trillion in 2023, private credit's expansion has fundamentally altered the credit landscape [1]. This transformation coincides with a concerning trend: the proliferation of covenant-lite loan structures that strip away traditional early warning mechanisms. For trade credit professionals, these parallel developments present both opportunity and peril, creating new avenues for customer financing while generating blind spots that could expose trade creditors to unexpected losses.

The erosion of financial maintenance covenants represents more than a technical documentation shift—it fundamentally redistributes credit risk throughout the lending ecosystem. While private equity sponsors and their portfolio companies gain operational flexibility, the burden of monitoring and early intervention increasingly falls to remaining stakeholders, including trade creditors who often lack the tools and access needed for comprehensive oversight.

#### The Rise of Private Credit and Covenant-Lite Structures

Private credit's ascent has been nothing short of meteoric. Morgan Stanley estimates the market expanded to approximately \$1.5 trillion at the start of 2024, up from \$1 trillion in 2020, with projections reaching \$2.6 trillion by 2029 [2]. The 2025 fundraising pace remains robust, with \$124 billion raised in the first half of 2025, positioning the asset class to exceed 2024's full-year total of \$209 billion [3].

Direct lending continues to dominate, capturing 65% of total fundraising in 2024 [3]. This concentration reflects investor preference for established managers, with 84% of capital raised in 2024 flowing to managers established before the financial crisis—an increase from 78% in 2023 [3]. The "flight to safety" mentality suggests institutional awareness of mounting risks as the credit cycle potentially turns.

The growth trajectory parallels an equally dramatic shift toward covenant-lite structures. Over 90% of senior leveraged loans now carry no meaningful maintenance covenants [4]. In private credit, the trend varies by deal size: fewer than 10% of loans above \$500 million include

maintenance covenants, while middle-market transactions often retain some protective provisions [5]. This divergence creates a two-tier system where larger borrowers enjoy maximum flexibility while smaller companies face tighter oversight.

Modern covenant-lite loans increasingly feature "covenant loose" terms—technically maintaining maintenance covenants but setting cushions so generous that violations become virtually impossible [6]. These arrangements preserve the appearance of lender protection while effectively neutering early intervention mechanisms.

The covenant-lite share of leveraged loans rose from less than 15% in 2007 to over 80% by 2023 [7]. This trend accelerated during the pandemic as borrowers sought maximum flexibility to navigate operational uncertainty. Private credit markets, competing for deals with traditional banks, often match or exceed the covenant flexibility offered in syndicated markets.

#### **Implications for Risk Distribution**

The covenant-lite phenomenon fundamentally redistributes risk among market participants, with trade creditors bearing an outsized burden despite having limited influence over loan documentation. Traditional maintenance covenants—such as maximum leverage ratios and minimum interest coverage requirements—served as tripwires that alerted all creditors to deteriorating borrower performance. Their absence creates information asymmetries that disadvantage trade creditors who lack direct access to borrower financials.

Historical data highlights the stakes involved. In 2022, approximately 91% of defaulted loans were covenant-lite by outstanding amount at par, though this figure decreased to 54% in 2023 [8]. Covenant-lite loans have consistently demonstrated lower recovery rates than their covenant-heavy counterparts [7]. Studies show recovery rates for all loans historically average around 70% of par, with leveraged loans slightly lower at 60% [5]. However, covenant-lite structures contribute to declining recovery trends due to reduced debt cushions and delayed intervention capabilities.

The J. Crew case illustrates these dynamics. In 2017, management exploited carve-outs and deductibles in its credit agreement to extract significant collateral securing loans, issuing new debt primarily to refinance expiring unsecured obligations [9]. This maneuver demonstrated how weak contractual language enables value transfers from secured creditors to management and other stakeholders, prompting market-wide attention to covenant quality.

#### **Credit Exposure and Monitoring Challenges**

Trade creditors face mounting challenges in traditional risk assessment as covenant-lite lending eliminates familiar monitoring tools. The absence of financial maintenance covenants forces credit professionals to construct alternative early warning systems without the benefit of lender-mandated reporting or intervention rights.

Payment pattern analysis becomes increasingly critical as traditional financial metrics lose relevance. Trade creditors must develop sophisticated models to interpret subtle changes in

payment behavior, recognizing that initial delays often precede more serious distress. Cash application patterns, dispute frequency, and collection interaction quality can provide early signals unavailable through conventional financial analysis.

Working capital monitoring requires enhanced attention as borrowers operating under loose covenants may pursue aggressive cash management strategies. Days sales outstanding (DSO) trends, inventory turnover rates, and accounts payable patterns offer insight into operational stress that may not trigger covenant violations. Trade creditors with multiple touchpoints across customer operations—through different product lines or service agreements—possess unique visibility into these operational indicators.

Alternative data integration becomes essential for comprehensive risk assessment. Credit bureaus, legal databases, and industry-specific data sources can supplement traditional financial reporting. News monitoring, executive team changes, and competitive positioning analysis help construct a complete risk picture in the absence of lender-mandated disclosure [10].

The challenge intensifies for middle-market customers caught between traditional bank lending and private credit markets. These borrowers often lack the transparency of public companies while operating under more flexible covenant structures than historically available. Trade creditors must balance the commercial benefits of supporting growing customers against the reduced visibility into their financial condition.

Technology plays an increasingly vital role in bridging information gaps. Advanced analytics platforms can identify subtle patterns across multiple data sources that human analysts might miss. Machine learning models excel at detecting combinations of risk factors that historically preceded defaults, even when individual metrics remain within acceptable ranges [11]. However, implementation requires significant investment in data infrastructure and analytical capabilities that may exceed smaller trade credit operations' resources.

Traditional credit scoring models lose effectiveness when covenant triggers disappear. Credit professionals must develop new frameworks that weight operational indicators more heavily than financial ratios. Customer behavior analysis, industry trend correlation, and competitive position assessment become primary risk assessment tools.

#### Hidden Risk Blind Spots in the Era of Flexible Financing

As private credit expands, traditional warning systems that once protected trade creditors are disappearing. The shift toward "covenant-lite" structures means weaker contracts and fewer early signals of borrower stress. For suppliers and subcontractors who depend on timely payments, this creates a dangerous blind spot: financial trouble is often visible only after payments slow or stop. The following areas represent some of the most pressing blind spots for today's credit teams.

#### 1. Vanishing Early Warning Signals

For years, lenders relied on covenants—tests like leverage ratios or interest coverage—to detect distress early. Now, most new loans are structured as cov-lite, with minimal

triggers to force borrower transparency. Research from Resonanz Capital warns that this trend reduces early warnings and can lower recovery rates when defaults occur [12]. Trade creditors, who rarely have access to financial covenants in the first place, lose even the indirect protection that bank monitoring once provided. Without these contractual tripwires, suppliers must rely on operational signals such as slowed order frequency, unusual payment extensions, or disputes over change orders.

#### 2. Creditor-on-Creditor Conflict and Asset Shifts

When protections are weak, distressed borrowers may use liability management exercises (LMEs) like uptiering or transferring valuable assets into unrestricted subsidiaries. These moves can fundamentally change the recovery waterfall. Barclays highlights how such actions have created "creditor-on-creditor violence," where senior lenders are pushed behind new debt in priority [13]. For trade creditors, the risk is stark: invoices become unsecured exposure while borrowers reshuffle assets to protect financial sponsors. Staying alert to news of refinancings, amendments, or restructuring talks can help credit teams anticipate when payment risk is about to spike.

#### 3. Hidden Value Declines in Private Credit

Unlike public bonds, direct lending loans aren't marked to market. Valuations may only update quarterly, and in some cases they remain static until a restructuring event. This creates a blind spot where counterparties appear healthy, but the underlying loan value has already eroded. The Pluralsight case, where a sponsor-engineered deal forced dissenting creditors into worse terms, illustrates the risks of opacity [14]. While suppliers may not track valuations directly, awareness of the illiquidity and lag in private loan pricing is essential. It underscores the need to build independent monitoring—tracking payment speed, material drawdowns, and project slowdowns—rather than waiting for lenders to signal distress.

#### 4. Cooperation Agreements and Exclusion Risk

In restructurings, groups of lenders increasingly use "cooperation agreements" to coordinate and strengthen their hand. Oaktree Capital notes that these agreements can reduce intercreditor conflict but don't ensure fairness for outsiders [15]. Trade creditors are rarely included in such alliances. This leaves them exposed: even if invoices are contractually valid, payment recoveries are determined in negotiations they aren't invited to. The practical takeaway is to recognize when a customer has entered restructuring discussions and to prepare collections actions early—before outcomes are locked in.

#### 5. Smokescreens of Interest-in-Kind (PIK) Payments

Another blind spot comes from interest-in-kind (PIK) structures, where borrowers pay lenders with additional debt rather than cash. On paper, the company looks compliant. In practice, cash flow is deteriorating. Resonanz Capital cautions that PIK can mask real stress until a full liquidity crunch arrives [16]. For trade creditors, this creates the illusion

of stability while cash for payables is drying up. The only safeguard is focusing on cash-based metrics—days sales outstanding (DSO), frequency of short-pay disputes, and whether promised payment methods shift from check to credit card or financing programs.

#### 6. The Erosion of Structural Protections

Finally, the cumulative effect of these blind spots is the erosion of traditional creditor protections. What once served as a multilayered safety net has become porous. For trade creditors, this means it's no longer enough to rely on contracts and lien rights alone. Payment visibility must come from real-time project data, behavioral monitoring, and proactive communication with counterparties.

#### Adapting Credit Strategy in a Covenant-Lite Environment

Trade creditors must fundamentally reimagine their approach to risk assessment and portfolio management as covenant-lite lending becomes the norm. Success requires both defensive measures to protect against increased exposure and offensive strategies to capitalize on the financing flexibility that benefits customer growth.

Enhanced due diligence processes represent the first line of defense. Credit applications must capture more detailed operational metrics beyond traditional financial statements. Understanding a customer's capital structure, including private credit arrangements and covenant terms, becomes essential for accurate risk assessment [17].

Layered protection strategies offer multiple avenues for risk mitigation. Personal guarantees from key executives or parent companies provide recourse beyond the primary obligor. Security interests in inventory, equipment, or accounts receivable create priority positions that may survive restructuring processes. Letters of credit or cash collateral arrangements eliminate credit risk entirely while supporting customer operations. Progressive protection escalation—requiring additional security as exposure increases—balances customer relationship preservation with risk management.

Payment term optimization becomes more critical as early warning systems weaken. Shorter payment terms reduce exposure duration while preserving commercial relationships. Incentive structures encouraging prompt payment through early payment discounts can improve cash flow timing without appearing punitive. Progressive penalty structures for late payments help offset increased collection costs and encourage timely settlement.

Technology-enabled monitoring transforms reactive credit management into proactive risk assessment. Real-time payment tracking systems identify concerning patterns before they become acute problems. Automated covenant tracking for customers subject to maintenance requirements ensures credit teams receive immediate notification of violations [18]. Integrated data platforms combining internal payment history with external credit bureau data, legal filings, and industry intelligence create comprehensive risk profiles that exceed traditional financial analysis.

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Relationship management enhancement capitalizes on trade creditors' unique position in customer operations. Regular business reviews with key customers provide insight into strategic direction, operational challenges, and competitive positioning that financial statements cannot capture. Strong operational relationships often translate to payment priority during liquidity stress.

Portfolio diversification strategies help manage the aggregate risk of increased individual exposures. Geographic and industry diversification reduces correlation risk as economic conditions affect different markets asymmetrically. Customer size diversification prevents overconcentration in segments most affected by covenant-lite lending trends. Credit limit optimization across the portfolio ensures appropriate exposure relative to customer risk profiles and payment capabilities.

The opportunity side of covenant-lite lending deserves equal attention. Customers with access to flexible private credit financing may pursue growth strategies that increase trade credit demand. Understanding customer growth plans and financing capabilities enables credit professionals to appropriately size facilities and capture increased business volume.

#### What It Means for Credit Professionals

The intersection of private credit growth and covenant erosion creates a fundamentally different credit risk environment that trade creditors ignore at their peril. While private credit provides customers with valuable financing flexibility, the accompanying reduction in traditional monitoring mechanisms forces trade creditors to evolve their risk management approaches.

Private credit's trajectory toward \$2.6 trillion by 2029 ensures covenant-lite structures will dominate corporate lending for the foreseeable future [19]. Regulatory attention acknowledges systemic risks but shows little appetite for restricting market evolution. Trade creditors must therefore adapt to a world where early warning systems depend more on their own capabilities than on lender-imposed constraints.

Success requires balancing opportunity with prudence. Private credit enables customer growth that benefits trade creditors through increased volume and strengthened relationships. However, the reduced visibility and delayed intervention capabilities inherent in covenant-lite structures demand more sophisticated risk management tools and processes.

The covenant-lite world is not necessarily more dangerous for trade creditors—it is simply different. Traditional early warning mechanisms are disappearing, but alternative indicators remain available for those willing to invest in finding them. The credit professionals who adapt quickly to this new environment will discover competitive advantages in serving customers whose financing flexibility enables growth and success.

#### **Key Takeaways**

#### • Your customer's flexible loan is your rigid risk

When lenders remove traditional safeguards from loans, the risk does not disappear. It shifts to you, the supplier. Your company's Accounts Receivable becomes the first line of defense.

#### • Credit approval is a starting point, not a guarantee

A customer's financial position can weaken long before a late payment appears. Continuous monitoring of payment behavior and operational signals is now central to credit management.

#### • Know your customer's capital source

A customer funded by private credit will manage cash and payables differently than one with a bank loan. Understanding their financing helps you anticipate payment behavior and set the right terms from the start.

#### • Proactive terms are your early warning system

With loan covenants gone, your safeguards are the tools you set: shorter terms, firm policies, and vigilance for red flags such as disputes or slow responses.

#### • The credit department is a cash flow guardian

Every credit decision is a defense of company liquidity. The credit team has shifted from back-office support to a strategic protector of the company's most vital asset: cash.

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#### About the author:

Chris Woodard is the CMO and Co-Founder of Handle.com. Handle's software powers the largest credit and finance teams in construction. Fortune 500 material suppliers and con¬tractors trust Handle on a daily basis to provide their credit and collections departments with an end-to-end solution that saves their staff 10-12 hours per week.



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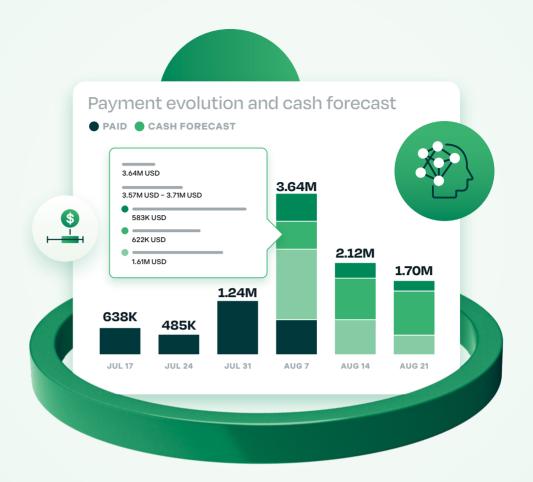
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MOVING FINANCE FORWARD

## Under Pressure: When Creditor Pressure Impairs the Applicability of the Objective 'Ordinary Course of Business' Defense

By: Eric Chafetz, Lindsay Sk.lar and Samantha Caraballo, Lowenstein Sandler LLP

#### Abstract

This article focuses on the Objective Prong, which was addressed by the Bankruptcy Court for the District of Delaware (the "Court") in FI Liquidating Trust v. C.H. Robinson Company, Inc. (In re Fred's Inc.). In In re Fred's Inc., the Court held that the Objective Prong is unavailable as a defense to a preference claim where a creditor applies pressure to extract payment from a debtor. Unlike the Subjective Prong, where there is a significant body of case law holding that collection pressure may result in an otherwise ordinary payment (from a timing perspective) no longer being "ordinary," there is a dearth of case law, especially in the Third Circuit where Delaware is located, addressing the impact of the same types of pressure on the Objective Prong.

#### Introduction

Section 547 of the Bankruptcy Code allows certain parties to claw back payments made by a debtor to a creditor within the 90 day period prior to a debtor's bankruptcy filing (the "<u>Preference Period</u>"). This means that the transaction can be effectively unwound and the creditor required to return or "disgorge" the payments.

In turn, the target of a preference action may avail itself of nine defenses, one of which is the ordinary course of business defense (the "OCB Defense"), in section 547(c)(2) of the Bankruptcy Code. The OCB Defense provides the following:

- (c) The trustee may not avoid under this section a transfer—
  - (2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, *and* such transfer was—
    - (A) made in the ordinary course of business or financial affairs of the debtor and the transferee (the "Subjective Prong"); *or*
    - **(B)** made according to ordinary business terms (the "Objective Prong").<sup>2</sup>

This article focuses on the Objective Prong, which was addressed by the Bankruptcy Court for the District of Delaware (the "Court") in FI Liquidating Trust v. C.H. Robinson Company, Inc. (In re Fred's Inc.). In In re Fred's Inc., the Court held that the Objective Prong is unavailable as a defense to a preference claim where a creditor applies pressure to extract payment from a debtor. Unlike the Subjective Prong, where there is a significant body of case law holding that collection pressure may result in an otherwise ordinary payment (from a timing perspective) no longer being "ordinary," there is a dearth of case law, especially in the Third Circuit where Delaware is located, addressing the impact of the same types of pressure on the Objective Prong.

In the wake of this decision, creditors should exercise caution when dealing with a financially distressed customer, as excessive payment pressure may result in the loss of not only the Subjective Prong, but also the Objective Prong of the OCB Defense.

#### Elements of a Preference Claim and the Objective OCB Defense

Under section 547(b) of the Bankruptcy Code, the trustee may, based on reasonable due diligence in the circumstances of the case, and taking into account a party's known or reasonably knowable affirmative defenses under subsection 547(c), avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor (generally a cash payment made by check, wire or ACH transfer);

- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made (generally a transaction on credit terms);
- (3) made while the debtor was insolvent (there is a presumption of insolvency);
- (4) made—
  - (A) on or within the 90 day Preference Period; or

\*\*\*\*\*\*

- (5) that enables such creditor to receive more than such creditor would receive if—
  - (A) the case were a case under chapter 7 of this title;
  - **(B)** the transfer had not been made; and
  - (C) such creditor received payment of such debt to the extent provided by the provisions of this title.<sup>3</sup>

In the Third Circuit, the Objective Prong "looks to the general norms of the creditor's industry[]" and measures whether the transfers are "so idiosyncratic as to fall outside the broad range' of practices customary to the creditor's industry." Generally, if the transfers are within the customary practices for the creditor's industry they are not avoidable. Courts are split as to the standard to be relied upon when identifying customary practices. While some courts rely on a financially distressed debtor standard, others – such as the Third Circuit – rely on a "healthy debtor" standard. Under the "healthy debtor" standard, a preference payment is not avoidable if the pressure applied by a creditor is customary practice in the industry for financially healthy debtors.

#### **Facts and Procedural History**

Fred's Inc. ("<u>Fred's</u>") was a chain of a general merchandise retail stores located in the southeastern United States.<sup>7</sup> Fred's lead logistical provider was C.H. Robinson. Under an agreement dated April 25, 2019 (the "<u>Agreement</u>") between Fred's and C.H. Robinson, C.H. Robinson was obligated to provide Fred's with transportation brokerage services, and Fred's was required to pay C.H. Robinson within 30 days of receipt of each invoice.<sup>8</sup> The initial credit limit under the Agreement was \$3 million.<sup>9</sup> As Fred's financial condition deteriorated, C.H. Robinson began, via e-mail, tightening the credit limit and applying pressure to obtain payment.<sup>10</sup>

On June 21, 2019, C.H. Robinson reduced the credit limit from \$3 million to \$1.75 million "on account of Fred's announcement of a 'round of store closings." Within a one-week period in July of 2019, C.H. Robinson sent two emails to Fred's initiating a credit hold, threatening to halt shipments, and warning of further tightening of the credit limit. First, after Fred's responded to an e-mail received on July 11, 2019 from C.H. Robinson concerning certain overpayments and asking if credits could be applied to Fred's oldest invoices to help with their financial situation,

C.H. Robinson emailed Fred's on the same day putting them on a credit hold. This credit hold resulted in Fred's paying C.H. Robinson \$800,000 the next day, which included \$300,000 that C.H. Robinson had requested via the emails sent on July 11, 2019. Less than a week later, on July 17, 2019, C.H. Robinson sent a second email to Fred's expressing additional concerns and informing them that "the credit terms would be reduced to '14 days to pay with credit limit of \$1M.'"<sup>14</sup>

On September 9, 2019, Fred's and seven of its affiliates (collectively, the "<u>Debtors</u>") filed for chapter 11 bankruptcy protection in the Court. On June 4, 2020, the Court confirmed the Debtors' amended joint liquidating plan of reorganization (the "<u>Plan</u>"). The Plan provided for the creation of a liquidating trust (the "<u>Trust</u>") to effectuate the wind down of the Debtors' estates, and the appointment of a liquidating trustee (the "<u>Trustee</u>") to manage and oversee the wind down process. Upon the effective date of the Plan, substantially all of the Debtors' assets, including the right to bring preference claims, were vested in the Trust. 17

#### **The Preference Action**

On September 8, 2021, the Trustee filed an adversary proceeding against C.H. Robinson, seeking to avoid "15 separate transfers - one made by check, five by ACH, and nine by wire transfer – [to C.H. Robinson within the Preference Period] totaling \$3,454,012.88" (collectively, the "Preference Payments"). On August 2, 2024, the Trustee filed a motion for summary judgment (the "Summary Judgment Motion") in the adversary proceeding aimed at avoiding and recovering the alleged Preference Payments. In the Summary Judgment Motion, the Trustee asserted that every element required under Section 547(b) of the Bankruptcy Code had been satisfied with respect to the Preference Payments, justifying judgment as a matter of law. 19

In opposition to the Summary Judgment Motion, C.H. Robinson argued that the Objective Prong was satisfied even where C.H. Robinson may have applied pressure to extract payment because it was common – and therefore ordinary – to apply pressure in the relevant industry when dealing with a financially distressed customer.<sup>20</sup>

#### The Court's Decision

C.H. Robinson argued that the Court should apply the financially distressed debtor standard when analyzing the Objective Prong. The financially distressed debtor standard considers whether it is common for creditors to pressure a financially distressed debtor to make payments.<sup>21</sup> Alternatively, the Trustee argued that the appropriate standard was the "healthy debtor" standard, under which "ordinary terms are those which prevail in healthy, not moribund, creditor-debtor relationships." The Court disagreed with C.H. Robinson and applied the "healthy debtor" standard, consistent with the approach previously adopted by the Third and Tenth Circuits.<sup>23</sup>

In choosing the "healthy debtor" standard, the Court relied upon (i) the legislative history concerning the purpose of the ordinary course defense, and (ii) the aforementioned circuit court decisions adopting the "healthy debtor" standard. First, the Court stated that the legislative history shows "the point of [the OCB Defense] is 'to leave undisturbed normal financial

relations' and to discourage 'unusual actions,' such as the imposition of credit pressure, that might destabilize a debtor nearing bankruptcy."<sup>24</sup> Second, the Court relied upon *Molded Acoustical* and *Meridith Hoffman Partners*, from the Third and Tenth Circuits, which both adopted a "healthy debtor" standard.<sup>25</sup> The Court also held that Third Circuit precedent is binding and better aligns with the congressional purpose behind adopting the Objective Prong.<sup>26</sup>

Given the foregoing, the Court held that the Objective Prong was unavailable because C.H. Robinson applied credit pressure to extract payment from the Debtors in a manner inconsistent with how similar creditors would treat a financially healthy customer. Accordingly, the Court held that the Trustee was entitled to a partial summary judgment on the Preference Payments.<sup>27</sup>

#### **Conclusion**

The *In re Fred's Inc.* decision may have major implications for creditors relying on the Objective Prong of the OCB Defense in cases pending in the Third Circuit (including courts in Delaware, New Jersey, Pennsylvania and the Virgin Islands) and beyond. It is important for defendants in preference cases in the Third Circuit to be aware that courts may, when analyzing the Objective Prong, apply the "healthy debtor" standard and not the financially distressed debtor standard. And, as result, certain collection actions or pressure, like reducing a credit limit, imposing a credit hold, or changing credit terms, may not only adversely impact the applicability of the Subjective Prong, but now also the Objective Prong. Accordingly, creditors should tread lightly—i.e., at minimum, try avoiding written communications—when trying to collect from a financially distressed customer because prior precedent holding that pressure does not impact the Objective Prong may no longer provide creditors with as strong of an argument.

<sup>&</sup>lt;sup>1</sup> 11 U.S.C. § 547.

<sup>&</sup>lt;sup>2</sup> 11 U.S.C. § 547(b)(2) (emphasis added).

 $<sup>^{3}</sup>$  Id

<sup>&</sup>lt;sup>4</sup> Courts in other jurisdictions focus on the debtor's industry, a combination of the debtor's and creditor's industry or general business practices common to all business transactions in all industries.

<sup>&</sup>lt;sup>5</sup> *Id.* at 15 (citing *Abovenet, Inc. v. Lucent Technologies, Inc.*, 2005 WL 3789133, at \*5 (Bankr. S.D.N.Y. Dec. 20, 2005); *In re Molded Acoustical Prods., Inc.*, 18 F.3d 217, 224 (3d Cir. 1994)); *In re Conex Holdings, LLC*, 524 B.R. 55, 59.

<sup>(</sup>Bankr. D. Del. 2015); *Stanziale v. S. Steel & Supply LLC*, 518 B.R. 269, 285 (Bankr. D. Del. 2014) (quoting *In re American Home Mortg. Holdings, Inc.*, 476 B.R. 124, at 140-141 (Bankr. D. Del. 2012)).

<sup>&</sup>lt;sup>6</sup> *Id*.

<sup>&</sup>lt;sup>7</sup> Id. at 3 (citing In re Fred's Inc., No. 19-11984 (Bankr. D. Del. Sept. 9, 2019)).

<sup>&</sup>lt;sup>8</sup> FI Liquidating Trust v. C.H. Robinson Company Inc., Adv. No. 21-51065 at 6 (Bankr. D. Del. Aug. 2, 2024).

<sup>&</sup>lt;sup>9</sup> In re Fred's Inc., No. 19-11984 at 3 (citing D.I. 28-1 ¶ ¶ 8-9).

<sup>&</sup>lt;sup>10</sup> *Id*. at 4.

<sup>&</sup>lt;sup>11</sup> *Id.* (citing D.I. 28-1 Ex. B at 66 of 137).

<sup>&</sup>lt;sup>12</sup> *Id.* at 4-5.

<sup>&</sup>lt;sup>13</sup> *Id.* at 4 (stating "[t]hat \$300,000 [, requested in the first email,] was apparently included in a \$800,000 wire payment that Fred's made to C.H. Robinson [the day after the first email correspondence.]"

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<sup>14</sup> Id.
<sup>15</sup> Id. at 5.
<sup>16</sup> Id. (citing Main Case D.I. 1162).
<sup>18</sup> Id. (citing D.I. 28-1 at 69 of 137).
<sup>19</sup> Id.
<sup>20</sup> Id. at 8, 16.
<sup>21</sup> Id. at 16.
<sup>22</sup> Id. (citing In re Molded Acoustical Prods., Inc., 18 F.3d at 227).
<sup>23</sup> Id. at 17 (citing In re Erie County Plastics Corp., 438 B.R. 89, 92 (Bankr. W.D. Pa. 2010); In re Meridith
Hoffman Partners, 12 F.3d 1549, 1553 (10th Cir. 1994); In re Molded Acoustical Prods., Inc., 18 F.3d at 227).
<sup>24</sup> Id. at 14-15 (citing Molded Acoustical, 18 F.3d at 224; In re Conex Holdings, LLC, 524 B.R. 55, 59
(Bankr. D. Del. 2015); Stanziale v. S. Steel & Supply LLC, 518 B.R. 269, 285 (Bankr. D. Del.
2014) (quoting In re American Home Mortg. Holdings, Inc., 476 B.R. 124, at 140-141 (Bankr.
D. Del. 2012))).
<sup>25</sup> Id. at 17.
<sup>26</sup> Id. at 19.
<sup>27</sup> Id. at 8 (citing Sept. 30, 2024 Hr'g Tr. at 6-7).
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# AI is Not a Tool: The Truth About Artificial Intelligence in O2C Processes and Beyond

By: Michael Koehler, Principal Solution Architect O2C, North America, Serrala

#### Abstract

We've already examined how AI is already making a big difference to the effectiveness of collections teams. But the current discourse around the topic is leading to misunderstandings about what AI can and cannot do for your AR function. This isn't just about the usual hype cycle associated with new technologies, because these misunderstandings are giving leaders both an overly optimistic (and imprecise) view of AI's capabilities, and an overly pessimistic and limited view as well.

This leads to a warped perspective that sees many companies adopting AI with the best of intentions, but for the wrong reasons. The fact that recent research from MIT suggests that around 95% of AI pilot projects fail to produce any return serves only to highlight this. We believe that much of the misunderstanding lies in finance organizations and their leaders still thinking of AI as a "software tool" that performs a specific function — in this case as a "general software tool" that can be applied to almost any problem indiscriminately. Effectively leveraging AI requires us to abandon this framework entirely and think about AI in a new way and on its own specific merits.

Let's start at the very beginning. Those of you reading this who are thinking about AI are likely thinking about it because you've heard a lot of people talking about it. Those people have probably said a lot about what it will be able to do in the future, in expansive and general terms. But most commentators are reluctant to get into any specifics. This may have already led you to gamble on some AI pilot projects just to see what all the fuss is about—but this is never a viable approach when it comes to technology.

For any enterprise technology or software tool to "work" (that is drive value for the business), it has to have clear, well defined use cases – practical applications to specific workflows that simplify them, scale them, or replace them.

These are lacking for "AI" because AI is not a software tool. This misunderstanding is leading to many well-meaning people promoting and purchasing AI "solutions" for their businesses in a manner that's likely to lead to frustration, dead ends, and most importantly, to missed opportunities.

But if AI isn't a tool, what is it? AI is a collection of discrete technologies with a similar purpose. They all mimic specific aspects of human decision-making processes with the aim of processing, analyzing, and presenting data more quickly and more accurately.

Let's quickly review the five most important technologies for O2C, as recently defined by Forrester:

**RPA:** Robotic process automation is by far the most established subtype of "AI" in business today. It creates a rule set that allows tasks and data to be routed in particular ways based on their characteristics. Most of us will be familiar with it from call center interactions, but within O2C its most important role is in automating workflows like the generation and sending of invoices and reminders, the routing of customer queries, and the tagging and escalation of tasks for exception handling and human review.

**Machine learning:** At the most basic level, machine learning provides an algorithmic method for processing data that updates itself as it's exposed to new data. ML allows your systems to "learn" from process failures or breakdowns and spot them before they happen, allowing for early intervention in cases that need special attention across cash application, credit risk management, and collections.

**Predictive analytics:** This is the application of machine learning to extrapolating future events based on current and historical data. Our customers already use this in O2C to predict likely customer payment dates (and even defaults) to proactively manage workflows from cash application to dunning.

**Prescriptive analytics:** If you're already able to make predictions, suggesting potential courses of action based on them is the next logical step. In O2C, we've seen many customers successfully use prescriptive analytics to create more flexible workflows for their teams, empowering them to make more nuanced exceptions and modifications to company policies that improve customer and bank relationships and optimize working capital and cash flow.

**Generative AI:** The current "star of the show" in AI applications, generative AI uses complex statistical models to complete data transformation tasks according to natural language prompts.

More than any other AI technology, generative AI is most likely to be sold as a kind of "everything app" that can complete any task you ask of it. This often leads to disappointment when a lack of specific training on your unique datasets yields poor results.

But despite this, it also has what is potentially the largest scope for scale and expansion. With connection to the right datasets, O2C teams can use generative AI to instantly look up and cross reference data, creating complex bespoke reports in a matter of minutes and tracking down key information that would otherwise have kept the most skilled forensic accountants busy for weeks. You'll increasingly hear this kind of setup referred to as "agentic AI"—using specialized deployments of generative AI to conduct analysis tasks on behalf of your people to present them with action-ready insight.

As you can probably see from this little primer, the real power of AI comes not from buying in any one of these technologies and applying it to a specific part of your workflow. It comes from combining each of these across the entire O2C cycle at strategically relevant points in order to create an integrated smart workflow that eliminates chokepoints created by disconnected, highly manual processes and poor data visibility and quality.

This is why many organizations struggle to find practical use cases for "AI". The use cases exist not for "AI" as a kind of nonspecific add-on or tool, but as an orchestration of multiple different elements that each have their own individual use case and areas of strength.

Now that I've explained this to you, I've hopefully given you a taste of the true extent of AI's capabilities and benefits for your organization. This is more than just a virtual assistant or chatbot that can look up data on your behalf or make things more efficient.

If you integrate it the correct way across your O2C workflow, you'll end up with an unrecognizable and far more sophisticated approach to handling your receivables than traditional "automation" approaches could have ever made possible. It will allow your teams to manage cash reserves, incoming payments, and liquidity in ways that strengthen your entire organization's cash position now and open the door for sustainable strategic growth for many years to come.

You will also want to know how you can achieve this. The use cases for each of our 5 key AI players are individually very strong. The use case for an integrated approach that includes all of them is even stronger. But tech implementations and change programs are difficult enough when there's only one of them. How do you cope when you have to implement five at once?

The market currently allows you to take one of two options.

The first is the one advanced by Forrester in their report on AI use cases in AR, which we've referenced here and elsewhere as it's such a fantastic and clear-headed source of advice on this

very issue. The analyst suggests carefully reviewing the sub processes within your AR and O2C cycle where the relevant AI technologies are most obviously useful and have the clearest vendor roadmap, and starting with these as a low-hanging fruit approach that allows you to build an integrated workflow over time, step by step, and solution by solution.

It's a sensible and moderate approach to a huge transformational project, especially for organizations that already have to contend with elaborate, highly specific O2C estates that span multiple different territories, processes, systems of record, and data integration approaches.

However, it is not without its disadvantages. A piecemeal approach to adoption isn't likely to make your tech stack any less complex—after all, different vendors have different strengths. A leader in RPA might not have quite what you're looking for when it comes to prescriptive analytics. Companies building tools on generative AI models won't necessarily be able to provide the best predictive analytics approach or build machine learning approaches that are right for your data sources and flows.

This is an issue we've recently highlighted elsewhere in our exploration of an analysis by Gartner of the benefits of standalone "best of breed" solutions for specific finance process challenges versus fully integrated platform options. Even though the specialists can outperform the generalists in their areas of strength, a collection of specialist solutions often loses out to a generalist platform in terms of overall effectiveness, especially when we factor in the complexities of integrating and managing data flows between different systems created by different vendors for different ends, which run on different architectures.

Which brings us to the second option: invest in an integrated system that incorporates all of the AI functionalities you need out of the box.

But while integrated systems certainly make handling data flows across your O2C processes easier in theory, and can set your organization up in a stronger position for the long haul, they also have distinct disadvantages. They generally carry a higher initial investment, for which leadership teams might not have the greatest of appetites in a period of ongoing economic uncertainty.

It may also be the case that your organization simply isn't prepared to make this kind of investment. You may see a clear business case for AI in one area, but not in others—even if you're likely to need it later as your organization grows and its needs evolve. Moreover, your operational realities may make implementing an integrated platform difficult or impossible, causing too much upheaval in your teams' day to day to make it worthwhile in the short to medium term.

In these circumstances, a full bells and whistles solution represents a misallocation of precious capital that could be better tactically invested elsewhere – to say nothing of a potential source of disruption to core workflows that comes back to haunt you in the form of runaway operational expenses.

At Serrala, we believe there's a better way to implement AI into your core O2C processes – one that gives you the best of both worlds in terms of the staged adoption and full-freight adoption pathways outlined above.

This approach demands that we all view both O2C and AI not as a series of stations in an assembly line that take is from raw components to increasingly finished products, but as a carefully balanced symphony of different technologies, processes, and people working together to create a greater whole.

If we look at it like this, we can create a useful analogy. In an orchestra, different instrumentalists first hone their skills and parts alone. Then they come together with others in their section. It's only after they've all worked individually that they start playing together as a singular ensemble. But every stage of the process is conducted with that final team effort in mind.

This is how we believe finance leaders—and tech vendors in the space—must approach the question of AI in order to allow it to deliver the kind of tangible, integrated value that we already know it's capable of delivering.

What does this mean? It means that finance automation vendors in AR and beyond must take a radically different approach to the way in which they architect and build their solutions. AI must be a core part of every part of the workflow they want to create for their customers.

But they won't be able to present all of this as a singular, monolithic solution into which different teams plug different inputs and data sources—as in the manner of a traditional finance system of record or ERP platform.

Instead, they'll have to create something that organizations like yours can invest in step by step – making smaller investments in specific parts of a much larger whole which can scale not only with volume but also with functionality as needs and demands change over time according to evolving business priorities.

This represents a much more helpful approach to transformation for finance leaders like you. Rather than having to tackle the problem as a mountain to summit all in one step or face the potential difficulties of a piecemeal approach in the future, transformation can become something you pursue at a pace that actually makes sense for you. The ultimate goal is visible and clearly signposted from the very start, but you can still approach it via a series of logical and tangible milestones that constitute your own smaller, self-contained, and more manageable change projects.

Because we're convinced this is the approach modern CFOs need—whether their organizations are scaling mid-market companies or established international enterprises—we've made it the heart of our own strategic product roadmap.

Our entire portfolio of O2C automation solutions (and the P2P and treasury and liquidity management offerings that accompany it) will still be sold as standalone products, but we'll

deliver them through a single cloud hub that's fully AI-enabled and empowered. This will provide the integrated architecture to deploy all AI use cases for accounts receivable workflows in a way that ensures total and seamless operational efficiency while still providing complete choice and flexibility as to which parts of the offering your organization uses (and pays for) at every stage of your transformation journey.

For those of you ready to begin this journey now, the first step (after cleaning your data to make it legible and readable by AI-enabled systems) is planning your own investment roadmap. Forrester's analysis is a great place to start, and offers a great step by step play.

Begin by prioritizing your adoption of AI technologies according to the use cases which are most mature, and which you can most easily implement. This will help you to both demonstrate value and unlock resources for future rounds of investment and development. It will also allow you to plan for a change approach that provides ample time to educate and support your teams to fully understand the benefits and make the best possible use of technologies while also implementing working approaches to successfully manage increasing exposure to AI risk.

This gentler approach will also allow you to escape the trap highlighted in MIT's assessment of attempted AI adoption in enterprise: top-down imposition of AI by leadership that favors flashier and more visible functions as opposed to improvements to higher-ROI fundamentals, and which ultimately stalls when the time comes to scale up.

You will note from the Forrester heatmap that the most mature AI use cases in AR are actually the older and less glamorous applications like RPA. While not likely to win your firm much in the way of PR accolades if you implement them, these are much more likely to pay dividends than diving straight into deploying agentic AI on top of incomplete foundations.

AI is far more than a buzzword, and far more than simply another tool. Deployed thoughtfully, it's a recipe for an entirely new approach to finance. Hopefully, this piece has given you some food for thought.

#### About the author:

With over 15 years' experience working in the order-to-cash field, Michael's present and previous roles have given him unique insight into best practices in managing credit and compliance risks as well as collections operations for businesses of various sizes and industries. Michael has led and delivered a number of complex international solution implementation projects for global corporations around the world. In his current role with Serrala as a Solution Architect, Michael's main focus is on analyzing organizations' needs around credit risk, compliance, and collections management and translating them into software solutions that are both user-friendly and aligned with the trends in an ever-changing environment.

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