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CREDIT RISK IN FRAGMENTED & MULTIPOLAR WORLD

Presented by:

JUNIOR MBUYI

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PART I — CREDITRISK IN A FRAGMENTED AND MULTIPOLAR WORLD

How Geopolitical Fragmentation and Sovereign Risk Are Reshaping Credit Frameworks

The End of Macroeconomic Continuity

- Models assume cycle
- Stress tests assume gradual deterioration
- Frameworks assume historical calibration
- Geopolitics introduces rupture

From Cyclical Risk to Structural Fragmentation

- Sanctions regimes
- Strategic decoupling
- Energy weaponization
- Bloc-level industrial strategies

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GEOPOLITICS AS A STRUCTURAL DRIVER OF CREDIT RISK

Shift from a Globalized World to a Fragmented and Multipolar One

Economic interdependencies are giving way to bloc-based dynamics and strategic rivalries.

Transformation of Geopolitical Shocks from Episodic Events into Persistent Risks

Geopolitical tensions are now long-lasting and increasingly shape the risk environment.

Direct impact on growth, trade flows and financial flows

Conflicts and sanctions durably disrupt trade and capital flows.

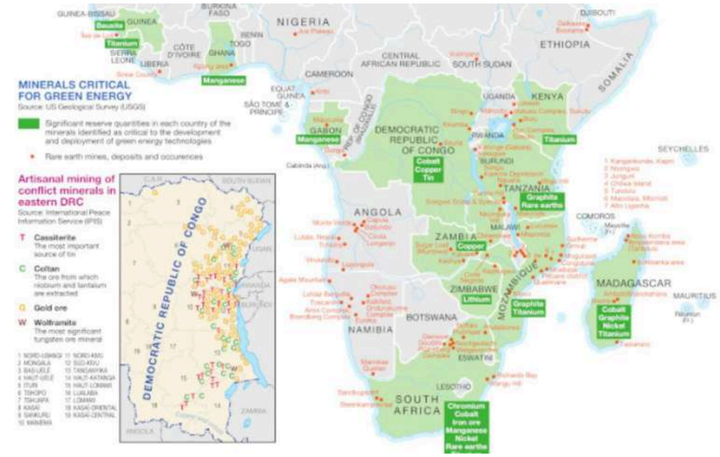
Growing impact on the solvency of sovereigns, banks and corporates.

Macroeconomic deterioration is quickly reflected in the balance sheets of economic actors.

Need to integrate geopolitics at the core of credit risk analysis.

Geopolitics is becoming a central factor in credit risk decision-making.

TRANSMISSION OF GEOPOLITICAL RISK AND REGIONAL IMPLICATIONS



Discontinuity vs Deterioration

Traditional Risk:
Gradual economic decline

Geopolitical Risk:
Abrupt structural rupture

Transmission Channels

- Macroeconomic
- Financial

Rapid propagation of regional shocks to global markets

- Rapid transmission through trade and financial flows
- Increased interconnectedness of markets and value chains
- Contagion effects and rising correlations
- Simultaneous repricing of credit risk at the global level

Major Geopolitical Hotspots

- Africa (critical resources, political vulnerabilities)
- Asia (strategic rivalries, value chains)
- Europe (Ukraine, energy, fiscal pressures)
- Middle East (energy, sanctions, instability)

REGULATORY FRAMEWORKS HISTORICALLY ORIENTED TOWARD THE PAST

- Basel IV, IFRS 9 and stress testing frameworks based on historical data
- Assumption of stability in economic and financial relationships
- Models calibrated on “traditional” economic cycles
- Limited consideration of major geopolitical disruptions
- Growing gap between prudential frameworks and geopolitical reality

PART II — LIMITATIONS OF CURRENT CREDIT RISK MANAGEMENT FRAMEWORKS

Designed in a more stable environment and based on backward-looking analysis, current credit risk management frameworks are now showing their limitations in the face of more frequent and non-linear geopolitical shocks.

Where Current Frameworks Fall Short ?

- Macro-linear stress scenarios
- PD calibrated on past defaults
- Static sovereign risk weights
- Limited sanction exposure modeling

Climate Risk = Sovereign Risk

- Resource concentration
- Political fragility
- Infrastructure gaps
- Sovereign exposure

The Sovereign Risk Illusion

- 0% risk weight ≠ 0% risk
- Political default
- Regulatory divergence
- Strategic exposure concentration

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Difficulty in integrating geopolitical disruptions

Low-frequency but high-impact geopolitical shocks

Major geopolitical events occur infrequently, but when they do occur, their effects are immediate and profound. Their exceptional nature makes statistical integration difficult, even though they can rapidly reshape credit risk profiles.

Insufficiently severe or weakly plausible scenarios

Stress scenarios often incorporate gradual and calibrated shocks that fail to capture the abruptness and complexity of recent geopolitical events. This limits their ability to anticipate rapid deteriorations in credit risk.

Risk models are designed to operate in relatively stable environments. In the event of geopolitical disruptions, they struggle to adapt quickly to new economic regimes, leading to a gap between actual risk and measured risk.

The inadequate consideration of geopolitical disruptions can lead to an overly optimistic assessment of solvency. As a result, credit risk may deteriorate faster than expected before being properly reflected in risk models.

Difficulty in translating political events into quantitative

Political events are inherently qualitative, uncertain and sometimes ambiguous. Translating them into quantitative variables usable in credit risk models remains complex, which limits their operational integration.

Underestimation of Extreme Risks and Non-Linearities

Limitations of Linear and Historical Approaches

Current credit risk management frameworks largely rely on linear relationships and assumptions of continuity in economic dynamics. However, geopolitical shocks often generate threshold effects, abrupt disruptions and rapid risk adjustments that are difficult to capture with models calibrated on historical data.

Purpose and Scope of the Presentation

During periods of stress, correlations across regions, sectors and asset classes increase significantly, reducing diversification benefits and amplifying potential losses. This non-linearity leads to an underestimation of extreme risks, highlighting the need for more dynamic, forward-looking approaches capable of integrating severe yet plausible scenarios.

PART III — ECOLOGICAL TRANSITION AND THE GEOPOLITICAL RECOMPOSITION OF CREDIT RISK

The ecological transition represents a major structural shock, profoundly transforming global energy, industrial and geopolitical balances.
It reshapes value chains, intensifies rivalries around critical resources, and durably alters the distribution of credit risk across countries and sectors.

The Geopolitics of the Green Transition

- Copper
- Lithium
- Cobalt
- Nickel
- Manganese

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The energy transition as a global structural shock

The energy transition is emerging as a global structural shock, durably reshaping economic, industrial and financial balances. The transformation of energy systems is driving a profound reallocation of risks, with differentiated impacts across countries, sectors and production models. This dynamic is progressively redefining the global credit risk landscape.

Critical Raw Materials and Geopolitical Rivalries

The energy transition significantly increases demand for critical raw materials, whose production is geographically concentrated. This concentration strengthens strategic dependencies and intensifies geopolitical rivalries, exposing economies and companies to new supply and volatility risks, with direct implications for credit risk.

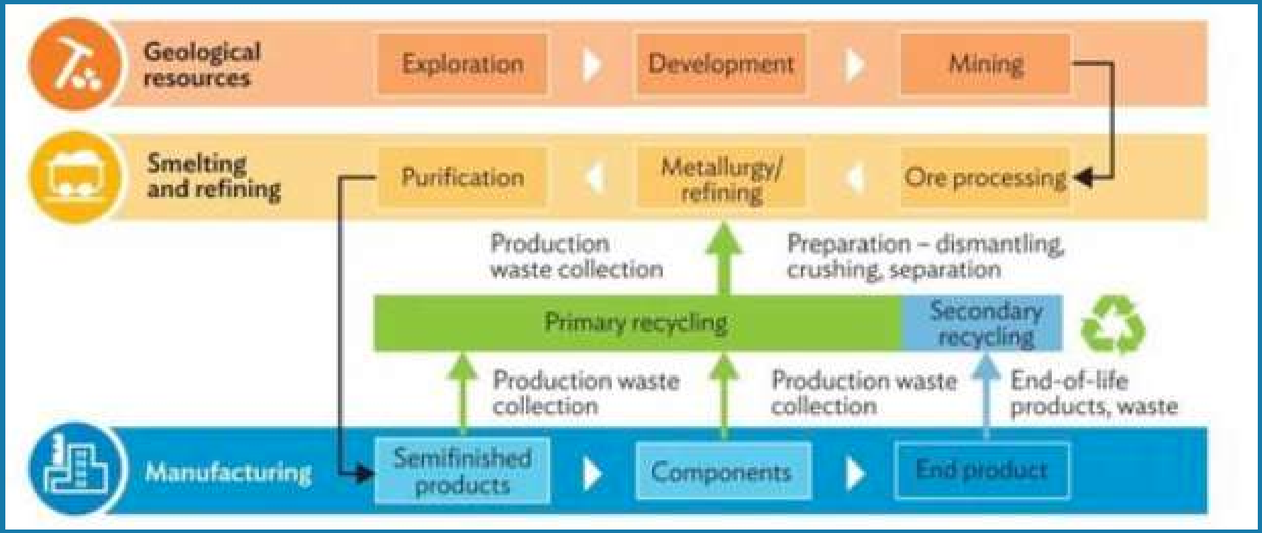
- **Geographical Concentration of Strategic Resources**
- **Increased dependence on producing countries and supply chains**
- **Intensification of geopolitical rivalries over access to resources**
- **Risks of supply disruptions and price volatility**
- **Progressive integration of these risks into credit analysis**

Reconfiguration of Value Chains and New Dependency Risks

The reconfiguration of global value chains, accelerated by geopolitical tensions and the energy transition, is profoundly reshaping cost structures and geographic dependencies. Relocation and supply-chain security strategies are exposing companies to new country and logistical risks, with direct effects on their credit risk profiles.

Four Strategic Implications

- Reframe green finance as strategic finance
- ntegrate sovereign risk into stress testing
- Exit the “green = low risk” illusion
- Redefine the CRO role



Reconfiguration of Global Value Chains (nearshoring, friendshoring)

Rising production costs and margin pressures

Increased exposure to country risk and logistical risk

Differentiated impacts on corporate and sectoral credit risk

Need for a more forward-looking and geographically granular credit approach

PART IV — Capital Allocation and Portfolio Diversification in a Multipolar World

The transition toward a multipolar world order is reshaping the traditional foundations of international finance. Investors now operate in an environment where geopolitical alliances, competing monetary systems and political risks are redefining capital allocation strategies. In this fragmented context, geographic diversification and granular analysis of regional dynamics are becoming essential to preserve portfolio resilience.

Capital Allocation in a Fragmented World

- Bloc capital dynamics
- Cross-border funding constraints
- Risk pricing asymmetry
- Strategic capital position

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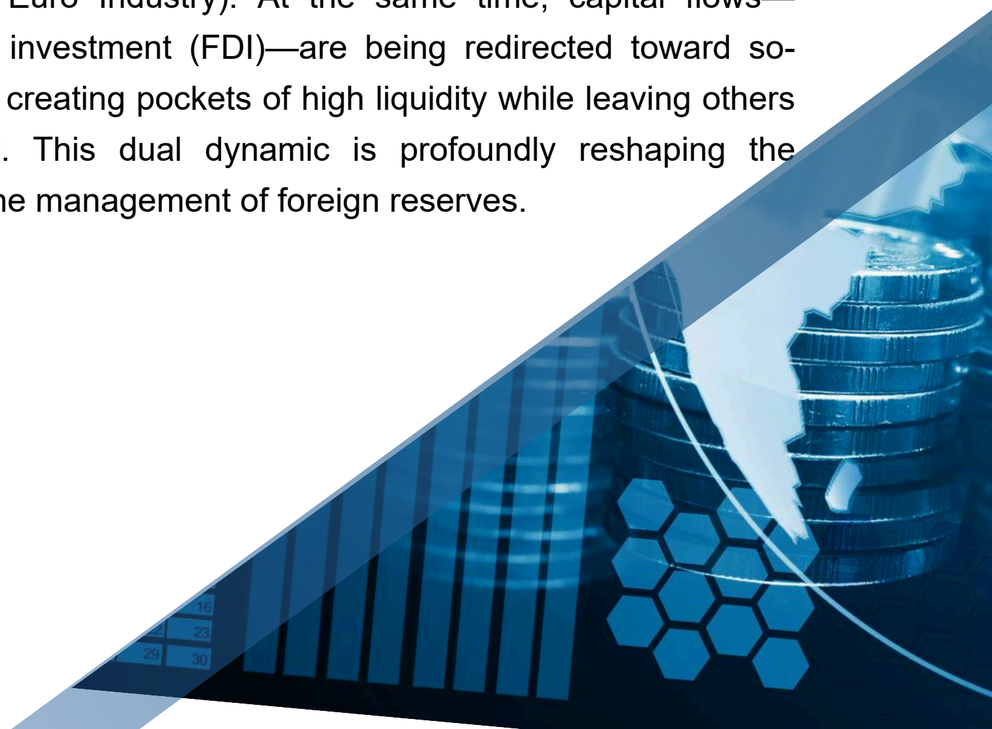
Global Financial Recomposition and New Trade-offs

Risk–Return Trade-offs in an Unstable Environment

- Return calculations must now incorporate a significantly higher political risk premium.
- Tail risk modelling: events previously considered unlikely (e.g. asset seizures) are becoming standard risk variables.
- Liquidity vs. return: a market may offer high returns (e.g. Russia pre-2022), but if capital is frozen due to sanctions linked to a conflict or a geopolitical crisis, the effective return becomes –100%. The challenge is therefore no longer just the headline return, but the ability to recover capital in the event of a political shock.

Financial Fragmentation and Reorientation of Capital Flows

Global finance is gradually fragmenting into multiple geopolitical blocs rather than operating as a unified system. While the U.S. dollar remains important, it is losing its exclusive role as more countries increasingly rely on their own currencies and alternative payment systems (see “The Shift Away from the U.S. Dollar in Global Trade”, Euro Industry). At the same time, capital flows—particularly foreign direct investment (FDI)—are being redirected toward so-called “friendly” countries, creating pockets of high liquidity while leaving others increasingly marginalized. This dual dynamic is profoundly reshaping the circulation of capital and the management of foreign reserves.



Strategic Diversification and Opportunities in Emerging Economies

Benefits of Geographic Diversification

Geographic diversification is becoming essential in a multipolar world, as crises do not affect all blocs in the same way. Investing in regions that are less correlated with Western cycles and in “connector” countries such as Vietnam, Mexico or India helps reduce risk while capturing opportunities linked to the reconfiguration of global trade.

Case of Emerging Economies, Including Africa

In a multipolar world, Africa is taking on growing strategic importance for investors. On the one hand, the continent holds resources that are essential to the energy transition, making capital allocation as much a geopolitical issue as an economic one. On the other hand, the coexistence of Western and Chinese creditors complicates debt restructurings and increases the risk of over-indebtedness. Finally, some African countries—such as Nigeria, Egypt and South Africa—are adopting a “middle power” stance, engaging with multiple blocs without aligning with any single one. This approach allows them to attract diversified financing and creates return opportunities for investors able to navigate this fragmented environment.

PART V — RWA and Prudential Treatment in an Uncertain Geopolitical Environment

The international prudential architecture, originally designed to stabilize the financial system after the 2008 crises, is now facing an unprecedented challenge: the large-scale emergence of geopolitical risk. RWA calculation frameworks, historically based on statistical data and relatively predictable market behaviors, must now account for sudden disruptions, extraterritorial sanctions, and the reconfiguration of economic blocs. In this new environment, the limitations of the current prudential framework are becoming increasingly evident, underscoring the need to evolve toward more dynamic and geopolitically sensitive approaches.

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Vulnerabilities of the Prudential Framework to Geopolitical Shocks

Limitations of the Current Prudential Framework in the Face of Geopolitical Shocks

The Basel III framework largely relies on historical data to measure risk. However, geopolitical shocks generate “black swan” events—rare, unpredictable and highly disruptive occurrences—that these models are unable to anticipate.

Lag in credit rating agencies: RWAs depend partly on external ratings, yet these ratings are typically adjusted only after a conflict, sanction, or asset freeze has already occurred. As a result, actual risk increases well before capital requirements are revised.

The illusion of “zero sovereign risk”: Within the EU, domestic sovereign debt is treated as risk-free (0% risk weight). In a multipolar world, however, a country can experience a form of political default—such as asset freezes, sanctions or payment blockages—even while remaining economically solvent. This type of risk is not captured by current prudential rules.

Procyclicality, Risk Biases and Credit Rationing

The prudential framework may end up amplifying crises rather than cushioning them.

Cliff effects: when a geopolitical crisis erupts, rating downgrades can trigger a sudden surge in capital requirements (RWAs), creating abrupt and destabilizing adjustments.

Credit rationing (credit crunch): in order to preserve solvency ratios without raising new capital, banks may sharply cut credit lines to sectors or geographic areas deemed “under stress,” thereby exacerbating the local economic downturn.

Impacts on Emerging Markets and the Imperative for Prudential Modernization

Challenges for Exposures to Emerging Markets

The “frontier penalty”: capital requirements for lending to emerging economies are often perceived as disproportionate to actual risk, as models struggle to distinguish between temporary political instability and structural insolvency.

Strategic withdrawal: rising RWAs encourage international banks to scale back their exposure to countries in the “Global South,” leaving room for less regulated lenders or regional powers, thereby reinforcing financial fragmentation.

Toward a More Sensitive Approach to Real Geopolitical Risk

Moving Beyond Static Models: The need to shift away from purely backward-looking measures in favor of forward-looking indicators.

Valuing Resilience: The prudential framework must evolve to incorporate the ability of a State or a company to navigate a multipolar world (alliances, strategic resources).

PART VI — Integrating geopolitical risk into internal models as a solution to systemic uncertainty

The integration of geopolitical risk into internal models represents one of the major challenges of contemporary risk management. Traditional approaches, based on historical data and relatively stable market behavior, are no longer sufficient to capture the complexity of a world shaped by bloc disruptions, extraterritorial sanctions and systemic shocks. Financial institutions must now adapt their credit models, stress tests and RWA calculation methodologies to reflect non-linear dynamics and extreme scenarios. This evolution requires a hybrid approach combining quantitative analysis with geopolitical expertise.

Evolving Internal Models

- Geopolitical proxy indicators
- Bloc-level stress scenarios
- Sanction exposure mapping
- Scenario layering approach

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Required Adaptations for International Exposures

Integrating Geopolitics into Credit Risk Models

01

The challenge lies in moving from an intuitive and approximate assessment of geopolitical risks to quantifiable indicators that can be integrated into probabilities of default (PD) and loss given default (LGD).

Proxy indicators: use alternative data such as the Geopolitical Risk Index (GPR), cross-border capital flows, or sovereign CDS spreads as explanatory variables.

Score adjustments: incorporate a geopolitical “penalty” into the credit scoring of companies that are highly dependent on supply chains exposed to friction zones (e.g. the Taiwan Strait, the Red Sea).

Multi-Region Geopolitical Stress Tests

02

Unlike traditional stress tests that simulate increases in interest rates or unemployment, geopolitical stress tests must model connectivity disruptions.
Decoupling scenarios: model the impact of a full embargo between two blocs on the asset portfolio.

Contagion effects: analyse how a localized conflict can destabilize an entire region through supply shocks (e.g. commodities) or refugee crises, indirectly affecting the solvency of exposed borrowers.

Advanced Approaches and the Evolution of Prudential Methodologies

Incorporating Non-Linearity and Extreme Scenarios

01

In geopolitics, crises do not evolve in a proportional manner: a small shock can trigger a massive reaction. Risks evolve in a non-linear way and can escalate very rapidly.

Threshold effects / tipping points: a minor diplomatic tension can suddenly trigger a sharp collapse in market confidence. Identifying these tipping points—where dynamics abruptly shift—is therefore essential.

Fat tails: major crises occur far more frequently than predicted by traditional models based on the normal distribution. More appropriate statistical models are required to capture these extreme events, often referred to as “black swans.”

Evolution of RWA Calculation Methodologies

02

For Internal Ratings-Based (IRB) models to remain credible in the eyes of regulators, they must evolve.

“Adverse Bloc Scenarios” approach: propose asset weighting that does not depend solely on the country of origin, but also on the asset’s vulnerability to a reconfiguration of global alliances.

Model governance: establish geopolitical expert committees to validate the assumptions underlying quantitative models, thereby creating a hybrid “quant–qual” approach.

Governance Must Absorb Complexity

- Hybrid quant–qual framework
- Strategic CRO positioning
- Cross-functional committees
- Enhanced supervisory dialogue

MANAGING CREDIT RISK MEANS MANAGING GEOPOLITICS

CREDIT RISK IS NOW STRATEGIC, PRUDENTIAL AND GEOPOLITICAL

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