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Why Boards Should Care More About Geopolitics Than Ever Before

Geopolitical risk seems higher than at any point in recent memory. Managing this risk effectively should be a core competency for all businesses — and the board should lead the way.

After decades of globalisation shaping the world order, businesses are now forced to accept a new reality. Geopolitical risk is an ever-growing threat with far-reaching potential consequences. This risk arises from a growing polarity in the interactions between and among countries. Shifting and expanding alliances, intensifying economic competition among nations, national security concerns, and political division and instability all contribute to geopolitical risk.

The future gets even cloudier given concerns over the duration and possible expansion of regional conflicts, the existence of potentially volatile territorial disputes, and multinational attempts at climate initiatives. So far in 2024, geopolitical analysts have been focused on the ongoing conflicts in Eastern Europe and the Middle East, and myriad other issues as diverse as:

- China's faltering economy
- Actions of emboldened terrorist groups
- Opportunities and threats from the growth of artificial intelligence (AI)

Also gripping analysts' attention is what *The Economist* has called the "biggest election year in history,"[1] in which more than half the world's population — over 4 billion people — will vote in national elections. Many elections will have impacts that extend beyond the voting country's borders. But none is likely to affect the geopolitical landscape more than the U.S. election.

Bottom line: The effects of geopolitical risk include profound human and societal consequences, as well as broad commercial impacts. While large multinational companies may be the most exposed, midsize and smaller companies across the globe may also experience a wide range of downstream consequences.

Why the Board Should Care About Geopolitics

The current disruptive environment is nuanced and complex. The swing of the pendulum to nationalism, the fragmenting global economy, and expanding economic sanctions and trade restrictions are impacting leaders' assessments of global opportunities and risks. These dynamics are also forcing some nations and businesses to choose sides.

A Bloomberg article asserts that tensions between the U.S. and China and the Russia-Ukraine war, as examples, are prompting businesses to redirect their investments, a sign that they are making geopolitical bets.[2] Similarly, an emphasis on friendshoring[3] is targeting economic regimes like China that the West — principally the U.S. and the European Union (EU) — views as unfairly supporting their domestic industries. Their efforts to de-risk reliance upon China are intended to increase resilience and reduce vulnerabilities in strategic sectors. But these efforts can only go so far given China's preeminence in global supply chains. For example, China produces 60% of the world's rare earths and processes almost 90%.

The geopolitically fragmenting marketplace is also driving the emergence of so-called "connector economies." As Western economies de-risk their reliance on China, some countries — Poland, Vietnam and Mexico, for example — are playing both sides of the political divide as they seek to attract Western and Chinese investments and imports.

India, the most populous country and the fastest-growing emerging economy, despite its strong ties to the West (and notably the U.S.), also continues to act in its own national interest in how it chooses to engage with Russia and China given its long-standing ties with both.

[1] "2024 Is the Biggest Election Year in History," *The Economist*, November 13, 2023: www.economist.com/interactive/the-world-ahead/2023/11/13/2024-is-the-biggest-election-year-in-history.

[2] "The Global Economy Enters an Era of Upheaval," by Shawn Donnan and Enda Curran, Bloomberg, September 18, 2023: www.bloomberg.com/graphics/2023-geopolitical-investments-economic-shift/#:~:text=Economics%20The%20Big%20Take,companies%20are%20making%20geopolitical%20bets.

[3] The *Financial Times* defines friendshoring as "the relocation of production capacity closer to customers to limit vulnerability to geopolitical tensions."

The polarity of these relationships, especially in the case of a country the size and importance of India, creates a geopolitical challenge for the West: how to balance longer-term interests with the current national security agenda.

Add to all of the above the proliferation of misinformation and disinformation in social media, the convergence of China, Russia, Iran, North Korea and other countries in opposition to Western democracies, and terrorists' disruption of the supply chain, and strategists are looking at a combustible mix of real and potential disruptive events.

Underlying it all is the reality that at the same time some countries are sparring with each other — the U.S. and China being the obvious examples — they and indeed other countries are relying on each other's cooperation. The U.S., while it continues to impose trade and investment restrictions on China, is also imploring China to keep North Korea and Iran in check. The U.S. and China have major trading ties that are mutually beneficial for them to sustain. The future of the global economy depends on their finding a way to work together as they compete on the world stage. But this won't be easy. China, by continuing to sure up its relationships with other jurisdictions such as India, Brazil and fast-growing African countries, is playing strategic chess on the geopolitical board in seemingly a more deliberate and thoughtful way with a longer-term playbook than the U.S. (or EU).

Key takeaway: Companies cannot afford to ignore the evolution in global markets as it is altering trade relationships and investment hurdle rates. Accordingly, geopolitical risk warrants strategic conversations in the boardroom.

The Board's Focus on Geopolitics

Following are suggested steps that directors can take:

Stay informed. The complexities of the geopolitical environment mean that general knowledge of world events is likely not sufficient to anticipate the potential consequences. As necessary, the board and management should enlist the assistance of advisers who can offer insights based on experience, research and deeper market intelligence.

There are geopolitical risk indices — both overall and by country — available from multiple sources that offer barometers of the level of risk in markets across the world. They can be used to inform boardroom discussions.

Include geopolitical risk in enterprise risk assessments. Consider and evaluate, through scenario analysis, the potential implications of the changing geopolitical landscape for the business and for customers of the business.

- Keep in mind that comprehensive scenario analysis may require assessing the consequences of multiple geographic events occurring simultaneously and assessments of geopolitical risk must be dynamic.
- A one-and-done annual assessment won't cut it.

When developing scenarios, the focus should be on geopolitical developments and trends over, say, the next two to three years that could alter the assumptions underlying the company's sources of supply, global markets, customers, business model and regulatory oversight. Look for market opportunities as well as emerging risks to factor into the strategy-setting process.

Evaluate relevant scenarios in terms of their impact on capital allocations to and business plans for different markets and response plans in the event of a disruption or more significant crisis. The scenarios that management considers to be significant threats should be closely monitored.

Analysis of scenarios offers an opportunity for strategists and planners to play out their impact on the business and identify appropriate actions to take in the event they unfold. Geopolitical scenarios should consider both the risk of potential events materialising as well as the risks associated with an escalation of existing events.

Adopt a value chain lens to manage geopolitical resilience. Think about resilience by focusing on the implications of different types of geopolitical risks on the value chain. To illustrate, consider what the potential business impact would be if any of the following value chain elements were taken away:

- A strategic supplier (or the subcontractor of a strategic supplier) of essential raw materials or other inputs currently provided at a reasonable cost
- The availability of power currently provided at a reasonable price
- Key employees on whom the company depends
- Critical insourced and outsourced systems and facilities
- Transportation and logistics for delivering products or major customer contracts

Contingency plans should address geopolitical impacts on all key components of the value chain.

What losses would the company sustain? How long would it be able to operate?

The point: Contingency plans should address geopolitical impacts on all key components of the value chain.

Prepare for a complex and nuanced geopolitical landscape. As noted earlier, nationalism, the fragmenting global economy and expanding economic sanctions are forcing nations to choose sides. Companies operating globally should take note as nations assess trade relationships and dependencies of strategic importance — all in the name of national security.

Geopolitical developments — such as nation-states using technology to control, obfuscate and confuse — can lead to a reemergence of hostilities akin to the Cold War of the last century. But globalisation remains a potent force. There will remain some form of a scaled-back or reshaped model — a global marketplace anchored by the U.S. and China that is geopolitically fragmented, yet economically linked. That said, hostilities can still create blocs that could constrain revenue growth.

Ultimately, managing geopolitical risks is about ensuring the company is sufficiently resilient to prevent significant impacts on the customer experience. Lengthy cessations of supply or service can erode the customer base.

Geopolitical developments drive new business realities. As companies evaluate their impact on global markets and operations, they should factor their assessments into growth forecasts.

Be prepared for a more complex global regulatory environment. Companies operating globally often point to varying national regulatory regimes as a complicating factor that impacts operating processes, products and services. Regulators all over the world have a line of sight on adverse consequences, intended or unintended, of AI and other technologies, the escalation of cybersecurity risks, and the specter of insufficient global cooperation and progress on environmental and sustainability issues.

These and other matters bear watching closely to understand their impact on the business model, product innovation, sustainability policy and reporting, and ever-growing stakeholder demands.

Consider the impact on the customer experience. The fallout of geopolitical events can impact the company's ability to meet customer demand and service customer needs. Ultimately, managing geopolitical risks is about ensuring the company is sufficiently resilient to prevent significant impacts on the customer experience. In today's marketplace, customer loyalty is fleeting. Lengthy cessations of supply or service can erode the customer base.

In the event that significant disruption cannot be avoided, timely communications regarding the nature of the disruption (which will likely be in the news cycle), and the expected duration should be directed to customers, employees and other stakeholders, including investors. Consideration should be given to creating a buffer by increasing inventory levels and stocks of critical raw materials and components.

Be mindful of escalating asset impairment, and legal, credit and reputation risks. Following Russia's invasion of Ukraine, Western allies quickly — and in an unprecedented manner — turned to economic sanctions in an effort to punish Russia for its actions. While aligned in principle, the differences in timing and application of national sanction regimes present significant compliance challenges and reputation risk for companies with direct Russian exposure or exposure through their customers.

Sanctions imposed are often retaliated, creating asset impairment, and legal and credit risk challenges for companies (or their customers) that are trying to unwind their exposures. Companies choosing to circumvent sanctions risk substantial fines, criminal proceedings and reputation loss.

Be prepared when risk management gives way to crisis management. Preparedness is essential to achieve decisiveness under fire. When bilateral or multilateral armed conflict between states (either as proxy or open warfare), internal civil unrest and social violence, the intentional or accidental release of hazardous material, another global airborne pandemic, or other events expose the health and safety of local employees and expatriates in any foreign country or region, or otherwise raise serious questions about the future viability of a market, management's playbook should address the steps needed to protect people and company assets and investments.

It is imperative that management's response plan empower local management to do what they have to do to take any and all necessary steps to protect the safety of employees and safeguard company assets.

When the company decides the circumstances of a high-risk situation are such that it is necessary to limit exposure to asset impairments or reduced returns on investment, a prior issue of *Board Perspectives* presents options to consider.[4] While response plans facilitate preparedness, their effectiveness largely depends on timing. Once the crisis unfolds, all bets are off.

Not every geopolitical event can be anticipated, but the board and the C-suite should define in advance the circumstances that would prompt messaging about an event to the organisation and the broader market.

Consider internal and external communications plans. How a company responds (or whether it responds at all) to geopolitical events has become a lightning rod for controversy and criticism. Not every geopolitical event can be anticipated, but the board and the C-suite should define in advance the circumstances that would prompt messaging about an event to the organisation (i.e., internally) and the broader market. They should also outline the parameters of the response.

[4] "Managing Country Risk," *Board Perspectives*, Issue 46, Protiviti, July 2013: www.protiviti.com/sites/default/files/2023-02/board-perspectives-risk-oversight-issue46-managing-country-risk-protiviti.pdf.

Conduct a post-mortem when surprises occur. For misses, a post-mortem provides management and the board with an opportunity to review what happened and determine "lessons learned" they can apply going forward. Why did we not see the event coming? If we saw it coming, could we have done anything different to prepare? Did the risk indices offer a warning? If a consultant was used, what advice was given?

Play offense as well as defence. Those organisations that are most resilient in a volatile world are most likely to achieve and sustain a competitive advantage. Continuous monitoring of global developments, integrating scenario analysis into strategy-setting, redirecting capital to markets with less risk, de-risking supply chains, staying ahead of the regulatory curve, and taking preemptive steps to reduce exposure in countries and regions in which the company is heavily invested, taken together, offer a proactive, complementary approach to playing offense and defence in the management of geopolitical risk.

In summary, the reason geopolitical risk is so important is simple: Companies operate in a hyper-digital world and global markets are incredibly nuanced and complex. Bloomberg Law states that "global events can rapidly evolve into a polycrisis that reverberates through countries, economies and business sectors for years."[5]

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That is why the above steps are important. They enable executive teams and directors to engage in critical thinking in the cool of the day regarding a company's options — both before and during either an anticipated scenario or a simultaneous occurrence of multiple intertwined scenarios. The primary objective of evaluating geopolitical risk is to give decision-makers time advantage and options to allocate capital, sustain investment returns and protect company assets. The board has an important role to play in these deliberations.

[5] "Special Report: Geopolitical Risk Is the New Reality for In-House Teams," Bloomberg Law, February 26, 2024: https://news.bloomberglaw.com/us-law-week/geopolitical-risk-is-the-new-reality-for-in-house-teams.

How Protiviti Can Help

We assist boards and executive management with identifying and assessing the enterprise's risk scenarios and formulating and implementing strategies and tactics for managing those scenarios. Also, we assist public and private companies in integrating their risk assessment process with their core business processes, including strategy-setting and execution, business planning, and performance management.

We provide an experienced, unbiased perspective on issues separate from those of company insiders to help organisations improve their risk reporting to better inform the board's risk oversight process.

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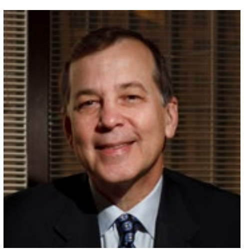

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