The confluence of geopolitical risk and ESG issues

KPMG Board Leadership Centre

A spate of global corporate surveys in recent years, across industry sectors, show concern about geopolitical instability has spiked amongst directors and management teams. In this article, Derek Leatherdale, Managing Director of GRI Strategies, and Peter Neville Lewis (Risk Coalition) discuss some of the issues driving the recently released joint Risk Coalition / GRI Strategies principles-based guidance for Geopolitical risk oversight and its integration with ESG issues for boards, risk committees and risk functions – 'The Extra G – ESG[2]

The spike in concern about geopolitical instability is not surprising. The immediate post-Cold War years, memorably described by Francis Fukuyama as 'the end of history', are long gone – though not before many firms globalised their market footprint and supply chains. However, globalised business models are now exposed to an increasingly antagonistic geopolitical environment.

Deteriorating US-China relations represent perhaps the most significant aspect of this for firms, given the significance of both countries in the global economy. Trade wars, sanctions and financial and geo-economic measures in key industry sectors like technology, financial services and strategic commodities have all come to the fore in recent years and show few signs of abating despite the change in US administration.

Underlying these measures are concerns about China's role in Hong Kong, and increasingly militarised disputes over Taiwan and maritime sovereignty in the South and East China Seas.

In the Middle East, new tensions drive the kind of volatility long associated with the region. The politics and fiscal arrangements of the Eurozone remain unsettled, while post-Brexit tensions between the UK and the EU, and between NATO and Russia, continue to generate potential political risk impacts for firms in Europe. Concern has also risen in recent years about domestic politics in the US. Emerging markets elsewhere in Asia, Africa and Latin America remain characterised by political and socio-economic challenges.

In other words, geopolitical risk has gone from a peripheral emerging market concern to a core challenge across almost all of the global economy. While this was apparent before 2020, the pandemic's long-term macroeconomic and fiscal impacts will exacerbate global political friction.

The same corporate surveys also show something else, however.

Neither boards or management teams feel confident in their internal capabilities to interpret fast-moving geopolitical events or judge how these might impact their firms. The absence of this capability makes it impossible to consider effective impact mitigation.

Geopolitics increasingly cuts across the ESG landscape for corporates too. For instance, climate change is likely to drive scarcity across national borders of key resources like water or generate destabilising migration flows is generally well known.

Less well appreciated are the causal links in the other direction. Measures such as the EU's Carbon Border Adjustment Mechanism, regarded by some as thinly veiled protectionism, risk adding to geopolitical friction, while the long-term stability implications of Net Zero for oil-exporting states in the Middle East, Africa or Latin America, or the political risks inherent in their attempts to diversify economic models away from fossil fuel dependency, are not well understood.

> **"Key Judgment 1:** Geopolitical tensions are likely to grow as countries increasingly argue about how to accelerate the reductions in net greenhouse gas emissions that will be needed to meet the Paris Agreement goals. Debate will centre on who bears more responsibility to act and to pay—and how quickly—and countries will compete to control resources and dominate new technologies needed for the clean energy transition.
>
> Most countries will face difficult economic choices and probably will count on technological breakthroughs to rapidly reduce their net emissions later. China and India will play critical roles in determining the trajectory of temperature rise."
>
> Climate Change and International Responses Increasing Challenges to US National Security Through 2040, *US National Intelligence Council, October 2021*

In addition, access to the raw materials needed in green technology, such as rare earths, are already the subject of geopolitical friction. As demand for technological solutions to climate change grows, so demand for these sensitive raw materials will also grow, and those firms involved in their acquisition, markets or the increasing reliance that may accompany attempts to decarbonise their own supply chains will find geopolitics presents an increasing challenge.

> "Competition will grow to acquire and process minerals and resources used in key renewable energy technologies. China is in a strong position to compete; it currently controls more than half the global processing capacity for many of these minerals, according to the US Geological Survey and industry reporting, including **rare earths for wind turbines and electric vehicle motors; polysilicon for solar panels; and cobalt, lithium, manganese, and graphite for electric vehicle batteries**.
>
> China is able to process these at reduced cost mainly because of its lower environmental standards, lower labour costs, and inexpensive power."
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> Climate Change and International Responses Increasing Challenges to US National Security Through 2040, *US National Intelligence Council, October 2021*

How does this backdrop affect business more broadly? Observers tend to think primarily of impacts on supply chains or perhaps enhanced cyber risks. While these are certainly pressure points for some firms, the impacts go much wider.

For one, geopolitical volatility, and the associated use of geo-economic policy measures like tariffs and investment restrictions, degrade the macroeconomic conditions and industry sector performance on which corporate strategies are based.

Geopolitical volatility can also disrupt key consumer or client segments for firms, while longer term political uncertainty undermines investment strategies. The increasingly complex crossover with corporate ESG agendas also creates additional reputational pressure on firms with key external stakeholders such as investors, regulators and NGOs.

Geopolitics therefore has consequences for balance sheets and financial performance, as well as for operational and non-financial risk and control functions. Some of these areas are new, but geopolitics is equally capable of exacerbating risks an organisation already recognises.

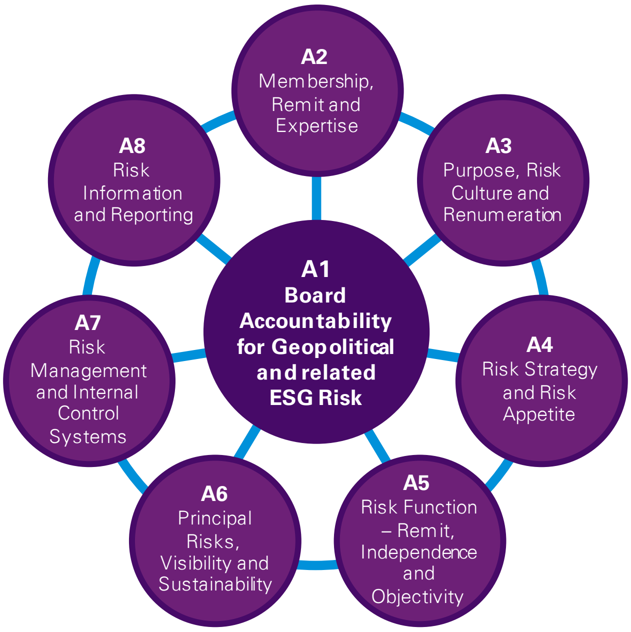
The challenge therefore is to optimise the management of multiple risk impacts from a new kind of macro external uncertainty and instability.

In this context, how can boards ensure their organisations remain resilient to adverse external trends and shocks? Who in the organisation should have the leadership and oversight capabilities and responsibilities in this area? More generally, what internal capabilities do businesses need to anticipate geopolitical risks and their impacts, and how should these be deployed internally?

Given the increasing significance of these issues it is striking that comprehensive guidance for firms on this subject does not already exist. This is partly because the issue is still relatively new and geopolitical risk management is not a traditional part of the corporate repertoire.

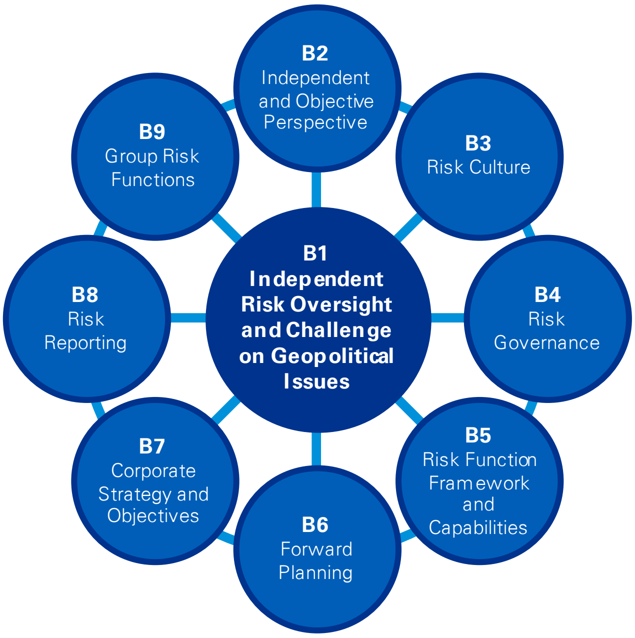
We at the Risk Coalition and GRI Strategies have sought to close this gap with innovative and comprehensive leading practice guidance, called 'The Extra G – ESG^2'. It focuses on the role of boards, their risk oversight committees, heads of risk and risk functions and articulates a framework approach that spans accountability, risk culture, the integration of specialised analytical capabilities and expertise, including within complex multinational groups, and the interface with corporate strategy setting.

Board accountability for geopolitical and related ESG risk



Source : The Extra G – ESG^2, RCRC and GRI Strategies, 2021

Independent risk oversight and challenge on geopolitical issues



Source : The Extra G – ESG², RCRC and GRI Strategies, 2021

The guidance also addresses the close links between geopolitical risks and environmental and social issues – hence squaring the G in the guidance title. Not only do these issues share a requirement for the kind of agile governance needed to anticipate and manage the multifaceted corporate impacts of a risk over which firms have no direct control, but their overlap means integrated oversight and risk management are increasingly key.

The guidance does not stand alone, however. Linked to it is a self-assessment tool that directors, management teams, heads of risk and others key stakeholders in firms can use to do two things.

First the tool generates an organisation-wide perspective on whether leading practice is in place. Second, and more importantly, it allows internal users to select the practical steps and actions that can be taken to implement the guidance, allowing internal users to select the options that most suit their organisation.

Early use of this tool, based on how the guidance applies to them, is beginning to yield interesting insights. Our data show how corporates in different sectors are responding to the challenge of geopolitical volatility and integrating new approaches to the oversight, anticipation and management of the impacts of risks that have traditionally been seen as outside the control of businesses.

As the geopolitical environment becomes more 'competitive' – the euphemism used by diplomats and other political analysts to describe the trajectory of the geopolitical environment over the next two decades – business is increasingly affected. This is not all downside – geopolitics can also generate commercial opportunities for agile firms. For the first time, ESG² gives boards and senior business leaders the guiderails needed to consider these issues systematically, develop resilience and enhance decision-making to successfully navigate a more challenging macro environment.

More details on ESG² are available at: www.riskcoalition.org.uk/geopolitical

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