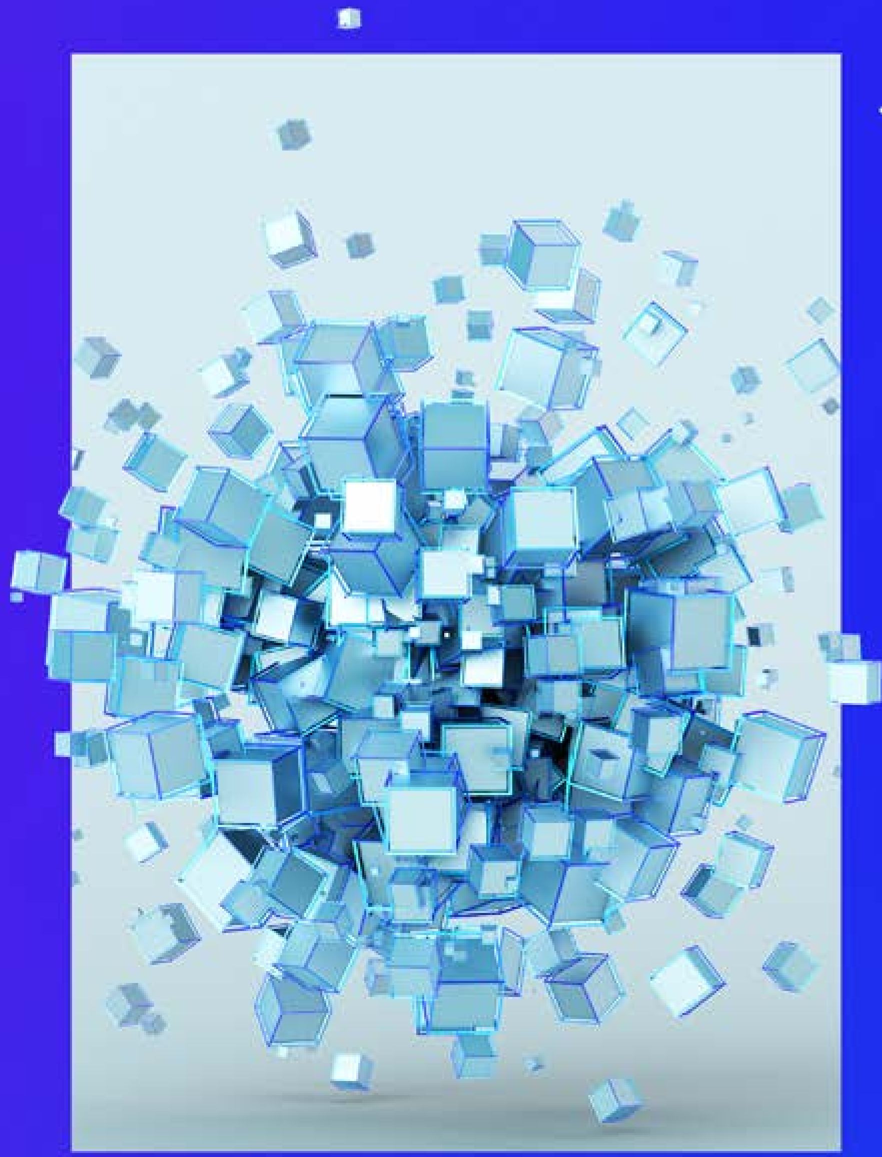
Managing today's geopolitical risks



A financial services guide

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Geopolitics and political uncertainty — the greatest risk to business growth?

What is a *permacrisis*? And why is the term so well suited to reflect the key global events and challenges of the last few years?

Permacrisis describes the feeling of living through a period of ongoing conflict, inflation and political instability.[1] And it succinctly sums up today's troubling reality amid ongoing global volatility that has seen the world pivoting from one disruptive challenge to another. Make no mistake — today's geopolitical landscape is growing more complex and its impact on the economy is undeniable.

We can no longer take the traditional pillars of peace and prosperity for granted amid economic trends and geopolitical events that include ongoing conflicts in Europe and the Middle East, inflation's impact on consumers and businesses, bank liquidity and stability challenges, global recession fears, the aftermath of the global pandemic's disruption, labor-market challenges and the global battle for talent in the digital economy.

In this evolving landscape, globalization itself is undergoing significant transformation. The future of global trade, supply chains, and economic integration is increasingly influenced by national security priorities and heightened policy interventions, particularly among the world's leading nations.

This year, geopolitical developments are poised to further affect supply chain strategies, alter investment destinations and escalate costs for companies. Whereas highly integrated and complex supply chains were once celebrated as achievements of free trade and economic efficiency, today, they are often viewed as vulnerabilities, necessitating strategic adjustments in the face of escalating geopolitical competition.

In response to these challenges, there is a noticeable shift toward national industrial policies that prioritize domestic suppliers, aiming to onshore or "friend shore" procurement within critical industries such as technology (semiconductors), energy, pharmaceuticals and defense. This strategic realignment, intended to bolster resilience, contributes to making inflationary pressures more persistent and structurally ingrained than markets previously anticipated.

Forward-looking businesses wisely recognize the need for decisive action amid today's profound challenges.

Timely strategies to manage today's geopolitical risks should be high on the agenda of every financial organization. This paper explores three steps to achieving successful and sustainable geopolitical risk management using a comprehensive and future-ready framework.

[1] Helen Bushby, "Permacrisis declared Collins Dictionary word of the year," BBC.com, November 1, 2022.

01

Geopolitical risk drivers — keeping it simple amid complexity

Defining geopolitical risks

Geopolitical risks involve emerging, unpredictable, or hazardous events with political underpinnings that could affect the strategic operations and activities of financial institutions — including strategy development, profit and revenue targets, product delivery, market activity and operational processes. From a financial industry perspective, geopolitical risks are not concrete risks but risk drivers. Similar to ESG *risk drivers*, geopolitical risk drivers can directly or indirectly affect other risk types such as credit, liquidity or non-financial — ultimately threatening the stability of financial institutions.

Unlike ESG risk drivers such as extreme weather events, geopolitical developments or tensions are difficult to identify and assess. Geopolitical risk management should screen for relevant information and facts — predict megatrends, defining scenarios based on them, and setting guidelines and guardrails for truly effective risk management.

Megatrends as a starting point

Geopolitical risks are assessed top-down, starting with analyzing megatrends and trends. Trends are identified as the noticeable trajectory of development, whereas megatrends are viewed as significant, slow-moving forces. These are distinguished by their broad reach and longevity, intricate interconnections, and profound influence on economic, political and social spheres.

By focusing on specific megatrends, related subordinate trends with the potential to affect a bank's geopolitical risk exposure can be identified and included among potentially relevant risk drivers.

Businesses should start taking a closer look at the following two geopolitical megatrends and their direct impact on the financial sector:

- **Global fragmentation**: The world is undergoing significant transformations marked by the partial economic disengagement of nations and the emergence of new economic and political alliances, rendering years of global reconciliation a distant memory. The disruption of European peace undoubtedly fueled this trend. However, it has been shaping the strategic policy direction of democracies and authoritarian regimes around the world, moving towards strong protectionist inclinations for some time. Possible manifestations of this megatrend include Europe's economic isolation or rising tensions among the world's largest economies.

- **Disruptive technologies:** The radicalization and destabilization of societies through disruptive digital technologies is accelerating. New tools and platforms, such as AI and social media, unlock new opportunities and risks. For example, the unprecedented threat of technologies being used as economic and political weapons — unethical AI algorithms, fake news, ransomware, cyberattacks and cyber-terrorism — has created a disturbing new reality.

The Russia-Ukraine War underscores global fragmentation. Nations have imposed sanctions on Russia and on Russian banks, companies and individuals, spurring shifts towards self-reliance and altering alliances, driving a pivot from global unity to protectionism. Possible scenarios for the war include the escalation towards increasing geopolitical tensions or alternatively a de-escalation and diplomatic solution for the region.

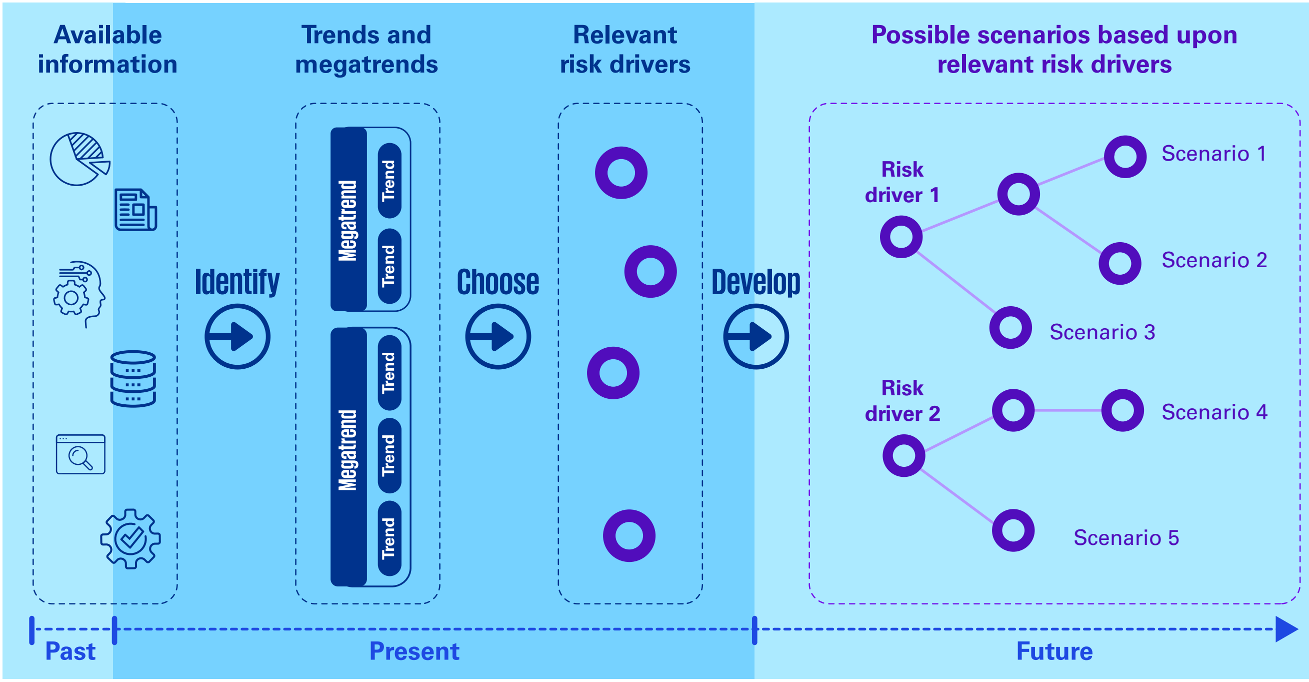
The question of complexity

The geopolitical risk drivers identified will serve as the foundation for developing scenarios that cannot be ruled out due to their significant risk potential and business impact. The focus is neither on correctly calculating the risk potential nor the likelihood of defined scenarios occurring. Instead, the objective is for business leaders to be aware of relevant risk drivers and to actively address the resulting scenarios.

Due to multifaceted interactions between defined risk drivers, the complexity of possible scenarios can increase unpredictably (Figure 1). As complexity increases, so does the danger of ignoring geopolitical risks amid a mistaken belief that the institution cannot cope with the complexity it faces. The inevitable question is: *What complexity do you need to penetrate, and what can you actually penetrate?*

The question of complexity is closely linked to the question of how to respond: How many resources will your organization devote to the challenge, how much new expertise will be needed internally, and how should governance be shaped? The answers to these questions depend on the size of an institution, its global reach, the complexity of the business model, and the strategy for dealing with geopolitical risks, whether they are protectionist or proactive. Answering these questions requires an initial structured analysis and understanding that today's geopolitical instability is a new reality, not just a passing phase.

Figure 1 — Forecasting geopolitical risks



Source: KPMG International

Key actions

Before deciding on governance and resources, start with a few relevant risk trends and drivers and perform an initial analysis. Develop your approach from there. **The more experience gained,** the more sophisticated methods could be used to identify central risk trends and drivers, such as KPMG's Dynamic Risk Assessment.[2]

[2] Dynamic Risk Assessment, The power of four, KPMG Australia, 2023.

02

No need to reinvent the wheel — same methods, different goals

Mitigating geopolitical risks through familiar methods

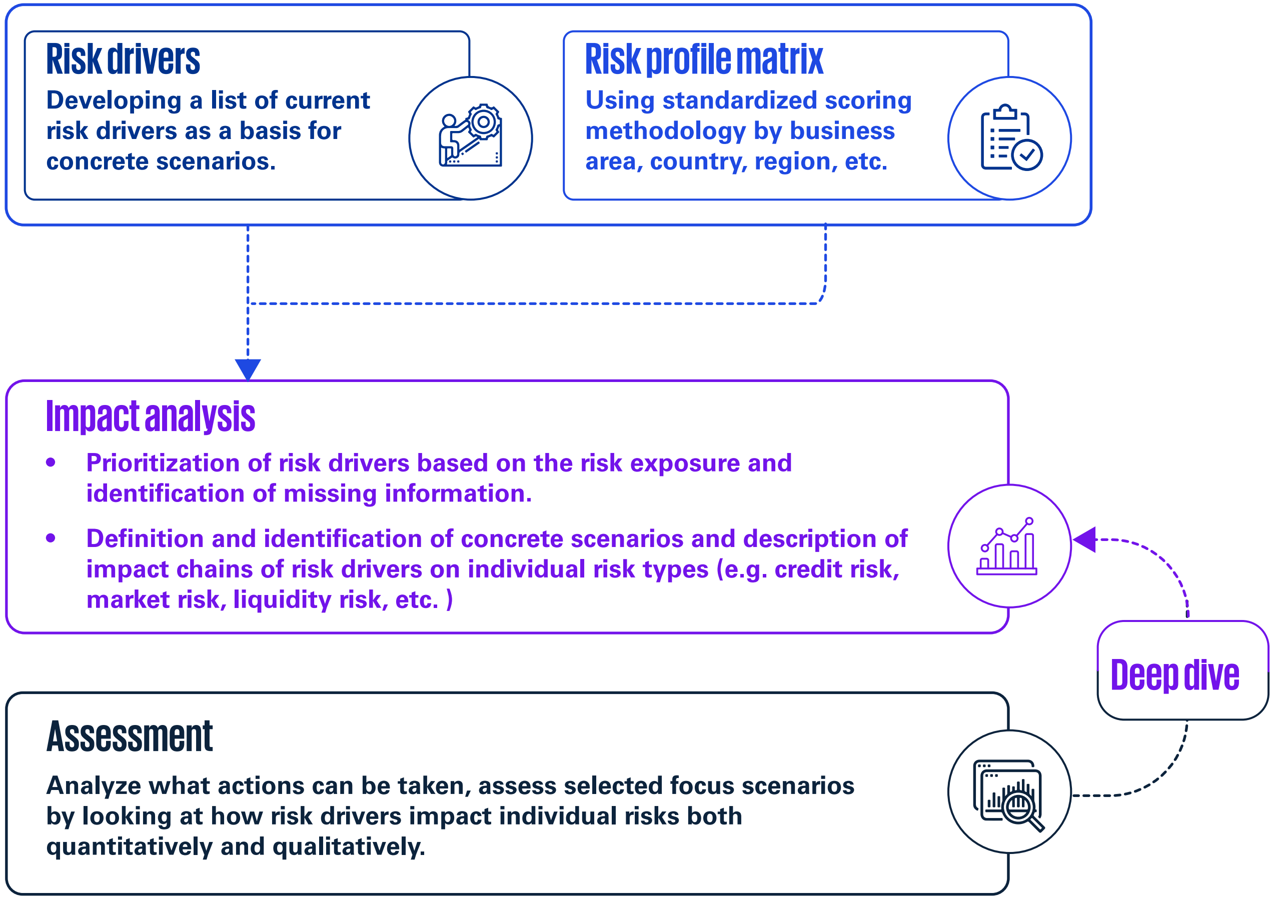
Financial institutions regularly navigate risks using various analytical methods. While geopolitical risks are common in their operations, currently there is no standardized approach for managing them in the financial sector. This absence of a market standard stems from the need to adapt familiar risk assessment techniques like scenario analysis to the unique challenges of geopolitical risk.

Unlike traditional risk management practices focused on estimating event probabilities and financial impacts, or solely preparing for specific emergencies, the objective here is different. It's about fostering a proactive mindset, ensuring readiness to respond effectively to unexpected emergencies. Rather than aiming for precise future predictions, the emphasis is on cultivating adaptive thinking and actions among decision-makers and staff, fostering resilience in today's dynamic environment.

Impact analysis and assessment enhance geopolitical risk resilience

The approach outlined treats geopolitical risks as key factors influencing risk and draws on principles from ESG risk management (see Figure 2). The starting point is creating an extensive list of current significant risk drivers as the basis for concrete and realistic scenarios. To pinpoint pertinent risk factors, a geopolitical risk profile matrix is employed. This profile can categorize risks based on exposure across various dimensions such as countries, regions, sectors, and business areas.

Figure 2 — Framework for managing geopolitical risks



Source: KPMG International

Next, findings from the risk profile matrix and the list of risk drivers are combined into an impact analysis. The goal is to prioritize the identified risk drivers by exposure and to analyze the impacts of high-level scenarios formulated through these drivers on individual risk types such as credit risk, market risk, and liquidity risk. Specific key scenarios of interest or relevance can then be developed for more detailed analysis based on the impact analysis.

During the assessment stage, the selected key scenarios are analyzed quantitatively and qualitatively to determine their hazard potential, scope of impact and identify potential actions that can be taken. However, it is important to go beyond analyzing scenarios that are currently considered realistic. In particular, exploring worst-case scenario's can provide critical insights into building geopolitical resilience.

The results of this assessment should be presented in a manner that is appropriate to stakeholders. For example, lists of high-priority scenarios can be created based on the need for action and the scope of the impact, while heat maps of particularly critical risk drivers can be created and monitored with AI-based tools such as news crawlers.

Financial institutions should develop an action plan with short-term or medium-term measures to best identify information gaps that require a deep dive.

Following the Russian government's invasion of Ukraine in 2022, the **analyses and assessments of banks revealed impact chains and compliance hurdles across all risk types**, notably affecting risk management, investments and balance sheets. Best practices, however, also included extensive stress testing and plans for scenarios with improved stability in the region, reduced market uncertainty, and potential opportunities for investment.

Key actions

To help ensure effective geopolitical risk management, engaging an interdisciplinary team, particularly in scenario analysis, is important. Strong leadership with crucial senior management involvement, rather than just commitment, is also necessary to prevent operational gaps.

03

The absence of a strategy is the worst strategy

In today's challenging geopolitical reality, ignoring the need for a strategy is simply not viable. While adopting a 'head-in-the-sand' approach might offer temporary relief, it's inevitably unsustainable amidst ongoing instability and permacrisis.

The previous two sections outlined a structured analysis of geopolitical risks and their potential impact on the institution. This section explores why a concrete and meaningful geopolitical strategy aligned with business and risk strategy is necessary to ensure informed management decisions.

Strategy as a starting point

When addressing geopolitical risks, two contrasting approaches emerge. One is a purely defensive strategy, emphasizing safeguarding the business against potential risks. The other is an offensive strategy, characterized by proactive engagement and perceiving geopolitical shifts as opportunities. While the defensive strategy aims to shield the organization from geopolitical shocks and risks broadly, the offensive strategy aims to capitalize on them.

In response to the conflict in Ukraine, banks have pursued an overall defensive strategy, driven by risk and shock mitigation as well as compliance with sanctions. Actions included the freezing of assets, the diversification of investment and lending portfolios and the enhancement of risk and compliance functions.

Between these two extremes, there exists a spectrum of strategies that can vary based on region, industry, level of proactivity, and other factors. It is here that we recognize a pivotal shift is required — from a traditionally reactive posture to a more dynamic, proactive approach in managing both risks and opportunities. For decades, businesses have predominantly responded to geopolitical developments as temporary fluctuations. However, with the landscape now marked by structural changes and the rewiring of geopolitical alliances, the value of anticipation over mere reaction has significantly heightened.

Leaders are increasingly crafting geopolitical playbooks, moving beyond the conventional response mechanisms. This proactive development signifies a major transformation in how companies engage with geopolitical dynamics. A sound methodology is essential to begin managing geopolitical risks. It provides the foundation for a structured discussion that leads to well-founded assumptions and informed management decisions. These decisions are then incorporated into various strategies, such as business or risk strategies, ultimately resulting in adjustments to multiple processes, for example, the lending process.

At this critical geopolitical juncture, the integration of strategy and risk management across various time horizons becomes paramount. Adopting a long-term perspective not only facilitates the anticipation of issues but also empowers organizations to adopt a proactive stance. By identifying top scenarios and developing corresponding action plans, companies can ensure that both executives and boards are actively engaged in navigating the geopolitical landscape.

The right expertise is crucial

Selecting the right strategy requires both an external and internal perspective, including a thorough understanding of geopolitical, economic, market, and industry environments and an objective assessment of strategic implementation. The success of an offensive or diversified strategy hinges on a mature governance framework, sophisticated risk assessment and impact analysis methods. Building this capability requires perseverance, strategic foresight and commitment from management.

If conditions are not yet conducive to adopting a sophisticated strategy, a medium-term approach focusing on opportunistic views of geopolitical risks can offer significant advantages, transforming potential risks into opportunities. Moreover, a protective stance in geopolitical risk management stabilizes institutions even in times of crisis. Understanding possible scenarios and monitoring risk drivers enables informed action and rapid response capabilities, underlining the dramatic changes in our global landscape.

Key actions

Developing a plan is an iterative process. A sound methodology can serve as a starting point to overcome the complexity hurdle. Begin with a smaller assessment to create awareness and facilitate the first iteration.

04

Embracing the shift in geopolitical risk management

Future-proofing against global risks

Inflation. Recession fears. The global battle for talent. Ongoing conflicts in Europe and the Middle East. Labor market challenges. Supply chain disruption. As the geopolitical landscape grows more complex and unpredictable, its troubling impact on the world's economy is undeniable.

Global CEOs now rank geopolitics and political uncertainty as the greatest risk to business growth. Forward-looking businesses are wisely recognizing the need for decisive action amid today's profound challenges. Simply put, strategic management of geopolitical risks should be high on the agenda of every financial organization.

Business leaders should be implementing three key steps amid the pressing need for a new reality of geopolitical risk management:

Screen for relevant information and facts. Identify key megatrends, define your response scenarios and establish guidelines for effective risk management. Avoid being overwhelmed by the complexity of today's evolving geopolitical regimes. Start by closely examining two geopolitical megatrends at play — global fragmentation and disruptive technologies.

Don't try 'to reinvent the wheel' in this environment. Financial institutions can fall back on a toolbox of appropriate and proven methods for effective risk management. Develop a timely plan that effectively applies the same trusted methods to different goals. It's not about predicting the future — it's about pursuing new ways of thinking and acting.

Develop an informed strategy. Beware — proceeding in today's uncertain environment without a solid strategy is not an option. A 'head-in-the-sand' approach amid fears of making the wrong decisions is unsustainable in these times of instability. The right strategy requires an outside view — an understanding of the geopolitical, economic, market and industry environment — and an informed inside view that objectively assesses which strategies to implement.

KPMG professionals understand the importance of implementing risk-management strategies that harmonize with present-day requirements. Assisting leaders across all sectors in navigating future pathways, the emphasis lies on the urgency of adapting and taking action to surmount prevailing global challenges and maintain competitiveness.

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The complex and unpredictable geopolitical landscape requires risk and control management to adapt and evolve. KPMG firms recognize the paramount importance of continuous further development of established risk management practices. Our KPMG professionals bring a wealth of experience and the courage to take on new and challenging risks, such as geopolitical risks.

Working together with KPMG firms can bring significant value to your risk management while ensuring it closely aligns with your strategic business goals. KPMG professionals collaborate with you to develop tailored risk management strategies that help you manage your risk environment actively and proactively. KPMG firms' skilled team of risk professionals can help improve your organization's resilience with risk management practices that consider the ever-evolving business and global landscape.

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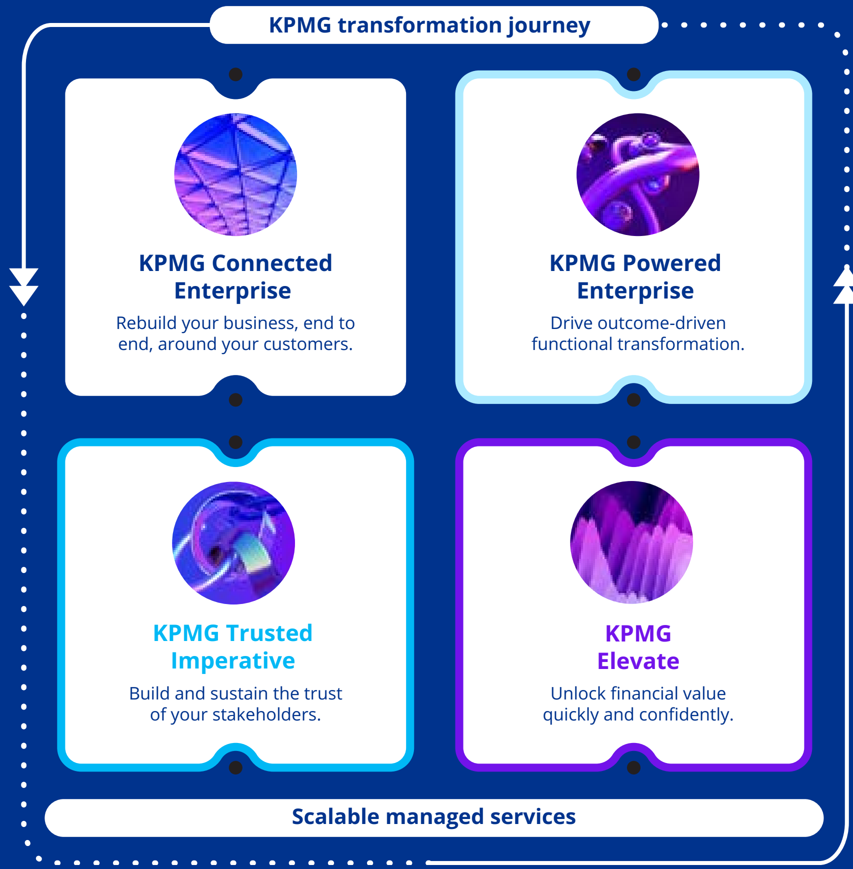
KPMG firms' suite of business transformation technology solutions can help you engineer a different future — where new opportunities are designed to create and protect value.



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