BOARD OVERSIGHT OF GEOPOLITICAL RISKS AND OPPORTUNITIES

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Geopolitics is "the study of the effects of Earth's geography (human and physical) on politics and international relations."[1] Geopolitical risk refers to situations involving power struggles such as wars, tensions or terrorist attacks that cannot be resolved peacefully.

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An escalation of geopolitical events can lead to outright wars, violence, political uncertainty, trade wars, tariffs, sanctions and international unrest, which may threaten and disrupt global trade and supply chains. The threat of business disruption risk has a negative impact on businesses and forces boards to face up to unpredictable challenges globally.

The world is in a period of increased geopolitical uncertainty. Inequality, especially within-country inequality, has become an important driver of geopolitical tensions. Nationalism, populism, and anti-globalization sentiments appear to be on rise everywhere. To a certain extent, democracy has evolved to become a populist tool in some countries. With the US striving to maintain its position as the world's largest economy, geopolitical tensions between the US and China have intensified. Starting in 2018, the two nations imposed tit-for-tat tariffs on one another's goods, amounting to hundreds of billions of dollars. Globalization is crumbling as trade policies shift.

The annual Global Risks Report (GRR) released by the World Economic Forum highlighted rising geopolitical tensions among the world's major powers in 2018. A year later, 85% of respondents expected 2019 to involve increased risks of "political confrontations between major powers."[2] In the fourth quarter of 2019, Ernst & Young conducted a survey of more than 1,000 C-suite executives from companies around the world. The results show that executives from the largest companies perceive a higher business impact from geopolitical risk: "The top three geopolitical issues that global executives expect to have the greatest impact on their company over the next five years are the changing role of the US in the international system, European Union (EU) stability and US-China relations."[3] The COVID-19 crisis in 2020 had the effect of increasing geopolitical risk, and economic risks are also rising as a result of the pandemic.

Geopolitical risks are reshaping the world. Political uncertainty will remain and could potentially generate shocks that will have a negative impact on global business. Geopolitical risk can affect business in various ways, such as:

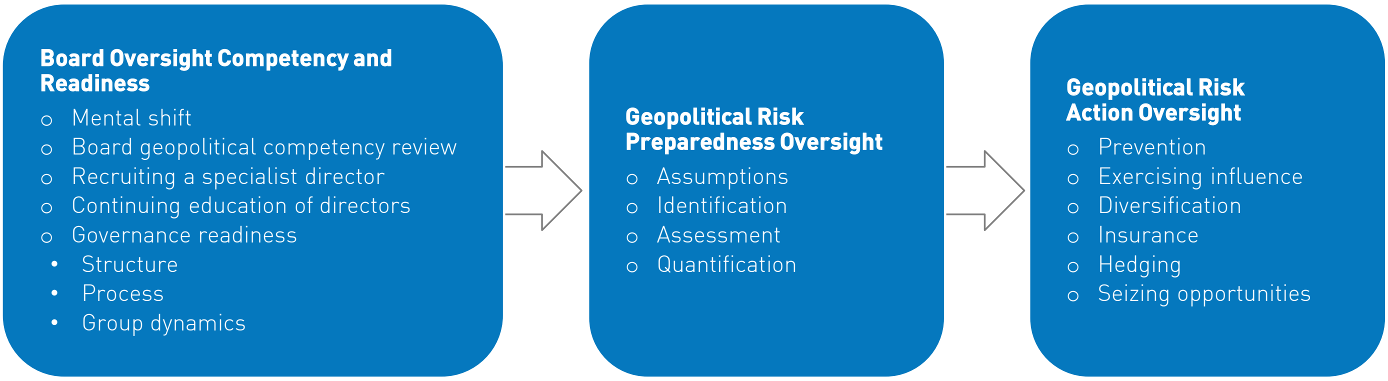
- Capital controls
- Capital flight
- Closed transportation or trade routes
- Currency devaluations
- Damaged infrastructure
- Reduced economic activity
- Default
- Discriminatory actions against a targeted company, industry or technology from certain countries
- Disrupted business operations (people, plants, manufacturing, sales or supply)
- Disruption of the global value chain
- Exchange controls
- Expropriation and confiscation of assets
- Global supplies of energy and other raw materials
- Investment impairments due to violent political unrest or war
- Lower profitability
- Lower stock market returns
- Reduced M&A activity
- Nationalization
- Entry into new markets
- Non-payments
- Price controls
- Production controls
- Quotas and tariffs
- Regulatory changes
- Rising taxes or tariffs
- Slowing growth in the home country
- Strikes
- War and terrorism
- Workforce disruptions

Coping with geopolitical risks is a challenge for businesses. Political events are hard to predict; the effects of political tension can be magnified and spread in this interconnected world; geopolitical risks can lead to economic risks that have both direct and indirect consequences for companies.

At board level, the increased complexity and uncertainty pose governance challenges. Boards need to oversee geopolitical risk management more proactively than ever before. This means that they need to prepare their company well to manage the risks – limiting the downside and seizing the upside of disruption. To gain a competitive edge, board oversight of geopolitical risk would help a company to incorporate geopolitical risk management into its strategy setting, investment decisions, governance and broader risk management processes. The board should set the tone for actively managing geopolitical risk and confronting the challenge.

The way companies react to geopolitical risks is continually evolving. The aim of this article is to provide a framework to facilitate the task of boards and directors in carrying out geopolitical risk oversight duties effectively. For the board, it is critical to understand its own oversight competency and readiness to engage management on these complex issues. By the same token, the board needs to make sure that management is well prepared for geopolitical risks and understands risk impacts – assumptions, identification, assessment and quantification of risk. Successful companies will be those that can take actions to manage and mitigate geopolitical risks. Board oversight also ensures that the proper actions, both tactical and in terms of strategic risk management, are taken. Finally, board oversight of actions would focus on how management turns risks into growth opportunities. We believe that both board and management have an active role to play in managing geopolitical risks and opportunities. We propose three steps for boards to consider with respect to geopolitical risk oversight (see Figure 1).

Figure 1: Three steps for oversight of geopolitical risks



Questions to ask:

- Is your business likely to be exposed to an unexpected geopolitical event?
- How can geopolitical factors affect your objectives?
- Have geopolitical risks been factored into the risk management framework in your company?
- What role will the board play vs. management in terms of geopolitical risks?
- How should a board set the tone for active geopolitical risk management?
- Is your board comfortable with what management is doing about geopolitical risks?

Board Oversight Competency and Readiness

How does a company's board cultivate competency and readiness with respect to geopolitics? To support and supervise the management of geopolitical risks, the board needs to have its own expertise. There are five major components to consider. First, the world is changing course and directors need to accept this change with a mental shift. Second, to increase the board's readiness to handle geopolitical risk oversight, assessment of board expertise is a crucial step. Third, companies can go further and recruit geopolitical experts or politically savvy directors to sit on the board. Fourth, continuing education can improve board competency and help directors to better understand geopolitical risks and opportunities. Finally, the board should be "governance ready," with the appropriate structure, processes and group dynamics for effective and efficient oversight.

Mental shift

For many years, geopolitical trends have been neutral to favorable in general, thus enabling companies to embrace global strategies. Increasingly, however, geopolitical tensions are coming to the fore, in the form of trade conflicts, hot wars, political assassinations, vaccine protectionism post-COVID-19 and the like. This represents a reversal of political and social forces that will reshape globalization in the long term. Business actions and models, including long-term strategies and valuations, will have to be re-evaluated, as it remains unclear how long this uncertainty will last and what the full repercussions of the disruption will be. The longer uncertainty persists, the harder it will be to revert to the old track.

Directors must make a mental shift and avoid complacency. What is going on in the world at any one time could have a significant impact on business in the next five to ten years. The board should be aware that geopolitical tensions will drive the strategic planning process. In this regard, measures to deal with geopolitical risks must be integrated into corporate strategies and the board should exercise proper oversight to build a lasting and resilient business.

Board geopolitical competency review

Competency assessment is a crucial first step to ascertain the skill sets and experience of board members in relation to geopolitical issues. A successful review allows the board to honestly determine members' geopolitical proficiency. In some companies, the board might have enough competency, so there is no need to change the board composition. However, gaps in the board's knowledge could prevent it from understanding geopolitical threats.

Having geopolitical expertise on the board can be critical to effective oversight of geopolitical issues. The board would be kept informed about the world's shifting geopolitical landscape, managing geopolitical risks and seizing geopolitical opportunities. Geopolitical events may be less disruptive if they are approached and handled by geopolitically competent directors.

Recruiting a specialist director

Board expertise has been evolving. Over the past years, boards have had to recruit cyber, technological, financial and regulatory expertise, as well as paying attention to diversity by appointing, for example, more women and younger members. With rising geopolitical risks, companies need the right people in the boardroom to effectively oversee geopolitical risks and opportunities. The composition of the board determines a company's ability to cope with geopolitical uncertainties.

The exact kinds of geopolitical experience and expertise required vary by country, industry and company. Some backgrounds can be more helpful than others. For some, it might be useful to have regional expertise in the volatile markets where the company has operations. For others, it might mean having special expertise in global compliance, policy or geostrategy. Good potential candidates for board seats are former government officials or diplomats who are more versed in foreign policy. Bringing a specialist on to the board has various benefits. A geopolitical expert provides diverse perspectives to enable robust boardroom conversations, lends credible insights, breaks possible group think, identifies possible scenarios and provides valid responses and solutions.

Continuing education of directors

Regardless of directors' geopolitical expertise and experience, all board members ought to be able to analyze geopolitical events in order to have meaningful discussions. Since the global geopolitical landscape is constantly shifting, a company's exposure to geopolitical risks might change as well. Too often, untrained directors are either too optimistic and see only opportunities or they are too pessimistic and see only risks. It is necessary to make these opaque geopolitical issues more transparent.

Therefore, boards should have continuing education to help all directors improve their understanding of geopolitical exposure. This may come in the form of active coaching, formal training, tabletop exercises or seminars conducted by leading experts, consultants or specialists in the field. The training should be forward looking – how geopolitical tension is evolving and what kind of impact it will have on business in the future. In a world where misinformation and fake news are constantly available, an insightful geopolitical perspective is critical for boards. Continuing education will help directors connect geopolitical events with corporate strategy and come up with creative solutions.

Governance readiness

Governance provides the structure and process of board oversight. An efficient structure, strong processes and effective group dynamics must be in place to guide corporate decisions. Boards ought to be governance ready to answer questions such as who has responsibility for geopolitical risk management, what is the process for information flow and how are geopolitical issues discussed?

Structure

Boards need to see that appropriate committee structures and oversight responsibility are assigned for geopolitical risks and opportunities. An empowered individual, function or committee at management level could be assigned responsibility for geopolitical risk management.

To implement a geostrategy successfully, it is crucial for the responsible party to correctly identify the core geopolitical risks, assess their impacts and take appropriate actions. In general, the impact of geopolitical risks can be felt across the company. Therefore, the empowered party needs to work cross-functionally and coordinate communications at various levels. Boards should make sure that adequate resources and tools are available to allow the responsible party to identify, assess and quantify geopolitical risks.

Process

Boards need to have a process for collecting crucial information and staying current on how the geopolitical landscape is evolving. Even if a board has a member who is a geopolitical expert, the increasing complexity of geopolitical tensions can make navigating the effects of geopolitical shifts rather difficult. It is therefore necessary for board members to remain open to external professionals who have a deep knowledge of geopolitical issues that could affect the company's strategy, operations and compliance.

At the management level, board oversight ensures that management follows a proper process for information flow. The process should involve monitoring geopolitical tensions, including tracking changes in legislation and regulations, as well as in nominations of key positions such as president, federal judge or Federal Reserve chairman. The process also entails evaluating the potential impact of various geopolitical events as a basis for containing geopolitical threats. In response to the changes, the company might engage proactively, shape policy making or modify existing strategy and operations.

The information collected and measures taken should be transmitted to appropriate corporate levels. It is also important that management update the board regularly. This facilitates meaningful dialogue and allows an exchange of views on geopolitical events and developments. With deep knowledge about geopolitical subjects, directors have the competency to challenge management and offer insightful inputs.

Group dynamics

Competent directors, governance structure and appropriate processes are necessary but not sufficient. To handle geopolitical challenges, boards ought to have a heathy boardroom culture. Board effectiveness depends on the quality of directors, structures and processes, but group dynamics, which deal with the attitudes and behaviors of directors, often sustain the board as an effective team. Values, beliefs and attitudes drive directors' actions and behaviors, which should converge to create a cohesive team to achieve business success.

Board culture is one of the toughest challenges for boards to confront. According to PwC's 2020 Annual Corporate Directors Survey, "for the second year in a row, about half (49%) of directors say that at least one fellow director on their board should be replaced.

Twenty-one percent (21%) say that two or more directors should go."[4] The survey results reveal how difficult it is to build a cohesive team with different personalities.

To connect individuals with different educational backgrounds, work experiences, expertise, gender, age, mindsets, opinions, personalities and cultures, the board chair must view the board as a collective entity. Board members need to work together to steer the company through geopolitical uncertainty. To achieve this objective, the effort of all directors should be united though cooperation, critical discussions and mutual trust.

Questions for the board to consider on competency oversight:

Does your board have the capability to form its own perspectives on geopolitics?

- Does your board include members with geopolitical expertise?
- Does the board have the right people, structure, processes and group dynamics to oversee key geopolitical risks and to challenge management?
- How often is the board briefed on geopolitical developments and their potential implications?
- Will your corporate structure need to change to manage geopolitical risk?
- Are your board's information systems responsive to geopolitical information and data?
- Does the board understand how geopolitical risks map to the company's enterprise risk management policies and procedures?
- Who or which committee is responsible for monitoring, analyzing and interpreting geopolitical risks?

Geopolitical Risk Preparedness Oversight

The stability and survival of companies are threatened by geopolitical risk. Management needs to be aware that the company's strategic goals could be impacted by geopolitical tensions, and it is imperative to prepare a response. The last thing a board needs is to be paralyzed by the headline news. In changing geopolitical settings, the board needs to take a long-term view, see the big picture and build a comprehensive oversight framework around preparedness.

To develop an oversight framework for better anticipation and preparedness, the board must focus on four areas – assumptions, identification, assessment and quantification. When geopolitics and regulations shift, the board should be aware that the previous *assumptions* of corporate strategy and risk management practices are likely to change accordingly. Therefore, the board needs to oversee the *identification* of relevant geopolitical factors, the assessment of their impact on reputation, sales, supply chain, finance, operations and stakeholders, and the *quantification* of their impact under various scenarios. Proactive risk management will reduce the negative impact and could even allow the company to benefit from the opportunities.

Assumptions

At first sight, geopolitical risk covers events and general uncertainty that seem unpredictable and impossible for a company to manage. For instance, wars may drag on for years – decades even – and the outcomes are hard to predict. This assumption often results in geopolitical risk being underestimated or ignored. Although it might be impossible to make consistently accurate predictions, geopolitical awareness could help a company build capabilities to manage geopolitical shocks resiliently. In fact, many unpredictable events can be predicted in terms of probability or likelihood, and their impact can be measured to a certain degree. The board should challenge the "unpredictable" assumption of geopolitical risk and incorporate it into corporate strategic decisions and oversight.

Every strategy or decision has underlying assumptions about the global environment and markets. Some assumptions might be explicit, others implicit. When paradigm shifts happen, previous assumptions and expectations become invalid. These risks are no longer macro issues, but threats that can directly affect top lines, bottom lines and valuations. Management must anticipate potential threats and act proactively – not reactively – to build resilience. It is imperative for the board to oversee management in re-evaluating strategic assumptions and adjusting the strategy and business models when geopolitical landscapes create uncertainty.

Identification

To provide oversight of geopolitical risk preparedness, the board should understand management's framework for identifying geopolitical threats and opportunities. It is valuable for the board to have a deep understanding of current and likely future geopolitical drivers of risks. These forces, drivers and factors could be identified by management as potentially relevant and reviewed by the board in the oversight process. With its perspective and expertise, the board can challenge management on the likelihood of geopolitical events and the potential impact on the business.

Many companies perform a PESTLE (political, economic, social, technological, legal and environmental) analysis, which is a framework adapted from COSO's 2017 ERM update for categorizing and analyzing the macro environment. The PESTLE framework allows companies to better identify external forces and potential changes in the geopolitical landscape that could impact all aspects of the business. The results of the PESTLE analysis can be incorporated into a SWOT analysis by assessing internal capabilities (i.e. strengths and weaknesses) relative to the external environment (i.e. opportunities and threats).[5] Board oversight of geopolitical risk identification can push management to be more proactive in identifying geopolitical factors.

Assessment

Once geopolitical risks and opportunities have been identified, the board should oversee that management develops and stress tests geopolitical scenario plans. This assessment includes the likely and worst impacts, the time frame when the impacts will be felt, and the chain effects of corporate response, which might lead to changes in the company's strategy. Board oversight of assessment should look beyond the most obvious, examine everything to help protect the company and fulfill its duty of care.

Companies need to assess the worst-case scenarios of their geopolitical risks from different angles. Geopolitical shifts can affect sales in markets that are vulnerable to geopolitical shocks; unstable geopolitical relationships can deter expansion in new and emerging markets; unstable locations and policies may affect the company's ability to attract and retain talent; insecure borders or military conflicts could impact supply chain and partnerships; political and regulatory whims may create capital risk such as high cost of capital or loss of investment; geopolitical turmoil may result in loss of assets due to confiscation or expropriation.

Management also needs to have a fair assessment of the time frame of risk evolution. Many risks could manifest over years or decades. For example, income disparity has been on the rise for some decades with scattered protests and geopolitical events, such as Occupy Wall Street (OWS) and Brexit. It could evolve into violence and create conflict that divides politicians, communities and even families. Boards should be aware of the possible scenarios arising from "gray rhino" risks, defined by author and strategist Michele Wucker as highly probable, high impact, yet neglected threats.[6] Scenario planning with various time frames is useful for formulating response plans and ensuring business continuity.

Just as chess masters can calculate positions 25 to 30 moves ahead, it is important for boards to apply forward thinking and consider the reputational impact of corporate reactions to geopolitical risk, since geopolitical risk is driven by governments, religions and society. Any missteps perceived by these groups could be amplified and enhanced by positive feedback loops. These circular relationships could affect corporate reputation when a corporate action is either condemned or praised by stakeholders, such as the communities in the which the company operates.

In March 2021, H&M and Nike faced a boycott in China because of the political stand they took. H&M, Nike and some other Western apparel companies spoke out against the alleged use of forced labor to produce cotton in Xinjiang, China. H&M's stance was viewed as meddling in Chinese politics, and its stores were closed by landlords, and its apps were removed from e-commerce platforms and blocked by major search engines and other apps in China. Board and management need to be aware that geopolitical risks could cost a company's social license to operate.

Quantification

As discussed above, assessing the impacts of geopolitical risks is an integral part of preparedness. As part of assessment, quantification is key to determining the optimal reaction. Quantifying geopolitical risks might be deemed difficult. If not done adequately, companies could misprice the potential negative impacts and choose less effective responses.

Boards need to oversee management in developing capabilities, processes and tools to quantify geopolitical uncertainties. Management can use ad hoc methods for internal analyses. For example, in unstable regions, geopolitical risk affects all main elements of financial statements including assets, liabilities, equity, revenues and expenses. Although it is hard to track cause and effect for all elements simultaneously, the impact on individual elements could be quantified for a more granular and dynamic look. A bit like a sum-of-the-parts analysis, a company's reaction strategies – avoid, mitigate, transfer, accept – in relation to geopolitical risks on individual elements can be well integrated into its financial statements forecast. Based on a cost/benefit analysis of each reaction strategy, the company could choose the best reaction approach.

Boards also need to oversee that management is using credible data models to provide insight and decision-making support. For example, the impact of geopolitical risk on investment projects can be measured using the discount rate, which must be credible. A question the board can ask management is how a particular discount rate is chosen. If a discount rate can be broken down into different elements, the board needs to know which risk-free rate was chosen as a benchmark, how much sovereign yield spread was added, whether sovereign credit default swaps (CDS) were used, etc. Since the market price of risk reflects the consensus of market participants at a particular moment, bond yield spreads or sovereign CDS premiums could be volatile. To account for the fat tail risk erupting as a result of geopolitical tensions, companies might have to apply models to quantify risk exposure to terrorism or natural disasters.

Directors need to stay current on the latest analytical tools and technology. In recent years, artificial intelligence (AI) has been used to identify and quantify geopolitical risks, which is completely different from traditional methods. AI can aggregate and analyze tremendous amounts of non-numerical data (videos, texts, social media, etc.) that are hard for humans to analyze. In terms of videos, AI can analyze many videos to evaluate the impact of a social media influencer calling for political protest. On the text side, natural language processing (NLP), a subset of AI for scraping millings of websites or parsing through tremendous amounts of text data, has become popular for estimating geopolitical developments.

Take Cambridge Analytica, for example. The company has been criticized for using AI-targeted ads on social media to help swing the 2016 Brexit referendum and US presidential election, respectively. JP Morgan's process for identifying and quantifying geopolitical risk is described as follows: "JP Morgan uses a range of political and social indices, focused on freedom, democracy, business conditions and corruption, and has developed the Volfefe index to track Donald Trump's tweets. Bizarre as it sounds, the Volfefe index is real, measuring the volatility in market sentiment for US Treasuries caused by tweets by the US president, as these have a statistical significance on bond prices."[7]

Boards and directors need to be aware of the latest technology and choose the best tools for geopolitical risk quantification.

Questions for the board to consider:

- What corporate strategy assumptions could be derailed by geopolitics?
- If geopolitical risks challenge management's critical risk assumptions, is the board ready to push for a strategic shift?
- How can "unknowable" geopolitics can be planned for and understood?
- Which framework does the management team utilize to identify and assess geopolitical factors? Is the geopolitical framework robust? What are the critical factors identified?

- What suggestions does the board have for management to improve monitoring to identify shocks early or to have adequate visibility over the supply chain to identify threats?
- Does the board understand the process for managing geopolitical risk through scenario analysis and stress testing?
- Considering possible geopolitical trajectories and new economic scenarios, how might geopolitical uncertainties affect the company's valuation and financial statements?
- Is management addressing geopolitical risk in a comprehensive fashion (e.g., cultural, technological innovations, social, legislative)?

Geopolitical Risk Action Oversight

Once geopolitical risk has been analyzed, what then? Boards ought to develop, with management, strategic options for acting on geopolitical risk and overseeing implementation in decision making. Along with other risks such as economic, market, ESG, cyber, technological and legal, geopolitical risk management needs to be integrated into a company's enterprise risk management (ERM) program. All risks are linked to strategy; therefore, risk management should be dynamically incorporated into operations across the company's entire ecosystem. Boards should oversee and support management to anticipate, assess, avoid, mitigate, eliminate, transfer or accept certain geopolitical risks.

When geopolitical tensions evolve, a company needs to anticipate and assess the situation as early as possible. Companies must be proactive, rather than reactive, when it comes to handling geopolitical risks. In some situations, geopolitical disruptions can be prevented or proactively influenced; in other situations, geopolitical risks can be mitigated well in advance through diversification; and in still other situations, geopolitical disruptions and cost could be minimized through insurance and hedging. Furthermore, growth opportunities might exist alongside geopolitical risk. With board expertise, foresight and oversight of action, companies can be more resilient to geopolitical risks.

Prevention

A thorough understanding of geopolitical risk is the foundation for prevention and protection against disruptions. Management ought to collect and analyze information for early warning signs if the company plans to expand into new markets. Assessing the likelihood of geopolitical disruption before it happens and avoiding high-risk regions completely is the first step to proactively preventing being negatively affected.

In unstable or dangerous regions, global companies could establish contingency measures to exit as a preventative measure in the event of disruptions. It is essential to be prepared to respond quickly in order to protect people, assets and reputation. In volatile regions, companies need to safely evacuate employees in danger. When the risk of confiscation emerges, management could consider rapid repatriation of cash. If feasible, it might be appropriate to move nontangible assets out of the disrupted region. For tangible assets, the company could initiate an exit by divesting assets to a willing buyer. Other prevention measures include cutting capital investments and overseas supplies to the disrupted regions. To reduce exposure to confiscation risk, management might consider partnering with powerful local businesses and establish joint ventures if necessary.

For global companies that source from regions or countries where geopolitical risks are rapidly increasing, management needs to build supply chain resilience. To ensure business continuity, management needs to develop more collaboration with key suppliers, which should develop their own business continuity plans. A company facing supply chain disruptions needs to perform joint scenario testing with key suppliers to ensure that they will survive the same crisis. Never underestimate just how hard things can get – or even that they can get worse! Chinese tech giant Huawei learned the lesson the hard way.

Huawei Technologies: From bad to worse

Huawei Technologies was in big trouble in 2019 when the Trump administration banned it from buying US chips and technology. The ban dramatically disrupted the Chinese company's supply chain, since Huawei acquired about $21 billion worth of chips from US vendors each year.

The Chinese company's chip arm, HiSilicon, announced that it had long been prepared for the "extreme scenario." In the last decade, Huawei invested billions of dollars in HiSilicon, which secretly developed back-up products in anticipation of the unlikely scenario that Huawei might be unable to obtain advanced chips from the US. Shortly after the official ban, Huawei announced that it would use HiSilicon products to substitute for banned American components. It was time for "all the spare tires in the safe" to be deployed to fend off the US's "crazy decision" that brought an "extreme and dark moment," said the company.

But a more "extreme and dark moment" for Huawei was yet to come.

HiSilicon designs the high-end chipsets, but the manufacturing is handled by a foundry company - Taiwan's TSMC. In May 2020, the US introduced a new regulation stating that a license must be obtained for any product using American technology that is to be sold to Huawei. In this case, TSMC would be banned from supplying Huawei, since the extreme ultraviolet (EUV) lithography machine it used to produce chips is supplied by ASML, a Dutch company jointly controlled by the US, the Netherlands and Japan.

In November 2020, Huawei announced plans to sell off Honor, part of its smartphone business. Huawei said the decision "has been made by Honor's industry chain to ensure its own survival," following "tremendous pressure" and "a persistent unavailability of technical elements needed for our mobile phone business."

Exercising influence

Business leaders ought to develop holistic political perspectives and establish a geopolitical strategy that is aligned with the company's position on key issues. This may involve proactively seeking to influence geopolitical and regulatory developments by engaging with key stakeholders at local, national and international levels. For example, a company can clearly anticipate the impact of tariffs and quotas on its business. Thus, it is imperative to educate politicians about the potential impact of such policies. Companies and governments ought to work together through a consultative process when acting on geopolitical risk.

For smaller players, it might be hard to exercise political influence. In this case, it might be advisable to find allies and build coalitions. This includes working with industry groups, trade organizations, competitors or even activists whenever there is common ground on a particular issue that might influence a wide range of stakeholders. When united, widely dispersed weak stakeholders can get their concerns heard and taken seriously.

For powerful players, exercising influence could involve building relationship with politicians and pushing for or against certain policies and legislation. Sometimes companies can shape the geopolitical landscape through lobbying or political spending. Boards are normally involved with oversight of the political influencing process. Leveraging political spending to influence national policies is a delicate issue as it could be viewed as bribery. Directors must consider reputational risks and make the process transparent and open to scrutiny by stakeholders.

In today's world, many companies go stateless to maximize profits and some are even more powerful than many countries. It is not surprising that when companies become global superpowers, they find new ways to protect their interests or act in their own interests. These corporate superpowers operate in political and social spheres in small countries to such an extent that they can cause geopolitical instability more than being vulnerable to it. As such, boards and directors need to be aware of the role of business in society and take their social responsibility seriously when dealing with geopolitical risks.

Diversification

To proactively deal with the unpredictable impacts of geopolitical risk, directors need to pay attention to diversification. It is never too early for boards to consider alternatives. When geopolitical tensions are on the rise, the fragility of global supply chains intensifies.

The Trump administration (2017-2021) caused uncertainties for companies and boards through confrontations and frictions with China. Boards had to reassess their supply strategy with the weakening of global supply chains. The COVID-19 pandemic added fuel to the fire and forced companies to confront the worst-case scenario: Global supply chains might be split into two parallel and competing systems. Companies need to work on supply chain diversification and pursue a "China-plus-one" strategy.

According to the Global Supply Chain Disruption and Future Strategies Survey Report 2020, conducted by law firm Foley, which surveys nearly 150 manufacturing

C-suite executives on the future of global supply chain: "43% of respondents have already withdrawn some of their production or sourcing from China or are planning to do so. .... Seventy percent agree that companies will, as a result of the pandemic, lessen their focus on sourcing from the lowest-cost supplier in favor of higher supply chain resiliency."[8] A McKinsey survey reported similar results. Respondents to the McKinsey survey would make similar strategic changes – diversifying supply chains across countries and sourcing more from regional supply chains.[9]

In 2020, China unveiled a long-term "dual circulation" strategy to cut its dependence on overseas markets and technology. Since this decoupling will shape the global supply chain, boards and directors ought to oversee corporate diversification strategies to ensue business continuity.

Insurance

Cost-effective insurance is a key factor in risk mitigation. "Political risk insurance is designed to mitigate against the loss of commercial assets, income or property as a result of a political risk event. The policies can provide coverage for a wide range of risks, including political violence, expropriation, currency inconvertibility, non-payment, and contract frustration."[10]

Many companies do not yet insure against geopolitical risks such as supply chain disruptions. If a company operates in a country where geopolitical risks are intensifying, with the right insurance coverage, it can maintain business continuity or at least secure compensation for business disruptions. The recent introduction of political insurance can cover a wide range of damages across the value chain. For example, Willis Towers Watson provides tailored solutions to help clients build cross-border resilience plans, such as political risk or violence insurance, reputational risk insurance and terrorism insurance.[11]

Boards and directors ought to ensure that the geopolitical insurance program proposed by management will stand up to the geopolitical events and cover damages from disruptions. There is also a counterparty risk – the insurance provider should be credible and handle claims in an efficient and timely manner to minimize the cost to and impact on the business. Insurance, which is part of business continuity planning, can help increase resilience to geopolitical risks.

Hedging

Apart from insurance, geopolitical risk can be hedged in a variety of ways. Geopolitical threats often result in ripple effects that impact every part of the financial markets. For example, geopolitical tensions could lead to capital flight and controls, followed by currency devaluations, collapsing sovereign bonds prices, surging sovereign CDS premiums, or higher precious metals prices. Adverse movements in currency, real assets and financial assets can diminish the value of investments in countries that are affected, and hedging – if used properly – could minimize the negative impact. Boards and directors who oversee geopolitical risk management need to understand the principles and ways of hedging to deal with geopolitical threats.

Sovereign credit default swap (SCDS) spreads can be used as a proxy for country risk. "Country risk refers to the risk of investing or lending in a country, arising from possible changes in the business environment that may adversely affect operating profits or the value of assets in the country."[12] Thus, SCDS spreads capture sovereign credit risk, political risk and macroeconomic risks. Buying SCDS is like buying insurance: With a fee paid to the seller, SCDS provides protection to buyers from losses resulting from a default of sovereign debt. Using SCDS to hedge geopolitical risk can be viewed as proxy hedging, since the value of the real assets being hedged is correlated with the creditworthiness of the country. SCDS is a valuable hedging instrument against investments or assets that are likely to lose value in regions with high geopolitical threats.

As geopolitical risk intensifies, companies could face significant currency risk. That is, if profits are denoted in foreign currency, a company may experience unfavorable exchange rates when converting back into domestic currency. Currency swaps can hedge against currency risk exposure by swapping cash flows in the foreign currency with domestic currency at a predetermined rate. Companies can also use currency forward contracts to lock in the exchange rate for a specific period. If the exchange rate makes foreign currency less valuable, the company is protected with the locked-in rate; if foreign currency becomes more valuable, the forward contract is then no longer needed (although the company will have incurred additional cost to buy it). By giving up some returns, companies can have protection against potentially negative impacts on their investments.

In addition to SCDS and currency, precious metals such as gold, silver, palladium and platinum are also positively related to geopolitical threats. These safe-haven properties can be used to hedge against geopolitical risk. An article on "Hedging Geopolitical Risk with Precious Metals"[13] examines the relationship between precious metals prices and geopolitical risk with the objective of determining whether precious metals are potential hedges. The authors considered a hedging strategy that adds a long position in a precious metal future to an existing stock portfolio proxied by the return on S&P 500 futures, when a geopolitical risk signal is generated. They found that gold and silver have some ability to hedge geopolitical risks for both normal and extreme geopolitical risks. However, the test of the hedging strategy did not include trading costs, thus implementation requires caution.

For boards and directors, hedging with derivatives requires certain financial sophistication and should be carried out in a professional way. To many people, "derivatives" are synonymous with corporate scandals leading to financial losses and bankruptcy. Credit derivatives – namely collateralized debt obligations (CDOs) – led to the financial crisis of 2008. The 1993 Metallgesellschaft hedging debacle – a flawed long hedge strategy that was meant to protect against forward sales commitments – resulted in the company losing $1.3 billion. With negative cases in the past, should boards and directors consider hedging? The negative impression of derivatives comes from speculation, rather than hedging. Directors need to understand the fine line between speculation and hedging using derivatives: Speculation would create risk, while hedging would reduce risk if done with the right instruments. Acting in the best interests of the business, directors should authorize hedging against geopolitical risks.

Seizing opportunities

For many executives, the word "risk" often has a negative connotation and adding "geopolitical" does not change their view much. However, most geopolitical events take time to develop, which leaves ample time to respond. Events such as Brexit and the US election have minor impacts on most companies. To take a longer-term perspective of larger geopolitical events the collapse of the USSR and the opening of China, for example, created more opportunities than risk. A 2019 event study from BlackRock shows that the average market response to unexpected geopolitical shocks has historically been relatively modest and short-lived. The BlackRock study states that "equity prices tend to take a hit and bonds rally in the immediate aftermath, but these moves often dissipate quickly. Example: The S&P 500 Index fell almost 12% in the first week of trading after the 9/11 attacks of 2001. Yet the stock market had recouped all of these losses by 25 business days after the event."[14]

Boards and directors who have dealt with risks in the past know that most risks can create opportunities, as BlackRock shows study. Best-in-class companies view geopolitical risks from multiple perspectives, deal with the risk, and look for opportunities when possible. For example, the 2003 SARS outbreak in China paved the way for the rise of Alibaba and other e-commerce companies in China. During The COVID-19 pandemic, as more people began ordering takeouts online, mobile food-ordering and delivery apps became popular by connecting diners with local takeout restaurants. The leading food delivery app in the US, DoorDash, filed its IPO prospectus with the SEC in November 2020. The company reported $1.9 billion in revenue for the nine months ended September 2020.

Successful companies do more than manage risk. When looking for opportunities globally, they look to emerging markets such as Africa and India, which often provide new avenues for business as well as varying degrees of geopolitical risk. If individual companies can find an agile and resilient approach to incorporating geopolitical risks into strategy, they can exploit opportunities, mitigate risks and turn capabilities into a competitive edge. Boards and directors need to constantly adapt and evaluate various options to harness opportunity while minimizing risk. On the oversight side, directors ought to oversee management going beyond risk management by harnessing potential opportunities.

Questions for the board to consider:

- Do the board and management translate perspectives and preparedness on geopolitical risk into actions?
- Does your board work with management to prevent geopolitical risk in the first place?
- How can your company's voice be heard without risking adverse reactions from government or the public? Will influencing strategy such as lobbying work in your industry?
- Does your board have robust processes and controls to protect against bribery and corruption while exercising political and legal influence?
- What is the nature and extent of corporate superpowers' intervention and influence on the governments of small countries?
- How quickly can your company reduce supply chain dependency on a

market affected by geopolitical tensions?

- How does diversification offer resilience and stability in the company's growth and performance? Could diversification increase other risks?
- What inputs can the board give on geopolitical risk insurance?
- How does the board tell the difference between management's hedging practice and speculation?
- Is the company capable of using derivatives to hedge against risks?
- Are there opportunities for enhancing growth when geopolitical risks are minimized?
- Is the company willing to accept a certain level of geopolitical risk to harness opportunities?
- Are geopolitical opportunities and risks considered simultaneously as part of the strategy setting process?

Conclusion

Global risks, which have become more complex and increasingly interconnected, are here to stay. In such a context, geopolitical risks have clear consequences for business, from supply-chain disruptions to tariffs, to expropriation and even potentially to hot wars. The COVID-19 pandemic-induced disruptions to global supply chains have presented boards and directors with the opportunity to rethink geopolitical risk oversight. Companies must adjust to the new reality and implement geostrategies to improve agility and resilience to whatever geopolitical risks arise in future.

Geopolitical risk is central to the world beyond COVID-19. Boards and directors need to make a mental shift, review their board's geopolitical competency, continue their education and bring specialists onto the board to strengthen high level expertise on geopolitical risks. With the right structure and processes, boards and directors assign responsibility for geopolitical risk management and receive regular updates on the latest developments of global geopolitical tensions. Boards will also benefit from healthy group dynamics which sustain members as an effective team when contemplating geopolitical risk management.

It is important for boards to oversee management in terms of geopolitical risk preparedness – assumptions, identification, assessment and quantification. The "unpredictable" assumption of geopolitical risk must be challenged, and when geopolitical factors change, previous strategic assumptions should be reevaluated. Companies can do more on preparedness: Identify early warning signs and trends that are specific to the company with proper analytical tools and frameworks; assess the potential negative impact using scenarios and stress testing; and quantify the exposure to enable informed decision making. With thorough preparedness, companies can assess the impact of geopolitical risk that they face and build a solid foundation for action.

To mitigate geopolitical risk, boards and directors need to oversee management choosing the right set of response measures and integrating them into the decision-making process. The first step is to avoid high-risk regions completely to prevent being negatively affected. It is also essential for boards and directors to deal with geopolitical risk proactively. This may involve exercising influence on the regulatory and legislative agenda in a country without bribery and corruption. Diversification absorbs supply chain shocks if deployed early enough. Insurance coverage exists for many geopolitical risks, thus allowing business to continue. Hedging geopolitical risk with derivatives such as SCDS, futures, forwards or precious metals requires scrutiny from boards and directors. Boards should monitor management and forbid speculation in the name of hedging. Finally, boards and directors will want to capture opportunities in addition to undertaking risk mitigation in a holistic risk management approach.

In today's shifting world with unexpected geopolitical outcomes, we need to realize that boards and directors may still miss certain geopolitical risks or opportunities. But that should not paralyze boards from overseeing management in incorporating geopolitical risk and opportunity identification into overall risk management. Having a board and management that understand geopolitical risk preparedness and action can create an agile and resilient organization and sustain growth and value creation in the long term.

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