ADAPTING TO A CHANGING WORLD ORDER

Six ways financial institutions can manage geopolitical risk

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EXECUTIVE SUMMARY

The Russian invasion of Ukraine has highlighted the importance of a pervasive geopolitical risk management framework for financial institutions (FIs), given the partly unexpected second and third order impacts many had to manage through. Market expectations of other potential geopolitical shifts have become elevated, and possible scenarios range widely. Regulation often follows such expectations.

As FIs have started to do for climate risk, the management of geopolitical risk requires a horizontal approach that spans across various vertical risk stripes that FIs usually manage themselves to. To date, progress on systematic management of geopolitical risks has been slow in Financial Services, and responses are often ad hoc through “crisis coordination rooms” once a geopolitical event actually occurs.

This short paper lays out six “no regrets” steps that FIs can take now to effectively integrate the management of geopolitical risks into their broader strategic planning and risk management:

1. Define ownership for geopolitical risk
2. Identify geopolitical risks and design scenarios
3. Conduct impact assessments for priority scenarios
4. Define mitigants, develop playbooks and run simulations
5. Integrate into stress testing, planning, and steering
6. Manage using Early Warning Indicator dashboards

GEOPOLITICAL RISK — A "HORIZONTAL" TAIL RISK AMONGST MANY?

In the history of humankind, pandemics, wars, economic crises, and meteorological disasters have consistently been featured as often abrupt and sometimes cyclical disruptions to economic progress and stability. It is rare for all types of these events to occur on a global scale in as short a period as we have just experienced since the year 2020. Hence, the risks of them materializing are still too often treated as "tail" risk drivers by society — that is, unlikely to materialize regularly or in a meaningful way — and by the financial institutions (FI) that are drivers of growth in the economy.

Exhibit 1: Geopolitical risk as one horizontal tail risk driver financial institutions face

Short-term meteorological risks (e.g., "Acts of God")	**Long-term meteorological risks** (i.e., climate change)	**Geopolitical risks** (e.g. military conflicts, sanctions)
Societal risks (e.g. mass migration, polarization, nationalist uprisings)	**Pandemics**	**Economic cycle risks** (largely part of banks' core mandate already)

Source: Oliver Wyman Analysis

FIs often manage their risks primarily through the lens of so-called vertical risk stripes. For a bank, for example, this may include credit risk, e.g. direct counterparty, retail and indirect issuer; market risk; treasury risk, comprising of liquidity, interest rate, solvency, foreign exchange risk; and non-financial risk, which includes compliance and financial crime risks, cyber risks, operational risks.

In addition to these vertical risk stripes, there are "horizontal risk drivers" that affect FIs across all vertical risk stripes, often in interdependent ways. These horizontal risk drivers include the tail risks mentioned above, like pandemics, environmental disasters, or geopolitical conflicts. There has been material progress in financial services in recent years to define how some horizontal risk drivers — like economic cycle risk or climate risk — should be incorporated in the management of each vertical risk stripe.

It is now time to do the same for geopolitical risk drivers as progress has been slower, both in terms of guidance from regulators and action from the FIs themselves. For example, banks that are regulated by the Office of the Comptroller of the Currency (OCC) in the US must consider country risk. This is defined broadly[1] but in practice focuses more on first order impacts and on the risk of direct investment exposure and conducting business in a foreign country. Generally, when major geopolitical crises, like the 2022 Russian invasion of Ukraine, erupt, firms are quick to stand up “crisis coordination rooms” to manage across impacts and react tactically as events unfold. These are not that different from similar “war rooms” that firms stood up during the beginning of the Covid-19 pandemic.

However, while the rapid response is admirable it has exposed the shortcoming in firms’ business-as-usual preparedness for such events. It has also laid bare that many FIs have not historically fully priced in or considered the potential costs of major geopolitical events in their participation choices. This is due to their uncertainty and myriad ways of potentially unfolding. But in 2023, the likelihood of major geopolitical risks materializing has arguably become greater than at any point since the end of the Cold War, and FIs need to prepare accordingly. The conflict in Ukraine has been a stark reminder of the spillover risks for FIs from geopolitical disruption. Market expectations of other potential geopolitical shifts have become elevated, and possible scenarios range widely. Regulation often follows such expectations.

So, what should FIs do to be prepared for a likely shift back to a world of multi-polar international relations?

We have identified six “no regrets” steps FIs can take now to effectively integrate the management of geopolitical risk into their broader strategic planning and risk management. Outlined in Exhibit 2, the remaining sections of this piece will walk through each step to help firms plan for this unlikely but increasingly plausible tail risk.

1 “[T]he risk that economic, social, and political conditions and events in a foreign country will affect the current or projected financial condition or resilience of a bank” — Source: https://www.occ.gov/news-issuances/bulletins/2002/bulletin-2002-10a.pdf and https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/country-risk-management/index-country-risk-management.html

Exhibit 2: Six steps to mitigating geopolitical risk

Ownership definition	Designate central responsibility for monitoring and managing geopolitical risk across the institution	
Risk identification and scenario design	**Define geopolitical scenarios** with varied duration and reach **Identify and prioritize risks** cascading from each scenario	
Impact assessment	**Financial impact analysis:** Identify vulnerable business lines, products, and clients. • Calculate prospective cash flows, **P&L, balance sheet and other risk**	**Non-financial impact analysis:** Identify non–financial impacts • Assess impact of scenarios on: **People, Reputation, Cybersecurity**
Mitigants, playbooks and simulations	**Identify "no regrets" moves to** mitigate immediate identified risks	**Develop crisis playbooks** outlining potential actions
	Test crisis playbooks via **management simulations**	
Planning and steering	**Incorporate geopolitical risk considerations** into BAU strategic planning processes	
Risk monitoring	Improve **risk management monitoring and decision making** • Create data dashboards to help inform decision making • Create compensating controls for vulnerabilities	

Source: Oliver Wyman Analysis

#1 DEFINE OWNERSHIP OF GEOPOLITICAL RISK

The first step in effectively managing geopolitical risk exposure is to assign responsibility to a dedicated risk owner or team who will monitor and drive management of this risk across vertical risk stripes. This helps ensure that there is central accountability for active monitoring of potentially disruptive geopolitical events which de-duplicates efforts to track them and ensures that management of geopolitical risk remains a priority across the firm's business lines.

Banks have started to introduce this concept for climate risk and should contemplate something similar for geopolitical risk. This type of horizontal risk management can be challenging because risk management in a bank is usually centralized through the Chief Risk Officer (CRO). Yet horizontal risks often manifest in ways that exceed 'classic' risk management problems, leading to

- Impacts on participation choices of the firm as a result of drastic changes to the business environment — the remit of the broader ExCo and strategy teams
- Demand for new and innovative financial solutions from affected clients — the remit of the business
- Direct and indirect operational challenges for the firm — the remit of Operational Resilience teams
- Heightened cyber and financial crime risks — the remit of those respective teams
- Challenges for employees affected by the event — the remit of HR teams

To help manage enterprise coordination, financial firms should establish a single point of accountability for monitoring and measuring potential fallout from a geopolitical event, as well as for coordinating the company's response.

#2 IDENTIFY GEOPOLITICAL RISKS AND DESIGN SCENARIOS

FIs should seek to maintain catalogs of potential major risk events, including geopolitical risks, and many already do so as part of their horizontal risk reviews. It would be easy for firms to end up with long lists of potential geopolitical events that could potentially unfold at some point in the future. Initial prioritization and triage are hence essential first steps to make this exercise useful. The most important dimension to consider in the risk identification and scenario design step is likelihood. The likelihood of an event materializing will dictate how a company manages against it. Firms should focus on events that are at least somewhat likely to materialize in the foreseeable future and can group events into:

- **Events that are likely to unfold:** Embedded into baseline planning and decision-making
- **Events that are somewhat likely to unfold:** Embedded into sensitivity analyses around the baseline planning and may influence decision-making
- **Events that are unlikely to unfold:** Viewed as tail risks that should be considered in stress tests

Exhibit 3: Example dashboard of geopolitical events to be tracked by global financial institutions in 2023

Populist Return	Politicians escalate punitive measure to placate rising populist mood
Military Conflict	Taiwan conflict Escalation of Russian conflict w/Nato Escalation with Iran or North Korea
Economic Nationalism	National governments intervene aggressively to pick industrial winners and losers
Bifurcated World	US–China rivalry splits global economy and force companies and governments to take sides
Deglobalization	Collapse of WTO and global trade rules disrupts supply chains and rising protectionist measures
Climate War	Climate policies and carbon price tariffs are used to further geopolitical rivalries

Source: Oliver Wyman Analysis

Companies do not need to be overly scientific about this assessment, and a simple, directional classification is likely to be sufficient. But the assessment should be consistently reviewed and challenged by those made accountable in step 1. Firms should establish a regular cadence of workshops with relevant stakeholders to review and challenge the likelihood of the selected scenarios. They should also use third party resources (for example, the Marsh McLennan / World Economic Forum Risk Report[2]) to check their dashboards against latest trends and to identify any potentially significant gaps in their field of vision.

2 https://www.marshmclennan.com/insights/publications/2023/january/global-risks-report.html

#3 CONDUCT IMPACT ASSESSMENTS FOR PRIORITY SCENARIOS

Once a short list of events has been identified that could viably materialize in the regions the FI is exposed to, risk managers need to have a view of how the events could unfold and what the downstream impacts will be. The impact of events on the company directly, its clients, and its employees will differ, and firms should prepare for each in very different ways:

- Events that could be catastrophic: Such events are akin to those used in bank resolution plans already to simulate a potential bank failure. Banks can hence use their resolution plans as a blueprint for avoiding a full depletion of shareholder value and creditor repayment. They need to understand the actions that would be taken to minimize (albeit not avoid) losses to shareholders and creditors, such as safeguarding those parts of the bank that are not directly affected by the event. Other FIs can learn from this experience.
- Events that could have severe or moderate impact: Such events could be considered in firms' contingency and/or recovery plans. FIs should develop a full strategy for dealing with the fall-out from such events, as described in the remainder of this paper.
- Events that would have limited impact: Such events likely require some preparation, but it may be more targeted at specific countries or business lines — and may already be captured in existing country risk frameworks.

Many FIs, such as major banks, have tools in place today that they can leverage to estimate impacts. For example, processes and analytics that have been put in place through stress testing exercises such as the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) can for certain types of events be used to estimate losses from geopolitical events, albeit with a change to major assumptions. Integrated planning analytics at some FIs — where designed with strong "what if" capabilities — can allow for a broader review of impacts on other financial resources. And Operational Resilience processes should play a part in determining how an event could affect the ability of the company to maintain its operations.

CASE STUDY

IMPACT ANALYSIS: LESSONS FROM RUSSIA'S INVASION OF UKRAINE

Using the Ukraine crisis as a case study in managing geopolitical risk has highlighted second and third order consequences, beyond direct financial impacts & sanctions.

Some immediate impacts were largely predicted by experts and many FIs had them on their radar:

- Sanctions on Russian state-backed entities disrupting business with these entities
- Credit risk elevation for entities with direct exposures to Russian markets
- Increased operational disruption to Russian entities and counterparties
- Market disruptions in commodities markets
- Exclusion of Russian FIs from Western financial system and securities/investment restrictions on Russian entities

However, there were also unanticipated effects in the early stages of the crisis:

- Inability to divest from Russian operating and investment assets, and sanctions on individuals and non-state backed entities
- Credit risk impacts via indirect (e.g., supply chain / vendor) exposures to the region
- Disruptions to service provisions to and from the broader region (e.g., from vendors in U.S. or Poland to Russian subsidiaries, but also to other markets)
- Potential impacts on counterparties from inability to source materials coupled with a rise in inflation
- New geopolitical alliances forming as a result of the war, making business relations elsewhere more fraught as well

#4 DEFINE MITIGANTS, DEVELOP PLAYBOOKS AND RUN SIMULATIONS

After identifying likely and impactful geopolitical risk scenarios and quantifying their effects, FIs should identify potential mitigating actions and develop playbooks to ensure that senior leadership is ready to manage the fallout from these impacts should the risks materialize.

- Mitigating actions can be segmented into those that are "no regrets" today versus those that may be needed should the scenario become more likely or evolve. No regrets moves are not limited to decisions to stay or exit a market or business line, but can include a range of options to accept, share, mitigate or avoid a particular risk.
- Building on lessons learned from recovery and resolution planning efforts after the 2008 financial crisis, playbooks should be activity-focused instruction manuals that provide a step-by-step guide to mitigate fallout. Exhibit 4 provides an example of a playbook structure firms could consider.

Exhibit 4: Potential playbook architecture for geopolitical events

'Master' crisis playbooks to coordinate responses across geopolitical events; used by central risk owners and committees to coordinate response to an event, and drive decision-making, e.g. by the "crisis coordination room"

'Impact mitigation' crisis playbooks: Playbooks for impact owners who will need to take actions to mitigate the impacts of the event, at direction of central risk owners and committees

Financial Contingency Playbooks to manage financial impacts, such as by amending collateral requirements for customers in vulnerable sectors and regions, changes to provisions for credit losses in advance of heightened defaults, and contingent Treasury actions to safeguard the bank's financial position	**Operational Resilience & Cyber Playbooks**, focused on maintaining business continuity, such as navigating disruptions due to the sudden loss of service centers in affected countries, impacts on third parties, or heightened cyber risks	**Legal & Sanctions Playbooks**, leveraging firms' existing anti-financial crime (AFC) risk management functions to rapidly review changes to sanctions lists and update screening models to ensure they remain compliant with their AFC obligations
Client Engagement & Support Playbooks, which each business can use to determine ways to support clients affected by the event in different ways	**HR / Employee Support Playbook** for communicating with and assisting affected employees, such as those located in impacted jurisdictions, or those subject to travel restrictions imposed following a geopolitical risk event	**Communication Playbooks** to align with relevant external stakeholders and mitigate reputational damage, including existing financial relationships with newly sanctioned individuals and companies, as well as communicate with internal stakeholders such as employees

Source: Oliver Wyman Analysis

Tabletop simulation exercises, comprising of simplified simulations of geopolitical events with senior management, can complement the playbooks and immediately bolster risk management efforts in two ways. First, they can help shed additional light on the actions and decisions that are likely to be needed should an event unfold, which can be incorporated back into the playbooks to refine and enhance the response. Second, they can help identify moves that senior management can undertake immediately to mitigate identified risks.

#5 INTEGRATE INTO STRESS TESTING, PLANNING, AND STEERING

As briefly discussed in step #3, ultimately, FIs will need a way to take geopolitical risk drivers into consideration when setting and executing against business strategies. Firms should dissect drivers of revenue, cost, capital, and other financial resources and then run scenarios that affect those drivers to determine the RoE impacts of different choices. Integrating these elements into stress testing, planning, and steering has the benefit of translating a major geopolitical event into a set of tangible financial impacts that will drive customer and firm behavior. Some will be purely viewed as stress tests, while others may increasingly become part of the “base case” — as the status quo in Ukraine has recently become for European FIs.

Unlike climate risk, which gradually is being incorporated into planning, geopolitical risks will need to be viewed more as a source of risk that ultimately affects the drivers of each component of return on equity in different ways — hence creating additional complexities. This consideration will become more critical as regulators increasingly focus on geopolitical risk as a stress testing exercise, as has been indicated by some supervisory authorities.

Ultimately, FIs will need to drive businesses to take actions to mitigate the most material risks, either by actively steering firms away from areas that could be particularly problematic in more likely scenarios — and/or indirectly by adjusting transfer pricing and capital allocation mechanisms to reflect these risks.

#6 MANAGE USING EARLY WARNING INDICATOR DASHBOARDS

Like Ernest Hemingway's famous characterization of bankruptcy, geopolitical events can happen gradually, then suddenly. For each major geopolitical event, firms should monitor key indicators that provide warnings of increased risk, such that preparatory actions can be taken in a timely manner.

As geopolitical risk events initially emerge, qualitative indicators can provide valuable insight. Wars are usually not abrupt affairs, especially with the benefit of hindsight. The Russian invasion of Ukraine, for example, was preceded by an extensive buildup of troops and equipment in Belarus and on the Russian/Ukraine border under the guise of joint military exercises. Separately, the US and its allies telegraphed what the potential sanctions response would be as a potential form of deterrent.

FIs can also develop heatmaps of quantitative metrics to supplement their qualitative risk surveillance. Types of quantitative indicators include:

- Empirical measures, such as market movement indices and covolatility metrics that capture the sudden repricing of risk assets in response to geopolitical developments.
- Textual analysis models, which employ machine learning-driven natural language processing (NLP) to quantify relative risk levels over time and surface emerging geopolitical risk topics from thousands of news sources across the globe.
- Ratings-based measures that reflect expert assessments of country political risk.

Of course, a cone of uncertainty applies to qualitative and quantitative indicators, and it is extremely challenging to know in advance at what exact point escalating tensions will reach a breaking point. Nonetheless, FIs can learn from their recovery planning experiences, where they established metrics and limits that indicated the level of stress the firm was in across the crisis continuum. A similar concept could be applied to the level to which a geopolitical risk driver is materializing. Ongoing monitoring is a crucial component of risk management in the current paradigm of heightened geopolitical risk. Early warning indicators can help calibrate levels of geopolitical risk and the appropriate responses as situations evolve.

CONCLUSION

Recent global events have emphasized the importance of managing geopolitical risks and provided a case study for how to do so. Many companies across industries face geopolitical risk, but FIs, as intermediaries and proxies for the global economy, are uniquely sensitive to the macroeconomic side effects and capital flows that are so often associated with geopolitical risk events. While some firms have taken steps to more actively monitor and manage their exposure, significant room for improvement remains to embed geopolitical risk in a structured manner into business decisions. Oliver Wyman has been actively addressing this issue with proactive institutions around the globe. As a starting point, FIs can apply the six steps in this paper to strengthen their risk management frameworks and adjust to the new paradigm of heightened geopolitical risk.

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