European Risk Management Council

Risk Landscape Review

December 2021

- Geopolitics, Corporate Governance and ESG
- UK Risk Sentiment Index: Q4 2021 Update

DEAR READER,

I am delighted to present Q4 2021 edition of the Risk Landscape Review.

The ongoing pandemic crisis has amplified many traditional and emerging risks and revealed “fault lines” of the industry risk landscape. One of the traditional risks exposed by the pandemic has been geopolitical risk. Today we publish an article “**Geopolitics, Corporate Governance and ESG**” by Derek Leatherdale and Peter Neville Lewis. The article discusses links between geopolitical risk, business resilience and ESG and an integration of geopolitical risk to the existing risk management framework and the Board agenda.

We also continue our publications of **UK Risk Sentiment Index (RSI)**, an expert driven forward-looking index that reflects expectations of experts about the risk landscape of the UK financial sector in the next 12 months. Using results of our recent survey, we have updated UK RSI and present you the summary which this time gives us a glimmer of hope that the turbulent times might come to the end soon.

My huge thanks to all contributors.
Enjoy the reading.

Yours sincerely,

Dr Evgueni Ivantsov

Chairman of European Risk Management Council

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Geopolitics, Corporate Governance and ESG

By Derek Leatherdale and Peter Neville Lewis

Surveys show that business leaders and board members are generally well aware of global geopolitical volatility. This is not surprising. Firms who globalised their market footprint and supply chains in the last three decades must now operate in an increasingly antagonistic geopolitical environment.

Deteriorating US-China relations top the risk list, with trade wars, sanctions and financial and geo-economic measures in key industry sectors like technology, financial services and strategic commodities. Concerns about Hong Kong, and increasingly militarised disputes over Taiwan and maritime sovereignty in the South and East China Seas drive this.

In the Middle East, new tensions drive the kind of volatility long associated with the region. The politics and fiscal arrangements of the Eurozone remain unsettled, while post-Brexit tensions between the UK and the EU, and between NATO and Russia, continue to generate potential political risk impacts for firms in Europe. Concern has also risen in recent years about domestic politics in the US. Last but not least, emerging markets elsewhere in Asia, Africa and Latin America remain characterised by political and socio-economic challenges.

Geopolitical risk has therefore become a challenge across much of the global economy. While this was apparent before 2020, COVID's long-term macroeconomic and fiscal impacts will exacerbate these trends.

The same corporate surveys also show something else, however. A majority of boards and management teams do not feel confident in their internal capabilities to interpret fast-moving geopolitical events or judge how these might impact their firms. The absence of this capability makes it impossible to consider effective impact mitigation.

Geopolitics increasingly cuts across the ESG landscape for corporates too. For instance, analysts often suggest climate change is likely to drive scarcity of key transnational resources like water or generate destabilising migration flows. As the absence of major nations at November's COP26 summit also showed, geopolitical friction is undermining the multilateral public policy response needed from the world's biggest CO2 emitters to restrain rising temperatures.

Other factors mean geopolitics increasingly underpins ESG dynamics. For instance, a US government report published in October 2021 concluded that:

"*Competition will grow to acquire and process minerals and resources used in key renewable energy technologies. China is in a strong position to compete; it currently controls more than half the global processing capacity for many of these minerals ……. including rare earths for wind turbines and electric vehicle motors; polysilicon for solar panels; and cobalt, lithium, manganese, and graphite for electric vehicle batteries*."

How does this complex and volatile backdrop affect business more broadly? Observers tend to think primarily of geopolitics as either disrupting supply chains or exacerbating cyber risks. While these are certainly pressure points for some firms, the impacts go much wider.

For one, geopolitical volatility, and the associated use of geo-economic policy measures like tariffs and investment restrictions, degrade the macroeconomic conditions and industry sector performance on which corporate strategies are based. Geopolitical volatility can also disrupt key consumer or client segments for firms, while longer term political uncertainty undermines investment strategies. The increasingly complex crossover with corporate ESG agendas also creates additional reputational pressure on firms with key external stakeholders such as investors, regulators and NGOs.

Geopolitics therefore has consequences for balance sheets and financial performance, as well as for operational and non-financial risk and control functions. Some of these areas are new, but geopolitics is equally capable of exacerbating risks an organisation already recognises. This means the geopolitical challenge for firms may be as much to optimise existing risk management frameworks and tools as it is to create entirely new capabilities.

In this context, how can boards of international companies ensure their organisation remain resilient? Who in the organisation should have the leadership and oversight responsibilities in this area? What analytical capabilities do businesses need to anticipate geopolitical risks and their impacts, including on ESG deliberations, and how should these be deployed internally for maximum effect?

Comprehensive guidance for boards that answers these questions has not existed before. We at the Risk Coalition and GRI Strategies have sought to close this gap with new leading practice guidance, entitled 'The Extra G – ESG2'. It sets out how boards can make better use of their risk oversight committees and risk functions to improve oversight of geopolitical and related ESG risk, within a framework spanning accountability, risk culture, the integration and deployment of specialised analytical capabilities and expertise, and the interface with corporate strategy setting.

The guidance is also supported by examples of emerging corporate practice in this area and links to a self-assessment tool (GABI-GEO). This allows directors, management teams, heads of risk and other key stakeholders in firms to identify whether internal approaches reflect best practice and what practical actions could be taken to improve these.

Early use of this tool is beginning to yield interesting insights. The data shows how corporates in different sectors are responding to the challenge of geopolitical volatility and integrating new approaches to the oversight, anticipation and management of the impacts of risks.

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

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

UK Risk Sentiment Index: Q4 2021 Update
Expecting the end of the turbulence…

The European Risk Management Council has updated its UK Risk Sentiment Indices (RSI). Fresh data have been collected in Q4 2021. Chief Risk Officers and other senior risk executives from financial institutions provided their views on the future trends of seven types of risk (credit, market, liquidity, operational, cyber & IT, conduct and regulatory risks). Using the survey results, the Council aggregated the data into forward-looking index that reflects expectations about a change of the risk landscape for UK financial services industry in the next 12 months. Numerically, the RSI reflects the adjusted percentage of respondents who consider that risk will increase in the next 12 months.

Q4 2021 UK Risk Sentiment Index

- In spite of the ongoing COVID crisis, in Q4 2021 respondents maintained a quite positive view on the future risk landscape. The aggregated RSI for seven risk types decreased from 0.43 in Q2 2021 to 0.35. Therefore, the optimistic trend that started in Q1 2021 stretched for the whole year. The current level of the aggregated RSI is the lowest since a launch of the index 3 years ago.

- Overall, in the last 3 years the UK risk landscape has been shaped by two major events – Brexit and the pandemic. This is reflected in the "Twin Peaks" of the RSI trend (Figure 1). The highest "fear point" was achieved in Q4 2020, when the UK faced the second COVID wave. The mood of respondents changed in Q1 2021 after a launch of the vaccination programme. The current level of RSI indicates that the respondents expect the end of the pandemic crisis in 2022.

- The optimistic mood is demonstrated by a shift in the vote distribution among main categories in 2021. A percentage of respondents who expected that risk would increase has been constantly reducing in the past 12 months (88% in Q4 2020 vs 55% in Q4 2021). At the same time, based on the latest survey, 35% of respondents believe that the risks will not change in the next 12 months – the highest percentage since the RSI launch. It is a clear indication of the expected migration from a turmoil stage to a stable risk environment (Figure 2).

- A comparison of RSIs of individual risk types shows that cyber & IT risk remains the prime concern for UK respondents. Respondents identified market risk as a potential new hot spot. The RSI of market risk is now the second highest with 83% respondents believe that this risk will increase in the next 12 months (Figure 3). At the same time, RSIs of conduct, regulatory and liquidity risks dropped to a very low levels.

- The recent RSI survey revealed a different expectation regarding the dynamics of financial and non-financial risks. RSIs of all three financial risks have increased in H2 2021, while all RSIs of non-financial risks have dropped quite substantially (Figure 4). RSIs of regulatory and operational risks have reduced more than by 50% in the last 6 months. RSI of regulatory risk not only had the largest reduction from the previous level but also hit its all-time low.

Figure 1. UK RSI trend: Q4 2018 – Q4 2021

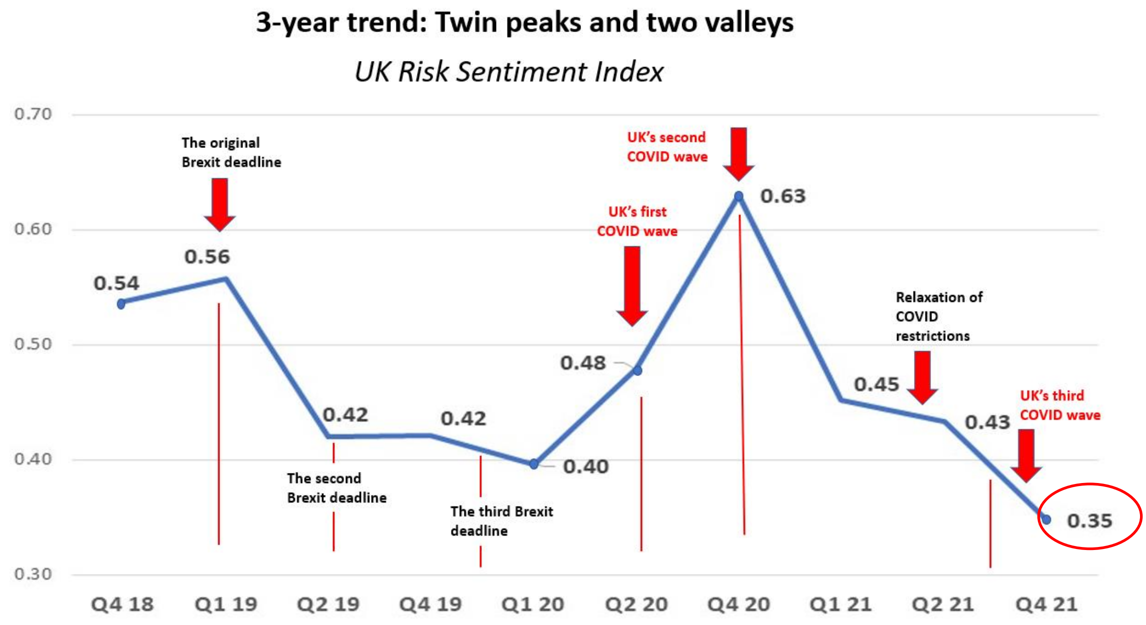

Figure 2. UK RSI: Distribution of respondents' votes

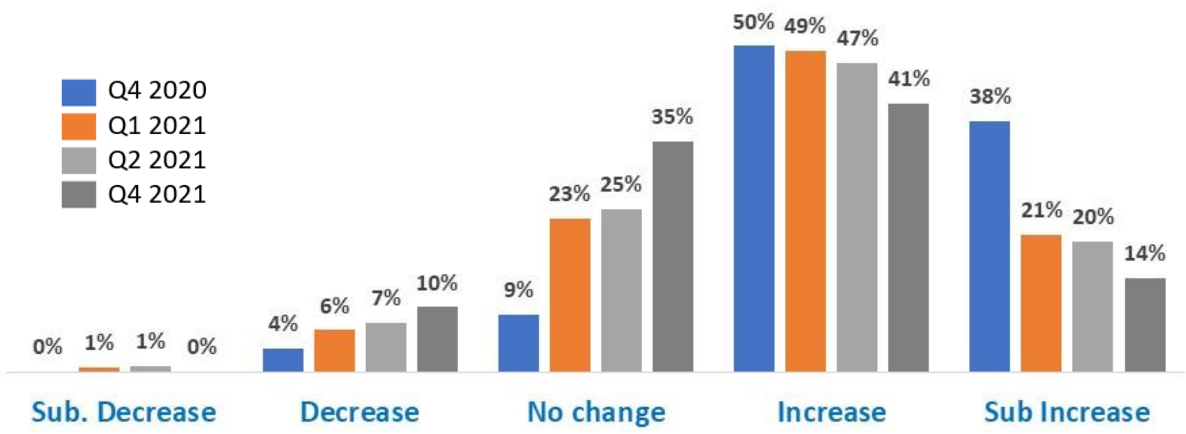

Figure 3. UK RSI: Comparison of RSIs for different risk types in Q4 2021

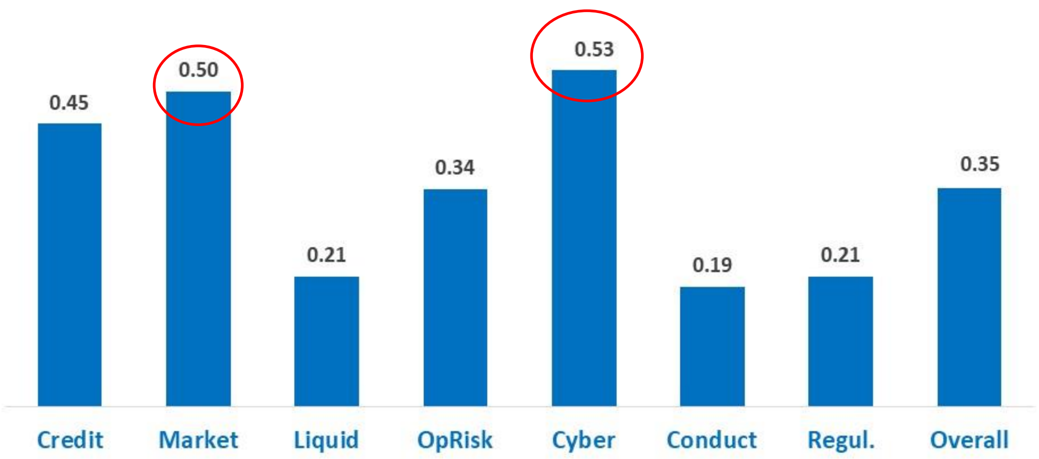

Figure 4. UK RSI: 1-year RSI trends for individual risk types