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Expect the unexpected

How can treasurers even begin to manage the vast range of geopolitical risks that exist? Rebecca Brace offers some pointers

Corporate treasurers have to identify, evaluate and manage a number of different risks that may affect their organisations. Geopolitical risk is an area that they should consider closely because of its significant implications for everything from exchange rates and interest rates to commodity prices and supply chain stability.

What is geopolitical risk?

Geopolitical risk is "any political tension occurring in a country – or between two or more countries – which could lead to riots, secession and wars, to the point it affects the physical security of the company's counterparties or personnel, while permanently disrupting any movement of goods or services", says Jean-François Lambert, MD, global head of commodity and structured trade finance, at HSBC.

Others adopt a looser definition of the term. James Binns, MD, head of working capital, EMEA, at Deutsche Bank, says that the definition of geopolitical risk has widened in recent years. "Where domestic, social and political policies used to be the main concerns, geopolitical risk now encompasses everything from extremist groups to cybercrime to epidemics," he notes.

"From many of our clients' perspective, I'd say it includes geographical risk, such as earthquakes or resiliency of infrastructure, as well as political risks, such as conflict, terrorism or security," says Rick Cudworth, partner, resilience and crisis management, at Deloitte. "But we are also seeing many clients include environmental risk, such as climate change, and socioeconomic risk, such as economic growth, inflation and corruption. We also see people including health-related risks, such as human pandemics."

In terms of specific risks, some of the most significant threats that companies currently face include political tensions in the Middle East, and the relationship between Russia and the US and Europe. Other factors include the ongoing possibility of Greece exiting the euro – or, indeed, the UK exiting Europe.

From a commodities point of view, the price of oil is another notable concern. "The phenomenon of falling oil prices is far more than a pure economic supply-demand reaction," says Gabriel Wang, research associate at research consultancy Aite Group. "It certainly has political roots, as oil prices started to fall off in July 2014, not long after the Russia-Ukraine crisis began in early 2014." Wang also cites deflation risk in the eurozone, the possibility of rising rates in the US and slowing economic growth in China as major sources of geopolitical risk.

Other sources of geopolitical risk range from human disease and natural disasters, such as tsunamis, to man-made disasters, including oil spillages and technical failures.

Impact on treasurers

From the point of view of the treasurer, these risks can have wide-ranging and significant consequences. HSBC's Lambert says that geopolitical risks can have substantial effects on treasurers, including the inability to trade, payment defaults, price risks, sanction risks and embargoes, as well as the possibility of *force majeure* preventing deliveries.

"With the treasurer's role becoming increasingly strategic, these risks need to be firmly on their radar," comments Binns. "The potential paradox is that, with its lack of clarity, our current environment encourages short-term thinking. At the same time, increased competition and threats from fast-growing local and regional corporates, with ambitious growth plans, lower cost bases and fewer constraints, mean that large multinational corporates need to be focused on medium- to

Oil casts a shadow

Lower oil prices are increasing the political and economic uncertainty in oil-producing states outside the Gulf Cooperation Council, according to risk management business Aon Risk Solutions, part of international insurer Aon.

Its *2015 Political Risk Map* highlighted the risk of increasing instability in countries such as Iran, Iraq, Libya, Russia and Venezuela. It added: "The effectiveness of extremist groups in the Middle East and Africa will be amplified in afflicted countries that lack the resilience to absorb economic shocks."

Meanwhile, Russia undoubtedly presents a significant political risk as a result of lower oil prices, sanctions and the war in Ukraine. Aon noted that the Russian investment environment was continuing to weaken, while the risk of corporate defaults in Ukraine was increasing. It added: "The low oil price continues to cast an economic shadow over the Commonwealth of Independent States region, particularly for Russia's larger regional trading partners, such as Belarus and Kazakhstan."

The heightened political threat posed by Russia – and also China – was emphasised at the start of July when the US military released a report that warned of a "low, but growing" probability of the US going to war against a major power.

BUILDING A RISK PLAN

When building a plan to mitigate geopolitical risks, organisations typically put in place three layers of preparation:

1. **GENERIC CONTINGENCY PLANS. Companies should create a plan to deal with generic consequences that might arise from a number of different events, such as the loss of technology or facilities.**

2. **SCENARIO-SPECIFIC CONTINGENCY PLANS. For the most high-impact and likely risks, companies can create scenario-specific contingency plans to detail the course of action that will be taken.**

3. **CRISIS-MANAGEMENT CAPABILITIES. Companies need to ensure that they are not only able to execute their plans, but that they are also able to respond effectively even when an event occurs for which a specific plan does not exist or is not appropriate. This should enable the company to deal with unanticipated events, as well as those that can be anticipated.**

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long-term trends in order to maintain/grow their future market share."

Sam Sehgal, head of trade, EMEA, at Citi, says that countries with increased geopolitical risk often have highly restrictive regulations that make it difficult to conduct business in those markets. "There may be capital controls or FX risks due to devaluation of local currency," he explains. "For example, the impact of sanctions resulting from the Russia-Ukraine crisis has greatly reduced the ability of banks to do business in those markets. The Arab Spring a few years ago, and resulting social unrest in various countries, had an appreciable negative impact on business. There is greater likelihood of higher interest rates for the geographies impacted."

FX is one of the most significant risks associated with geopolitical risk. "In a country where there is a political or other event, you might expect the currency of that country to devalue, and volatility to increase dramatically," says Cudworth. "This might well have a knock-on effect on volatility in currencies not related to that particular territory. You might also see a flight to safety towards other currencies. In addition, in areas of market risk, you might have reduced access to various financial instruments that you take for granted." Cudworth points out that access to simple FX transactions has become very difficult in Russia, while pricing for these instruments is not currently attractive.

Geopolitical events can also have an impact on commodity prices and the ability of certain markets to produce commodities. Other considerations include the availability of credit: if banks are suddenly unable to provide committed funding, companies will face the challenge of securing an alternative source of funding. This can be particularly crucial during a crisis, when costs may escalate while revenues decline. Other problems could include

the knock-on effects of the sudden loss of customers or markets, such as reduced cash flow or currency exposures.

Managing geopolitical risk

With so many disparate threats included under the umbrella of 'geopolitical risks', knowing where to start can be daunting. "The obvious geopolitical risks are fairly clear to everyone – at least, after the event," comments Damian Glendinning, treasurer of Lenovo. "The problem is that, as treasurers, we need to see them before they happen."

Robust treasury management practices can play a part in mitigating these risks, however. "A detailed view and access to global liquidity are becoming more essential – in combination with more insightful cash-flow forecasting and sensitivity analysis to maximise efficiency, while still building contingency," says Binns. "As a result, there is an increasing focus at the CEO level on working capital dynamics, including cash generation efficiency, risk mitigation and cost reduction."

Cudworth notes that contingency measures can be developed that may apply to a number of different possible events. "The planning and resilience that you are building, and the infrastructure that you require, is not necessarily tied to individual risks – it's about types of risk," he explains. "Whether it's war, terrorism, Grexit or a pandemic, once you start to prepare, the cause becomes less important. The point is that you are facing a shock to the organisation caused by an external factor that could impact your whole operation – so how do you put a plan in place in order to resume operations if the infrastructure goes down?"

How, then, can treasurers manage these risks? "In the end, I think it comes down to the old adage: don't put all your eggs in one basket," Glendinning says. "It is much easier to handle a problem of this nature if the wellbeing of your company does not depend on it. It is best to make sure that your sources of revenue are sufficiently well diversified – or that you have a clear and well defined plan B."

As Lambert points out, some geopolitical risks are manageable but others are not. "If geopolitical tensions build up in a certain region where the company's trade is significant, the treasurer will have to assess current exposures of all kinds depending on whether the affected zone is a sourcing area or a sales one," he adds. "For all risks, they will also need to assess the possible mitigations: insuring payment risks or performance risks; slowing or stopping trade; and moving securities where possible – if players in the affected region are still willing to trade."

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Sehgal says that treasurers need to work with business managers across the organisation in order to navigate geopolitical risks. He adds that various techniques can be used to mitigate the impact of this type of risk. "There are structures under trade finance, given that these risks are not new, that can substantially mitigate and immunise businesses to geopolitical risks," he says. "These have been time-tested and used in a number of varied circumstances globally."

Such techniques might include the use of letter of credit confirmations by exporting companies when they are exporting to countries experiencing geopolitical risks, or the use of collateral, which can be obtained for deals and kept outside the country experiencing geopolitical risk. Insurance and parent guarantees may also reduce the risk of doing business in countries facing geopolitical risk – for banks, as well as for their corporate clients.

But Sehgal points out that regulation can make managing geopolitical risk a more complex undertaking. "As central banks respond to the situation at hand, they can make some solutions less viable than others."

Watch this space

The nature of geopolitical risks means that exposures need to be monitored continuously. Natural disasters may strike without warning but other types of event, such as disease or political tensions, can take more time to develop. As such, treasurers should monitor risks closely and remain alert to potential new sources of risk.

Sehgal says that developments that could cause future geopolitical risk include the potential escalation of tensions between countries aligned with Iran and Saudi Arabia, the South China Sea dispute between China and its regional neighbours (with potential US involvement), and the delicate relationship between the West and North Korea.

As Glendinning concludes: "Bad things happen. We can't always tell in advance what they will be. But we should never rule out any possibility."

Rebecca Brace is a financial journalist with extensive experience of writing about corporate treasury