How businesses are coping with the ever-increasing geopolitical risks

Ahead of the World Economic Forum in Davos at the end of the month, ING's Global Head of Research Marieke Blom spoke with decision-makers of European organisations with a significant global footprint to see how they're responding to the ever-increasing geopolitical risks

Marieke Blom is Chief Economist and Global Head of Research at ING Group

This article was originally published on the World Economic Forum's website. You can read it here.

What's at the top of your geopolitical risk list? Whether you're the CEO of a multi-billion-dollar organisation or a small business owner, you'll know just how wars, climate change, or cyber-attacks can hit your business. Everyone's aware of those 'known unknowns', as Donald Rumsfeld once put it.

While there are plenty of articles and suggestions advising organisations on how to deal with these risks, how are they responding? We've spoken with decision-makers from European organisations with a significant global presence across various industries to understand their responses.

A framework for approaching resilience

We've identified four types of organisational responses:

1. Risk assessment: trying to understand the risks better.
2. Risk reduction: try to lower the risks or their impact on the business model.
3. Ringfencing: Some risks cannot be lowered but their impact can be limited.
4. Rapid response: Adapt to risks that remain through correct responses.

In conversations with corporate leaders, we find that all these approaches are used, though more as part of routine decision-making rather than as a formal, structured concept. Let's now examine each of these individually.

1 Risk assessment

All the businesses we've been speaking to say they're devoting significantly more time to understanding the world around them. Many have hired additional government relations employees, whose primary duty is to understand what new laws, wars or sanctions might be coming. These government relations employees devote only a small amount of their time to explaining to politicians how to avoid unnecessarily harming business. They focus on trying to understand what politicians want to achieve and what might be on the horizon in terms of new tariffs, sanctions or regulations.

Risk assessment is not only about the political environment but also about understanding supply chains – understanding what suppliers and customers depend on and how geopolitics and the post-Covid supply chain hangover affect them.

Some leaders treat the extreme scenarios more seriously now. They have determined their company-specific worst case, where they would find themselves in an 'unmanageable' situation. For most, that is either an escalation of the war in Ukraine or a breakdown in the current world order.

As one corporate leader puts it: "A lot of the developments have been painful, but their magnitude was at the border of our normal business cycle. The West ending economic ties with China, however, would be very hard to overcome."

2 Risk reduction

Once the risks are clearer, risk reduction can take many forms. For manufacturing companies, that's often about sourcing and operations.

"We are producing in China for China now, and in India for both the domestic market and exports," says a manufacturer. Another says, "We have always produced local for local because of transport costs, but now we are also sourcing more from within the region." Many report a diversification strategy: "We decided to opt for more suppliers – dual sourcing with fallback options."

A services company is changing its operations too, noting that "Previously we centralised functions like risk and data management on a global scale. Now, we aim to be a local champion. We need country-specific ways of working."

However, what may seem like a change related to geopolitics often has more drivers. A trading company stated: "We diversify, yes, but that has been our strategy for a long time." A manufacturer notes that: "Changing our global footprint is mostly cost optimisation, sometimes growth opportunities and regulation. It also is a bit of resilience against geopolitics."

Higher inventories are also a way to increase resilience. But the tide is turning. "We have increased our inventories since the semiconductor crisis, but we are pushing it down again. It is costly and the risks seem lower now," says a manufacturer.

Cyber defence is another issue. All companies see a strong rationale to invest much more in it. In line with other surveys, most respondents say geopolitics isn't the driver behind that.

Corporates are also looking differently at the markets they sell in. "We used to see developing markets as interesting options, but now OECD countries seem more attractive because of relative regulatory strength, currency strength and available financing options".

A services company says they are scaling down in China. Surveys and macro data on FDI in China confirm a trend: Western corporations are not withdrawing but are also not pursuing significant growth in the country. For the countries mentioned as alternative production locations (India, Mexico or Central and Eastern Europe) it is hard to find evidence of increased FDI, meaning that on a macro scale, the effect is limited.

When it comes to operations, sourcing and markets, diversification is mentioned often. This suggests that macro data does not indicate a significant impact on net globalisation. However, there are exceptions. "As volatility is high, we focus on the core customers, capabilities, mission, and competencies. That's how we believe we become more resilient."

Risk reduction can seem less radical when it comes through financial hedges. For exchange rate risks this has been common, but there is a measurable increase in commodity hedges and some mention interest rate hedges. In some cases, this is significant. As one business leader says, "We try to limit risks beyond our control, to keep our credit rating stable. So, we hedge our positions. We are flooring the downside, which means we are capping the upside. This can involve hundreds of millions of euros, but that's the price we believe our investors expect us to pay."

Some corporates try to diversify their funding. "We have added bonds next to the bank's credit facilities and we're actively looking to attract a larger Asian investor base." Others have decided to go for local funding instead.

The resilience framework

Risk assessment

- Policy insights
- Supply chain insights
- Scenario analysis

Risk reduction

- Sourcing
- Operations
- Inventories
- Cyber defence
- Sales
- Hedging
- Funding

Ringfencing

- Legal
- IT
- Data
- Research

Rapid response

- Plans and drills
- Mindset and agility

Source: ING Research

3 Ringfencing

There are several ways to ringfence. Legal structures come to mind but don't seem to be very common. Where it does occur, it seems to mostly relate to China.

One company says, "We still operate in China, but in such a way that we can easily close it down."

IT hardware and software, data and research are areas where companies sometimes go for a ringfencing approach. For data, this can also relate to privacy and regulation. A services company says, "Our software system has to be able to process data within our countries."

Ringfencing, like other mitigation efforts, is not always driven by geopolitics. A technology firm says, "We have centralised R&D in our home market. This is simply optimal in any case."

4 Rapid response

Every business has a different attitude to risk. Being well-prepared to deal with a 'Black Swan' event is, at the very least, comforting. Having contingency plans is the norm – some organisations have their board rehearsing wars or cyber events.

"We don't know what is coming, so we try to be prepared for different scenarios," says one leader. Some rehearsals lead to off-the-shelf plans that can be enacted quickly, while others don't see the need for a plan B. “We will adapt quickly. That’s what we’ve always been good at and under the current circumstances that’s what is needed.”

Understanding key vulnerabilities

Being prepared makes good business sense. Most decision-makers seem to agree that with higher anticipated volatility, more internal stability is crucial. Very few corporates go in a different direction.

But are all these mitigation efforts costly? Not really, when compared to the business’s overall value. A services company mentions that it comes down to a few interventions, “We are more conscious of what is done in every location. We have more contingency plans, and we are more local for local.”

That goes for most: our framework shows many possible mitigations, but no organisation applied all of them. There’s another reason for downplaying the mitigation cost: they are often related to other goals too. One leader at a trading company said, “I don’t see it as a significant cost because it boosts our efficiency too.” This helps us understand why mitigation efforts only show up in the macro data after a proper deep dive.

Corporate leaders are making different decisions, but a shared mindset is clear. Preparedness comes through mental resilience and agility. As one business leader put it, "The main change is that we have trained our crisis management muscle." Another, “We are good at mobilising the company in times of crisis.”

While no business leader believes all risks are eliminated, they all think that understanding key vulnerabilities helps to deal with a world that can sometimes appear to be out of control. There’s never been a better time to get mentally fit to deal with whatever the world is about to throw at us next.

Author

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com