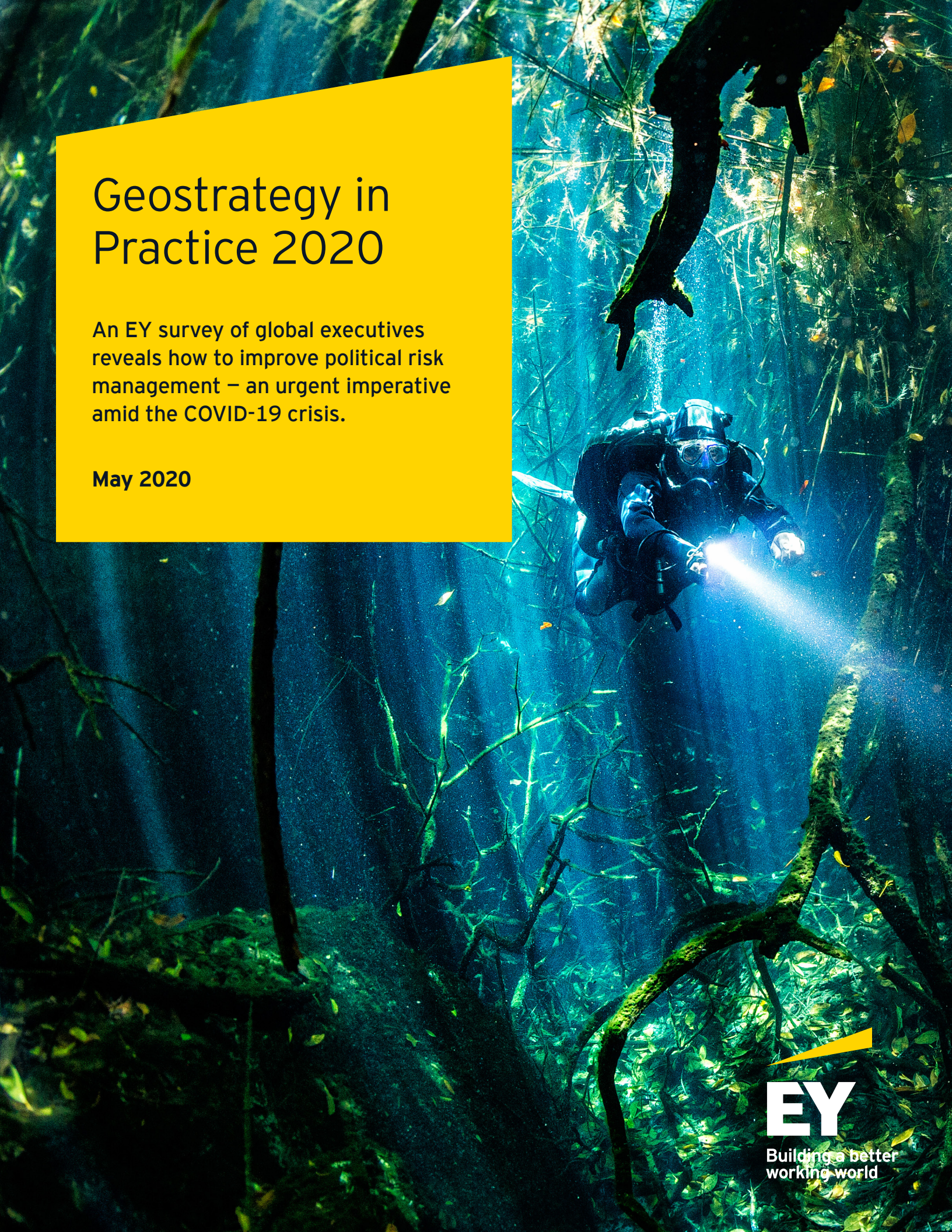
Geostrategy in Practice 2020

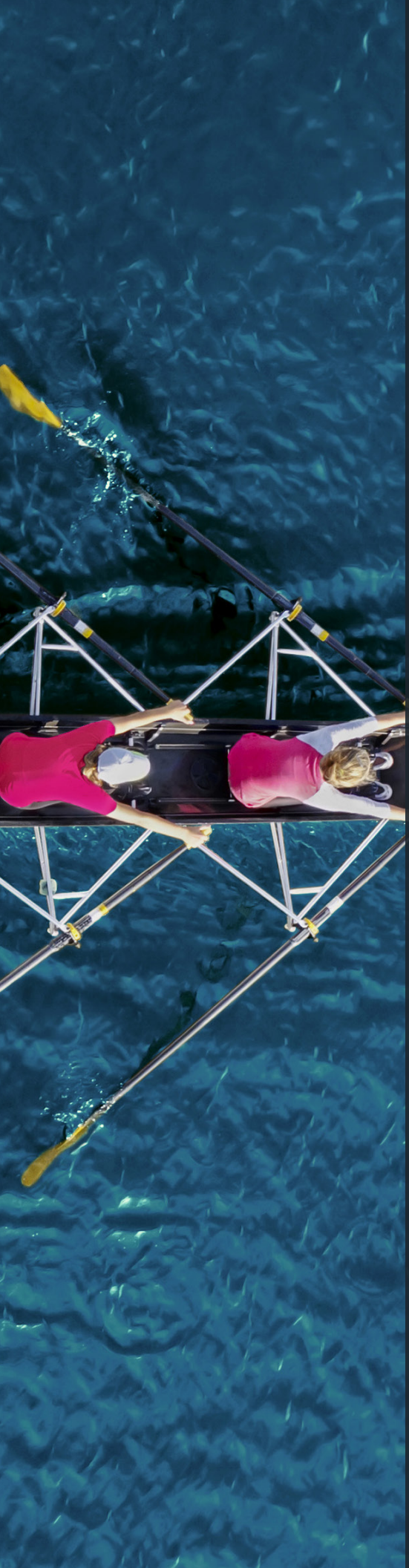
An EY survey of global executives reveals how to improve political risk management — an urgent imperative amid the COVID-19 crisis.

May 2020



EY
Building a better working world

Contents



Executive summary

Geostrategy in Practice 2020

The COVID-19 pandemic is a public health crisis, but it is also a political risk event on a global scale.
Political risks are rising as governments around the world dramatically change policies and regulations in response to COVID-19. Geopolitical tensions are also mounting as countries close their borders to people and goods from abroad. Executives need to monitor these risks, identify how they will affect business activities, and proactively manage them as part of a structured and comprehensive approach to crisis management and business resilience.

Even before COVID-19, political risk was having a rising impact on global companies.
Just over half of the executives in the *EY Geostrategy in Practice* survey say the effect of political risk on their company is higher now than it was two years ago, with companies in the Asia-Pacific hit harder than their peers in the Americas and Europe. And fully 72% of the largest companies are feeling a greater impact from political risk today.

Political risk can have a profound effect on enterprise resilience.
Executives identify a wide array of business activities that are highly affected by political risk. But they see the highest impact of political risk on strategy and M&A. Risk isn't always negative though — half of executives say political risk presents threats and opportunities in about equal measure.

Executives may be too optimistic about their ability to manage external risks with existing processes.
About half of the global C-suite say they are very confident in their company's ability to manage political risk. Fully 85% of executives say their company has integrated political risk into enterprise risk management (ERM) frameworks and processes, while more than three-quarters assess political risk exposure and recruit individuals with political experience onto the board or senior leadership. But is this enough? Is this just checking the box? The COVID-19 crisis is likely to expose the risk of overconfidence.

Effective political risk management requires core governance changes.
The appropriate individual needs to be tasked with responsibility for political risk management – but there is no consensus among the global C-suite for whom this should be. And almost 60% of executives say overcoming internal silos would significantly or highly improve their company's management of political risks. Breaking down silos is also vitally important as companies navigate the COVID-19 crisis.

Companies are more likely to thrive in today's volatile environment with a robust geostrategy.
A geostrategy is the incorporation of political risk management into companies' broader risk management, strategy and governance approaches. This requires adopting a systematic and cross-functional approach. Companies that implement a geostrategy can more successfully migrate political risk management from the periphery to the core, improving their resilience to pandemics and any other future external risks they may face.

A crisis is a terrible thing to waste: executives should review their own geostrategy.
Executives can use the momentum around risk management and strategic foresight inspired by the COVID-19 crisis to improve external risk management practices, including political risk, and benchmark practices used elsewhere. Our survey results provide a useful starting point for determining whether companies are taking the actions necessary to mitigate political risk and improve enterprise resilience. We've identified five questions they need to ask.

Introduction

Geostrategy in the COVID-19 era

The COVID-19 pandemic has created an unprecedented global business environment. It has effectively halted international travel, shut down factories, turned shopping districts into ghost towns, and affected companies in every industry and major market around the world. It is first and foremost a human tragedy. It is also a public health and governance crisis. And it is generating a high level of political risk as well, making it a political risk event on a global scale.

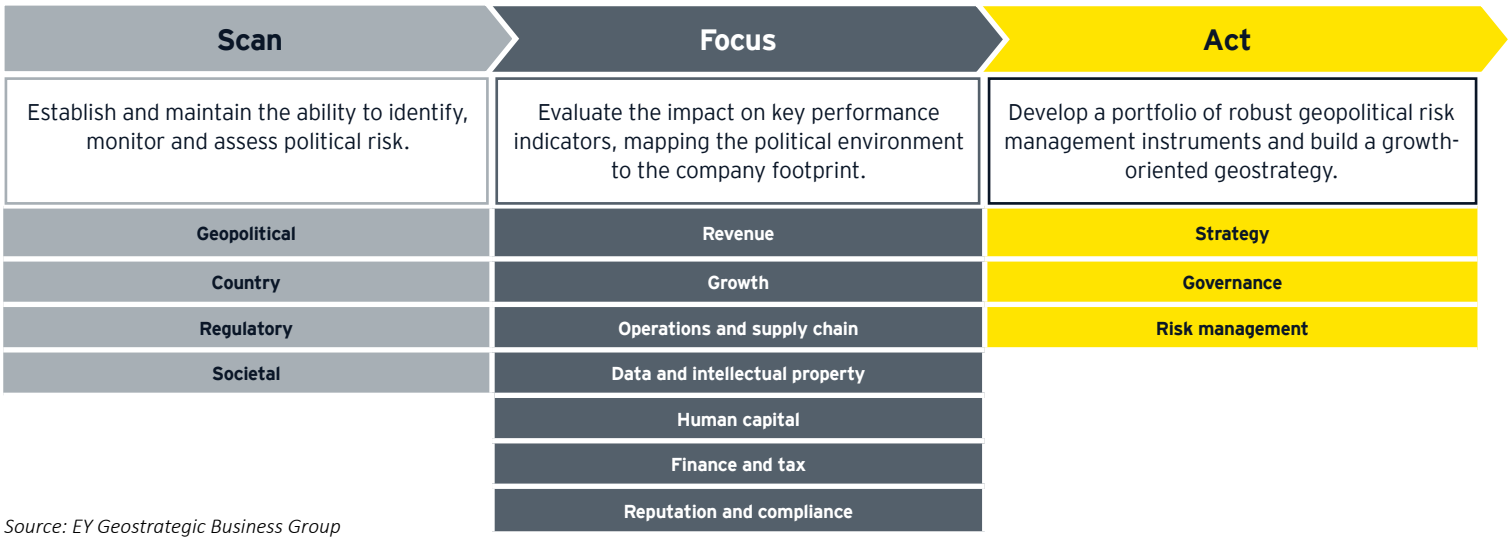
As the novel coronavirus spreads globally, governments' responses are evolving even as public health officials race to learn more about how the virus works and how to treat it. These government policy responses — from school closures and shelter-in-place directives to expanding unemployment insurance and injecting financial markets with liquidity — create political risks for companies, because these policies are largely unpredictable due to the fast-moving nature of the pandemic and its incredibly high impact on business; in some cases, the survival of entire industries is at stake.

It has therefore never been more important for companies to have a geostrategy as part of their enterprise resiliency framework. By this, we mean incorporating political risk management into companies' broader risk management, strategy and governance approaches. We conducted a survey of more than 1,000 C-suite executives from companies around the world in the fourth quarter of 2019 — before the novel coronavirus had entered the zeitgeist. But our findings have important relevance in the COVID-19 era because the pandemic is bringing to the fore questions about the most effective risk management tools. Chief among these should be political risk management tools — given that government policy responses to the pandemic are so vital in determining public health and economic outcomes.

A crisis is a terrible thing to waste. Executives should take this opportunity to review their own geostrategy. This involves a three-part process: scan, focus and act **(see figure 1)**. We therefore asked global executives about their companies' perception of political risk, which business functions it impacts the most, and what strategies and methodologies they use to manage it. This final piece — the act in the EY Geostrategic Business Group geostrategy framework — is essential for executives seeking to improve their management of the COVID-19 crisis. Organizations need to assign responsibility for political risk management, use the right set of tools to manage it, and integrate it into the core of how they operate. Companies that successfully employ such a geostrategy can improve their enterprise resilience to the COVID-19 crisis and the myriad of political risks that may come in the future.

Figure 1

Geostrategy is the incorporation of political risk assessment into risk management, strategy and governance



Source: EY Geostrategic Business Group

Political risks have risen dramatically

Political risk – a political event that alters the expected value of a business investment or economic outcome – can emerge from international, country-level or civil society actors. The overall incidence of political risk has increased dramatically in recent years – hitting a post-World War II high in the 2016–2018 period, according to research we conducted in collaboration with the Wharton School's Professor Witold Henisz. And now, the COVID-19 pandemic and resulting geopolitical tensions and volatile country policy environments are likely to dwarf that previous high. It is crucial for executives to continually scan the landscape to determine what political risks their company faces.

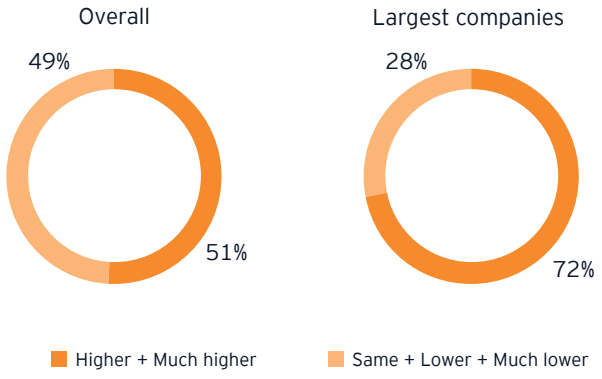
Political risks are on the rise ...

Global executives are increasingly aware of these political risks. Just over half of the executives in say the effect of political risk on their company is higher than it was two years ago **(see figure 2)**. Another 40% said political risk is at the same level – leaving fewer than 10% who believe political risks have lessened.

Figure 2

Political risk is affecting companies more than in the past, with the largest companies experiencing a greater rise

In general, is the effect of political risk on your company higher or lower than two years ago?



Source: EY Geostrategy in Practice 2020

The intensity of these political risk effects varies across the size, headquarters location and industry of a company, however. Most strikingly, 72% of executives from the largest companies assess that political risk is higher or much higher than two years ago (see "About the survey" on page 21). This may reflect the largest companies' greater exposure to overseas markets and their often longer and more complex supply chains. Many of the mid-sized companies we surveyed likely also have suppliers and customers around the world, though. This divergence could therefore also reflect the largest companies' higher level of sophistication or resources dedicated to political risk assessment – which may indicate that mid-sized companies should heighten their political risk awareness.

Executives based in Asia-Pacific are slightly more likely to assess that the impact of political risk is higher than it was two years ago than are their peers in the Americas and Europe. This could be due to companies in Asia-Pacific being more exposed to recent US-China trade tensions, as well as the rise of other regional political risks, such as the Japan-South Korea tensions that escalated in 2019.

... and are most prevalent at the geopolitical and country levels

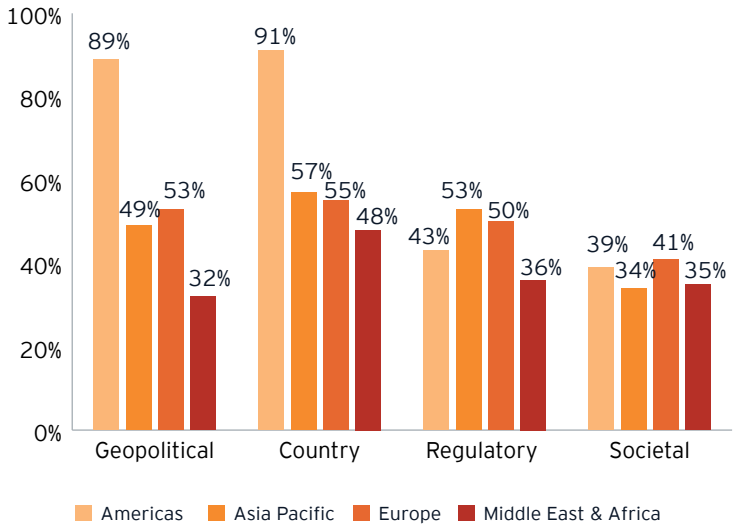
Political risks manifest across four levels: geopolitical, country-level, regulatory and societal (**see sidebar: Defining political risks**). Global executives see country-level and geopolitical risk as most impactful on their companies today. Some 68% and 62% of executives, respectively, say these two risks are having a very high or high impact on their company – significantly more than those who say the same of regulatory risk (47%) and societal risk (37%). This focus on country-level political risk may reflect both the way corporations have long organized business units (along national boundaries) and the traditional focus of the political risk field.

This assessment may underrepresent the impact of regulatory and societal risk, however. In the Wharton Political Risk Lab database of political risk events, regulatory or legal impacts were prevalent in 73% of the events in the fourth quarter of 2019. And while many political risks may begin at the societal level, they only begin to impact companies once they have filtered through to another of the risk levels – such as with populism affecting country-level policies and protectionism affecting geopolitical relations (**see sidebar: Stakeholder capitalism and long-term value on page 17**).

Figure 3

Executives' perceived impact of different political risks varies by region

Please rate the impact of the following types of political risk to your company.



Note: Data shown are "very high" and "high" responses.
Source: EY Geostrategy in Practice 2020

This view differs among executives in different types of companies, however **(see figure 3)**. Most notably, about 90% of executives from companies in the Americas say country-level and geopolitical risk are having a very high or high impact on their company. But only about half of executives from companies in Europe and Asia-Pacific say the same.

About three-quarters of executives from the advanced manufacturing and mobility industry say geopolitical risk is having a very high or high impact on their company – the highest percentage of any industry. Notably, this is the only industry in which more executives say geopolitical risk has a higher impact than country-level risk. US-China trade tensions may be a reason why this is, given that much of the focus around this issue has been on sectors that compose this industry, such as manufacturing, industrial products and automotive. And more broadly, the Trump Administration's focus on the auto sector in United States-Mexico-Canada Agreement (USMCA) negotiations and trade talks with Japan and Germany also likely explains this industry's higher experience with geopolitical risk in recent years.

Executives from the largest companies also perceive a higher business impact from geopolitical risk – significantly more so than executives from mid-sized companies do. Similarly, the largest companies are also reportedly much more impacted by regulatory risks than are mid-sized companies. Executives at the largest companies may be more attuned to these risks because of the increasing regulatory focus on competition policy and anti-trust measures in markets around the world.

Sidebar

Defining political risks

Geopolitical risks emerge when the interests of countries in defined policy areas collide, or when the international system at large is undergoing transformation.

Country-level risks emerge when the national political environment, the stability of the government and institutions, or legislation has measurable economic consequences for companies acting in that market.

Regulatory risks emerge when governments – at the international, national or local level – change the rules or implementation of environmental, health and safety, financial market, and other regulations.

Societal risks emerge when groups, from trade unions to consumer bodies, launch public activism such as boycotts or protests that have consequences for markets and companies operating globally.

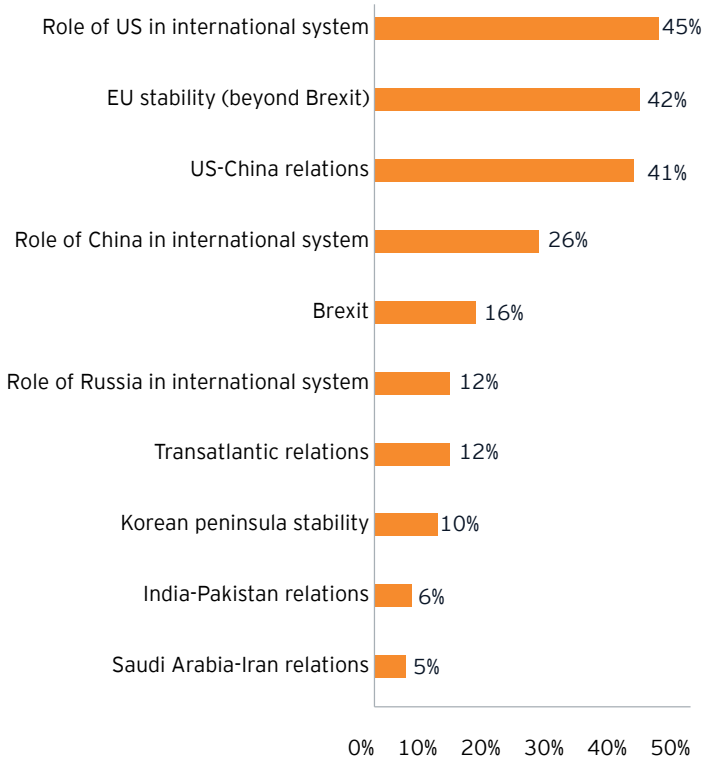
Are geopolitics local?

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 **(see figure 4)**. This assessment reflects the shifting balance of power among the world's largest economies. The US is retreating from its international leadership, China is playing a bigger role in geopolitics, and Europe is seeking a more cohesive projection of its own power. As the emerging blocs consolidate their power, relations between them could become volatile – political risks will then rise. The global nature of the COVID-19 crisis will only serve to increase tensions and raise the stakes of political risk even higher.

Figure 4

The three emerging power blocs dominate executives' view of likely geopolitical risks

Which of the following issues will likely have the greatest impact on your company over the next five years?



Note: Percentages do not add to 100 because respondents could select up to three choices.

Source: EY Geostrategy in Practice 2020

How these geopolitical risks affect a company will depend on its geographic footprint, industry, size and other characteristics. For instance, the US's withdrawal from regional trade agreements may put US companies at a competitive disadvantage in foreign markets that have preferential trade relationships with other countries. Questions about the future of the EU include the continued free movement of people within its borders, which could affect companies' human resources policies within the bloc – particularly amid the COVID-19 crisis in which many EU member countries have closed their borders. And US-China relations will impact supply chains, data and intellectual property, regulatory compliance, M&A prospects, and a variety of other business functions.

There are important divergences in this assessment based on company characteristics, however. Most notably, the C-suite's perception of geopolitics appears to be local. Executives in Asia-Pacific point to US-China relations, China's role in the international system, and the stability of the Korean peninsula as the most impactful geopolitical risks for their company. In contrast, European executives are focused on EU stability, Brexit and Transatlantic relations. And executives in the Americas overwhelmingly see the role of the US in the international system as having the greatest impact on their company.

This focus among the C-suite on relatively local geopolitical risks raises an important strategic question: Should they be focused on risks closest to home? On the one hand, many companies' supply chains and sales footprints are concentrated within their home region – a concentration that could deepen as a result of rising regionalism in geopolitics. On the other hand, geopolitical risks emanating from a far-flung market can have significant impacts – even if indirect – on companies around the world, particularly if a key component in a company's supply chain comes from the affected market. This is all too evident given how rapidly and dramatically the novel coronavirus has spread to every region of the world. As a result, executives' focus on local geopolitical risks could leave their companies vulnerable to unforeseen shocks.

Another striking variation is by company size. Almost 60% of executives from the largest companies expect US-China relations to have the greatest impact on their company, compared to just 31% of mid-sized companies. This likely reflects the greater exposure of the world's largest companies to the world's two largest economies. In addition, the largest companies face the greatest risk of being caught in the crosshairs of any US-China tensions, as well-known companies are most likely to be targets of politically motivated actions.

COVID-19 intensifies the geostrategic focus on trade and technology

US-China trade tensions, Brexit, the proliferation of bilateral and regional trade agreements, and the declining influence of the World Trade Organization (WTO) have contributed to the rise of trade policy to the top of the geostrategy agenda. These policy shifts have created uncertainties about supply chain resilience, market access and operating costs for companies around the world — uncertainties that have become exponentially greater as a result of the COVID-19 pandemic.

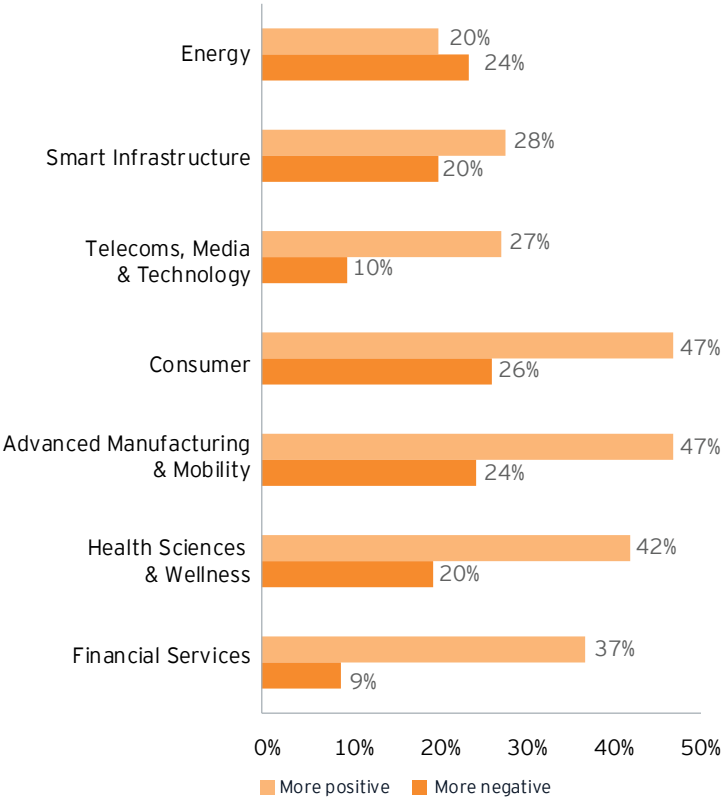
Whether this uncertainty translates into opportunities or challenges depends on company characteristics. Executives from the largest companies are more likely to see a primarily negative impact from protectionist trade measures (38%) compared with their peers from mid-sized companies (24%). This could reflect smaller companies being more localized in their supply chains and customers, enabling them to expand domestic market share as the cost of foreign competitors' products increase due to tariffs. And while most executives across all industries identify both opportunities and threats stemming from trade protectionism, those in the energy industry are most likely to see protectionism as primarily a threat **(see figure 5).**

Almost 90% of global executives say that their company has an overall trade strategy — which is by far seen by executives as the most effective action for addressing this trade policy uncertainty. Other actions believed to be effective by almost 60% of executives are shifting operations or procurement relationships between geographies and participating in industry-wide trade associations or business councils.

Figure 5

Negative effect of trade protections is strongest for companies in the energy industry

What is the impact of protectionist trade measures (e.g., tariffs, quotas) on your business?



Note: Remaining respondents in each industry selected a more "balanced" impact.

Source: EY Geostrategy in Practice 2020

Interestingly, global executives say that engaging with governments or multilateral organizations (such as the WTO) is the least effective in addressing trade policy uncertainty. As countries unilaterally limit the export of medical supplies and take other protectionist actions in response to the COVID-19 pandemic, engagement with multilateral organizations is likely to remain an unpopular geostrategy tool.

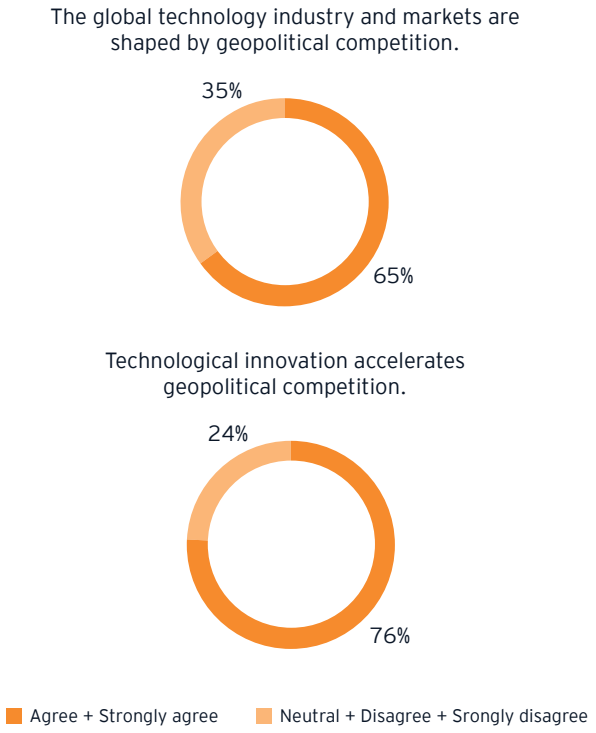
Technology is another driving force in company's geostrategy agendas today. About three quarters of global executives agree or strongly agree that technological innovations such as AI accelerate geopolitical competition. Strikingly, more than 90% of executives from companies in the Americas share this view. And 65% of executives overall also agree or strongly agree that geopolitical competition is shaping the global technology industry and markets **(see figure 6).** These responses point to the circular relationship between technology and geopolitics. That is, geopolitical competition is driving technological innovation and, in turn, the race to innovate is catalyzing competition between the emerging power blocs.

Technology's crucial role in the global economy, national competitiveness, geopolitical competition and national security is amplified by the COVID-19 pandemic. With so many employees working from home around the world, never before has remote server bandwidth and stable internet connections in homes been more important. Robotics and artificial intelligence (AI) are also increasingly important in keeping factories and warehouses operating efficiently. And of course, biotechnologies and life sciences will be crucial in developing vaccines and treatments for COVID-19.

Figure 6

Geopolitical competition and technological innovation reinforce one another in a circular relationship

What is your view of the relationship between technology and geopolitics? Please rate the following two sentences.



Source: EY Geostrategy in Practice 2020

Geopolitical competition is driving technological innovation and, in turn, the race to innovate is catalyzing competition between the emerging power blocs. And technology's crucial role in the global economy, national competitiveness, geopolitical competition and national security is amplified by the COVID-19 pandemic.

Identifying the political risks isn't enough

It is not enough for executives to understand that political risks exist or are likely to manifest in the coming years. They must also map the impact of political risks across their company's activities so that they can better anticipate and prepare for potential disruptions – and mitigate their impact. This is particularly important in the fast-changing political and policy environments that the COVID-19 pandemic presents.

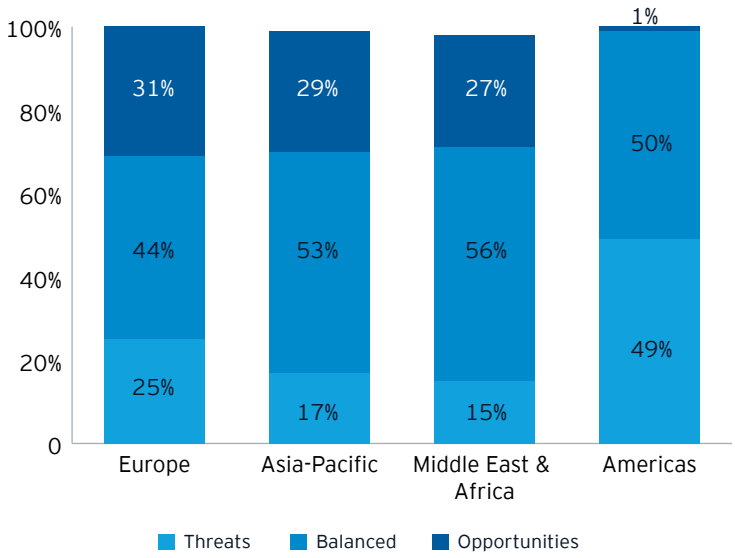
Political risk presents opportunities as well as challenges ...

Despite common parlance assigning "risk" a negative connotation, global executives have a relatively balanced view of what political risk means for their companies. Half of executives say that political risk presents threats and opportunities in about equal measure (**see figure 7**). While 30% of executives believe that political risk presents mostly threats, 20% say it presents mostly opportunities.

Figure 7

Executives in the Americas have a far more negative view of political risk impacts

To what extent does political risk pose threats and/or opportunities to your strategy and business objectives?



Note: Responses are on a 10-point scale, ranging from political risk presenting only threats (0) to only opportunities (10). Data presented here are threats (0-3), balanced (4-6) and opportunities (7-10).

Source: EY Geostrategy in Practice 2020

Only 1% of executives see political risk presenting only threats or only opportunities. This is encouraging because a risk manager who sees only threats on the horizon will forego opportunities through an excess of caution. By contrast, a manager who is overconfident about political risk may make decisions where the downward risks heavily outweigh the potential rewards.

Executives from the Americas are a notable deviation from this relatively balanced perspective, however. Fully 49% view political risk as presenting more threats – and just 1% see more opportunities than threats stemming from political risk. In contrast, executives from all other regions believe that political risk presents more opportunities than threats to their company. It may be that companies in the Americas have experienced greater negative impact from political risk than their peers elsewhere and therefore see it as more of a threat. Indeed, a materially higher percentage of executives in the Americas compared to their peers in Europe and Asia-Pacific say their company is experiencing a very high or high-level impact from country-level and geopolitical risk.

Some variation occurs by industry as well. Executives in the energy sector, for instance, lean toward political risk presenting threats more so than do executives in other industries. This may be due to a long history of resource nationalism and challenges to the social license to operate in host countries. And amid increasing global attention to climate change, energy companies are increasingly subject to a range of new political risks as well.

The view from executives in the financial services and the technology, media and telecoms (TMT) sectors is the most balanced between threats and opportunities. In the case of technology companies, one reason for this may be that governments are both seeking to more tightly regulate certain aspects of technology – such as data privacy – while also supporting domestic technology sectors to get a leg up in the accelerating global competition in the technologies of the fourth industrial revolution. Although, in the fourth quarter of 2019, 8 of the top 10 companies most targeted by political risk events were in the technology industry, according to the Wharton Political Risk Lab political risk events database.

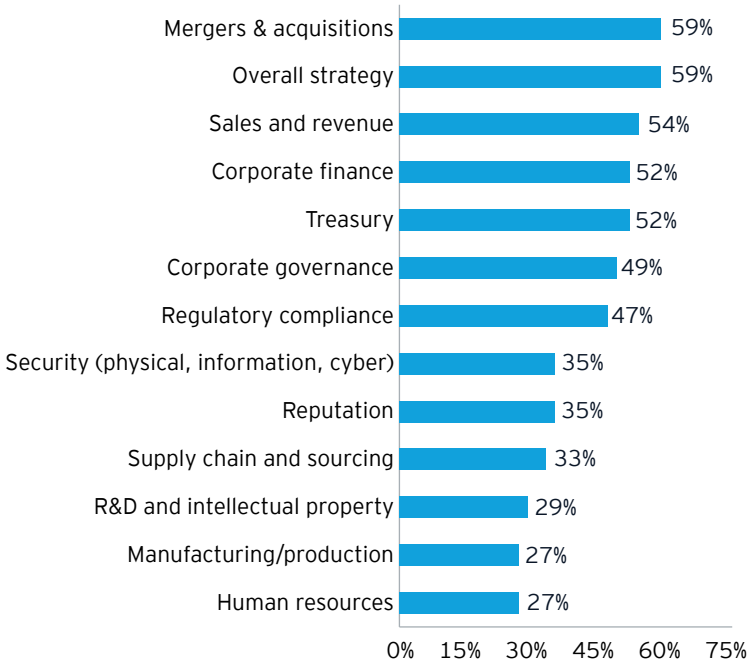
... with the most significant impact on strategy and M&A

Strategy and mergers and acquisitions (M&A) are seen by executives as the business functions that are most impacted by political risk. About 60% of executives in the survey assess a high or very high level of impact on these two areas (**see figure 8**). And about half of executives say sales and revenue, corporate finance and treasury are similarly highly impacted. With such a wide array of highly affected business activities, political risk can therefore have a profound effect on enterprise resilience.

Figure 8

Political risks impact companies across functions but M&A and strategy are most affected

Please rate the impact of political risk on each of the following.



Note: Data indicate "high impact" and "very high impact" responses.
Source: EY Geostrategy in Practice 2020

The global C-suite likely sees such a high impact of political risk on strategy because strategies are meant to endure for the medium to long term and can therefore be acutely vulnerable to shifts in political risk over time. And since strategies often deal with a company's footprint, political risks that make certain markets more or less profitable can significantly affect the viability and profitability of a company's global strategy.

Political risk can have a similarly potent impact on M&A — although the directionality is mixed. There is a wide body of research that demonstrates the medium- to long-term negative impact of political risk on foreign direct investment (FDI) and the magnitude of M&A. Recent interest in enhancing anti-trust enforcement and more restrictive cross-border investment policies, such as strengthening the Committee on Foreign Investment in the United States (CFIUS), are likely to negatively affect M&A activity. And amid times of elevated geopolitical tensions and policy uncertainty — such as the current COVID-19 pandemic — cross-border deal-making activity can also slow. But the most recent EY Global Capital Confidence Barometer finds that, in spite of the COVID-19 crisis, 56% of C-suite executives are actively planning to pursue an acquisition in the next 12 months.

Also notable are the business functions that executives do not assess as highly impacted by political risk. The three that stand out the most in this regard are supply chains, R&D and intellectual property, and human resources. Trade tensions and the proliferation of bilateral and regional trade agreements have already complicated supply chains for many global companies, so on one hand it is surprising that executives do not rank it higher in terms of political risk impact. On the other hand, since these risks have begun to manifest themselves, executives may feel that their companies have already taken the appropriate mitigating actions and so future impact will be low. The same may also be true for R&D and intellectual property, as this has been a long-standing challenge in some markets.

And while stricter immigration controls in key markets and shifting global migration patterns may have already been internalized by human resources departments, the drastic restrictions on cross-border people movement in response to the COVID-19 pandemic are likely to raise this issue higher up the political risk impact assessment in the short term. Depending on how long such policies last — and any related underlying sentiments regarding the public health risk of non-citizens — the human resources impact of COVID-19 could prove to be significant in the medium to long term as well.

Assign responsibility for risk – and empower the assignee

As many companies are currently experiencing with their business continuity responses to the COVID-19 pandemic, having an individual responsible and accountable for a particular risk is crucial. The importance of assigning responsibility holds true for political risk as well. In order to successfully implement a geostrategy, the EY Geostrategic Business Group recommends that companies make an individual, committee or function responsible for political risk management. It is also crucial for the responsible party to be empowered to work cross-functionally in terms of identifying political risks, assessing their impacts on the business and taking action to mitigate them.

Most companies have someone who owns political risk management ...

Encouragingly, 70% of executives say their company has an individual or function assigned responsibility for political risk management. This global view hides important discrepancies by region, however (**see figure 9**). More than 80% of companies in Asia-Pacific and Europe say they have someone tasked with political risk management, but only 51% of companies in the Americas say the same.

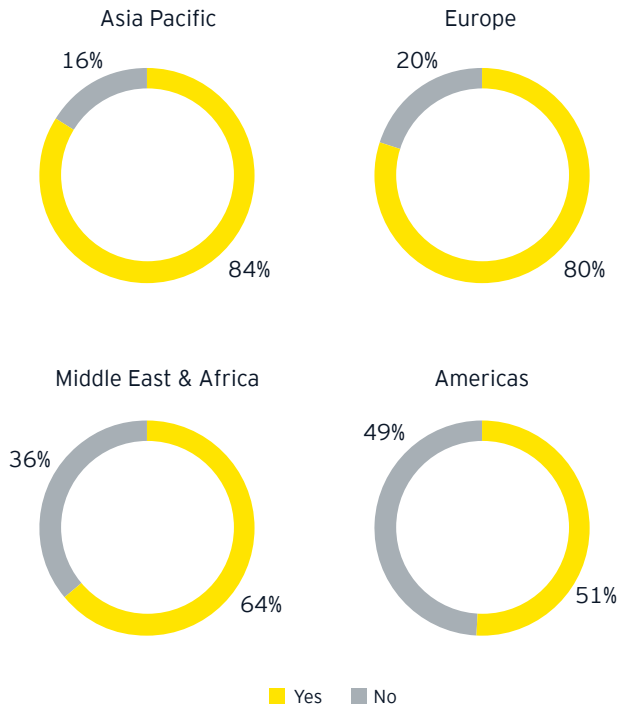
This regional discrepancy could be driven by traditional differences in business operating environments. For instance, Japan's long-standing natural resource dependency on imports has instilled in Japanese companies the importance of political risk management. And Chinese companies have a person who acts as a liaison with the Chinese Communist Party – a position that could be interpreted as managing political risk. Similarly, many large European companies have roles dedicated to government and labor union relations.

Given that only half of Americas-based companies have someone who owns political risk management, companies in the region may be at a disadvantage from an enterprise resiliency perspective. Political risk management was already vital to achieving enterprise resiliency in an environment of elevated political risk levels around the world – which are now being amplified even more by the COVID-19 crisis.

Figure 9

The degree to which companies assign political risk ownership varies by region

Does your company have an individual(s) or function(s) tasked with responsibility for political risk management?



Source: EY Geostrategy in Practice 2020

... but there is a lack of consensus on whom it should be ...

The global C-suite has not yet reached consensus on where primary responsibility for political risk management sits. The survey shows that it is held in a number of different business functions (**see figure 10**). The most commonly cited functions for political risk management responsibility are risk and finance or treasury – but each of these is only pointed to by about one-quarter of global executives. The other half of companies assign responsibility to a wide array of functions and individuals. This may indicate that many companies are still in the process of working out leading practices in this area of corporate governance. It may also be true that the optimal solution differs from one company to the next.

Figure 10

There is a strong lack of consensus in the C-suite about who should own political risk management

Which of the following individuals or functions has primary responsibility for political risk management?

Note: Data do not add to 100 because respondents were allowed to rank up to three responses in order of responsibility.

Source: EY Geostrategy in Practice 2020

These results also raise questions about whether the responsible party knows they are tasked with political risk management. Among survey respondents, chief risk officers (CROs) take some responsibility, with 33% saying the CRO has primary responsibility for political risk management. CEOs were more likely to tell us that the chief financial officer (CFO) has primary responsibility for political risk management (28%), compared to just 20% of CEOs pointing to the CRO as the responsible party. And CFOs are relatively split between whether they (27%) or the CRO (24%) are responsible for political risk management.

... and a mismatch between responsibility and impact

Despite the significant impact of political risk on company strategy – with 59% of global executives saying political risk has a high or very high impact on strategy – only 9% of executives say the strategy function has political risk management responsibility. Similarly, only 14% of companies assign political risk management ownership to the general counsel or government relations, yet almost half of executives point to the high impact of political risk on regulatory compliance. And while more than one-third of global executives say political risk has a high impact on security, just 13% of companies assign political risk management responsibility to the information security or physical security functions. In contrast, finance and treasury are better aligned in terms of political risk impact and management responsibility.

These mismatches are somewhat worrying because they indicate that companies may not be appropriately managing the political risks that are affecting their business. But they also point to a potential reason that the CRO and CFO are the most popular governance options for political risk management: It does not make sense for a more discrete or siloed business function to own political risk management, because responsibility needs to be in a cross-functional office tasked with coordinating the strategies for all stakeholders. And it is important for the responsible party to have a voice in the design and implementation of initiatives in the enterprise's key functions, from finance to marketing and research and development. The CRO or CFO – or, indeed, any individual or function with strategic cross-functional authority – are therefore natural choices for the coordination of political risk management.

Make sure you have the right tools for the job

As companies implement or update their pandemic response and broader business continuity plans, others are scrambling to determine how they should respond to the rapidly shifting policy, regulatory and operational environments that they face today. The COVID-19 pandemic is bringing to the fore questions about the most effective risk management tools. Chief among these should be political risk management tools – given that government policy responses to the pandemic are so vital in determining public health and economic outcomes.

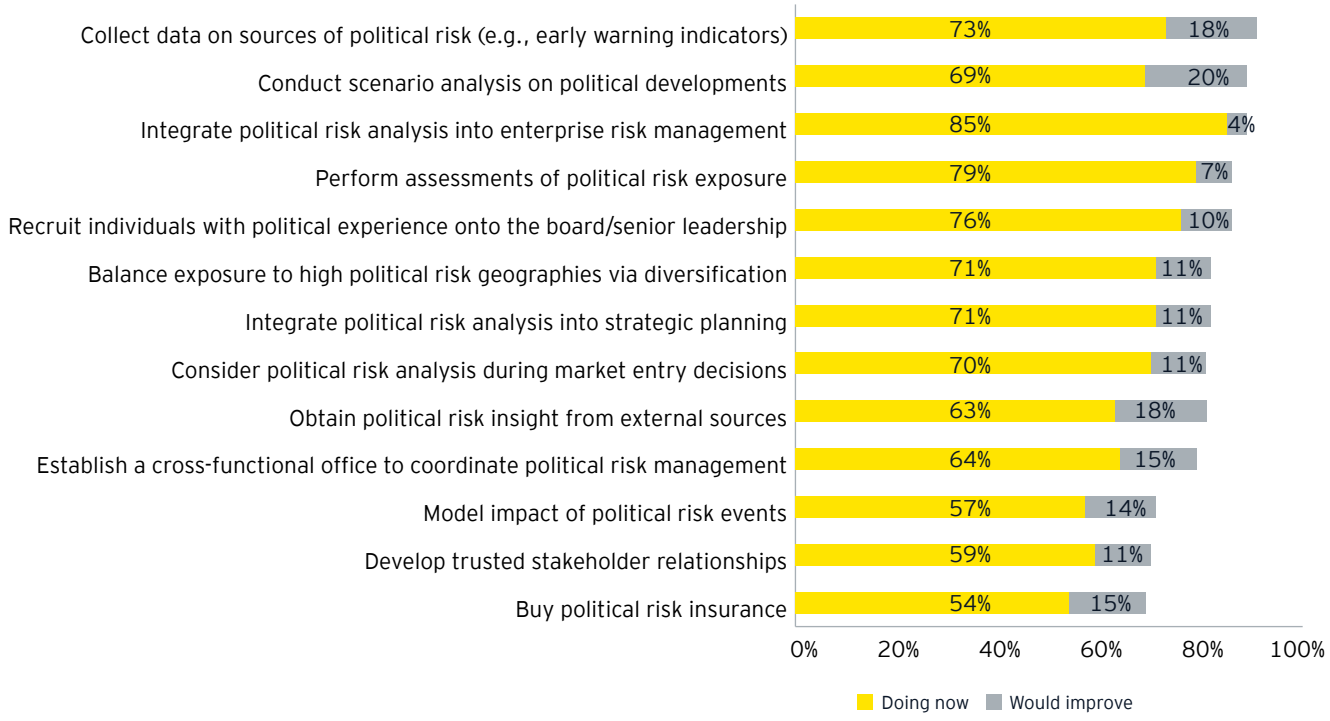
Key risk management actions companies are taking today ...

It is important for executives to assess whether their company is drawing on all available tools to manage political risk – and combining them in the most effective ways. Executives tell us that companies are already taking a variety of political risk management actions. Integrating political risk into enterprise risk management (ERM) frameworks and processes is the most common, with 85% of executives saying their company has done this (**see figure 11**). The other most common risk management actions taken by the global C-suite today are performing assessments of political risk exposure and recruiting individuals with political experience onto the board or senior leadership.

Figure 11

Executives prioritize data sources, scenario analysis and enterprise risk management approaches to geostrategy

Which of the following does your company do to manage political risk? For those business activities not done by your company, to what extent would the corresponding selections improve your company's ability to manage political risk?



Note: Data reflect "yes" response to first question and "significantly improve" and "highly improve" responses to second question.
Source: EY Geostrategy in Practice 2020

Since ERM programs bring a more disciplined process to identifying, assessing and managing key risks impacting their business, it is encouraging that so many companies have integrated political risk into their ERM frameworks. This trend also underscores the rising importance and enterprise-wide threat that political risk presents.

Companies are engaged in multiple actions to manage the multiple threats political risk presents. Indeed, more than 40% of companies are taking 10 or more different actions to manage political risk. This multi-pronged approach is appropriate given the diffuse nature of the political risks that companies face. But what is not clear from our survey results is whether companies are taking this suite of actions to integrate political risk assessment into risk management, strategy and governance — what we call geostrategy — or if it is instead simply a series of one-off actions amounting to a piecemeal approach to political risk management.

Questions are also raised by the political risk management actions that are less popular among the global C-suite. Although still utilized by more than half of companies, the political risk management practices that are least widespread are buying political risk insurance, modeling the impact of political risk events and developing trusted stakeholder relationships. The relatively low focus on stakeholder relationships is especially striking in an era in which business leaders are publicly acknowledging the importance of stakeholder — rather than shareholder — capitalism (**see sidebar: Stakeholder capitalism and long-term value on page 17**).

... and the actions executives believe would improve risk management tomorrow

Despite taking so many actions to manage political risks today, executives still see room for improvement. Three practices stand out as providing companies with the opportunity to significantly or highly improve their political risk management: scenario analysis, collecting data on sources of political risk, and obtaining political risk insight from external sources.

Scenario analysis of potential political developments is widely recognized to be a powerful tool, enabling executives to think through how circumstances might evolve and what impact developments might have on their business. Most executives (69%) say their company is already engaged in scenario analysis, and another 20% see it as a key action they could take to significantly or highly improve their ability to manage political risk (**see figure 11**).

Put together, then, fully 89% of executives point to scenario analysis as a current or desired political risk management tool. This may be because executives realize politics is inherently difficult to predict, so they need to prepare for a variety of outcomes — something for which scenario analysis is well suited. Such strategic foresight is even more vital as companies grapple with how to maintain operations and preserve enterprise resiliency during the COVID-19 pandemic and simultaneously position themselves well for future growth.

The only other two political risk management actions that executives emphasize to a similar degree are collecting data on sources of political risk, such as early warning indicators, and obtaining political risk insight from external sources. The former may be seen as important because data are critical inputs in almost every decision an executive makes, while the latter is important because the often subjective nature of political risk analysis means that collecting a variety of viewpoints is useful to obtain a full picture of the risks that a company faces.

The COVID-19 pandemic is bringing to the fore questions about the most effective risk management tools. **Chief among these should be political risk management tools** — given that government policy responses to the pandemic are so vital in determining public health and economic outcomes.

It's not enough to simply "check the box" on a set of political risk management actions. Companies must go further to **implement a geostrategy** – incorporating political risk management into their broader risk management, strategy and governance approaches.

Sidebar

Stakeholder capitalism and long-term value

While executives are primarily focused on the business impacts of geopolitical and country risks, societal risk is arguably just as important for companies to focus attention and resources on. In fact, 70% of the political risk actions identified by the Wharton Political Risk Lab in the fourth quarter of 2019 were related to reputation or the social licence to operate.

Successfully mitigating societal political risks involves better stakeholder engagement and management. Critical to this is clarity of purpose and a commitment to all stakeholders, whether a customer, employee, supplier or the broader community. Executives seem to understand this imperative: Some 72% tell us they agree or strongly agree that companies have a fundamental commitment to all their stakeholders. This conviction may explain why societal risk is seen as having a lower impact on companies — executives believe they are managing these risks effectively thanks to their focus on stakeholder value.

Indeed, executives' strong agreement with the US-based Business Roundtable's statement on the purpose of a corporation, which focuses on providing value to all stakeholders — customers, employees, suppliers, communities and shareholders — supports this analysis. Fully 72% of global executives agree or strongly agree with this statement. Support is strongest among executives in the Americas (79%), followed by those in Asia (70%) and in Europe (64%). Companies embracing this stakeholder value purpose will help support long-term value creation. Investors are increasingly demanding that they do so. In the recent EY CEO Imperative study, 84% of institutional investors said that corporate reporting will shift to a focus on long-term strategy, growth and sustainability.

Whether executives see stakeholder management as a political risk management tool varies, however. In particular, the use of stakeholder management to mitigate political risks is more prevalent in some regions than others. Some 81% of executives in Asia-Pacific do so, making it the fourth most popular political risk management tool among companies in the region. In Europe, 65% of executives say they are actively developing these relationships to manage political risk. In contrast, only 36% of executives in the Americas say the same — the lowest percentage of any region and a direct contrast with Americas executives' strong support for the BRT statement on shareholder value. It is therefore an open question whether using such stakeholder relationships as a political risk management tool is in line with the shift from shareholder to stakeholder capitalism. It could be that executives are referring to a more narrow reliance on trusted insider stakeholder relationships (i.e., personal connects, elite ties and "friends of the firm") rather than engaging with a broader set of stakeholders that includes customers, employees, and communities. As attention to these issues rises, we expect that company approaches to stakeholder relations are likely to more explicitly recognize the link between stakeholder management and political risk management.

The COVID-19 pandemic makes this shift to stakeholder capitalism more urgent than ever. Investors, employees and customers are paying attention to how companies act during this crisis. Those that focus on delivering value to shareholders over other stakeholders are likely to be judged. Early findings from Just Capital's Corporate Response Tracker indicate that executives understand this imperative. Far more companies are responding to the crisis with accommodative policies for employees (such as work from home and paid sick leave) than with furloughs or layoffs.

Checking the box won't help the bottom line

Effective political risk management should not be simply a "box-checking" exercise. Companies need to integrate political risk management into their core, incorporating it into their broader risk management, strategy and governance approaches – which is what we call geostrategy. With the COVID-19 pandemic and the dizzying array of government policy responses in markets around the world, a cross-functional approach to political risk management is more important than ever before.

Board attention is crucial...

In today's volatile geopolitical environment, the minimum requirement for boards is to stay informed about the geopolitical risks facing the company and its business environment. But the minimum requirement will no longer be enough to establish a resilient enterprise – especially as the effects of the COVID-19 pandemic continue to reverberate around the world. Boards will increasingly be challenged to develop with management a strategic perspective to address geopolitics and integrate geopolitical risk analysis into decision-making.

It is therefore encouraging that global executives tell us that company boards are investing more time and resources to political risk management. Some 58% of executives report that their board is spending more time on political risk than two years ago, underlining the extent to which this risk has become major board preoccupation and priority. There are noticeable differences by company size, though, with the largest companies' boards increasing the time dedicated to political more so than their mid-sized peers (**see figure 12**). Whether this means the largest companies are ahead or behind the curve is an open question.

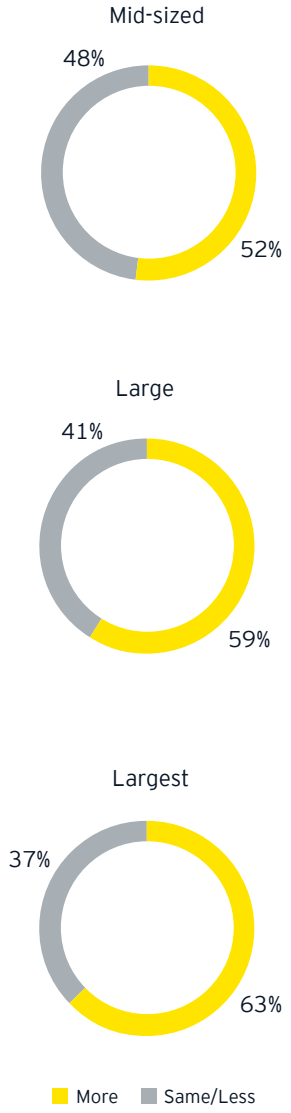
... as is breaking down silos

Beyond the specific political risk management actions discussed above, a majority of executives point to improvements in governance as crucial for better political risk management. There are three areas of governance that executives believe would significantly or highly improve their ability to manage political risk. Just over half of executives say that incentives and processes to overcome internal silos, a more dynamic process around communication of political risks, and a better understanding of political risk across key functions would strengthen their ability to manage the risk.

Figure 12

Most boards are spending more time on political risk now, but attention from the largest companies has risen most

Compared to two years ago, does your company's Board of Directors (or equivalent) spend more or less time on political risk?



Note: Data indicate "significantly more" and "slighty more" responses.
Source: EY Geostrategy in Practice 2020

This aligns with what EY has heard from other executives as well. For instance, the EY and Institute for International Finance global bank risk management survey found that four in five banks say they either need to enhance their understanding of political risks or improve their ability to adapt to those risks as they change.

Interestingly, a notably higher percentage of executives from companies where revenues have flatlined or declined in the past three years say that these governance actions would improve their ability to manage political risk than do executives from companies where revenues have been growing. This may indicate that executives from underperforming companies recognize the role that better political risk management can play in improving overall business performance.

The most important of these governance improvements is breaking down silos. Importantly, among the 76% of companies that have brought someone with political experience to the board or management, 66% of them still struggle with silos. It is not enough to simply bring political risk expertise in house — that expertise must be shared broadly across the organization to improve political risk management.

Indeed, the recent EY CEO Imperative study argues that C-suites need to break silos to increase organizational agility. Managing political risks — or any external risk for that matter — requires a cross-functional, whole-of-enterprise approach. And breaking down silos helps to achieve the other two impactful governance improvements by enabling better communication and greater understanding about political risks across functions. This is especially true in light of the COVID-19 pandemic, which is affecting all aspects of companies' strategy and operations and therefore requires a coordinated enterprise-wide response.

Conclusion

Geostrategy improves enterprise resilience

Companies don't have to accept the supply chain disruptions and revenue losses that rising levels of political risk can generate. These survey results indicate political risks can be managed. While 51% of global executives say political risk is having a greater effect on their companies today than just two years ago, 50% are also very confident in their ability to effectively manage it. Given the governance challenges a majority of executives identify, it's unclear whether this confidence is warranted, however. Many companies appear to be in the early stages of developing a strategic and holistic response to political risk. It's not enough to simply "check the box" on a set of political risk management actions. Companies must go further to implement a *geostrategy* — incorporating political risk management into their broader risk management, strategy and governance approaches — as part of an enterprise resiliency framework.

This is even more important today as companies around the world scramble to remain resilient in the face of the COVID-19 pandemic. As Nobel-laureate economist Paul Romer said, "A crisis is a terrible thing to waste." Executives have the opportunity to use the current crisis to design and implement a geostrategy to improve political risk management and enterprise resiliency in both the short term — mitigating the risks associated with pandemic-induced shifts in government policies and geopolitical relations — and the long term — as companies adjust to whatever new normal arises in the wake of this pandemic.

Our survey provides a useful benchmark for executives to determine whether their company is taking the actions necessary to mitigate political risk effectively, helping them to continue their journey toward a more strategic and broad-based political risk management. We've identified five questions leaders need to ask to reveal whether their company has an appropriate geostrategy to thrive amid the political risks generated by the COVID-19 pandemic and the other forces creating an increasingly volatile world:

1. What political risks does my company face?
2. Am I assessing the impact of political risk on my company?
3. Who's responsibility for political risk management?
4. What tools can I use to manage political risk?
5. Is political risk management at the periphery or core of my company?

Mitigating political risk requires adopting a systematic and cross-functional approach that embeds geostrategy within company culture. Companies that do so will successfully migrate political risk management from the periphery to the core, improving their enterprise resilience to the current COVID-19 pandemic and whatever political risks may come in the future.

About the survey

The ***EY Geostrategy in Practice Survey*** gauges how senior executives of companies across industries globally are perceiving, experiencing and managing political risk. Launched in 2019 for the first time, the survey was conducted by Thought Leadership Consulting, a Euromoney Institutional Investor company, and captures the views and insights of 1,009 C-suite level executives from companies across 17 industries and 30 countries, providing a comprehensive sector and world view on political risk.

- The survey was conducted during October and November 2019.
- Most executives surveyed hold the roles of CEO (20%), CFO (20%) and CRO (20%), with the remaining executives holding other C-suite or country leadership positions within their company.
- Respondents represented companies from 17 industries, grouped in the following way:
  - **Advanced Manufacturing & Mobility:** Aerospace & Defense; Automotive & Transportation; Chemicals; Diversified Industrial Products; Manufacturing & Industrial Machinery
  - **Consumer:** Agribusiness; Consumer Products & Retail
  - **Energy:** Mining & Metals; Oil & Gas; Power & Utilities
  - **Financial Services:** Financial Services
  - **Health Sciences & Wellness:** Health Care; Life Sciences
  - **Smart Infrastructure:** Real Estate & Construction
  - **Telecoms, Media & Technology:** Media & Entertainment; Technology; Telecommunications
- Surveyed companies' annual global revenues were grouped in the following way:
  - Mid-sized: $250m–$999m (23%)
  - Large: $1b–$19.99b (64%)
  - Largest: $20b or more (13%)
- By region, the response was split between select economies of the Americas (34%), Europe (25%); Asia-Pacific (35%); and Middle East & Africa (6%).
- Global company ownership was as follows: publicly listed (70%), privately owned (23%), state-owned (7%).

Authors

Mary K. Cline, PhD
Insights Leader
Geostrategic Business Group
Ernst & Young LLP

Courtney Rickert McCaffrey
Deputy Insights Leader
Geostrategic Business Group
Ernst & Young LLP

Acknowledgements

The authors would like to thank the following individuals for their assistance with this report: Jon Shames, Kyle Lawless, Ben-Ari Boukai, Witold Henisz, Sven Behrendt, David Michaelson, Kevin Kajiwara, Alexandra Rogan, Meghan McDonough, Duncan Kerr, Patrick Dawson, Gurbaksh Gandhi, Sampada Mittal, Shreya Popli, Dan Staps and Clint May.

Geostrategic Business Group contacts

Jon Shames
EY Global Leader
Geostrategic Business Group
Ernst & Young LLP
jonathan.shames@ey.com

Mary K. Cline, PhD
Insights Leader
Geostrategic Business Group
Ernst & Young LLP
mary.k.cline@ey.com

Regional contacts

Scott Sarazen
Americas
Geostrategic Business Group
Ernst & Young LLP
scott.sarazen@ey.com

Oliver Jones
EMEIA
Geostrategic Business Group
Ernst & Young LLP
oliver.jones@uk.ey.com

Nobuko Kobayashi
Asia-Pacific
Geostrategic Business Group
Ernst & Young Transaction Advisory Services Co., Ltd.
nobuko.kobayashi@jp.ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. For more information about our organization, please visit ey.com.

EYG no. 003136-20Gbl

2004-3469211

ED None

ey.com