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Banks' risk function needs updating to deal with geopolitical threats

Rising concerns over wars and armed conflicts should be matched by actions to improve risk management practices

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Banks are increasingly concerned about a threat that is usually considered of "second order": geopolitical risk. The latest risk sentiment survey by the organisation I chair, the European Risk Management Council, revealed such worries. This is understandable, given current conflicts in Europe and the Middle East.

However, because of the secondary nature of geopolitical risk, with its indirect impact on the banking industry, the full extent of its repercussions in terms of severity, predictability and mitigation has not always been fully considered. This exposes banks to unexpected and unmeasured consequences.

Geopolitical risk should be especially worrisome because of the special place it holds in the wide spectrum of other types of risks that the banking industry is exposed to. It is a risk that manifests indirectly through various "first-order" risks such as credit, market and liquidity risks, as well as operational and physical security risks, strategic risk, cyber risk and reputational risk, among others.

History teaches us that geopolitical events can be the most devastating for societies and companies. Over the past century or so, the world has endured devastating world wars, civil wars, state coups and waves of international terrorism, all of which have profoundly affected the lives and livelihoods of millions of people, destroyed businesses and led to economic collapses. Governments have paid a steep price for their inability to avert major geopolitical shocks. Witnessing the upward trend in geopolitical risk today is deeply alarming.

Predicting geopolitical events and their impact on society and the economy is an extraordinarily challenging task. With the benefit of hindsight, we now possess precise knowledge regarding the timing and magnitude of various major geopolitical events from the past. However, it's essential to acknowledge that these events were often unforeseen, catching even geopolitical experts off guard.

The first and second world wars, the Bolshevik revolution, the Iranian revolution, the collapse of the Soviet Union, the 9/11 attack, the Arab spring, Russian President Vladimir Putin's annexation of Crimea and invasion of Ukraine all serve as stark reminders of the unpredictability and far-reaching consequences of geopolitical upheavals.

The inherent nature of geopolitical risk poses specific challenges to its mitigation. Given that banks and other companies have no control over geopolitical shocks, navigating a major geopolitical crisis proves exceptionally daunting, leaving them struggling to find a safe harbour.

But there are proactive measures that banks can and should adopt to mitigate potential future shocks.

The initial imperative is to reassess and redefine the business strategy, acknowledging that the world is entering an era of global disorder where traditional political norms no longer guarantee stability. The new strategy should prioritise business resilience in the face of heightened geopolitical turbulence.

Another crucial step is to invest in acquiring greater expertise and allocating more resources to the field of geopolitical risk management, given its renewed significance and complexity. This area of risk management is currently substantially less developed compared to those of traditional banking risks like credit, market or operational risks.

Given the unpredictability of geopolitical shocks, the most effective mitigation strategy involves robust business diversification. Banks ought to scrutinise their business portfolios, identifying and mitigating high concentrations, and diversify not only geographically but also across customer groups, products and business lines. Additionally, diversification of supply chains and internal processes to ensure redundancy in critical resources and infrastructure is crucial.

Furthermore, banks must bolster their crisis risk management, serving as the last line of defence against severe unexpected risk events. A comprehensive crisis management framework should include five essential elements: crisis identification, contingency planning, crisis governance, crisis management information and crisis communication. Management should conduct dry runs for its crisis management framework using war-game exercises.

They should simulate severe geopolitical risk scenarios with broad implications for the global economy, financial system, energy security, global supply chains, cyber security and physical safety. These exercises serve to refine crisis response capabilities and enhance preparedness.

As geopolitical tensions continue to simmer, banks must remain vigilant. They must seek to evolve and improve their risk management practices, and learn from the experience of peers in their industry. Building resilience against geopolitical shocks is now critical.