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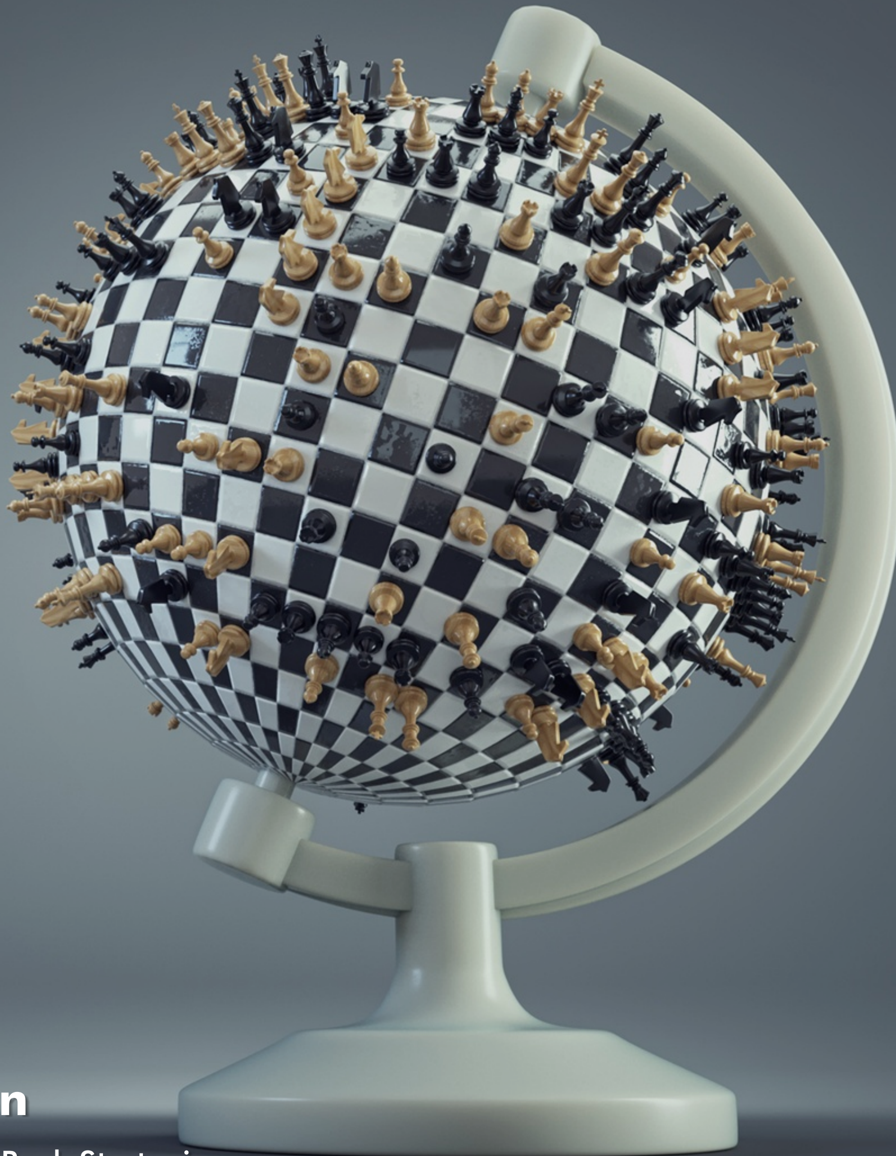
ADAPTING **GEOPOLITICAL RISK FRAMEWORKS** FOR FINANCIAL SERVICES

July 2024



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Introduction

Russia's expanded invasion of Ukraine in February 2022 elevated geopolitical risk from a historically niche capability for large multinational companies to an essential function for all types of organisations, especially financial institutions operating across multiple jurisdictions.

As a concept, geopolitical risk seeks to capture the impact of disparate but interrelated global political (i.e., non-financial) issues on financial institutions' operations. However, such broad scoping has not prevented attempts at a definition, the most general of which includes political and geographic considerations[1]. For instance, the European Central Bank defines geopolitical risk as "the threat, realisation and escalation of adverse events associated with wars, terrorism and tensions among states and political actors that affect the peaceful course of international relations"[2].

While the specter of armed conflict and other violence informs geopolitical risk, this article takes a broader interpretation of geopolitical risk to also capture internal domestic political dynamics within, rather than just between, states. This is especially due to the potential volatility and uncertainty surrounding nearly half of the world's population residing in countries with an election taking place in 2024[3].

Such risks can no longer be viewed solely as "long-tail" or "black swan" events. Instead, they should be viewed as part of "permacrisis" and integrated into business as usual (BAU) operations and strategic planning in addition to crisis and contingency planning.

Geopolitical risk for financial institutions can be understood in three parts:

1) tailoring geopolitical risk for financial services,
2) developing a common framework for diverse financial institutions to manage geopolitical risk, and
3) summarising and continuously updating the regulatory approach to geopolitical risk.

Financial considerations drive the need to manage geopolitical risk, as such scenarios inadvertently impact capital allocation. For instance, the International Monetary Fund (IMF) reported a decrease in cross-border capital allocation in light of geopolitical risks, due to reasons including financial restrictions that increase transaction costs, informational asymmetries, general mistrust and fear of expropriation[4].

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These circumstances also result in banks experiencing higher funding costs and lower profitability, especially in emerging economies[5], according to the IMF. This sentiment was echoed by senior economists in the U.S. Federal Reserve System, who found that foreign geopolitical events directly impact the overall loan portfolios of the exposed banks[6].

Geopolitical risk for financial services

Geopolitical risk involves some unique considerations for thousands of financial institutions, which themselves cover a broad spectrum of entities from small, early-stage fintech and digital asset companies to multinational banks operating in dozens of jurisdictions with hundreds of thousands of employees.

Geopolitical risk both amalgamates existing risks for financial institutions and presents novel ones to manage, leaving financial institutions with both non-financial and financial risk to internalise.

Below is a table explaining general types of geopolitical risks, broken down by specific examples and their potential impact on financial institutions[7].

Types of Risks	Examples of Risks	Impact on Financial Institutions
Non-Financial Risks	Physical Security	Limited or denied access to physical branches, offices or data centers; expropriation of physical assets
	Operational Security	Employee safety considerations in impacted jurisdiction(s); employee business travel risk
	Cybersecurity	Increase in potential or actual attacks due to nation-state or aligned criminal network offensive operations
Financial Risks	Changes to capital flows and payments	Sudden and large inflows or outflows, especially in emerging economies that may reduce asset prices or reduce access to credit lines
	Access to liquidity	Capital flows put stress on financial institutions through increased funding costs or debt rollover risk, changes in asset values
	Effect of new or expanded sanctions; investment restrictions, and/or export control measures	Changes to recordkeeping or reporting requirements; changes to firm risk tolerance for certain products, services, and/or jurisdictions; changes to client composition

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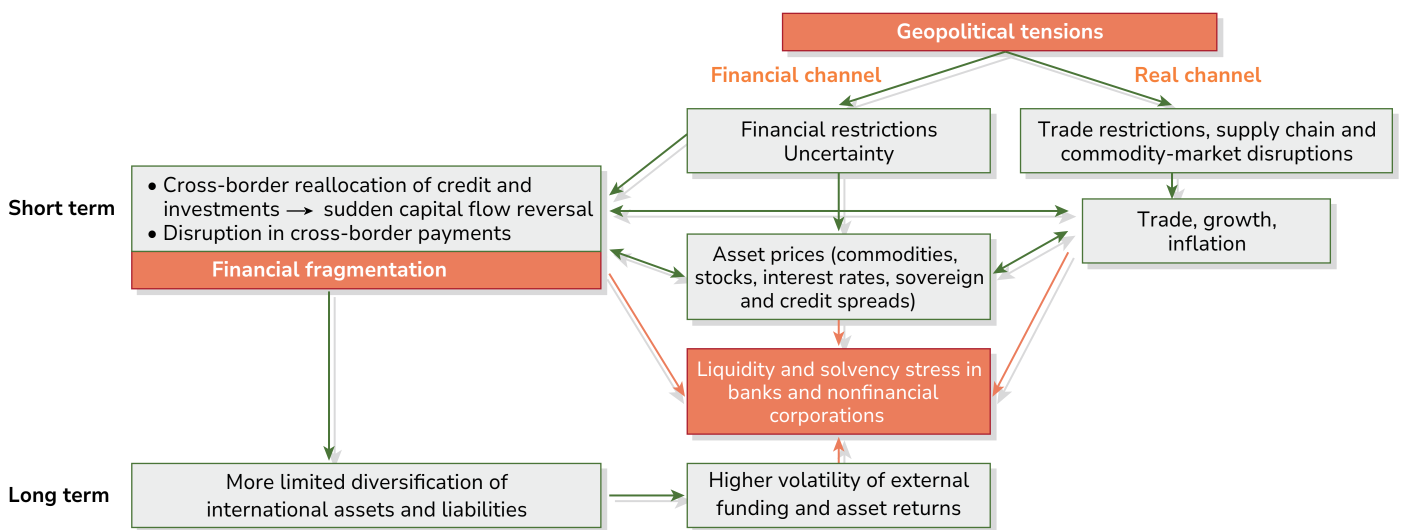
The International Monetary Fund provides a useful diagram of the interplay between these various financial and non-financial risks, including for their impact on wider macroeconomic stability[8]:



Note: The figure shows the two key channels of transmission, financial and real, through which geopolitical tensions could contribute to financial fragmentation and exacerbate macro-financial stability risks. In addition to these channels, macro-financial stability could also be affected if geopolitical tensions increase cybersecurity risks, compliance, legal and reputational risks for entities, risks associated with money laundering and financing of terrorism, or climate-related risks because of lack of international coordination to mitigate climate change.

Figure 1: The interplay between financial and non-financial risks due to geopolitical tensions across time.
(Source: International Monetary Fund)

A common framework for managing geopolitical risks

Anticipating all potential geopolitical risk contingencies misallocates resources and should not be the goal for most financial institutions. Outside of the largest global financial institutions, most organisations lack the internal expertise to focus exclusively on this problem. Geopolitical risks are also dynamic, so contingency mapping would be a perpetual exercise.

Today, resources exist to identify so-called "megatrends" that can help any-sized institution understand major known issue areas[9]. For instance, the BlackRock Investment Institute published a geopolitical risks dashboard in April 2024 that sets out 10 top risks beginning with U.S. China strategic competition and associated technological decoupling[10].

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Developing frameworks to manage geopolitical risks needs to be a tailored exercise for financial institutions based on their individual facts and circumstances that mirror other risk management and strategic planning functions. These factors include, but are not limited to, the size of the financial institution, its geographic footprint, its clients and counterparties, lines of business, products and services, and enterprise risk tolerance.

Public framing documents provide a helpful starting point for companies to establish a baseline for their existing geopolitical risk capabilities. KPMG, a global management consultancy, frames the geopolitical risk outlook for the financial services sector as a "permacrisis," thereby requiring financial institutions to permanently incorporate appropriate risk management as BAU[11].

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In 2023, Oliver Wyman, another management consultancy owned by insurer Marsh McLennan, identified a six-step framework for large financial institutions to use as a guide for strategic planning and risk management[12]:

1. Define internal ownership for geopolitical risk, which could sit in different business units depending on the organisational structure.
2. Map out relevant geopolitical risks and design scenarios based on those risks to anticipate secondary and tertiary effects.
3. Based on those identified risks, assess the risks by conducting impact assessments of the priority scenarios.
4. From the finding of the assessments, develop mitigation and planning capabilities, including by defining and actioning mitigants, drafting crisis or contingency playbooks, and using simulations or other exercises to prepare management.
5. Integrate these findings into BAU strategic planning.
6. Use these geopolitical risks efforts to inform quantitative metrics combined with qualitative risk surveillance, to develop early warning capabilities for major geopolitical events.

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This conceptualisation can be adapted for smaller organisations, especially those that lack the scale to invest full-time internal resources through both deputisation of existing legal, compliance, and government relations functions, as well as supplementing capabilities with a broad spectrum of professional service and technology providers.

Case Study: Sanctions on Russia and global spillover effects

The secondary effects of geopolitical risks can manifest in ways which can be hard to anticipate. Implementation of novel or expanded restrictive economic measures such as economic sanctions provide a case study.

Multilateral sanctions implemented against Russia beginning in February 2022 sought to strike a policy balance, including to degrade Russia's military capabilities, while minimising humanitarian impacts. Such efforts were consistent with guidance promulgated by the U.S. Treasury Department in October 2021 as part of a broader sanctions policy review[13].

For instance, the coalition provided licenses for agricultural products and fertilisers to minimise the impact of sanctions for these critical commodities[14]. The U.S. Treasury Department also put in place specific provisions to minimise disruptions for humanitarian-related financial transactions in third countries like Afghanistan[15].

However, despite addressing some of the legal concerns regarding sanctions through licensing, operational challenges still required sustained engagement by financial institutions to adapt. The spillover effects of the sanctions targeting Russia as well the effects of Russia's invasion of Ukraine impacted commodity prices and supply chain access in multiple third countries[16]. Such disruptions to trade flows and attendant financial transactions typify the acute crises and response mechanisms required by financial institution to manage ever-evolving geopolitical risks.

The regulatory approach and expectations

Effectively managing geopolitical risk by financial institutions must also reflect appropriate and ongoing regulatory engagement. As a starting point, limited supervisory guidance exists for consolidated geopolitical risk management.

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Using the United States as a case study, federal prudential regulators appear silent on geopolitical risk as a distinct risk area. Rather, geopolitical risk falls under the category of country risk, identified by financial supervisors such as the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and Federal Reserve System. In their last joint guidance on "Sound Country Risk Management Practices" in 2002[17], they defined country risk as "the possibility that economic, social, and political conditions and events in a foreign country might adversely affect the interests of a financial institution[18]."

To its credit, the OCC published a Country Risk Management booklet in 2016 for examination and supervision of covered financial institutions to manage "economic, social, and political conditions and events in a foreign country [that] will affect the current or projected financial condition or resilience of a bank." Such a document can be used by banks themselves to prepare for examinations and while developing and updating policies and procedures.

Financial institutions of all sizes would benefit from affirmative guidance provided by regulators.

However, financial institutions of all sizes would benefit from affirmative guidance provided by regulators. The Treasury Department's Financial Crimes Enforcement Network (FinCEN)-the country's Financial Intelligence Unit and primary federal antimoney laundering and countering the financing of terrorism (AML/CFT) regulator-publishes advisories and alerts in response to geopolitical risk events, such as Russia's expanded invasion of Ukraine and Hamas' attack against Israel on 7 October 2023[19].

However, FinCEN, and especially other regulators, can provide more strategic guidance on geopolitical risk issues. At a structural level, experts have suggested legislative changes to encompass geopolitical risk considerations for federal regulators while preserving regulatory independence from undue political influence[20].

Geopolitical risk opportunities

Lastly, brief treatment should be given to the economic opportunities for the financial services industry from increased geopolitical risks. In May 2024, *The Economist* published a special

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report detailing the impacts of geopolitical tensions, particularly between the United States and China, and what the ongoing fragmentation of cross-border capital flows means for global economic activities[21].

This fragmentation is leading to increased investments that require a wide array of financial services ranging from new infrastructure to advanced technologies. Fund managers have even begun to solicit new exchange traded funds (ETFs) from 8 million to 800 million USD to hedge against geopolitical uncertainty[22]. Other asset managers describe the need to understand geopolitical changes using a “granular approach” to surface opportunities at specific companies rather than at the jurisdictional or sectoral level[23].

Recommendations

Geopolitical risk management requires diverse stakeholder to update their capabilities.

Below are general recommendations for the public and private sectors to consider as geopolitical risks proliferate with attendant impacts for the breadth of the financial services industry.

For regulators:

- Need for more research on geopolitical risk in financial services by central banks.
- Need for regulators to articulate geopolitical risk guidance reflecting evolving cross-border financial activities, rather than just individual country risk.
- Need for regulators to issue timely and actionable crisis-related guidance for specific geopolitical crises.
- As per IMF staff findings, regulators could consider updating nonbank and bank capital adequacy requirements and liquidity buffers in light of geopolitical risks[24].

For financial institutions:

- Integrate geopolitical risk assessments into other risk management and strategic planning processes involving operational, compliance, legal, and business functions.
- Periodically update business processes and contingency plans based on geopolitical developments.
- Develop and refine capabilities to more granularly understand the impacts of geopolitical changes to improve risk management across jurisdictions, products, and services.

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