Emerging international risks

On 18–19 June 2014, the European and North American Audit Committee Leadership Networks (EACLN and ACLN) met in Amsterdam for their ninth summit meeting. On 19 June, there members discussed board and audit committee responses to emerging international risks. The evening before, members had been joined by Ivan Krastev, chairman of the Centre for Liberal Strategies and an expert on the Putin administration, to discuss the geopolitical issues emerging from Russian foreign policy.¹

This ViewPoints presents a summary of the key points, along with background information and selected perspectives that members and subject matter experts shared before and after the meeting.² For further information on the networks, see “About this document,” on page 9. For a full list of participants, see Appendix 1, on page 10.

Executive summary

Members reviewed the landscape of emerging international risks and discussed strategies for dealing with these threats, especially the approaches companies can use to anticipate them:

- **Types and examples of emerging international risks (page 2)**

  Companies operating globally face a variety of risks that are often hard to anticipate in advance. Political risks range from sudden changes in government policies that alter the business environment to full-scale wars that make business impossible. Economic risks include financial crises and economic slowdowns that are national, regional, or even global, depending on their severity. Audit chairs identified emerging international risks facing their companies including: events in Iraq and across the Middle East, the situation in Turkey, slowdown in emerging markets, exposure to the Chinese banking system, cyberattacks and global pandemics caused by treatment-resistant viruses.

- **Identifying risks and their ramifications (page 4)**

  While there will always be developments that surprise even the most sophisticated businesses, companies and boards can reduce the number of unanticipated yet significant events. Echoing recommendations offered by experts on risk management, members discussed the importance of such board strategies as talking to a wide range of senior executives, listening to outside consultants and key players in a jurisdiction or on a particular issue, and implementing longer-term scenario planning. The board itself should include directors who have a range of experiences and a mind-set that avoids complacency.


² ViewPoints reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.
Planning and implementing responses (page 7)

Once risks have been identified, companies can plan their responses, even testing them in dry runs and addressing any apparent weaknesses. For those threats that remain unanticipated, companies can develop more generic response plans and implement policies that make the company stronger in the face of any blow it might suffer.

For a list of discussion questions for audit committees, see Appendix 2, on page 11.

Types and examples of emerging international risks

The crisis between Russia and Ukraine illustrates a common challenge for today’s global companies. While many of the risks companies face are perennial and familiar, like the risk of fraud or losing a key customer or supplier, the landscape of global business also produces new risks on a regular basis. These emerging risks can quickly become as threatening as any well-documented risk, and they may require fresh approaches to mitigation. They may also be difficult to anticipate and assess, because they sometimes emerge quickly and unexpectedly. Few companies (or experts on global politics) predicted the Russian takeover of Crimea, yet it quickly changed the geopolitical landscape, with reverberations for companies invested in Russia and nearby countries. An EACLN member reflected on a similar situation, in which conditions in a key market deteriorated with little warning: “The main surprise was the velocity of the change.”

The international geopolitical arena generates a variety of emerging risks because it is a highly complex environment, with many variables, complicated connections and random events. A company with extensive international operations is unlikely to understand everything significant going on outside its home country. As an EACLN member noted, “We are active in every country around the globe, and there is always something happening somewhere that impacts our ability to do our business.”

Perhaps the most feared type of emerging risk is what Nassim Nicolas Taleb, a finance professor at New York University, terms “black swan” events.3 A black swan is an event that has enormous impact but is of low probability and completely unexpected.4 Narrowly defined, a black-swan event cannot be predicted, but there is a broader category of events that could conceivably be predicted but are nevertheless similar to black swans: they are overlooked and therefore unexpected, and their impact is significant.

The current crisis involving Russia and Ukraine is an example of a risk that fits into this broader category of black swan: while it was not completely inconceivable – given Russia’s invasion of Georgia in August 2008 – it was not anticipated. In pre-meeting conversations and at the meeting, EACLN and ACLN members pointed to a number of international risks that are often hard to predict yet potentially significant:

- Political instability. Disruption and chaos resulting from war, civil war or mass protest and unrest can disrupt operations or shut them down completely. They can also threaten the lives of employees. In

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4 A third feature of a black swan is that, after it occurs, people have a tendency to insist that it was predictable after all, thereby making it likely the company will be equally unprepared for future black swans.
addition to the current crisis in Ukraine, recent months have seen a military coup in Thailand, violent protests in Venezuela, turmoil in Turkey and insurrection in Iraq. Events that fall short of violent conflict may also be important: major policy changes by a foreign government – leading, for example, to expropriation of assets or draconian new regulations – can have negative consequences for a specific company or business in general.

Other members pointed to second-order effects of political instability. A member noted that if sanctions are imposed on a country, companies encounter a compliance problem that is exacerbated by the complexity of global supply chains: “How do we know we have enough degrees of separation?” Another member reported that Ukrainians are boycotting a company’s products because the products are produced in Russia: “People refuse to buy them because they are seen as Russian products as opposed to international ones.”

- **Economic slowdowns and disruptions.** An ACLN member noted that markets that seem to be on a strong, well-established growth trajectory can suddenly stall, threatening investments in that market. The member cited Argentina and its relative decline, asking if the same could happen elsewhere: “Regarding Russia and Brazil, people have been positive over the last years, and yet today, there is uncertainty. Are they truly growing, or have they turned a corner?” Other members expressed concern about China and particularly its banking system. One member said, “The Chinese banking system is a risk on a number of levels. It’s opaque and big, and there’s a shadow banking system. The exposure of foreign financial institution to China has gone from dead flat to $1 trillion … It makes me very nervous.” Another member noted that an economic crisis in China would have global ramifications: “China is an engine for growth, and everyone is counting on it.”

In pre-meeting conversations, several members mentioned the impact of sudden currency devaluations, which are one potential consequence of a sharp economic downturn. These can have a major impact on earnings if a company has significant operations in a country forced to take that route.

- **Natural disasters.** In addition to their tragic effects on human lives, natural catastrophes such as large earthquakes or storms can cause havoc for business in a variety of ways. They can disrupt sales and operations in the afflicted areas, sometimes for long periods of time. They can also affect supply chains in unexpected ways. Observers point to the example of the Japanese earthquake in 2011: most of Apple’s suppliers of lithium-ion batteries bought a critical polymer from a company that saw its operations disrupted by the earthquake. The supplier had 70% of the global market share for that polymer.5

- **Pandemics.** In today’s densely interconnected world, contagious diseases can spread across the globe very quickly. A member warned, “A governmental organization for health recently announced that some viruses don’t respond to medication. A pandemic might affect all of us. What kind of capital would we need to deal with it?”

- **Cyberwarfare.** Cyberattacks (often originating in China, Russia and Eastern Europe or the Middle East) have been a continual risk for some time, but they appear to be escalating to new levels. The

potential for an attack or conflagration of unprecedented scale is increasingly worrisome to many observers.

Emerging international risks are not confined to the developing world and emerging markets. One EACLN member remarked, “The most expensive risk for European companies is the US, where we can be hit with class-action suits and unexpected fines.” An ACLN member noted that US immigration policy can have substantial impact on the ability to recruit talent.

The discussion also touched on other types of risks that are not necessarily international but are emergent and significant. Several members mentioned technological disruptions, including disruptions spawned by technological change both inside and outside of the company. A member reflected, “It’s a huge problem, because a large and established organization can’t change quickly. So a start-up could change the situation quickly. Technological development presents opportunities for business in unusual ways.” This member’s company conducted a study that found that technological change could mean that the company might need only 10% of its current workforce by 2030.

Identifying risks and their ramifications

How can companies and boards identify emerging international risks that could have significant impact but are difficult to forecast? A true black swan comes out of nowhere, and there will always be events that are completely unanticipated. Nevertheless, observers note, companies and boards can try to reduce the number of unpredicted events or at least get a sense of what such events might look like, though this effort may require innovative approaches.

Going beyond the ERM and strategy functions

Some observers have argued that identifying such risks requires that a company go beyond its enterprise risk management (ERM) system. Matthew Le Merle notes in Strategy + Business magazine that ERM typically focuses on the many risks the company is likely to face relatively frequently, for several reasons: ERM resources are limited; high-magnitude, low-frequency risks are too complex for the ERM team to identify in full; and the internal politics and culture of many large companies unintentionally create blind spots that are hard to identify using standard ERM tools.6

Mr Le Merle explains that the solution to this problem is to establish a separate team that conducts “disrupter analysis,” a process that digs deeper than standard ERM analysis to reveal the more hidden dangers that might blindside a company.7 This process involves mapping the company’s operations and relationships, creating a list of possible events in all the relevant realms (political, economic, social, etc.), and analyzing the probable impact of these events on the company.8

Other experts have argued that companies also need to separate the risk function from strategy development and its inherently optimistic bias. Robert Kaplan and Anette Mikes of Harvard Business School have noted

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6 Ibid.
7 Ibid.
8 Ibid.
that managers focusing on strategy may discount low-probability threats to their strategic initiatives. Distinct analytical approaches are needed to identify these threats, including stress testing to gauge the impact of changes in key variables, scenario planning to assess the long-term effects of major trends, and war-gaming to understand what competitors might do.9 At the same time, the risk function must work closely with senior leadership.10

Sources of insight
ACLN and EACLN members echoed elements of these approaches when discussing how their companies and boards try to identify emerging international risks. In conversations before and during the meeting, they noted that their boards gather input from multiple sources, using a variety of measures:

- **Talking to a broad range of senior executives.** An ACLN member remarked on senior management’s understanding of developments in far-flung markets: “Various people within the management team, like the CFO and the general counsel, have their tentacles out to these countries and can give us more color into these trends.” Other members mentioned having the manager of operations in a crisis-hit region come speak to the board, and one member’s company established a risk committee consisting of top company executives, which reports to the audit committee. The chief security officer of a company can also provide valuable input.

However, members also noted that “management can be defensive when discussing risk … The best way to handle this is to build a trusted relationship with management, because it is important for them to share with us.” A member said that informal open sessions with just the CEO can be very useful. Members also described several ways in which boards can work more effectively with management during the strategy development process. A member said, “At one company, the board gets deeply involved in the strategy development process every three years. Board members get buddied up with senior managers and have three or four sessions with that person before it goes to the full board.” Another member highlighted the importance of continuing dialogue: “It’s not an effective process to have a single strategy session. It should be a more iterative process – a series of meetings.”

- **Engaging outside experts.** Outside experts can provide fresh insight based on their broader and/or deeper expertise, several members noted. A member said, “We have outside consulting resources – economists and others – who come in and talk to us directly or produce white papers.” Another remarked on the benefits of an outside perspective: “Sometimes an organization has enormous ability to not hear certain things.” One member noted the importance of resisting the tendency to talk only to people “who are like us.” The member recounted how their company received little warning about the impending crisis in Iraq from governmental sources but found useful intelligence from talking to a Russian oil and gas company with resources on the ground. The lesson is to build diverse networks outside the governmental intelligence community.

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10 Ibid., page 13.
However, members also offered warnings about the use of outside experts such as consultants. A member said, “I’ve seen great insight in their work. But there has to be a belief in them – it has to be really taken in by the CEO.” Another member had a different criticism: “They’re not always useful: they cry wolf all the time. Everything is going to erupt. What can you do with that?”

- **Listening to key players.** Policymakers and other influential players in a given jurisdiction or issue area can provide an insider’s insight into important developments. A member said, “We maintain relationships with all the authorities in the countries [where we operate].” Another member said, “We do one-day education sessions on international risk, and we invite high-level politicians to talk about the situation in Europe, strategic development and China. The minister of foreign affairs offers us their view of the world. We do this every year.”

- **Conducting board meetings overseas.** Several members described rotating board meetings to other locations as a way of getting closer to the risks that might lurk overseas. Meetings overseas allow board members to visit local operations and speak with local teams as well as officials and other players outside of the company.

- **Considering the long term.** Despite the difficulty of forecasting developments several years into the future, a number of members noted that they had derived value from attempts at longer-term scenario planning that went beyond the time frame of the company’s financial plans.

**Board composition**

Members touched on the skills and expertise needed on the board to assess international risks. A member remarked, “One risk – a persistent one – is who sits on the boards of international businesses? We do business mostly in accordance with our own culture. We don’t always try to understand the culture of countries where we do business, so we make mistakes.”

Several members noted that to address this problem, they recruit non-executive directors from overseas regions. “We have nine nationalities from three continents on our board,” said one. According to *Towards Dynamic Governance 2014*, Heidrick & Struggles’ 2014 European corporate governance report, the proportion of non-national directors on European boards increased from 24% in 2011 to 30% in 2013, though the percentage of non-national directors who are from North America (24%) is still much greater than the percentage who are from Asia (6%) and Latin America (3%).11 In the United States, the statistics are less compelling but the trend is upwards: a 2013 survey by Spencer Stuart found that the percentage of directors of non-US origin among the top 200 S&P 500 companies had increased to 8.6% from 6.4% five years ago.12

One member emphasized the importance of maintaining a certain mind-set: “You have to stay humble and keep having discussions [about your overall approach]. Don’t get too passionate in refining methodologies

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in the extreme.” Members underscored the importance of periodically taking a fresh approach that goes beyond incremental analysis and looks at potential risks from a completely different perspective.

Using data analytics to identify emerging risks

Many observers argue that new techniques of data analysis can help identify emerging risks, including the ones that are very hard to predict. As Irving Wladawsky-Berger, former vice president of strategy and innovation at IBM, noted in a Wall Street Journal blog, “When experts investigate catastrophic black swan events, be they airline crashes, financial crises or terrorist attacks, they often find that we failed to anticipate them even when the needed information was present because the data was spread across different organizations and was never properly brought together.”

Bill Pieroni, global chief operating officer at Marsh, has argued that the apparently increasing frequency of black-swan events suggests that some events that might seem completely unpredictable might, with the right analysis, be rendered at least somewhat predictable: black swans are giving way to shades-of-gray swans.

Planning and implementing responses

Once the potential risks and their ramifications for the company have been identified and evaluated, companies and boards can develop and implement response plans. These plans will include steps that the company can take immediately to reduce vulnerabilities, such as diversifying its supplier base if it has been revealed to be too concentrated, or strengthening certain internal controls if they are too weak. They will also include contingency plans that the company will activate if and when a certain risk actually materializes.

For identified risks, the established ERM system comes into play, as Mr Le Merle notes: “The ERM staff usually participates throughout the analysis and is the most logical and effective group to shore up any major exposures.” Indeed, once the process for identifying difficult-to-predict risks has identified a potential black swan, it is no longer a black swan, and the ERM processes that apply to risks in general can be applied.

In a pre-meeting conversation, Christian Mouillon, EY’s global risk management leader, described a testing procedure whereby the firm runs scenarios based on the risks identified, in essence conducting a dry-run of the response plan to see if it is robust. If the dry-run exposes weaknesses in the plan, they can be addressed, for example, through training or other measures. At the meeting, Mr Mouillon added, “The worst thing is not knowing what to do. It’s about deciding who will deal with it. If it’s a major crisis, you need to have people who are managing it on a daily basis. We have a plan where someone has a responsibility to act.”

What about the true black swans that remain unidentified? How can companies prepare for events that remain unknown and could unfold with little warning? Few EACLN and ACLN members mentioned having a response plan for these kinds of events, but as the notion of a black swan attracted attention in the wake of the financial crisis, many experts on risk tackled the issue. In 2011, for example, EY published

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15 Mathew Le Merle, “How to Prepare for a Black Swan.”
recommendations for dealing with black swans that laid out a number of general principles for responding to a major unforeseen event, such as clearly defining emergency management goals and values to guide responses and empowering local responders to take action.\textsuperscript{16}

Mr Mouillon noted that a generic response plan can be crafted in advance, with the specifics of the plan, and the members of the response team, to be determined only when the risk materializes. Companies can also implement general policies that make the company stronger in the face of any blow it might suffer. For example, maintaining a “fortress balance sheet” (although this may also attract activist investors) and a good credit rating can help a company survive a variety of challenges.\textsuperscript{17} In a pre-meeting conversation, another EY expert said that companies are increasingly studying their capacity to absorb shocks, an effort closely linked to establishing their risk appetites.

Other observers have emphasized additional considerations that come into play when responding to a major unforeseen event. For example, it is important to manage the psychological shock that a crisis can cause, which the leadership can ameliorate by focusing on facts and objective data, breaking the situation down into manageable components, and nurturing confidence that a solution will be found. By converting data into usable business intelligence and using communications tools such as dashboards, companies can also ensure that information reaches those who need it and can highlight progress in addressing the crisis.\textsuperscript{18}

In the international arena, identifying black-swan risks and planning and implementing responses is complicated by language obstacles, cultural and legal differences, and tenuous communications over great distances. Reflecting on the challenges of international crises for the board, an EACLN member stressed the advantage that age can offer: “If you only have bright young MBAs on the board, then you won’t have the experience. You need some old gray foxes on the board who have dealt with this.”

**Conclusion**

Tapping their varied experiences as executives and board members at large, global companies, EACLN and ACLN members reviewed a wide range of emerging international risks, including political instability, economic disruptions, natural disasters, and many others. To identify specific threats before they materialize, companies must seek information and insights from multiple sources and analytical approaches. A member reflected, “You need to spread the net wide.” And no matter how robust a company’s approach might seem, it is critical to avoid complacency: “As soon as a company believes it is world-class in risk management, I get really worried. You have to stay paranoid.”

\textsuperscript{16} Dana Hanson, Tony Ward, and Nathan Ives, “Responding to a Black Swan,” Insights for Executives (London: Ernst & Young, 2011), page 4.
\textsuperscript{17} Edward Teach, “A Fortress Balance Sheet,” CFO, 18 June 2009.
About this document

The European Audit Committee Leadership Network (EACLN) and Audit Committee Leadership Network (ACLN) are groups of audit committee chairs drawn from leading European and North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of ViewPoints lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive ViewPoints are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Participants

Members participating in all or parts of the meeting sit on the boards of 35 large-, mid- and small-capitalization public companies:

- Mr Carlos Colomer, Audit Committee Chair, Telefónica
- Dr Byron Grote, Audit Committee Chair, Unilever
- Ms Michele Hooper, Audit Committee Chair, PPG Industries
- Mr Lou Hughes, Audit Committee Chair, ABB
- Ms Marie Knowles, Audit Committee Chair, McKesson
- Dr Maurizio Lauri, Audit Committee Chair, Unicredit
- Mr Mike Losh, Audit Committee Chair, Aon and TRW Automotive
- Mr George Muñoz, Audit Committee Chair, Altria and Marriott International
- Mr Chuck Noski, Audit Committee Chair, Microsoft
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Ms Guylaine Saucier, Audit Committee Chair, AREVA
- Mr Tom Schoewe, Audit Committee Chair, General Motors
- Mr Jakob Stausholm, Audit Committee Chair, Statoil
- Ms Martine Verluyten, Audit Committee Chair, STMicroelectronics and Thomas Cook

EY participants included:

- Mr Steve Howe, Area Managing Partner, Americas
- Mr Frank Mahoney, Americas Vice Chair of Assurance Services
- Mr Christian Mouillon, Global Risk Managing Partner
- Mr Mark Otty, Area Managing Partner, EMEIA
- Mr Marcel van Loo, Country Managing Partner, EY Netherlands
Appendix 2: Discussion questions for audit committees

- What kinds of unforeseen international events have most affected your companies? What risks are you most worried about?
- What kinds of impact have unforeseen international events had on your company?
- How are your company and your board approaching these risks? Are you going beyond a standard ERM approach?
- What are the special challenges of identifying risks in the international arena? What kinds of planning tools and techniques have been helpful?
- What kind of outside input do you gather in order to try to identify and understand black-swan events? Is it worth the attempt? How can outside advisers or the audit firms help?
- Should public company boards have more international diversity in its composition?
- What steps has your company and board taken to ensure that a response plan is in place? What are the elements of such a plan? What are the special challenges of responding to unexpected events in the international context?
- How can a company prepare for events that might be completely unexpected? Are there practical elements of a generic response plan?
- What are the biggest issues that can cripple the response to an unpredicted crisis? How can companies mitigate these issues?
Appendix style (automatically starts at top of new page)

Body Text style