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Face the Future with Confidence

Board Perspectives:
Risk Oversight

The Board's Role in Addressing Geopolitical and Regulatory Shifts

In June 2017, Protiviti met with 22 active directors during a dinner roundtable at a National Association of Corporate Directors (NACD) event to discuss geopolitical and regulatory shifts on the organization and its strategy and business model, and the board's role in understanding and overseeing their implications. The discussion revealed a wide variety of topics that directors are concerned about as they oversee how their organizations manage the business in an unpredictable, uncertain environment amid escalating geopolitical tensions and the specter of significant regulatory shifts, both domestic and abroad.

Assumptions about the geopolitical and regulatory environments are critical inputs into strategy-setting. If one or more assumptions prove invalid, the strategy and business model may require adjustment. The timing — whether the organization is proactive or reactive — is often a function of the effectiveness of its monitoring process.

Key Considerations

At this time, the jury is still out regarding what the Trump administration and factions within the Republican majority in Congress can accomplish on major policy fronts. What has become evident during the initial months of the Trump administration is that there is a wide variety of policy initiatives that could have significant effects on business, both in the United States and globally. These initiatives include tax reform, fair trade, energy independence, immigration policy (including H-1B visas), infrastructure investment, employment and labor, and streamlining of governmental agencies, to name a few.

Regulatory shifts are also possible, including healthcare reform, Dodd-Frank relief in the financial services industry, and a scaling-back of the Environmental Protection Agency. (This is not to mention an executive order authorizing a sweeping review to reduce or streamline government regulations.)

During the roundtable, some directors we spoke with expressed concern over the short-termism of thinking inside the Beltway, as well as longer-term sustainability issues (e.g., environmental issues, income inequality, student debt levels, pay-for-performance). They also voiced concern about policy decisions affecting labor markets that could create potential talent shortages for their organizations.

As policy intent evolves into policy specifics that are shaped further through the legislative process, the question arises as to how companies monitor developments and their related impacts on the business. What role does the board play in overseeing this activity, and how often is the board briefed on fresh developments? Furthermore, how are significant geopolitical developments considered?

In exploring these and other related questions, several key points emerge:

1. **Managing the effects of policy, regulatory and geopolitical shifts requires a process —** The directors agree that a process of staying in touch with the sources of power begins with monitoring legislative, regulatory and global market developments through appropriate means (e.g., hiring insiders and consultants, tracking developments in published sources, monitoring geopolitical hot spots, and keeping close tabs on special interest groups). The process also entails engaging and informing legislators, regulators and policymakers through point-of-view statements, face-to-face meetings, lobbyists, correspondence, social media, advocacy groups, industry associations and other means. It continues with responses to new legislation and regulations through performing impact assessments, updating policies, modifying existing processes and systems, and implementing new processes and systems. Thus, the process facilitates monitoring, engagement and outreach, as well as response.

   Take trade agreements, for example. During the roundtable, several directors expressed concern about fair trade and risk of protectionist policies. The new U.S. administration appears to be committed to a reset of the North American Free Trade Agreement (NAFTA) and the Trans-Pacific Partnership (TPP, an agreement to lower or eliminate tariffs between the United States and 11 other countries, including Japan). It is focused on addressing trade issues with China (e.g., currency manipulation, exclusion of U.S. products from government purchases and subsidization of Chinese companies). How these and other policy initiatives play out can significantly affect companies' operations in or exports to these foreign markets and even transactions with suppliers based in these markets. Thus, multinationals and companies engaged in cross-border trade need to watch developments on this policy front closely.

2. **Evaluate strategic assumptions —** Every organization's strategy has underlying explicit or implicit assumptions about the future that represent management's "white swans" or expectations about the regulatory environment and global markets. In these times of uncertainty, it makes sense for the board to assess the underlying strategic assumptions in light of likely policy actions by the Trump administration and a Republican Congress that can impact the regulatory and geopolitical landscapes. If it's possible that one or more assumptions might be rendered invalid, then senior management should assess the ramifications to the strategy and business model and evaluate the options if such conditions transpire. As suggested below, scenario analyses may be useful in this regard.

3. **Consider the implications of scenarios germane to the sectors in which the organization operates and prepare accordingly —** Management should define plausible and extreme scenarios. The impact of the administration's various policy initiatives on the company's markets, channels, customers, labor pool, supply chains, cost structure, discretionary spend and business model should be considered. Scenario planning can be useful in gaining an understanding of potential impacts of market opportunities and disruptive change to the business and in formulating response and contingency plans. Accordingly, it may make sense to update scenario analyses as the legislative agenda unfolds and policies are clarified. One major Japanese automaker spent three months following the 2016 election evaluating alternative scenarios resulting from Trump's policies and their impact on U.S. and global sales. The company formulated contingency plans to pivot should a disruptive change occur, while also embracing the incoming administration as a market opportunity.

4. **Prepare for more discretionary spending capacity —** The Trump administration is looking to reduce the corporate tax rate significantly, making it easier for U.S. firms to repatriate profits earned and taxed abroad. It also seeks to eliminate the corporate alternative minimum tax, and provide special deductions for firms engaged in domestic manufacturing. While these proposals have a long road to becoming a reality, companies should consider how to deploy the hypothetical additional cash flow. Some example opportunities include undertaking new investments, reigniting deferred

projects, enhancing compensation to retain talented employees, expanding facilities, upgrading systems, and increasing dividend rates.

5. **Update M&A plans and strategy —** The 2017 global mergers and acquisitions (M&A) market remains active as companies continue to pursue transactions that complement organic growth and advance their respective strategies. As uncertain as the ongoing political and regulatory environment is, it is possible that the combination of a more favorable tax environment, access to foreign earnings and the trend toward deregulation may have a positive impact and further encourage M&A deal-making. Companies should consider these dynamics as they develop and reassess their M&A appetite given the overall corporate growth strategy, economic climate and market developments.

6. **Pay attention to sovereign risk —** The primary objective of managing sovereign risk is to protect company investments from risks of impairment and sustain returns on investment (ROI). Investment impairments may arise from confiscatory actions by a sovereign, such as nationalization of the business or expropriation of assets. ROI reductions may arise from discriminatory actions by a sovereign directed to the company, a targeted industry (say energy or banking) or companies from certain countries. Such actions might include additional taxation, price or production controls, and exchange controls, among other things, and could be directed to U.S. companies in response to American policy. In addition, investment impairments and ROI reductions may arise from destructive or disruptive events or circumstances (e.g., violence, terrorism, war or infrastructure deficiencies). These risks must be addressed by understanding the driving forces of change in countries where the company does business and taking proactive steps to manage identified exposures.

   For example, when high risk of confiscation or discrimination emerges, management might reduce the exposure by repatriating cash to the extent allowed given exchange controls and currency conditions. Companies can manage down the investment by avoiding additional capital investments, cessation of inventory replenishment from abroad and financing payroll, maintenance and other operational functions through local cash flow. Initiating an exit by divesting assets in the cool of the day is always an option if a willing buyer is available. If necessary and feasible, moving tangible and nontangible (e.g., data files, intellectual property) assets located in proximity to known hot spots out of harm's way may be appropriate. Entering into joint ventures with local and foreign partners may reduce exposure to confiscation risk since the presence of nationals can take a multinational under the radar. If cost-effective, political risk insurance is another option covering the risks of confiscation, political violence, insurrection, civil unrest and discrimination, among other things.

   When an adverse event arises in a country, a post-mortem should be conducted to review the assumptions the company had concerning that country from an economic, political and financial system risk standpoint. Did management see the event coming? If not, why not? If management saw it coming, did the organization take steps to prepare? Could the company have done anything differently? A post-mortem provides management an opportunity to review what happened and identify "lessons learned" that can be applied to other countries where the organization operates in which country risk is an important factor.

7. **Diversify if revenue mix is dependent on government funding —** Defense contractors can capitalize on defense spending and materials companies; heavy equipment manufacturers and construction contractors can focus on infrastructure spending opportunities. However, companies and not-for-profit organizations with a high dependency on government contracts and federal funding or close ties with federal agencies that may be placed under tight budgetary constraints may want to evaluate opportunities to deploy their core competencies in markets other than the public sector. The new administration's priorities may strain budgets that in the past called for subsidies, grants, discretionary spending and myriad projects. It is not unreasonable to surmise that the new administration and the current Congress will at least restrain growth in budgets in areas that are not deemed a priority.

As priorities and policy direction become clearer over time, companies can firm up their responses to potential changes in the operating environment. Meanwhile, it is never too early to start thinking about alternatives. Boards should ensure that the companies and organizations they serve are paying attention as developments unfold.

Questions for Boards

Following are some suggested questions that boards of directors may consider, based on the risks inherent in the entity's operations:

- Is the board satisfied the organization is in touch with the business environment and staying relevant in the marketplace? Does management have a process in place to monitor legislative, regulatory and geopolitical developments and stay current with developments germane to the business?
- Is there a process for reaching out to policymakers, legislators and regulators with the objective of informing them of the company's story and sharing marketplace realities when circumstances warrant?
- Does management respond timely to new laws and regulations and geopolitical developments with appropriate revisions to the strategy and its supporting policies, processes and systems? How does the board know?

How Protiviti Can Help

Protiviti assists boards and executive management with assessing the enterprise's risks and the capabilities for managing those risks. We help organizations identify and prioritize their risks, including emerging regulatory compliance and geopolitical risks that can impact the strategy and business model for creating value.

Is It Time for Your Board to Evaluate Its Risk Oversight Process?

The TBI Protiviti Board Risk Oversight Meter™ provides boards with an opportunity to refresh their risk oversight process to ensure it's focused sharply on the opportunities and risks that truly matter. Protiviti's commitment to facilitating continuous process improvement to enable companies to confidently face the future is why we collaborated with The Board Institute, Inc. (TBI) to offer the director community a flexible, cost-effective tool that assists boards in their periodic self-evaluation of the board's risk oversight and mirrors the way many directors prefer to conduct self-evaluations. Boards interested in using this evaluation tool should visit the TBI website at http://theboardinstitute.com/board-risk-meter/.

Learn more at
www.protiviti.com/boardriskoversightmeter

Protiviti partners with the National Association of Corporate Directors (NACD) to publish articles of interest to boardroom executives related to effective or emerging practices on the many aspects of risk oversight. As of January 2013, NACD has been publishing online contributed articles from Protiviti, with the content featured on https://blog.nacdonline.org/author/jdeloach/. Twice per year, the six most recent issues of *Board Perspectives: Risk Oversight* are consolidated into a printed booklet that is co-branded with NACD. Protiviti also posts these articles at protiviti.com.