EXECUTIVE SUMMARY

In this paper, we assess the disruptive transition in geopolitics, from a multilateralist and interconnected world to an emerging paradigm of “Splintered Integration.” In this emerging paradigm, state competition overlays and even pushes back against globalization. Economic interconnectivity remains deep but uneven, with greater restrictions in some domains than in others.

- Prominent features of Splintered Integration include U.S.-China strategic competition, economic segmentation, technology governance and cyber conflict.

- Facing the breakdown in multilateralism and the recent shift toward Splintered Integration, Canadian policymakers and financial institutions (FIs) should revisit their strategy and risk policies.

We then provide a new Frame of Reference with which to model past transitions and explain the present change in geopolitics. This frame does not make predictions about the future but helps FIs to interpret the implications of a range of potential geopolitical changes for risk management purposes. The model involves a 2X2 future scenario matrix defined by two uncertainty drivers: political state cooperation/competition and economic integration/fragmentation. The four quadrants reflect distinct geopolitical scenarios, each with implications for the range and frequency of risks:

- **Beggar-thy-Neighbour** — A world of negligible cooperation and highly regionalized economies in which risks have limited range but high frequency. The 1930s provide a historical case study.

- **Regional Order** — A world of strong cooperation but limited to blocs defined by geography or shared political/legal norms. There is minimal economic integration across these blocs. This world is exemplified by the Post-WWII (1945-91) U.S.-led order.

- **Hyper-globalization** — A world of strong multilateralism with diverse and wide-ranging interconnectivity across domains. It is illustrated by the immediate Post-Cold War era (1991-2000s).

- **Splintered Integration** — The emerging paradigm of decreased multilateralism. Global integration remains comparatively deep overall, but with pushback and even reversal in some sectors. Risks in this world have both increased range and frequency.

We conclude with four calls to action for FIs in a world of Splintered Integration:

a. Boards and senior management should review existing and planned exposures in light of the increased range and frequency of geopolitical risks. Updates to risk appetite and policies, in a manner that reflects their unique organizational and geographic profile, will likely be required following the review.

b. The first line (business managers) should integrate heightened geopolitical awareness with existing political/country risk assessments to find growth opportunities. Structures for streamlining on-the-ground assessments and information flow to management is essential to be nimble in timely business decision making.
c. The second line (risk oversight) should review country risk assumptions in policies and models, and structure their review cycle to remain responsive to geopolitical change. Detailed assumptions on portfolio diversification, structural foreign exchange risk and market stability/volatility should be revisited. Methods like scenario planning and stress testing can help organizations account for increased global complexity and determine whether existing corporate strategies are resilient to shocks.

d. And the third line (independent assessment) should adjust and implement flexible audit schedules to ensure that they are similarly responsive to shifting trends.

SECTION 1: A NEW WORLD OF STATE COMPETITION ATOP ECONOMIC INTEGRATION

The Onset of Structural Change

Canadian FIs need to revise the prism through which they view geopolitical risk to take into account recent, shifting global realities. The world is moving away from a paradigm in which institutions and shared norms underpinned the free flow of goods, services and capital. Country risks in emerging markets were common in that world but analysts could safely disregard scenarios in which the largest economies diverged. FIs now face an emerging paradigm of Splintered Integration, in which state competition among established, stable economies overlays and even pushes back against global interconnectivity. Great power rivalry and economic nationalism challenge the old liberal consensus. And multilateralism proves more challenging in the shadow of borderless threats like climate change or infectious disease. Geopolitical risk evolves to include both country-specific political risks and threats to and from the global system.

At the same time, recent moves towards economic decoupling reduce, but do not entirely reverse, global interconnectivity as established in the past two or more decades. States do not reject the benefits of trade and comparative advantage outright. Nor do they wish to retreat to economic isolationsism or "autarky." While trade in goods might decrease, the volume of services trade, data flows and people-to-people exchanges may continue to rise. This more tempered view of the emerging paradigm also reflects popular opinions toward integration. For example, despite the rise of more protectionist and nationalist sentiment on the right, a clear majority of Americans still recognize the net benefits of globalization, and support has been particularly high among millennials. The result is an emerging paradigm of seemingly contradictory forces, in which rising geopolitical competition, and anti-globalist skepticism within limited but highly active constituencies, meet the realities of deep economic integration. In this regard, a world of Splintered Integration is one of increased complexity for risk managers.

Features of Splintered Integration

There are several features that characterize the emerging paradigm of Splintered Integration, interrelated with the macro developments introduced above (Figure 1). These trends are cited by numerous experts and are familiar to even casual observers of geopolitics. The escalating rivalry between the United States and China remains a dominant theme. Bilateral tensions between the two powers raise the prospect of economic decoupling, a digital “splinternet” and even an outright military exchange. In part a reaction to vulnerabilities exposed by COVID-19, countries may look to the strategic re-shoring of critical industries on national security grounds. The proliferation of digital technologies may empower rogue states and transnational criminal networks. Localized or regional disputes may create instability with wider reverberations. Terrorism and civil violence remain perennial concerns. Global refugee and migrant flows linked to wars, ethnic violence and poverty may reach even greater levels and could instigate further popular backlash in destination countries. And the destructive effects of climate change may dislocate even larger populations, fuel inter-state conflict and disrupt national economies.
Notwithstanding this constellation of features, however, recent electoral outcomes have led some observers to question if the emerging paradigm truly represents a distinct pivot in geopolitics. The inauguration of Joe Biden as President of the United States would seem to mark a rejection of “America First” thinking and a return to business-as-usual in Washington. Restored U.S. leadership might even reverse the declines in global multilateralism. Indeed, over his first hundred days, Biden has brought a spirit of cooperation back to the White House. The new administration has already recommitted to global initiatives like the World Health Organization and the Paris Climate Agreement. It has also started to mend relationships with traditional allies. Yet, Biden is unlikely to usher in a return to previous eras of multilateralism, of the kind more amenable to collective action. The United States lacks the capacity or the opportunity to reclaim the leadership role it once held, and even with the support of its traditional partners, it cannot recement the old liberal order. The U.S. is set to increasingly compete with a rising China and early indications are of persistent strains in the bilateral relationship that could thwart major global initiatives. Furthermore, the 2020 election and the events of January 6, 2021 have demonstrated that far-right populism remains a significant force in American domestic politics. The disruptions of the Trump era may cast a long shadow in future elections and in the memories of other world leaders.

Implications for Canada & Canadian FIs

Canadian policymakers and FIs have long made strategic and operating assumptions based on the conditions afforded to them under a multilateralist system. In form, if not always in substance, Canada long embraced the role of a middle power in its foreign policy. Successive governments could leverage diplomatic customs and global institutions to positive effect. Although Canada lacked the political or economic heft of the great powers, it could still influence the course of events at certain times and in certain domains. In these efforts, Canada also benefitted greatly from its relative geographic isolation and its close security and economic ties to the United States.

These geopolitical fortunes proved nurturing to business as well. FIs could operate with confidence that their home market remained well insulated from external shocks. They could count on secure and stable access to the world’s
largest market south of the border. And when operating overseas, FIs could reasonably expect multilateralism to help manage crises, promote equal treatment and provide mechanisms for the orderly resolution of disputes.

The shift to a paradigm of increased state competition, layered upon global economic integration, upsets the geopolitical conditions under which Canadians have long reaped rewards. Ottawa finds it more challenging to assert its limited influence and resolve disputes with other countries, often to the detriment of the private sector. With the end of its strategic innocence, Canada now faces a harsher reality of geo-economics in which commercial interests increasingly drive geopolitical rivalry. National Bank of Canada CEO Louis Vachon and Frédérick Gagnon of l’Université du Québec à Montréal describe the more difficult choices that could face governments and businesses in this more zero-sum world. Foreign policymakers need to develop new “rules of engagement” on the global stage while more broadly defining and protecting their national economic interests. Corporate leaders may have to make strategic choices informed by geopolitical realities rather than just commercial preferences.

Encompassing the geo-economic age that Vachon and Gagnon describe, the emerging paradigm of Splintered Integration poses a clear risk for Canadian financial services. To varying degrees, all Canadian FIs are affected by global events that increase short-term market volatility and weaken fundamentals. Some institutions remain directly exposed to localized political risks through their out-of-country operations and portfolio holdings. Canadian banks maintain significant international footprints, whether in retail/commercial lending, wealth management or global capital markets. And institutional investors have increased real asset purchases abroad in the search for yield. Thus, FIs have an imperative to understand the new geopolitical reality taking shape, how it differs from past archetypes and how current trends can evolve to create alternative futures with unique risk profiles.

SECTION 2: A NEW FRAME OF REFERENCE

GRI offers a new frame of reference with which to model transitions in geopolitics and interpret the consequences of the emerging paradigm for FIs. This framework defines four mutually exclusive scenarios along two axes. Cooperation / Competition refers to the propensity of states to collaborate politically to meet their objectives. Integration / Fragmentation refers to the geographic and systemic scope of economic activity. This four-quadrant matrix draws inspiration from the “Future Worlds” geopolitical risk model set forth in the U.K. Ministry of Defence’s (MoD) Global Strategic Trends report, sixth edition. The MoD model draws upon other sources in turn, specifically Future Operating Environment: 2035 from the Australian Department of Defence.
Each of the four quadrants defined above have implications for both the *range* and *frequency* of geopolitical risks to FIs:

**Range:** Where geopolitical risks can/do arise, across physical geography, and specifically, jurisdictional borders.

**Frequency:** How often geopolitical risks instigate loss events that challenge business decisions/revenue generation.

### The Quadrants

Each of the four quadrants in the frame of reference outline distinct geopolitical paradigms. These archetypes provide structure to the historical context behind current trends. Three quadrants may be delineated by specific time intervals, while the remaining quadrant captures the emerging paradigm identified in Section 1. This scenario captures geopolitical conditions at present, with implications for the near- to medium-term. Beyond explaining “where we are” and “how we got here,” this frame of reference could also serve, specifically for risk management, as an aide to strategic foresight. Although it does not make predictions about the future, the framework can help FIs to think critically about geopolitics and identify early warning indicators. It allows for an examination of corporate strategies under a wide array of future states.

The sub-sections below include a relevant historical case study for each of the four quadrants as a concrete reference point and sample scenario narrative: *Beggar-thy-Neighbour*, *Regional Order*, *Hyper-globalization and Splintered Integration*. They then identify the key characteristics of each paradigm and their implications for the range and frequency of risks to FIs.

### Beggar-thy-Neighbour

*Beggar-thy-Neighbour* is exemplified by the unilateralism and economic protectionism of the 1930s. Amid the Great Depression, the United Kingdom, the United States and other countries chose to abandon the gold standard and triggered intense exchange rate disruptions. Multilateral efforts to repair the damage failed to produce an agreement on currency stabilization. Countries instead resorted to unilateralist measures like competitive devaluations, trade barriers and capital controls to support their recovery. Compounding the effects of the economic collapse, these measures inflicted serious damage on the global financial system.

*Beggar-thy-Neighbour* comprises the bottom-right quadrant in the GRI frame of reference. It reflects a world of limited international cooperation and highly regionalized economies. Foreign policy retrenchment and trade decoupling take their course, with autarky as the extreme state. Geopolitical risks have limited range as controls inhibit economic activity beyond national borders. However, the frequency of these risks remains high at the local level, as governments more actively intervene in the market to enforce protectionist barriers.

### Regional Order

The realities of a *Regional Order* are best reflected in the Post-Second World War rules-based and U.S.-led economic system, defined from 1945 to the early 1990s. Within a greater “liberal order”, this economic system emerged in the context of U.S.-Soviet confrontation and was limited to the non-communist sphere. It promoted the values of free trade, private property rights, cross-border investment and knowledge transfers. Other features included standards and measures for transaction settlement, currency conversion and invoicing. The Bretton Woods institutions – the World Bank and the International Monetary Fund (IMF), including a fixed-but-adjustable exchange rate system— were designed to prevent the competitive devaluations of the 1930s. A parallel initiative, the General Agreement on Tariffs and Trade (GATT), would set rules for economic exchange. Although this institutional architecture still provided individual states with significant autonomy over their

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A Frame of Reference: Geopolitical Risks to Canadian Financial Services

macroeconomic policy, it facilitated robust growth in international trade and investment. FIs benefitted from this rising tide.

Regional Order aligns with the bottom-left quadrant in the GRI frame of reference. Multilateralism exists but is largely confined to specific geographic blocs and can reflect shared political or legal traditions. Geostrategic or ideological barriers may inhibit further integration beyond the core members of a Regional Order. The range of geopolitical risks to FIs is limited by the scope of trade and investment flows. Yet cooperation within the bloc on matters of economic governance helps to reduce barriers-to-entry, standardize processes for dispute resolution, and in so doing, reduce the frequency of loss events.

Hyper-globalization

The Post-Cold War era, from the early 1990s to the mid-2000s, exemplifies the paradigm of Hyper-globalization. Introduced by Harvard economist Dani Rodrik, this term describes the rapid growth and integration of trade, investment and financial markets that distinguished the period. The surge in interconnectivity pushed beyond even the limits of the original Bretton Woods framework. With the export of the “Washington Consensus,” the tradeoff between national interests and integration leaned definitively toward the latter priority. It effectively marked both the internationalization and intensification of the U.S.-led economic order. A guiding philosophy of systemic “convergence” even posited that states would cast off traditional power politics, adhere to established norms and ease restrictions in their domestic affairs. As argued by Jonathan Hausman, Head of Global Strategic Relationships at the Ontario Teachers’ Pension Plan (OTPP), Hyper-globalization yielded real benefits for FIs. A combination of U.S. security guarantees, capital and labour mobility, open access and equal treatment, and the proliferation of Western-led technologies provided optimal conditions for investors, particularly those from a middle power like Canada given its relative size and influence.
are more fluid and blurred, and thus have substantial range. Traditional “safe havens” are subject to greater geopolitical uncertainty that blurs the lines between mature and emerging markets. Examples include Brexit and the rise of U.S. trade protectionism under President Donald Trump. Loss events linked to geopolitical risk are also more frequent in this paradigm. With greater state intervention in the market, geopolitical interests affect returns at more times and in more sectors. Restrictions on digital services, market access, and foreign investment are more common. Examples include tensions over the use of Huawei gear in 5G telecommunications networks and U.S. restrictions on semiconductor exports.

Recognizing Splintered Integration

The emerging paradigm of Splintered Integration increases the aggregate levels of uncertainty facing Canadian FIs. It is a paradigm with both increased range and frequency of geopolitical risks, which together add complexity to risk/reward assessments. It is all too appropriate that financial sector leaders have grown more attuned to the changing threat landscape in recent years. In both 2018 and 2019, geopolitical risk placed second in terms of its financial system impact in GRI’s Annual Risk Survey. It has also ranked among the top risks in the Bank of Canada’s Financial System Survey, and serves as a primary risk category in the World Economic Forum’s annual global risk reports. Industry concern is prone to rise as the geopolitical implications of the COVID-19 pandemic come into focus. Accordingly, FIs should revisit the steps they have taken in evolving their geopolitical risk management over recent years and holistically consider if it is adequate in overall coverage given the shift to the emerging paradigm.

SECTION 3: CALLS TO ACTION

Given the increased range and frequency of risks in a world of Splintered Integration, FIs should cultivate contextual knowledge of geopolitics as a key variable in their decision-making across the business. However, there are some more specific guidelines at the level of the board and senior management, and across the three lines of defence, that can help inform the response to the emerging paradigm.

Boards of directors and senior management can factor the increased range and frequency of geopolitical threats into their risk appetite statements. In turn, geopolitical variables can influence risk policies, qualitative/quantitative limits and bespoke exposure assessments. Naturally, these approaches will reflect the unique business profiles of organizations. The risk appetite is divided into financial exposure, asset exposure and staff exposure. With respect to financial and asset exposures, the challenges of trapped capital and non-fungibility are heightened in the Splintered Integration scenario. Notwithstanding the extreme case of state acquisition, institutions with trapped capital may need to reinvest within a given jurisdiction or else face cross-border tax or regulatory penalties. This means assessing foreign acquisition on a self-sustaining, standalone basis, and potentially discounting portfolio benefits. Assets held in a foreign nation may become a political liability irrespective of their valuation. Finally, staff exposures are reflected in the management of culture and physical safety. As applicable, FIs may consider whether evolving local business norms align with codes of practice in their home market and develop contingency plans to evacuate staff in the event of a downturn in local political conditions.

The first line can integrate their heightened geopolitical awareness and local market knowledge with institutional country/political risk assessments to find growth opportunities in alignment with the risk appetite statement. The first line of defence is the “boots on the ground” capacity that is vital to ensuring that risks, visible only at the customer-level, are managed. Issues such as know-your-customer and collections have local nuances, often complicated by language and cultural attitudes to financing. Additionally, the first line is often most aware of everchanging local political conditions, potential legal and regulatory changes, and the rise of popular movements, among other trends. It is imperative that an effective and efficient communication process is in place for the first line to communicate any (geo)political changes to the risk profile.

The second line can promptly review country risk assumptions in policies and models to better reflect the increased range and frequency of geopolitical threats.
The policy review cycle could be increased in frequency with the move towards a world of *Splintered Integration*. Common and consistent updates are needed to reflect dynamic events. The second line can also use strategic foresight scenario planning and stress testing to challenge prevailing assumptions and account for the greater complexity of macro global trends. These stress tests could be used to challenge portfolio diversification benefits and help align risk appetite. The GRI framework provides four guideposts for stress scenarios to assess the resilience of current corporate strategies. Arguably, the collections process is also a second line operational function, which is subject to, and must be critically aware of, any degradation of the rule of law.

The third line can adjust internal audit schedules to become more responsive given the velocity of geopolitical change. There is a historical precedent for operational failures in offshore subsidiaries that significantly impact the reputation of headquarters (e.g., Barings Bank). The maintenance of policy and culture in times of heightened geopolitical stress should then be audited more frequently.

**CONCLUSIONS**

Canadian FIs must recognize the emerging paradigm of *Splintered Integration* in geopolitics, one of increased state competition, layered upon and challenging to global interconnectivity. Threats have greater range and frequency in this world which complicates risk/reward assessments. FIs can factor new conditions into their risk appetites, policies and procedures and apply contextual knowledge to find growth opportunities in the emerging paradigm. They can also amend risk frameworks to challenge prevailing assumptions about country risk, develop risk and audit functions that are more responsive to geopolitical change, and identify early warning indicators for assessing global complexity. GRI will continue to support its members as they identify and respond to geopolitical risk.
ENDNOTES


15. Jonathan Hausman, “Geopolitical Perils In Investing” (lecture, Global Risk Institute In Financial Services (GRI) 2019 Annual Summit, Toronto Region Board of Trade, September 18, 2019).


19. Ian Bremmer frames the convergence of developed and emerging markets in terms of their levels of political risk as a trend post-Global Financial Crisis, refer to Bremmer, “End of American Order.”