ISS Risk Special Report:

Bangladesh Garment Industry – Contextualising Geopolitical Risks Beyond the Vanilla

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Introduction

The impact of geopolitical risk and terrorism upon economic and financial-business risks is often spoken of in terms of reactions: short-term equity market dips, loss of assets, loss adjustments, negative impact on share price for a company or sector caught up in a specific attack. A typical retrospective stance is taken.

At ISS Risk, we look to assess and provide predictive intelligence assessment on how events can adversely impact a company's operations. We say predictive, as most traditional risk assessments pay less attention to the effects and counter-effects that will take affect several months down the line.

Having line-of-sight on the direct and indirect risks which impact both your industry and your business (be these short, medium or long-term in nature) is paramount for any company. This is arguably doubly so when viewing risk from the garment industry's' global supply chain perspective. Global markets and end-clients are not known for their tolerance for supply chain disruptions – especially when emanating from links based in frontier economies such as Bangladesh's.

Do we just watch the equity markets and take our cue from there?

If equity market performances immediately following a one-off attack are anything to go by, the impact of a large terrorist event for example, could be a benchmark for an effective risk assessment – *right?*

The first day of trading after the 2001, 9/11 attacks in New York and Washington the S&P 500 index dropped 4.92%, yet the day after the October 2015 Ankara bombings it increased by 0.13%, and the day after the Brussels attacks in March 2016 it fell only 0.64%. What does this tell us? The market rectifies, volatility falls and trading volumes soon return to being conditioned by typical factors such as quarterly reports, rates decisions, policy announcements etc.

So, the impact of attacks' that are covered by the global media in a frenzied fashion apparently affect the markets in a transitory fashion. Therein is 'least said, soonest mended', a logical conclusion to the importance of such events?

Well, such an 'assessment logic' is fine if you are a toe-tipping spot trader … or the attack was in a country with a mature diversified economy … if the political risk event or terror attack was covered by your indemnification … and even if the impacted country, industry, sector or company represents less than a cautious 3% of your diversified portfolio.

Yet what if your investment in the country which suffered the terror attack is not so fleeting, remote or delicately hedged? What if the business activities operated in this impacted country are of critical value to your industry's global supply chain and long-term strategy?

Furthermore, what would you say to your shareholders at the next annual general meeting if the Global Terrorism Index[1] (GTI) ranked the country where these events were happening, as having the 25th highest terrorist activity in 2015? With it having been 39th only five years before?

What else would you have to say if in 2016 it was then ranked 22nd alongside Turkey and South Sudan, and recruitment of extremists and their attacks had been expertly identified as being concentrated in the regions where your supply chain link activity was traditionally located?

Do such trends give you confidence that the rise in its GTI ranking will slow down soon? or that the Bangladeshi government can counter this trend?

Still feeling relaxed about the next meeting with your bankers, underwriters, major shareholders, or that prospective client?

Bangladesh, case in point

If your business involves the textile and clothing industry ('garment industry'), and you are heavily dependent on stability in Bangladesh then cause for concern at both the strategic and operational level is genuine.

Whereas meeting foreign buyers in Bangkok or hiring security convoys for shipments works short-term, such tactical moves can only go so far in protecting a business model and your strategy.

As the quote goes 'knowledge itself is power', and in such circumstances knowledge of how political events now will translate into future economic and financial-business risks will empower a company to make the right tactical and strategic decisions in protecting its business goals.

But how wide a risk lens is needed?

At the Dhaka Apparel Summit in 2014, the Bangladesh Garment Manufacturers and Exporters Association (BGMEA) stated it was targeting a doubling of exports from the industry to USD 50 billion. Yet did this 'ambitious goal' account for an increase in terrorist activity levels? The facts speak for themselves.

The years 2015-16 saw the identification and emergence of a new brand of transnational terrorism which is effectively co-opting indigenous terrorist groups and bringing terrorism risk to the forefront of risk assessments for Bangladesh.

Yet what has the government's official response? The total rejection of this threat as transnational despite overwhelming evidence to the contrary, and therein awkward political and security responses that can be assessed as inadequate.

A logical question here is, what would a company have decided if it had known

[1] Institute for Economics and Peace

about the political risk trends being identified from events back in 2014? how would they have adjusted their corporate risk appetite for 2015 through 2017 and beyond?

However, the more important question to be asked at this juncture is what was missing from their risk assessment approaches in 2014 so as not to have identified these budding yet high risk issues?

Economic risks, both direct and indirect, are sparked by geopolitical uncertainty and terrorism. Without question, direct and indirect financial-business risks are subsequently felt by companies which are operating in environments suffering these economic risks. With the Bangladeshi garment sector being such a pivotal supply chain link to so many foreign companies and global brands the questions needs to be asked:

Is it only a matter of time before deaths by target type in Bangladesh switch from government or security targets and random private citizens, to a higher percentage being linked to the targeting of businesses?

How do you assess the risk of this happening or not? How can companies base their decisions?

Limitations of a traditional risk approach for the garment industry

Bangladesh's Garment industry accounted for over 82% of Bangladesh's total exports in 2016, 11% of FDI, houses roughly 7,200 factories and totalled US $28.1 billion in exports, keeping the country the second largest apparel exporter in the world.

Treating the events of 2016 such as the Holey Artisan Bakery attack in July 2016 in Dhaka as a 'rogue' or 'unexpected' event in both in both quantitative and qualitative terms would display out-dated early al-Qaeda era thinking. Yet examining such events only through domestic counter-terrorism responses despite being textbook 'old-think' is still frighteningly commonplace.

Quite frankly, such an approach gives little accommodation for assessing how state and non-state actors can bring about a fundamental shift to scenario based risk assessments. Maintaining this assessment methodology for Bangladesh in 2017 would be a fundamental risk assessment failure.

Risk borne geopolitical responses to industry safety standards

Economic risks – indirect and direct

Both the April 2013 Rana Plaza collapse and the Tazreen Fashions factory fire in 2012 provoked strong condemnations and reactions from the international garment industry. Demands for new safety standards and significant reforms were immediate and continue. The tragedies and suffering they brought were both focused on by the western media.

With the EU accounting for over half of the country's garment industry exports according to the BGMEA 2016 trade data, it is not a surprise that this is where the Bangladesh government first requested punitive measures not be taken and for labour rights and fire safety reforms to be undertaken by the Bangladeshis themselves.

The 'economic risk – indirect' brought on by the political risks stemming from these disasters, was seemingly three-fold:

1. The government's stance on regulatory tightening and how much reform it might undertake
2. Government effectiveness - namely are political parties able to co-operate sufficiently well to act in consensus in delivering a meaningful body of policy to meet the demands of foreign clients?
3. Foreign clients quickly finding themselves in the middle of public media coverage and public pressure back home, thereby getting exposed to reputational risks but also their government's responses.

The nature of the economic risk threat brought on from the events morphed from a business ethics and brand protection type risk, to one wrapped very firmly in geopolitical pressures. Companies with supply chain links in Bangladesh were facing the risk brought on by of the EU threatening to suspend critical trade privileges under the generalised system of preferences (GSP).

To put this in context, the US did just this in June 2013 with the suspension only to be reviewed in 2017. As at the time of this report, the US' suspension looks no closer to being lifted. When assessing the geopolitical risks posed by the US' decision, one can then identify a further fourth risk the garment industry is facing, namely 'government failure to create and enforce government policy'.

The Bangladesh government is looking to move from being categorised as a least developed country to a developing country in 2021. Upon doing so it will lose its default GSP qualification in the EU and US markets. Yet the EU is offering Dhaka a lifeline. If Dhaka can prove that it has undertaken sufficient reforms in the garment industry it can qualify for GSP Plus status. With the US, upholding its GSP suspension industry analysts continue to watch how the EU will base its 2021 decision.

The importance of this geopolitical-economic risk's monitoring speaks for itself. The achieving of GSP Plus status is of seminal importance to the garment industry in Bangladesh in terms of global competitiveness.

So, given the importance of this 'national issue' how well have the Bangladeshi government instituted a programme of industry reforms? The intransigence of the Bangladeshi government and opposition political parties towards affecting reforms to the industry is very evident. However, these failings are not only being watched by government ministries or the industry itself, credit rating agencies are watching carefully too.

There is no doubt that the country's sovereign credit rating (Moody's: Ba3 / outlook Stable[2]) will be placed under serious duress should the EU-Bangladesh Sustainability Compact fail and the country loses its privilege on duties afforded by the GSP / GSP Plus.

Where a more holistic approach that includes geopolitical and political risk assessments comes to forbearance is in assessing whether a government is too distracted by in-fighting and inter-party acrimony, and also the rise of transnational terrorism such as ISIS (which has serious strategic plans for Bangladesh vis-à-vis its regional objectives) can be effective. The question needs to be asked:

Will the Bangladeshi government be too distracted by inter-party politics and domestic security concerns to affect necessary reform to secure GSP / GSP Plus status?

[2] Non-investment grade speculative bracket (and one notch above Highly Speculative)

In the run-up to the last general elections in 2014 the garment industry took the extraordinary step of formally complaining en masse to the country's political parties. The basis for their grievances was the level of disruption the political fighting (figuratively and literally) was causing to the industry. So, it would appear that party rivalry has the ability to eclipse 'all other issues of national importance'. Will this be repeated at the next general election in 2019? Surely inclusion of such a serious political risk should be included in a garment industry firm's risk assessment? If not, why not?

Furthermore, if reforms to the garment industry have not been satisfactorily delivered by 2019, will a new government be able to deliver them by the EU's 2021 GSP – GSP Plus timeline?

Financial-business risks – indirect and direct

Reducing vulnerability and increasing preparedness are the key goals for a company when incorporating various geopolitical risks into their financial-business risk management space. The planning for worst case scenarios for a company is a well-known critical path for risk management. Yet the inclusion of geopolitical risk and the identification of both trends and associated potential tipping points is the element so frequently missing in such processes.

Where DESTEP (demographic, ecological,

social, technological, economic and political), PESTLE (political, economic, social and technological) and other similar strategic assessments stop, is where most companies suffer the maximum exposure to geopolitical risks. This becomes particularly true in case of companies operating in Bangladesh where shocks to the economy and / or shocks to its all-important garment sector industry becomes critical.

This is where the ability to build your own 'smart radar' which detects risks from 360 degrees at multiple layers is, quite frankly, a must.

Risk borne geopolitical issues stemming from transnational terrorism

The garment industry has historically remained off-limits to domestic terrorist groups, with acts of labour protest militancy even remaining selective. Yet, in early January 2017, the US State Department declared that in October 2016, ISIS in Bangladesh had threatened to target 'expats, tourists, diplomats, garment buyers, missionaries and sports teams' in the most 'secured zones' in Bangladesh.

As was reported by industry observers at the time, this was the first occasion in Bangladesh that the garment industry – more specifically its foreign clients – were listed as targets. It marked a clear change to the historical 'tacit understanding' with indigenous terrorist groups, yet it most certainly exposed that a new thinking and change in terror strategies were being deployed.

It is this type of emergent political risk threat that must be accommodated and planned for in 2017 and beyond by companies invested in Bangladesh. As ISS Risk Special Reports on Bangladesh have covered, the 'combat indicators'[3] we identified in terrorist actions or related incidents since late 2014 have clearly demonstrated the entrance of transnational terrorist groups into the country.

The focus of such groups, expressed in simple terms, is to cause maximum disruption in Bangladesh [4] so as to facilitate the opportunities for them to pursue their own extremist political-religious agendas.

ISIS' strategic ambitions for the country, for example, are to use it as a bridgehead to realise its regional goals, and these will be pursued aggressively to say the least.

ISIS and the local groups it has co-opted will look to induce as much volatility as possible, and to take the fullest advantage out of it.

[3] Devices used, tactics used for attacks, sophistication of IEDs, serious change in attack lethality, patterns of terrorist arrests coupled with location and presence of foreigners, change in targets, use of media, direction of ideology

[4] See January 2016 ISS Risk Special Report Bangladesh http://issrisk.com/research/south-asia/

Question: The Holey Artisan Bakery attack – can we expect a repeat of this?

Effective analysis of the trends in political-terrorism risk space in 2015 and early 2016 all pointed to a 'spectacular operation' as being a major objective for ISIS in Bangladesh. Yet, the July 2016 attack in the Gulshan locality of Dhaka, in which 29 people were killed (several of the foreigners being textile / garment buyers), was analysed and reported by the risk industry and media as being 'wholly unexpected' and the presence of ISIS in-country a revelation!

Clearly such comments reflect weak risk scenario analysis frameworks, as the terrorist's primary objective for the attack – achieving global attention by targeting foreigners – was missed.

As opposed to being able to 'respond' to the attack, the majority of companies were left to simply 'react' to the incident from an under-informed position.

Fast forwarding to 2017, one body of data reaffirms the importance of including geopolitical risk factors in predictive risk assessments for the garment sector: a pool of more than 200 terrorists or their supporters, with large concentrations in Dhaka and Chittagong[5].

The threat is far from disbursing any time soon for the garment sector's personnel, assets, business operations, business strategy, logistics costs, security costs and strategy, and insurance costs.

They are planning, waiting for the opportunity to strike but also spreading their capacity significantly to do so.

Transnational terror threats be they from emerging links to extremist groups and terrorists in Assam in Northeast India or amongst the Rohingya of Myanmar, or direct links between indigenous groups and ISIS, are set to increase.

Without question, the prospects for further spectacular attacks involving foreign nationals as targets is increasing in tandem to the threat from their improving militant capabilities, terrorist techniques, tactics and procedures.

These terrorist groups thrive on the oxygen of publicity for their cause, they are never not getting enough air or coverage. They have a desire to have their cause recognised and they need the legitimization from the global jihad too. Therein further attacks against foreigners and their business interests is the means to do so. The garment sector should consider itself a prime target.

So, less static, more dynamic risk management … what's this going to do for my bottom-line?

In a country, such as Bangladesh, increased geopolitical risk can impact an export industry's operational costs near as

[5] http://issrisk.com/wp-content/uploads/2016/12/ISS_Bangladesh_execsummary.pdf

heavily as economic ones. Increased geopolitical risks mean increased banking costs, the need for costly changes in logistics-transportation strategies, surges in security related costs, more comprehensive insurance policies, and above all the threat of a collapse in operational capabilities.

Banking costs – direct and indirect risks

'Complicated relations and discussions' with both bankers over borrowing costs and the structure of loan facilities will appear should business operations be suspended or assets damaged owing to the following:

- Terrorist acts
- Political party rivalry related rioting
- Militant labour actions spurred on by political parties ahead of elections

Such situations rarely end up working in the borrowers' favour.

Similarly, should the country's sovereign rating move from Stable to Negative outlook or suffer a rating downgrade owing to a perceived failure to qualify for the EU's GSP Plus programme in 2021, firms with high exposure to costs in Bangladesh will ultimately see their own credit rating pressurised by the potential drag on revenue from Bangladesh being a 'more expensive country'.

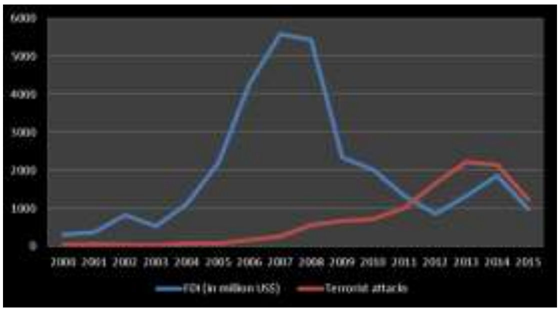
Ultimately even with most MNCs or global firms borrowing far from Bangladesh, the lender will understand your business model, and will most certainly factor in the risk environment of the ultimate destination or majority use of the borrowed funds and / or debt capital.

If Bangladesh presents risks that the banker believes legitimise the renegotiation of loan terms and fees (i.e. force up), a firm which has a better appreciation of the risk situation and various worst-case scenarios itself is far better placed to push back on such attempts by their bankers or to at least reach a more amicable solution.

Supply chain disruption – direct and indirect risks

Many garment industry players looked at Vietnam, Cambodia and even Kenya when the terror attacks of 2016 hit Bangladesh. The reality is that should an escalation in terrorism risk and associated political risk occur, further increases to transportation and logistics and even added security costs (security for convoys) can be absorbed, but not infinitely. Also, delivery failure is a reality which producers in a neighbouring south Asian country faced not too long ago, and their garment industry has never recovered.

Fifteen years ago, who would have expected "Made in Pakistan" (a country in 2002 that endured less than 60 terror attacks in that entire year) to have fallen so rapidly from global retail stocks, with a large part of this due to a multitude of political and geopolitical risks and their direct and indirect impact on the country's economy and security? Pakistan is continuing to see itself less and less included in the global value chains of the garment industry because of ongoing political risks.



Foreign direct investment and terrorist attacks in Pakistan, 2000 - 2015

Taking FDI as a proxy benchmark for confidence in the country's security and business risk environment, one can see above in quantitative terms the direct correlation between increased political risk and terrorism incidents, and fall in business confidence.

Predictability and stability in one's supply chain are difficult enough to be guaranteed in a stable developed or developing economy, but in a less developed country the impact of volatility from political risk on 'delivery of goods' is that much higher.

The costs of delays in production or need to change supplier or increase in costs of supplier each speak for themselves as to why being able to interpret geopolitical risk into economic and financial business risk is paramount for a firm which relies on Bangladesh as part of its global supply chain.

Insurance costs – indirect risk

With how indemnity coverage is structured and the access to necessary data for underwriters to make their decisions, it is no surprise that insurers quietly declare they have only a 'sufficient' line of sight on political risks, political violence and terrorism in Bangladesh.

Official data is a struggle to work with, if and when available. Therein the costs for coverage will be adjusted to fit such a situation. As with a firm's banker, a direct financial-business risk for a firm is an increase in insurance costs when 'unexpected' political or terrorism risk events occur.

Having a better awareness of geopolitical trends in Bangladesh will allow a firm with dependence on manufacturers in country to better plan their insurance coverage strategy.

The value and size of the physical assets and personnel in the impacted country or the value of the link that the country represents in a group's global supply chain, all contribute to the understanding of the overall risk rating. Therefore, the most robust and comprehensive risk assessments should take account of the diverse variables that may or can impact the said value.

Final takeaways

Be it a lack of consensus or a myopic decision to appease the business community until after the 2019 elections that is causing ineffective factory safety reforms, a forward-looking and comprehensive risk assessment is needed nonetheless by the global garment industry.

The 2021 deadline for doubling domestic garment production and the EU's GPS Plus qualification or failure rest very much on the political economy of the country. A garment firm looking to protect its business and manage its risk dynamically must have a cross-risk assessment methodology that takes into account the following:

1. An ability to view and analyse current political events and incidents through a short, medium and long-term risk lens
2. Risk scenario building and testing capabilities, where geopolitical risk and terrorism risks are fully integrated
3. Risk mitigation strategies that are based on holistic assessments of direct and indirect risk factors from geopolitical and terrorism risk
4. A perspective on the ability of the government to affect labour and safety reforms in the garment industry and to effectively counter threats from terrorism
5. A line-of-sight on transnational terrorist groups given further 'spectacular attacks' in Bangladesh are expected and the country's garment industry will be directly targeted regardless of government assurances to the contrary

A robust 'risk radar' that can identify risks effectively and in a timely manner is a must. The right risk data will allow for better management of critical supply chain links and operational costs.

Failure to build and continue to monitor risks the right way is a sure-fire route to a company being left to react to events as opposed to being able to re-strategize and plan a response to issues that directly or indirectly affect their business.

Please contact phill.hynes@issrisk.com for more information on how we can help your company assess the financial risks of political risk and terrorism