Political risk

Coming to grips with political risk

In the past, the concept of political risk has been somewhat obscure. Applications with relevance for day-to-day management have not been entirely clear. However, political events in early 2017 have fuelled the conviction that political risk is entering the global agenda again. Risk management instruments as established in the past require sharpening and need to be integrated into management routine.

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Political risk or geopolitical risk is of increasing concern. From a Western perspective, we have experienced peace and increasing wealth in recent decades. Political risk has been basically discussed in the context of developing countries. As such, this has been of limited practical relevance for day-to-day management. Shifting political preferences can be perceived in all global regions. Two major events have caused a debate which political risks we will need to face in the future.

- **The European perspective – Brexit:** The UK vote to leave the EU has come unexpected. There is a fear that in 2017 the EU might further disintegrate in the light of upcoming elections and fiscal instability.
- **The US perspective – Presidential elections:** The victory of the Republican candidate had not been expected by the polls. The new president is not only rolling out his domestic agenda. Other global regions are learning that the new US administration continuously adds new TOPs to global agenda.

So, is this covered by today´s understanding what political risk is? Are the tools available to add political risk to the management agenda?

Well established political and country risk landscape

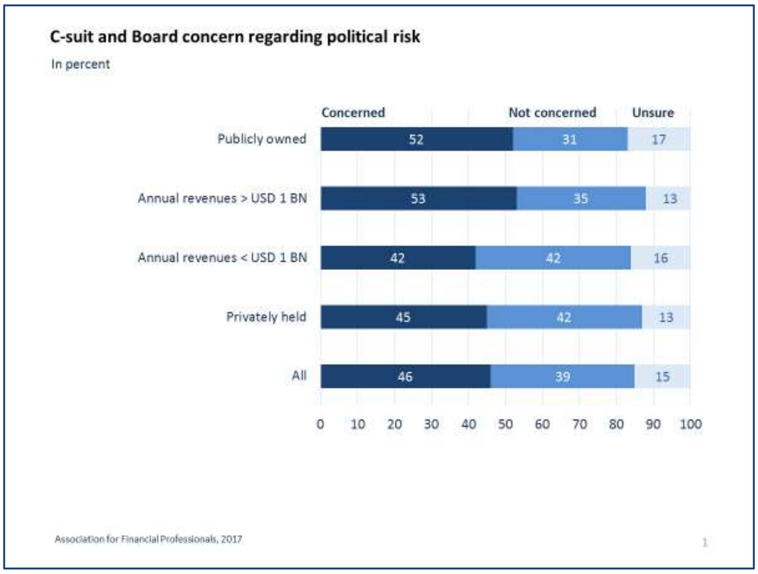
Yes, there are surveys and tools which capture political risks.

- **Country risk ratings** capture political risk on a country level. These are meant to inform investment decision making covering dimensions like legal stability, capital movements and default risk. These ratings provide little information about how businesses might be exposed to the evolving political risk and how these could be mitigated. Examples are e.g. Financial Times, Association for Financial Professionals, EIU, Euromoney, World Economic Forum.
- **Risk inventory** in companies covers some aspects of political risk but certainly not the dimensions of the evolving political risk landscape. Risks in the risk inventory typically follow a geographic structure. Some political risks in the general discussions are somewhat generic and are difficult to handle in a specific company context e.g. `failing states`, `armoured conflicts`.

But a new class of political risks is evolving which can be summarized as `decreasing political consent`.

`Decreasing political consent` - the evolving political risk

In Europe, new evolving political movements can be observed. Public opinion is shifting away from established political players. Consequently, new alliances and priorities are possible. Although economic well-being has increased across the board, social and geographic disparities are mounting. The new US administration is putting established policy areas to the test. It is quite articulate about potential future policy changes.



- **Global free trade** – Free trade agreements are challenged and a revision of corporate taxes and customs regulation with the intention to foster domestic business activity are to be expected. The changes seem to be in line with the general WTO framework. However, the new trade policies might impact security frameworks e.g. in APAC the role of China. As a result, Europe as a trade partner for countries in the region might be elevated further.
- **International security framework** – not only the Transatlantic Alliance is being questioned. The new administration signals that it is willing to move away from the current frameworks in APAC and in the Middle East. These movements are paired with mixed signals threatening or appeasing rivals not ruling out sanctions or even interventions.
- **Stability of foreign relations and multilateral political agreements** – Foreign relations in NA are being redefined. The policy framework regarding Russia and the Middle East is not clear yet but seems to be patchy and volatile. Europe will be affected whatever this framework will look like. Current communications suggest that the role of the EU is viewed as an economic adversary rather than a construct which has secured peace in Europe for quite some time now. Separation from the union is being supported (e.g. the Brexit).
- **Regulation of financial markets** – The administration intends to review and change some of the financial market regulation which was created after the financial crisis. Indeed, there are good reasons to review the regulation and its effects. Concentration of large banks has increased – this is the opposite what was intended with the regulations. As small and medium sized banks have been shaken out, loans provided to SMEs have decreased. On the other hand, international consent how to regulate financial markets and how to create a level playing field might be at stake. The Brexit will also leave its mark on financial market regulation with still uncertain outcome.

In the US and in Europe, the reason for a changed for a policy mix is routed in an increasing economic disparity.

Although some of these policy goals are controversial, also agreement to challenge established policy frameworks across thriving new political forces across regions and across the Atlantic can be observed.

Because of a changing policy environment, political risk becomes more relevant.

In Europe, political risk has become more important as well. Different elections will take place in 2017. Most importantly presidential elections in France and Germany will influence how the EU will develop further. Elections in Hungary and in some SEE countries will determine how stable the union is at its borders. Given increasing East-West tensions this will also have security implications.

As the financial recovery of Greece does not develop as planned, the stability of Southern European countries is back on the agenda foremost Italy, Iberia and Cyprus.

Immigration policies remain unaligned between the European partners.

The question is whether Europe will succeed to better form and execute common policy goals and hence strengthen the union or whether national interest will prevail increasing the likelihood of the union to further disintegrate.

Especially C-suit executives and boards are concerned that political risk might influence their financials significantly. Hence, they are convinced that their companies should prepare to mitigate political risks.

Observations on the evolving risk landscape

In early 2017 the signals are mixed. The expectation that a change of the US administration would send equity markets downward, has not materialized. Quite the opposite has happened.

Additionally, since the election, equity market volatility is low.

So, is the debate about political risk overheated? We would argue that it is not.

The short-term market effects are driven by announcements of low US taxes compared with targeted expansionist government spent in a low oil price market environment. These would also create a global stimulus.

On the other hand, policy effects driven by political dissent as described above and to a degree sympathized with by political forces across global regions might have a contracting effect according to the economic rule book.

One should also be reminded that risk is not just the downside risk but also a potential upside. Maybe this is what we observe in early 2017.

Implications for the risk management approach

Clearly, country risk ratings provide political risk information in a highly-aggregated form. As such, they are insufficient to provide guidance how to mitigate risks. They need to be complemented by some explicit understanding which allows to link company operations to the risk perspective.

In the case of changing political forces and regulatory interventions, political aspirations need to be broken down into policy areas.

A good understanding of the solution space and trending within given policy areas allows to take a much more pragmatic approach to political risk management. Potential outcomes and implications for the company can be assessed.

Impacts for the company can be linked to functional and business areas. Therefore, the financial impact of risk can be assessed.

- **Example 1: Sales –** How will new US customs regulations or an amended tax scheme influence the companies top and bottom line? Will it lose some of the export markets due to political instability? To which degree does local regulation facilitate or protect market access?
- **Example 2: Global supply chain and manufacturing footprint –** Are global supply chains stable? Are they exposed to geopolitical frictions? Will changing taxation require to restructure them?
- **Example 3: Workforce –** Will it be possible to continue to source the qualifications needed at an attractive price point?
- **Example 4: IP –** Is it possible to protect the property rights of the firm against private and public interference?
- **Example 5: Currencies –** To which degree will the company be affected by politically induced changes of exchange rates and the oil price? Can some trends be observed e.g. due to changes in monetary policies?
- **Example 6: Cyber –** Beyond traditional cyber risk, will increased cyber activity by governments and secret services face an increasing threat for my company operations and financial interests?

Some tangible actions can be initiated

What initiatives should companies pursue to better manage political risk?

1. **Build out political risk landscape:** Get a better understanding about how political intentions might translate into policies. Build an expectation about how different political stakeholders might behave
2. **Prioritise expected policy changes regarding the potential impact on company:** Concentrate on risks which have a high likelihood and relevance to the company (e.g. alignment with geographic company footprint); schedule reviews for risks currently being deprioritized
3. **Update risk inventory:** Integrate new type of risks into the company's risk register and evaluate the risks (likelihood and impact). Potentially amend parameterization of risk which are already in the current register (e.g. increased exchange rate volatility, corrected assumptions on GDP growth and interest rates)
4. **Discuss mitigation actions:** Make mitigation actions part of the ongoing risk discussion and performance dialogue. Assess the benefit of proactive defensive strategic moves (e.g. lobbying, communication, rebalancing of operations)

And ... don´t forget to cover the upside of political risk

As the risk inventory is being updated not only the downsides of risk should be looked at. Potential opportunities should be considered as well. Here are some examples.

As mentioned before, recent political developments have stimulated **capital markets.** This stimulus might continue to exist if US companies get more traction and benefit from the announced policy goals.

Banking in NA will most likely face more beneficial conditions compared to the previous years.

The Brexit is already causing the **relocation of financial services businesses** to other European geographies.

The **trade between China and Europe** has been growing and is expected to grow further especially if the US policy position on China and some of the APAC countries remains.

In case we would face a further disintegration of the EU, countries deciding to leave the union might become more **attractive as locations for production.** Production costs might decrease due to the devaluation of the local currency or fiscal policy changes (if bilateral trade agreements will still soften the burden of leaving the union). Today, this is not a very likely scenario because it contradicts the fundamental believes of the union.

However, the recent past has taught us that we live in a dynamic environment and that what seems unthinkable today should already be anticipated.
