Oxford Analytica

Political risk: best practice for companies

Oxford Analytica Conference Call summary

Political risk is rising and getting more expensive for companies. It is now more relevant to a wider range of sectors and is engulfing both emerging as well as advanced economies.

How should executives and shareholders respond? What is the best practice to mitigate and avoid political risk?

Every year, in partnership with Willis Towers Watson, Oxford Analytica publishes a survey on how leading companies are managing the current political risk. We will try to address the main findings of the 2018 survey.

What are the key findings of the 2018 political risk survey?

Last year's Political Risk Survey came about for two main reasons.

- Not only is the current period characterized by elevated political risks, but perhaps more importantly, partly for many of our Western-based and corporate clients, political risk has now spread to markets in North America and Europe. These are markets where the management teams are more used to dealing with economic risks (inflation, cyclical downturn, cost pressures) than political risks (local content requirements, sovereign risk, changes to government).

- Do corporates have the necessary expertise and organizational design and culture to effectively report on and manage political risk?

Based on this focus, there were three main findings:

- First, investors are beginning to ask the board and management more questions about corporate footprint and exposure to political risk.

- Secondly, the risk function (namely the country risk and ERM functions) is often used as a compliance function, and not considered central in the decision-making process.

- Thirdly, the risk function was typically engaged with only when a risk was in the process of being realised or had already been realised.

The situation identified in the second and third points was experienced by the big banks' market risk teams before the financial crisis. The emphasis was on revenue growth and, therefore, the power rested with the sales and trading teams; the market risk function was used primarily for sign off purposes. Over the last ten years though, the banks have tried to put more emphasis on proactive risk management and transparency.

Having confirmed that there is a problem, this year the survey tried to understand the size of the problem.

35% of the companies surveyed reported a recent political risk loss, either related to a top line revenue impact or an asset impairment. This figure grows to 55% if the focus is on companies with a billion dollar, or more, in revenue. 43% of companies that experienced losses reported losses of more than a 100 million dollars – including reported losses of 700 million dollars. In many cases, the loss is reoccurring, not a one off, and if political risk is managed more effectively, there is a meaningful amount to be saved.

With regard to parts of the world where companies experienced losses, the main findings point to Russia, Iran, Iraq, and Venezuela. Yet countries where the business environment is considered as improving also appear to be high risk countries. For example, in Colombia and Vietnam, concern is growing around the disconnect between local and national priorities; locally, the emphasis is on the preservation of the local environment, good jobs and access to services, while nationally it is on attracting FDI, improving infrastructure, and building up hard currency.

Finally, the trend of avoiding and reducing investments as well as pulling out of markets is the path of least resistance when it comes to risk management. This is not always a wrong approach, but it is worth noting that the identified list of companies includes all the BRICS, except India, together with Sub-Saharan Africa, Eastern Europe and Asia-Pacific. Since a large part of corporate valuation is premised on the idea of growth in these higher-risk but higher-growth markets, this approach should be evaluated closely.

Our expectation is that investor pressure will grow on such issues to ensure that companies remain focused on the bigger picture; this will require changes not only to how companies report geographic exposure, but also to how they are making decisions and pricing political risk.

How are companies changing their view on managing political risk?

A number of companies are completely avoiding or downscaling in certain countries exhibiting high risk. Political risk management aims to mitigate or reduce the potential risks companies could encounter in such countries.

The extent of the losses experienced by 43% of the surveyed companies is significant, even for the larger companies. How many of them though are insuring their exposures? A large number of them. The remaining are possibly looking at political risk in terms of a 'high severity-low frequency' scenario, counting on the few chances of being influenced directly. It is, however, evident that the chances of not experiencing losses for 2-3 years are currently almost non-existent. From 2007 onwards, insurable losses have totalled nine figures or more. Therefore, given the current global landscape, the 'high-severity' risks are near.

What are some top global and country risks?

Key risks that dominated the corporate and policy agenda in 2018 – and are likely to be on the agenda in 2019 -- are populism, disruptions from a rising China, and the crisis of emerging markets.

The election of US President Donald Trump, as well as Brexit, brought populism to the centre stage of the political debate. The type of populism on which these two events were based is rooted in a new version of nationalist pride, in a rejection of economic globalisation and in a backlash against immigrants (including economic migrants). In Western Europe, this trend is more visible in the United Kingdom, Austria, Italy and Sweden and to an extent in Germany and Spain. In Central-Eastern Europe, populist parties came into power in Poland, Hungary, and Romania. The feeling of having missed-out from the promises of globalisation and transition from communism, and the belief that elites are trying to change traditional society in unacceptable ways through the influx of migrants, are at the heart of this trend, as well as inequality.

The picture of populism is much more nuanced though; sometimes the picture of the rise of nationalist-based populisms may be overdone. Populism seems to be under control in France, the Netherlands, Denmark, and Norway. In other important economies, it seems dormant, including in Ireland, Portugal, and Switzerland. Even turning to the United States, where the rejection of globalisation has manifested most notably into the trade war, globalisation is not being fully rejected. The Trump White House is calling on countries such as India to not impose data localisation.

In other parts of the world, polarisation is a better register of analysis. Populism is not new to Latina America. In the second round of the Brazilian presidential elections on October 28, Jair Bolsonaro is likely to win. What's indeed new is the rise of a right-wing populism that is replacing the left-wing variety. His appeal lies in a backlash against pervasive corruption, against the failure to deliver continued growth and improved service provision, not in a nationalist pride of the kind that fuelled Brexit. In Asia, Indian Prime Minister Narendra Modi won the 2014 elections and is on track to win in 2019; his appeal also lies in anti-corruption and development promises.

Similarly, Pakistani Prime Minister Imran Khan turned popular backlash against corruption into a winning campaign. What these leaders have in common is their polarising discourse: they make consensus-based policy-making harder. This political polarisation will likely make the policy landscape more volatile. They accurately captured the public sentiment and offered policy proposals that address popular grievances but will not necessarily deliver on them. For example, Pakistan's Prime Minister Imran Khan promised Pakistan would not turn to the IMF again, but, weeks after his victory, he did the opposite.

Polarisation of politics is a key risk to watch in coming years. It is a much more useful register of analysis than populism, with more pervasive and risky consequences.

A second fundamental risk is China's rise and the disruptions it might trigger. China's global ambitions are wide-raging. The Belt and Road Initiative, launched by Chinese President Xi Jinping in 2013, best exemplifies this ambition. With Europe being the final destination of this project, China is engaging with all countries along the road, from Pakistan to Iran, Central Asia, Middle East, Central-Eastern Europe and Western Europe.

Resistance to this engagement and to the influx of Chinese money is rising. The EU had been quiet up until now, but it has recently developed a policy designed, in part, to complement China's development project, but equally to compete with it by offering an alternative to Chinese partners. This policy attempt, being a cautionary note from a global power, also aspires to influence China to follow international norms on human rights, on labour and market rules, transparency in financial transactions.

Developing countries too are showing more and more resistance and scrutiny towards Chinese investments; Malaysia, for example, has recently cancelled a 20-billion-dollar railway line under construction by a Chinese company. In Pakistan, the petroleum minister confirmed Saudi Arabia is going to build a new oil refinery that will not be part of the China-Pakistan Economic Corridor. Japan also is pushing back against China's influence, most notably cooperating with India on the Asia-Africa growth corridor and committing to invest 100 billion dollars over the next five years.

On the military front, China's activities in the South China Sea are the most striking aspiration. Claimants such as Vietnam are pushing back, as our non-claimants, including United Kingdom, France, Australia and India. China's influence is expanding, but the push back is also intensifying both from an economic and geostrategic point of view.

Like many emerging markets, namely Turkey, Latin America is at risk from changes in US monetary tightening. The need is to look at country specific factors that could exacerbate the shocks that come externally. The Argentine peso has been the worst performing currency this year. Argentina, though, has a history of debt defaults and has suffered from a longstanding domestic lack of confidence in the peso. The basic formula to which Argentina is used, namely raising debt, falling exchange rate, IMF bailout, recession and then austerity, is a cycle. In Brazil, the main concerns relate to domestic policy and Bolsonaro's unproven liberal-economic credentials.

In Africa, debt-distress characterises many Sub-Saharan countries, like Mozambique and Congo. The key issue will be to look at country-by-country dynamics and to wait for when, in 2020-21, many ten-years coupons are due for repayment. Ghana will perform pretty well and Senegal will be able to solidify its position.

Where is political risk developing in the future?

In the current environment of the emerging market crisis and sovereign debt defaults, the global liquidity cycle is turning with a tightening in the United States, with the euro-area expected to follow suit in about a year. The emerging markets that benefitted greatly from the intense global liquidity of the past ten years are now suffering: this started to manifest with defaults in 2017, in Chad and South Sudan, in addition to Congo and Mozambique going into severe debt distress. This year, this trend spread to large but vulnerable emerging markets, such as Argentina and Ukraine.

The main concern refers to a repeat of the tightening cycle of the 1980s that led to a wave of sovereign defaults (Mexico, Venezuela, Chile, Brazil) and of a debt crisis that spread globally to Ghana, the Philippines and Turkey, with 20 defaults per year and over 140 debt defaults in total. Will the current liquidity tightening result in a similar cycle of defaults? More losses will come into the market from this and the tightening is expected to continue.

Trade risks appear on the radar too. Most of the trade risks have to do with sanctions and policy changes, which will impact investors and triggering losses in emerging and frontier markets.

With regard to political risks in advanced economies, Greece represented the first political risk loss in an advanced economy. In 2016, the second highest losses were in Spain, an advanced economy. Speculatively, more political risk losses will affect advanced economies.

Questions:

How is the definition of political risk widening, from including civil rights risks to regulatory and corruption issues?

The definition is certainty broadening in scope. It not only refers to traditional sources of political risk related to expropriation, import-export embargoes, but also political risk in the form of economic and social fragmentation. From a corporate perspective, companies are positioning themselves to win by more directly connecting themselves to consumer values. There is a shift from the emphasis on consumer experience to consume values.

This plays into how companies are messaging themselves, the Kaepernick-Nike story in the United States is one example. Kaepernick, an American football player, demonstrated against social injustice and police brutality. He is now one of Nike's brand ambassadors. The messaging made subtle references to refugees, family values, immigration, and disabilities. Nike, along with many other companies, has accepted the view that by focusing on a particular demographic and set of values it can win.

Economics and politics are intertwined. Corruption, not a traditional political risk, may on the contrary become evident when that risk manifests itself. The scope of corruption in Brazil, both related to the corporate and governmental sector, has created the current political landscape. From an insurance perspective, it is becoming more complex.

How are political risks around environmental issues and green assets regarded?

The greens assets (wind and solar activities) face most of the political risks faced by any power producer. A mix of payment and expropriation risks are related to these assets, similar to traditional producers. They differ from normal power projects on the subsidy issues.

With regard to the climate issue, high risks are related to the condition of the crops and the supply of water for example, which also has a greater influence on the movement of populations. Are climate-related risks becoming more of a concern to companies? Growing concerns do not present themselves in this form, but climate issues may be the driver.

How should NGOs and non-profits regard political risks?

The NGO and non-profit sector is very diverse. There are lessons from the private sector that the non-profit sector can very usefully consider. Specifically, in regard to the pressure felt by companies to align themselves with consumers' values, the private sector has an advantage. By definition, NGOs work in a neglected sector which is inadequately covered by government policy and global governance structures, but it is not always the case that NGOs are aligned with their consumers. In regard to gender representation, for example, NGO boards are not taking the same measures and pledges some large private sector companies arein terms of board representation and senior management.

The second key lesson that this sector has to learn is to prepare for policy volatility. Political risk is nowadays increasingly affecting advanced economies too. This is resulting in policy volatility. NGOs should prepare and consider ever more carefully these changes, both in advanced economies (where the Trump administration is cutting funds to the family planning projects) and in developing ones (where Brazilian Presidential candidate Jair Bolsonaro has spoken against LGBT rights, and the Indian government has gone after NGOs working on the green movement).

What is the role of multilateral agencies? Can they mitigate political risk?

It is known that if a multilateral agency is involved in an investment (as lender or insurer), then it does improve the investee's ability to mitigate losses. Countries that are interacting with multilateral agencies, in bailout or lending programmes or in technical advice, do not want to antagonise the multilaterals.

In regard to the sustainable development goals (SDGs), multilaterals are indirectly helping sovereigns mitigate political risk since they are working with both the non-profit and governmental sector to implement them. The fact that more and more multilateral banks are incorporating the SDGs into their investment model is a way to help their government partners mitigate the related political risks.

Conclusion. What is the most practical piece of advice on how to mitigate political risk over the coming year?

A key step is to quantify the financial exposure that the company is running. Then, gathering information and data around the potential risk that a company may be confronting in that regard. Finally, examining the risk of the organization and what degree of severity is bearable. At that point, a mitigation strategy can be selected.

It is also important to place a lot of emphasis on how political risk is communicated internally. There should be a focus on how it is quantified and on how a company can get key functions of the organization to engage with it.