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Managing Political Risk

Controlling Loss, Finding Opportunity

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Recent developments have provided a stark reminder to organizations that political risks can affect their activities, objectives and profitability.

Crises such as the Eurozone negotiations, the debt ceiling debate in the United States and the Arab Spring protests throughout North Africa and the Middle East took form rapidly and with little advance warning. Threats by the Iranian government to close the Straits of Hormuz have had a direct effect on oil prices. Other types of political risk—including state actions to promote state-owned companies; tapping into the cash flow of companies operating within national borders; and erecting trade barriers—have re-emerged and pose significant problems to many companies.

Yet, while the management of financial, market and other types of risk has become a paramount business consideration since the economic crisis of 2008, Accenture's 2011 Global Risk Management Study found that most companies do not measure—or manage—political risk. Organizations tend either to accept these risks, or to avoid opportunities altogether when they pose large political risks. The management of political risk, however, can be a competitive differentiator that enables companies to enter and navigate new markets and business environments.

Accenture believes that political risk management can be integrated into existing Enterprise Risk Management (ERM) systems, yielding a number of benefits, including:

- Lower risk management costs through more rational hedging and insurance purchasing;
- New revenue streams obtained through access to markets that would be too risky without risk management support;
- Increased ability, confidence and organizational buy-in for growth strategy in frontier markets;
- Improved performance of existing business in emerging markets; and
- Loss mitigation through improved crisis management.

Organizations can now quantify their political risk exposure in order to design the most effective risk management strategy.

Defining Political Risk

Political risks are uncertainties to business objectives created by political actors or political conditions. Political risks can stem from governments, but also, as seen in Figure 1, from non-governmental organizations (NGOs), state-owned enterprises (SOEs), trade unions and other groups that pursue political objectives.

Figure 1: Types of Political Risk

Risk Types	Examples
Bribery	- Forced hiring of 3rd-party consultants for contract bids - Unforeseen border "taxes"
Capital Controls	- Limits on profit repatriation - Administrative delays in approving capital transfers
Contract Default	- Politically-driven debt default - Politically-driven failure to deliver on a contract
Expropriation/Nationalization	- Confiscation of a plant due to "unpaid" taxes - Forced sale of asset(s) to government buyer at below-market prices - Politically-driven increase in state ownership of joint ventures
License Cancellation	- Change to organization's License to Operate ahead of an election - Loss of Social License to Operate from lack or loss of local community support
Protests/Strikes	- Industrial action and work stoppages at key supplier(s) - Anti-government or anti-company protests and road-blocks
Regulatory Change	- Complex new environmental or labor standards - Regulatory enforcement authority handed to a state-owned company
Taxation	- Windfall taxes levied over "excessively high" profits - Duplicate tax claims by/between central and local governments
War and Terrorism	- Border and road closures due to interstate fighting - Politically motivated terrorist attacks against foreign investors

Figure 2: Common Manifestations of Political Risks

	Regulation and austerity measures	Cash flow expropriation	Social license to operate	State-sponsored competitors
Advanced Economies	Protection of national financial institutions or companies; evolving regulation of financial institutions Recent examples include increased regulatory scrutiny of oil and gas companies in Alaska leading to project delays	Various forms of taxation (on transfer pricing, windfall profits, etc.) Recent examples include windfall taxes in Australia	Social/environmental opposition to economic projects; brand-based boycotts Recent examples include opposition to shale gas projects in North America and western Europe	Quotas/tariffs, competition laws; government lawful stakes in public companies Recent examples include blocked mergers in "strategic" industries (e.g., transport, agriculture, energy) in North America
Developing Economies	Safe haven regulation; regional or bilateral agreements Recent examples include red tape affecting levels of foreign direct investment in the former Soviet Union, Asia and Latin America	Asset expropriation; compulsory partnerships; retroactive fines Examples include regulatory changes to increase government stakes in mining projects in Africa	Indigenous opposition to economic projects Recent examples include delayed or abandoned manufacturing projects in Asia	SOE merger and acquisitions (M&A) activities; Promotion of private national champions Recent examples include support for Chinese, Indian and Russian state-owned enterprises tied to development aid to African and Latin American governments

Political risks are taking new and previously unexpected forms.

They are increasingly a factor in advanced as well as developing economies. In advanced economies, governments are dealing not only with real and perceived income inequalities but with high levels of sovereign debt, as illustrated by the Eurozone discussions, the U.S. debates over the debt ceiling and tax policy, and the imposition of windfall profit taxes in Australia. The potential outcomes of the Eurozone discussions are being driven by politics as much as economics.

In emerging markets, resource companies have faced contract reviews as commodity prices remain high by historical standards and governments seek a larger piece of a growing revenue pie. State-sponsored competitors from countries such as Russia and China—armed with finance and incentives from their governments—can alter the competitive landscape in many industries. Figure 2 outlines how some key political risks manifest themselves in advanced and developing economies.

One of the most challenging forms of political risk is the loss of the Social License to Operate. Community opposition to projects such as the Keystone gas pipeline in North America can create extensive delays and add significant cost and complexity to already challenging initiatives. At the extremes, political upheaval can make it unsafe or impractical to do business in a country or region.

Another increasing risk is cash flow expropriation sometimes a product of "resource nationalism" in the energy and mining industries. In contrast with expropriation drives seen in the 1960s and 1970s, where governments took over physical assets such as mines and manufacturing plants, today's expropriation policies target cash flow. Cash is less costly to manage than physical assets, and its expropriation often takes place through regulation. For example, many governments have increased taxation over transfer pricing within companies, required companies to partner with local firms for specific activities such as processing (providing a hidden subsidy), or have applied retroactive environmental or health and safety fines.

Political risk is a major concern for companies in a wide range of industries. A recent World Bank study indicated that more than half of all organizations believe that political risk will be the most important constraint on investment in emerging markets. In the same study, however, most of those organizations indicated they have no way of measuring political risk and do not integrate it into their approach to risk management.

Managing Political Risk: A Three-Stage Process

Many companies mistakenly view political risk as something esoteric and "different".

By extension this leads them either to accept losses or to avoid risky environments associated with political risk, because they believe political risk cannot be measured and managed. Accenture contends that, in a three stage process aligned with most company approaches to risk management, risk managers can identify key political risks, measure their potential impact on performance, and determine the best method to manage them. This process allows risk managers to align specific risks in their portfolios to the most appropriate responses, in turn increasing operational efficiency, reducing losses, and aligning risk with overall business strategy.

Stage 1: Identify

In Stage 1, risk managers identify the main political risks by geography. The key question at this stage is: "How can political actors or conditions directly affect our objectives?" Risk managers can refer to a roster of political risk types, such as those in Figure 1, to scan the horizon for potential risks. Asking this question helps risk managers challenge inherent biases within the organization and determine whether threats are realistic.

An important part of political risk identification lies in separating "headline hype", or perceived risk, from real political risk. Some situations may create significant political or social instability but few real implications for the business; they may, in fact, present an opportunity to gain market share. For example, in India, political risks vary significantly from state to state. Some states have had highly publicized conflicts with some foreign companies but also offer significant investment incentives, such as a highly educated workforce. The ability to manage political risk therefore unlocks an investment opportunity.

In the Identify stage, the risk management team will develop an evidence-based set of risk scenarios, based on both well-defined and highly specific data directly relevant to the company's objectives. Data can be drawn from high-quality political risk consultants, local subsidiaries and partners, the public domain, other companies, industry associations, local organizations, and other sources. Larger companies will often use specialized data-mining software configured for their specific business.

A scenario set gives risk managers a basis to define their data requirements. For each scenario, risk managers should use political risk expertise to help them assess and monitor risks. Specifically, they should define what events would influence the probability of each scenario. This work should be carried out to a high level of detail and structured to help eliminate "noise," or excess information, with data requirements likely to change over time.

Once the organization establishes a broad political risk scenario set, the risk management team can prioritize those risks that are most material to the company's business. Although most often the criteria used for prioritizing will be a simple combination of probability and impact, other criteria may include recent losses, board-level concerns, or high vulnerability to extreme events.

Stage 2: Measure

In Stage 2, armed with a very specific set of political risk scenarios, risk managers assess and quantify the impact of each scenario on the business. Discounted cash flow (DCF) analysis can be used, for example, to estimate the financial impact of specific events. In this method, analysts estimate how political risks—such as a change in tax rates, regulation-related spending, delayed timelines or costs of partnering with state-owned enterprises—would increase or decrease cash flow.

Other tools, such as an organizational network analysis, can help determine the estimated operational impact of specific risks. Here, risk managers create a model of the company as a network of various inter-dependent business units; a consumer goods company might have manufacturing, packaging and distribution across countries, for example. Then, analysts model how a loss to one business unit would affect the others, qualitatively, quantitatively or both.

Finally, to estimate the organization's current ability to manage risks, risk managers can deploy an ERM diagnostic tool. Accenture's own ERM diagnostic measures risk management maturity along five dimensions: Risk Organization & Governance, Risk Strategy & Process, Risk Analytics, Risk Reporting, and Risk Data Management.

In the Measurement stage, political risk management increases the accuracy of capital performance estimation and also reveals opportunities for investment of capital and management resources. One of the most important aspects of measurement is the translation of projected events into readily identifiable and comprehensible metrics, such as dollar figures, an impact index, or an ability-to-influence index. Using these metrics, risk managers can assess whether the risk level surpasses the organization's risk appetite, or tolerance. Based on this input, a decision is made on whether to accept, avoid, or manage the risk.

Figure 3: Sample of Political Risk Management Controls

Political Risk Control	What is it?	Typical owner	Question(s) when considering this control
Portfolio Diversification	Diversify investment portfolio using political risk as a key factor	Chief Financial Officer (CFO) and Business Development Officers	Would diversification increase other risks?
Political Risk Insurance	Insurance policy covering a number or political risk types (e.g., expropriation, political violence, etc.)	Risk Managers	Is insurance available for the political risk in question?
Asset/Personnel Security Management	Management of risks to personnel and assets posed by political violence, terrorism, kidnapping, etc.	Corporate Security Executives	Can the risk be mitigated to acceptable levels? Can it be crisis managed?
Joint Business Ventures	Partner with local company who understands political risk environment and/or is in political favor with government	Strategy and Business Development Departments	Are potential partners suitable from a business perspective?
Lobbying and Prominent Alliances	Legitimate influencing of government policy through industry associations, or strategic advice from former cabinet members, ambassadors, etc.	Board Members	How likely is the influencing strategy to work? How current is the advice to the context we face?
Community Initiatives	Social Investment/Social Responsibility activities (e.g., NGO partnerships, health, education or infrastructure initiatives)	Corporate Social Responsibility Executives/Country Managers	Are suitable local community interlocutors available?
Financial Hedging	Financial instruments (e.g., currency options, forward supply contracts, commodity hedging instruments) to limit financial exposure to political risks	CFOs	What financial instruments would offset or minimize the impact of political risks?
Agile and Resilient Supply Chain	Flexible supply chain—including ability to recruit in new locations—to respond to significant disruptions	Procurement Director	Are alternative supply arrangements practical? Has the supply chain been stress-tested for political risk?

Stage 3: Manage

Once risks have been identified and measured, an effective system for active political risk management can be put in place. The first element in managing political risks is to map potential risk management methods against the priority risks. Companies actually have a range of tools and processes at their disposal to help manage and mitigate political risk. For firms unable to identify which measures are reducing their exposures and where there are gaps, managers should choose or evaluate the most suitable management method from a defined toolkit, such as the ones in Figure 3 above. Once the organization establishes a course of action, the risk management team can assign responsibilities and establish a schedule for consultation, reporting and review, as with other risk controls. (See Figure 3)

A company operating in a country where there are signs of corruption in trade practices, for example, may seek to review its overall code of conduct and step up local training activities to ensure that all rules are thoroughly understood.

Depending upon the seriousness of the problem, the company may take steps to find new sources for materials purchased in-country, or to enter other countries to diversify its geographic portfolio.

A company that identifies potential opposition to its investment in an infrastructure project may undertake a number of initiatives, including:

- Partnering with an established local company;
- Engaging in legitimate lobbying activities and/or building relationships with influential citizens; and
- Establishing appropriate sustainability and community programs.

Options also include political risk insurance (PRI), either from private insurers or governmental agencies such as the Overseas Private Investment Corporation (OPIC), and the Multilateral Investment Guarantee Agency (MIGA), part of the World Bank. Companies may consider the institution of security measures to protect assets and personnel. Any or all may be appropriate given the level of risk and the importance of the particular market.

Some companies use a shared services model to limit their physical exposure in high-risk countries, keeping only a commercial marketing team and support staff in-country while centralizing distribution and warehouse facilities regionally. This approach limits potential losses if the company has to exit the country if and when the political situation takes a turn for the worse.

Other political risk mitigation techniques by multinational companies include:

- Establishing agile supply chain capabilities to protect against the risk of disruption at key choke points;
- Maintaining a dialogue with local governments (including those at the state or provincial level) to track developments and identify possible shifts in attitude toward non-local companies;
- Hiring local workers who can provide intelligence and create a reservoir of goodwill towards the company as an attractive employer; and
- Stepping up involvement with local business groups and undertaking naming and branding initiatives that identify the company with the local market.

While each of these actions may have merit in a specific situation, we believe that a rigorous Identify-Measure-Manage process will put the company in a better position to determine whether any or all such efforts are justified.

Summary

Figure 4 provides some high-level examples of the discussed framework in action.

Figure 4: Illustrative examples of the 3-Stage Process in Action

Political Risk Scenario	Company	Identify Identify scenarios and data needs Define data needs and collect data	Measure Quantify risks and assess them against risk tolerance	Manage Allocate risk management method Implement and review
Politically-Driven Debt Default	Global Retailer	Bankruptcy of key supplier	Supply chain disruption leading to $X million in lost sales	- Alternative supplier arrangements - Insurance
		Opportunity to buy attractive acquisition target at significant discount	$X million discount in existing acquisition valuation	- Plan to carry out rapid acquisition (e.g., due diligence complete, advisors in place, etc.)
Popular Revolt Threatens to Overthrow Host Government	Oil Company	Severe disruption to production	$X million in lost production	- Continuity management to protect production and cash flow
		Threats to worker safety and security	Loss of lives, damage to reputation	- Robust evacuation and health and safety plans
		Oil policy change (increased taxes and royalties) in the event of regime change	$X billion in lost revenue	- Partnership and social investment programs aligned with population's needs
Election Uncertainty in Host Country - Populist Government a Possibility	Mining Company	Increases to taxes and royalties	$X million in value erosion of development project	- Legitimate influencing and stakeholder engagement initiatives - Partnerships supporting technical assistance program to maximize mining revenues
		Local community protest	Project delay leading to $X million in net present value (NPV) loss	- Social investment programs that align with local priorities - Strong local hiring initiative

How Accenture Can Help

Accenture can assist organizations integrate hard to quantify risks such as political risks into their risk management programs. We have developed a number of tools and methods applicable to each of the three stages that can speed up this process. These include a scenario generator that can assist in identifying political risks, a range of tools that can assist with quantification, governance and organizational expertise to help clients ensure that they possess optimal visibility and appropriate structures to manage political risks.

Conclusion

Organizations can gain significant benefits from managing political risk. Effective management of political risk enables companies to tap new revenue streams through access to markets and joint ventures that, without careful management, might seem too risky. Clear identification, measurement and management of risk facilitates organizational buy-in for growth strategies that target emerging markets and "frontier" markets, while improving the performance of existing businesses. The organization's improved ability to spot crises and respond more quickly and effectively is also likely to mitigate losses, providing improved confidence in management's ability to deliver high performance.

About the Authors

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About Accenture Risk Management

Accenture Risk Management consulting services work with clients to create and implement integrated risk management capabilities designed to gain higher economic returns, improve shareholder value and increase stakeholder confidence.

About Accenture

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