Global Counsel

Sizing up soft political risk

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Summary

Soft political risks from changes to regulation, fiscal policies and the way legislation is enforced are now at least as important as hard risks from security threats, political instability and geopolitical tensions. Their prevalence in Europe and the United States means they are now a core issue for just about any investment thesis or corporate strategy. This is partly explained by insular politics, economic nationalism, and challenges to policy orthodoxy. Managing soft risks requires an understanding of how political stresses impact on policy choices in ways that are materially important for businesses or investors. It requires knowledge of policymaking, the political process and the political currents that are influencing the choices being made. There may be up-side or down-side risks for businesses or investors, depending on the nature of the exposure. Businesses with the capability to manage soft political risks may find that this is a significant source of competitive advantage.

In a report published in June 2016, Global Counsel analysed the political risks identified by FTSE-100 companies in their 2015 annual reports. Among the conclusions, two stood out as being particularly important. The first, that we term 'soft risks' – from changes to regulation, fiscal policies and the way legislation is enforced – are now at least as important as the 'hard risks' that are traditionally associated with political risk, arising from security threats, political instability and geopolitical tensions. The second conclusion is that political risk is no longer a niche issue affecting operations in developing or emerging countries; it is now mainstream and sourced in a wider geographical spread of countries, with soft risks particularly prevalent in Europe and the United States. Taken together, these conclusions suggest that political risk should be a core consideration for just about any investment thesis or corporate strategy, particularly (but not only) for internationally active firms and investors.

The purpose of this Insight is to explore some of the wider trends that are contributing to the growing importance of soft political risk and to outline the issues that businesses and investors should consider when developing strategy or conducting due diligence to deal with this. It is not all bad news. There are potential opportunities from soft political risk, particularly for investors or companies who understand what they are dealing with and have the capability to mitigate risks. Those that do, may gain a competitive edge or find they can take advantage of the more attractive valuations on offer where risks are heightened.

This note is structured around three related trends that are contributing to the increase in soft political risk. They are not the only factors. And they are not universal, as it is always possible to come up with counter-examples. But together they help explain where and how soft political risks are increasing and evolving.

Insular politics

Policymaking in many countries, but particularly in Europe and the United States, has become more focused on national priorities at the expense of international engagement. This reflects public preferences (Fig. 1) which can be explained by years of low growth, stagnant incomes, and the cumulative effect of austerity. The electoral success of populists, which has squeezed the votes of mainstream parties, has made it harder for politicians to show international leadership. In many countries, there is a growing distrust of international or regional organisations, such as the EU, with the UK's vote for Brexit the starkest example.

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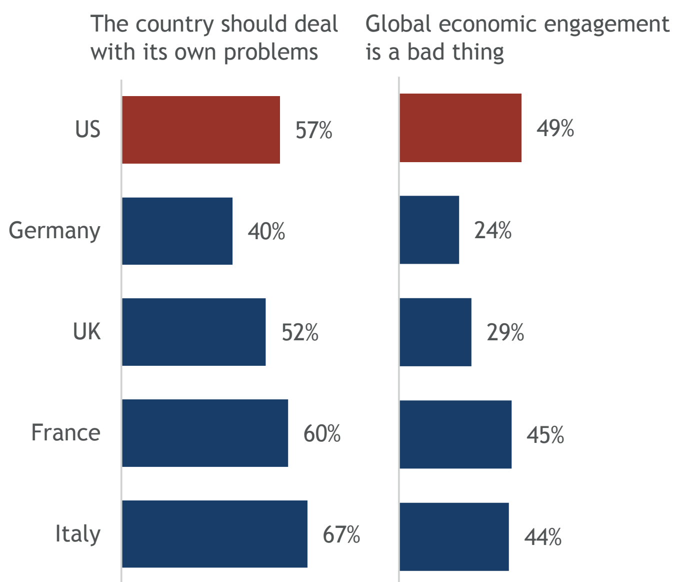

Fig. 1: Political insularity as measured by national surveys
Source: Pew Research Centre, 2016

The most direct policy consequences of this insularity are to be found at the border. These include tighter controls on migration, which was a central issue in the UK referendum and is a divisive issue in the US presidential election. They also include politically motivated restrictions on foreign direct investment. These can sometimes be justified on economic, national security or broader national interest terms, but in some cases the real motivation is to protect domestic interests. The control of Chinese investment in Germany has recently emerged as an election issue, with the political parties competing to show they are protecting German industry from "unfair competition".

Political insularity is also contributing to a creeping growth in trade restrictions and a much tougher environment for negotiating international trade deals. For most of the past three decades, there has been strong growth in trade volumes driven by fast-growing economies like China and the lengthening of international supply chains as the production of many goods (and some services) has become disaggregated and spread across countries. This has been backed by a steady, if not entirely even, liberalisation of trade policy, which has seen bilateral and regional trade deals reducing both tariff and non-tariff barriers. More recently the growth in trade volumes has slowed, however, with the WTO forecasting world trade will expand by just 1.7% in 2016, the slowest pace since the financial crisis of 2008/09 and only a fraction of the average growth rate in the years preceding that.

Data on trade measures introduced by G20 members since 2008/09 suggests protectionism (broadly defined) may be a factor. The net number of discriminatory measures has increased significantly since 2012 and far exceeds liberalising measures (Fig. 2). When comparisons are made across countries, it is clear European countries are as likely to be offenders as emerging economies and that the US is the biggest offender of all (Fig. 3).

Trade deals are becoming harder to negotiate and are more difficult to implement. The Trans-Pacific Partnership and the EU-Canada trade deal are both struggling as legislatures in Europe and United States have become more sceptical about the benefits of such deals and how these are shared. There are also growing concerns about the concessions to national sovereignty that are implied, especially when attempts are made to reduce regulatory barriers to trade. This is increasingly the core aim of the most ambitious and 'modern' trade deals. But it is precisely this type of agreement - involving the pooling of sovereignty or making concessions here to gain influence there - that becomes harder when national politics becomes more insular.

Economic nationalism

A second, related trend is towards economic nationalism, with a tendency for governments to discriminate between local and foreign operators. While insular politics usually means restrictions at the border, economic nationalism leads to discrimination in the market and the political risks that arise take a different form.

By its nature, discrimination is often easier to assert than it is to prove. In the US, many European companies are concerned they are being targeted by judicial activism and the uneven enforcement of rules, sometimes resulting in what are alleged to be disproportionate fines. Examples include penalties imposed on European banks for breaching sanctions,

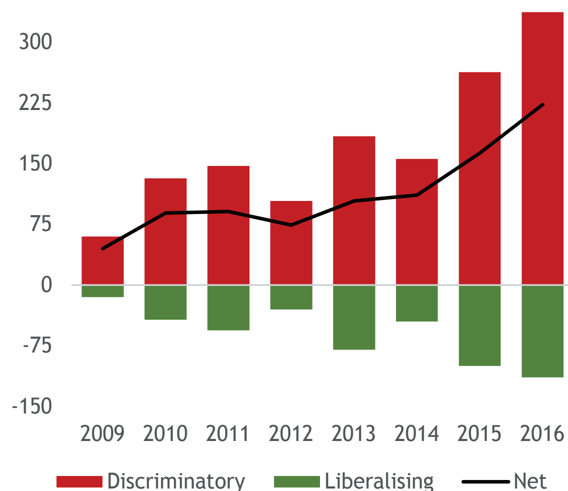

Fig. 2: Number of measures implemented by G20 countries each year since 2008
Source: Global Trade Alert, 2016

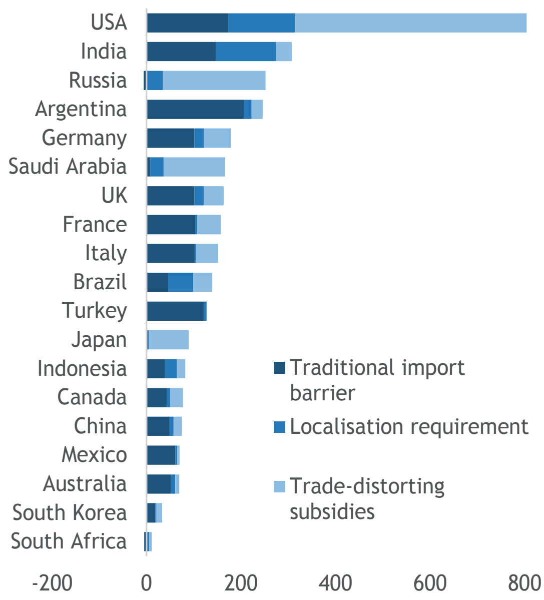

Fig. 3: Protectionist interventions since 2008 that remain in force, 2016
Source: Global Trade Alert, 2016

with BNP Paribas alone receiving a $8.9bn fine in 2014, and against BP following the Deepwater Horizon oil spill.

In the EU, many American businesses based on intellectual property are worried about the retrospective use of competition policy to challenge corporate tax arrangements. In a similar vein, American tech firms are concerned that the enforcement of local regulations by some member states is deliberately aimed at shielding incumbents from disruption. In both cases, the allegation is that interventions by national governments or the European Commission are favouring local interests and stifling competition.

In China – and in many other emerging economies – there is a much longer list of concerns. In China, these range from the preferential treatment being given to state-owned enterprises to the uneven (and unpredictable) enforcement of rules targeting bribery and corruption. The 2016 business confidence survey of the European Chamber of Commerce in China found that half of firms regarded the discretionary enforcement of regulations as one of the top three obstacles to business there, while almost a quarter complained of discrimination against foreign entities in public procurement. There have also been consumer boycotts against companies from countries involved in foreign policy disputes with China, affecting Japan and Norway among others.

These issues are not new. But where nationalism is more prevalent in national political debate – as it is arguably now in the US, the UK and China – it becomes much less likely that foreign companies will be treated on equal terms with national operators. For businesses and investors, the political risks that result are typically made harder to monitor and mitigate because the discriminatory intentions of policies are rarely explicit.

Challenges to policy orthodoxy

While the first two trends are about discrimination, either at the border or in the county of operation, the third is about policies that potentially impact on all producers or providers of services. Policymaking is arguably now more politicised in many countries, resulting in policies that are less predictable and more prone to reversal. Evidence for this is provide by survey evidence which shows a high proportion of companies are now concerned about the impact of domestic political gridlock and the regulatory environment on their businesses (Figs. 5 and 6).

The increasing challenges being made to policy orthodoxy can potentially be explained by several factors. One is the financial crisis of 2008/09, which exposed flaws in some long-established policy frameworks, particularly in the US and Europe, with financial regulation the prime example. There were multiple failures of financial regulation and therefore a clear need to reassess the policy orthodoxy, but policymakers have arguably been overactive in this area. Monetary policy orthodoxy has also been reassessed, albeit for different reasons. Conventional interest rate policy has been insufficient to provide the required stimulus following the crisis, meaning unorthodox policies have become essential, although there are also concerns that policymakers will find it difficult to reverse these policies. Meanwhile attitudes towards industrial policy have changed, with interventionist policies more acceptable in a wider range of

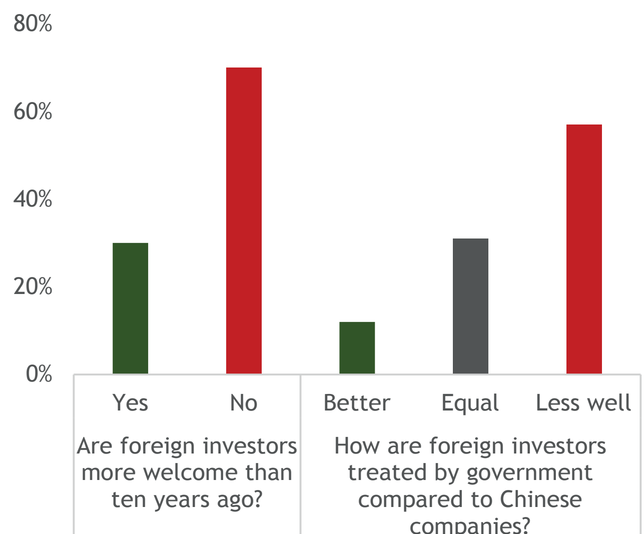

Fig. 4: Perceptions of European companies in China
Source: European Chamber of Commerce in China, 2016

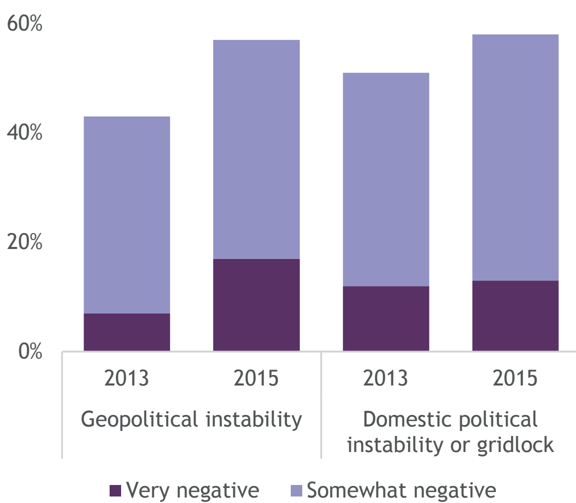

Fig. 5: Expected impact on company profitability over the next five years
Source: McKinsey, 2016

circumstances as shown, for example, by the bail out of the US auto sector. In each of these cases, the challenge to orthodoxy may be understandable. However, the combined effect may also be to reduce the sensitivity of policymakers and the public to challenging policy orthodoxy in other policy areas too.

A second factor that may help explain the increasing challenges to policy orthodoxy is the cumulative impact of the austerity budgets that have been passed in many countries since the financial crisis. This has required progressively more difficult choices about where the burden of spending cuts and tax rises should fall. Over time, this means that these choices have become more political with tax and spending measures increasingly concentrated where there is least political resistance. The financial transactions tax being developed by a group of European countries was inconceivable before the financial crisis; but that, and the austerity that has followed, has created a political rationale for the tax, even though the economic case is heavily contested.

	Financial services	High tech/ telecom	Manufacturing	Professional services	Healthcare/ pharma
Regulatory environment	54%	50%	46%	41%	40%
Political and/or social instability	40%	36%	27%	43%	33%
Protectionist policies	22%	32%	27%	17%	29%
Infringement of IP rights	10%	32%	24%	21%	34%

Fig. 6: Concerns about specific risks by sector
Source: McKinsey, 2016

A third factor is increasing inequality in most richer economies, including the United States and much of Europe. This partly reflects structural changes associated with technological innovations that have favoured a small part of the labour force that already enjoys higher incomes. This can lead to more uncertain and volatile policy, as policymakers struggle to understand, interpret and respond to these changes. Examples include housing policies in several European countries, which have been prone to repeated interventions and reversals. Similarly, policies concerning health, social care and pensions in both Europe and the United States have become more political and more volatile as governments struggle with the competing pressures of growing demand and fiscal constraints.

Challenges to policy orthodoxy may or may not be justified. What matters when assessing political risk is not whether they are. Instead it is what a trend towards increasing challenges to policy orthodoxy means for policy stability and predictability. It is this uncertainty that creates another source of soft political risks for businesses and investors.

Conclusions

Assessing and managing exposure to soft risks requires a different set of capabilities within a business than that required to deal with hard risks. The latter needs an understanding of security threats, foreign policy conflicts, and risks to government stability. There are rarely opportunities associated with hard risks except, perhaps, for businesses with an unusually high tolerance for such risk.

Soft risks are about the potential for political stresses to impact on policy choices in ways that are materially important for businesses or investors. Managing soft risk requires an understanding of policymaking, the political process and the political currents that are influencing the choices being made. There may be up-side or down-side risks for businesses or investors, depending on the nature of the exposure. Because soft risks are changing and becoming more important, particularly in Europe and the United States, many businesses do not yet have an adequate capability to manage such risks. Those that do may find that this is a significant source of competitive advantage, particularly if in the future, politics becomes even more insular, economic nationalism more prevalent, and challenges to policy orthodoxy more widespread.

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