How are leading companies managing today's political risks?

2019 Survey and Report

A report produced for Willis Towers Watson

Oxford Analytica

Willis Towers Watson

About this report

Oxford Analytica is providing this survey report for Willis Towers Watson.

Oxford Analytica is an independent geopolitical analysis and advisory firm that draws on a worldwide network of experts to advise its clients on their strategies, operations, policies and investments. Oxford Analytica's trusted insights and seasoned judgements on global issues enable its clients to navigate complex markets where the nexus of politics and economics, business and society is critical to success.

Founded in 1975, Oxford Analytica is the pioneer of geopolitical risk analysis, and today works with the world's most influential businesses, governments and international organisations.

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01 About the research

Will 2019 be seen as a turning point? In recent years, companies have faced escalating political pressures, from trade wars to anti-elite populism. The outbreak of mass unrest in Chile, France and Hong Kong has made it clear that political risk events can arise suddenly in regions traditionally seen as risk-free. In 2019 we witnessed what may well be the beginning of an increasingly proactive corporate response. For instance, the Business Roundtable made the dramatic announcement, signed by more than 180 CEOs, that businesses should serve society's broader stakeholders – including employees and local communities – rather than just shareholders.

A number of the participants in this year's study believed that such initiatives were crucial to addressing political risk. "Populism is leading to anti-business movements," said a panellist from the oil and gas sector. "Obviously, more recent ESG [Environmental, Social and Governance] efforts are a form of risk management." A mining sector panellist agreed: "when I think back five years," he said, "we were just beginning our stakeholder engagement initiatives; now that work is incredibly important."

Will such efforts be effective in addressing the sometimes fraught relationship between big business and society? What other strategies are companies using to mitigate political risks? What kinds of political risk losses have led firms to adopt such strategies? These are a few of the questions raised in this third-annual edition of our political risk study.

At a glance

Note: For details including sample sizes see the main text of the report

68% Have suffered a political risk loss

61% Believe political risk levels have increased since 2018

75% Share of expropriation losses that were larger than $250 million

37 Number of countries where political risk losses were reported

Source: Oxford Analytica

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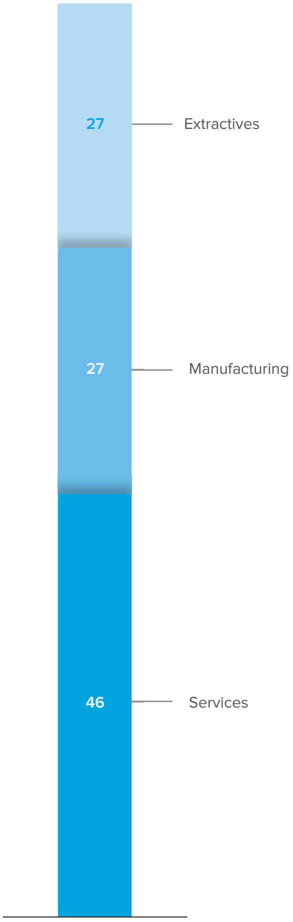
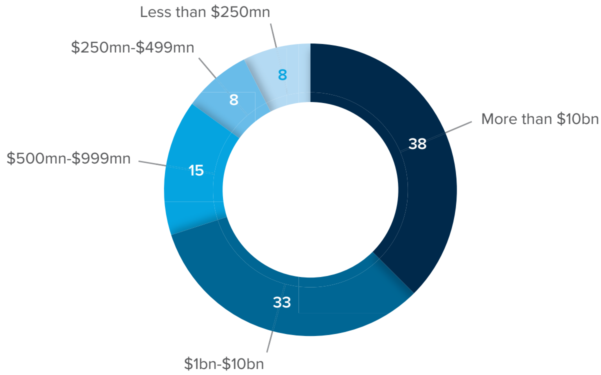
Industry of respondents (%)
Note: All respondents, n = 41



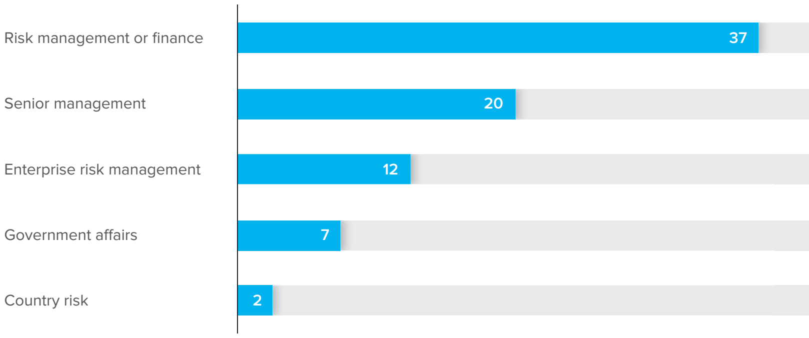
Source: Oxford Analytica

Annual revenues of respondents' companies (%)
Note: All respondents, n = 41



Source: Oxford Analytica

Job function of respondents (%)
Note: All respondents, n = 41; 'other' not shown



Source: Oxford Analytica

As with last year's study, we have combined a survey of 41 major corporations with in-depth follow-up interviews with a panel of ten participants. Because these corporations are clients of Willis Towers Watson and Oxford Analytica, they should not be seen as representative of typical firms worldwide. Rather, our study participants are leading corporations that have extensive and successful international operations, and in many cases invest heavily in the management of political risk.

Unsurprisingly given this focus, our sample is biased towards larger firms. More than 70% of respondents worked for companies with revenues of $1 billion or more. In terms of job functions, the largest portion of respondents, 37%, worked in risk management; functions such as enterprise risk management and government affairs were also well represented. Almost one-third of respondents were in the manufacturing sector, but overall the sample was widely distributed across industries – ranging from agriculture to transport to professional services.

02 Risks and regions of current concern

Last year, we asked our respondents in which regions of the world they thought risk was rising. This query produced some striking and alarming results – the Middle East came first, but Europe and North America were not far behind (with 70% and 63%, respectively, reporting rising political risk in those regions). This year we decided to pose our questions in a way that would address levels of political risk, rather than changes. We asked respondents about the regions where they specifically had exposure; for each region, we then compiled a ratio of respondents who were concerned about political risk to those who were not.

The results are shown in the accompanying figure, which provides a view of political risk levels globally. The Middle East continues to top corporate concerns about political risk, but is followed by other regions such as Africa and South America where operating environments can be challenging. Panellists were divided about which Middle Eastern country was of greatest concern. “Sectarian concerns seem to be rising and an economic downturn is underway in the region,” said a panellist in the hotels sector. “In terms of countries, we are concerned where Iran has strong support, and about states near Yemen and Syria.” A panellist in the manufacturing sector was worried about creeping expropriation, in the form of “subsidies to local competitors, worsening operating conditions, and discriminatory taxes,” noting these issues particularly in Egypt.

Regions where political risk is of concern (%)

Note: Respondents reporting financial exposures in each region only. For Middle East n=30; Africa n=29; South America n=27; Asia-Pacific n=34; Russia/CIS n=28; Europe n=33; North America n=29

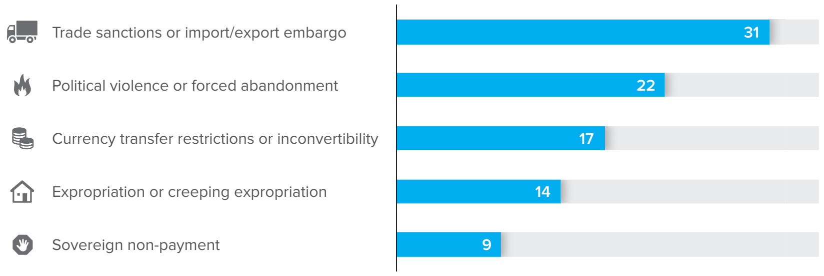
Source: Oxford Analytica

Panellists were quick to emphasize, however, that many of the most attractive commercial opportunities were to be found in risky regions. "We are focussed on Sub-Saharan Africa," noted a panellist from a US-headquartered global food and beverages company. "A free trade agreement would transform business in the region."

We asked our survey respondents about types of political risks of concern, both globally and at the regional level. Perils relating to disruption of international trade topped the global risk list – perhaps because such risks are apparent in every world region, with panellists reporting concerns about sanctions against Russia, Iran and Venezuela, a trade war involving China, and, as the survey was conducted, the threat of Brexit looming over Europe. Indeed, one panellist worried there were so many incipient trade disputes that some key risks had been forgotten. "Because not everyone was targeted, this [US-EU dispute over metals] has dropped off the radar while the China-US tariffs have not," said a panellist in the manufacturing sector. "The EU is our largest ex-US market and this is hurting us badly."

Types of political risk of greatest concern (%)

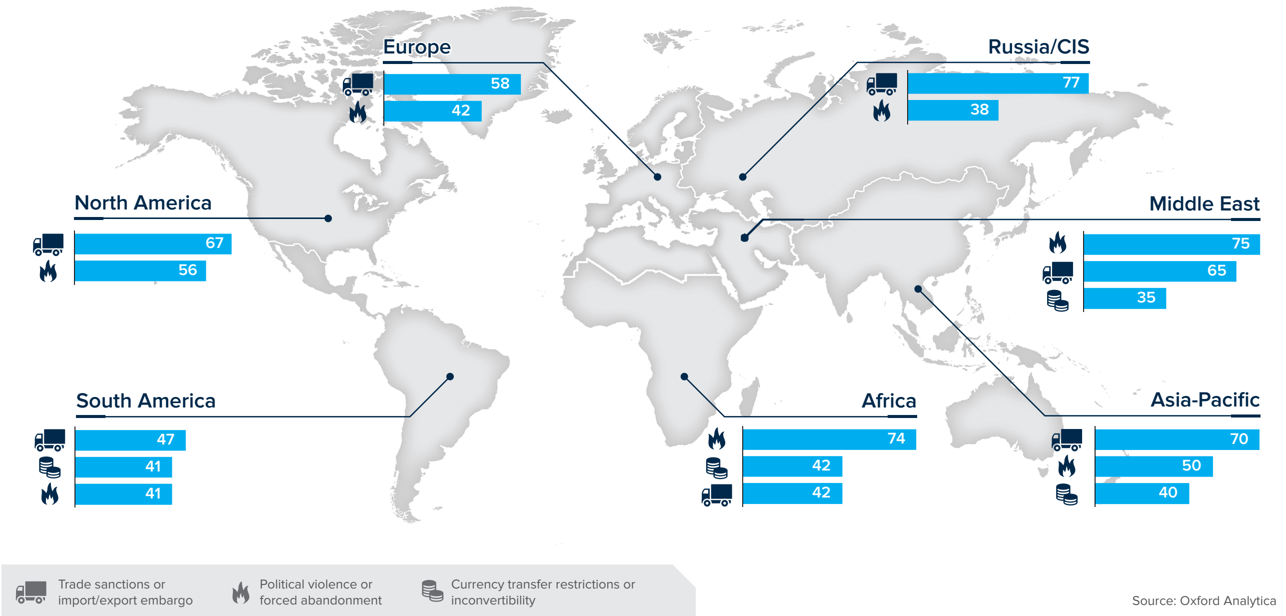
Note: All respondents, n = 41; "other" not shown; multiple responses permitted



Source: Oxford Analytica

Top political risks of concern for businesses operating in each region (%)

Note: Political risks most frequently cited as being of concern for companies indicating both financial exposures and political risk concerns in each region. Only risks cited by at least one-third of respondents are shown. For Africa, n=19; Asia-Pacific, n=20, Europe, n=12; Russia/CIS, n=13; Middle East, n=20; North America, n=9; South America/Caribbean, n=17



Source: Oxford Analytica

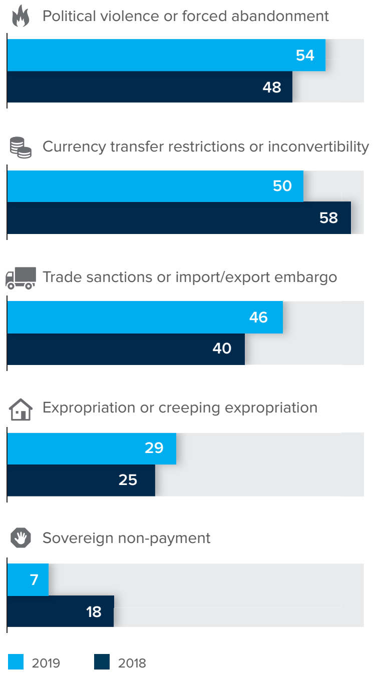
Trade risks did not top the political risk agenda everywhere, however. In Africa and the Middle East, political violence concerns were highest. One aerospace panellist worried that new technologies, exemplified by the drone strike on Saudi oil facilities, could elevate such risks. “Small, punchy little nations” could draw on such technologies to cause severe disruption, he said. Perhaps surprisingly, political violence risks also figured as the second-highest risk in Europe. A panellist in the hotel sector explained that his company was “watching far-right nationalist movements very closely in Europe – attacks or indirect impacts are a concern, through demonstrations, counter-demonstrations, and business interruption.”

Globally, expropriation risks figured fourth in terms of risk concerns – although higher in certain regions, notably Africa and South America. One might wonder if businesses are missing a crucial point. While trade and political violence losses are frequent, and losses can add up over time, other less-frequent political risk events – notably, expropriation – can have catastrophic consequences. We turn to the subject of financial loss in the next section.

03 Political risk losses

Types of political risk losses experienced (%)

Note: Companies experiencing political risk loss; n for 2018 is 14; n for 2019 is 28



Source: Oxford Analytica

In last year's study, we found that a majority of companies with $1 billion or more in revenues had experienced a political risk loss. We found that the preponderance of these losses (43%) had exceeded $100 million. This year we sought to achieve more granularity by breaking down political risk losses based on the type of risk exposure.

We found a broad continuity in terms of loss types. Both this year and last year, the two most commonly-reported types of loss involved political violence and currency transfer restrictions. In some geographies, these types of political risk losses are extremely common. "We have a lot of lost days due to political unrest, transport routes blocked, etc. – such issues are a weekly occurrence," noted one panellist in the mining sector. "We experience frequent property damage and business interruption."

Looking at a year-on-year comparison, we saw a small uptick in experience of losses due to political violence and trade sanctions or embargoes, as well as expropriation (although such shifts may also be due to changes in the industry breakdown of our survey sample). We saw a decline in loss events relating to currency transfer and sovereign non-payment. This latter shift may reflect a change in global liquidity conditions, as central banks in the US and Europe have reversed course from tightening to loosening monetary policy, making it easier for some emerging economies to obtain foreign currency.

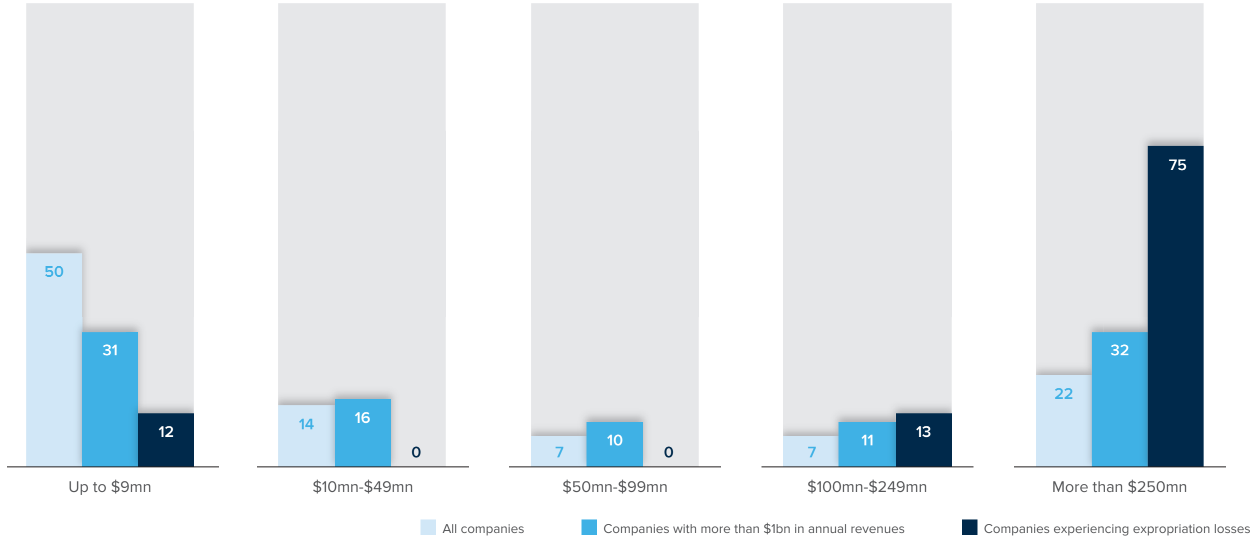
Looking at the distribution of losses by type of risk, we find a striking pattern. The distribution follows a "U" shape, particularly for companies with annual revenues of more than $1 billion. Indeed, for these companies, the majority of reported political risk losses are either relatively small (less than $9 million) or catastrophic (more than $250 million). Looking at the distribution of losses by risk type sheds some light on this pattern. Expropriation risks tend to be catastrophic in nature while the losses from other types of risks tend to be more frequent but smaller. For the companies in our sample who reported an expropriation loss, 75% reported a loss greater than $250 million. (As one panellist in the food and beverages sector noted, "that's a material risk.") Since catastrophic losses can cause volatility in earnings, make it difficult to fund future growth, or even jeopardize the ability to carry on day-to-day operations, businesses may wish to devote more attention to such infrequent but catastrophic perils.

> For companies that reported an expropriation loss, 75% reported a loss greater than $250 million

Turning to the countries where companies had experienced losses, the most frequently mentioned locations were Venezuela, Iran, and Zimbabwe. Many investors have watched the situation in Venezuela with disbelief as, over the past two decades, the country has progressed from a relatively stable market to unorthodox policy choices, to outright expropriation of foreign firms, to economic crisis and profound social disorder. (As one oil and gas panellist put it, “Venezuela – what is there to say?”) Another panellist who was continuing to operate in Venezuela noted that US sanctions, imposed in 2017 and escalated in 2018 and 2019, were the latest cause of political risk loss for his company. Sanctions were also a cause of political risk losses reported by panellists operating in Iran and Russia. (In both 2017 and 2018, Russia topped our list of countries where investors had experienced political risk losses.)

Distribution of political risk losses (%)

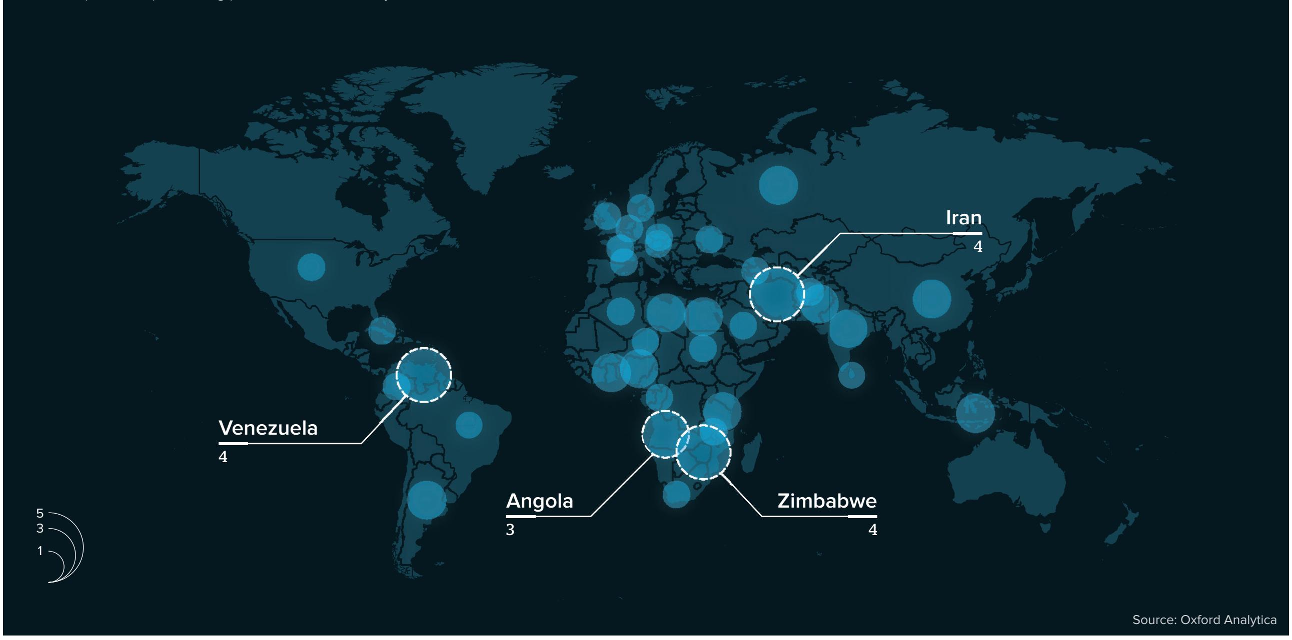
Note: Ccompanies experiencing political risk losses only; for “All companies” n = 28; for “Companies with revenues greater than $1 billion” n = 19; for “Companies experiencing expropriation losses” n = 8



Source: Oxford Analytica

In which countries did you experience political risk losses? (number of mentions)

Note: Companies experiencing political risk losses only



Source: Oxford Analytica

04 Managing political risk

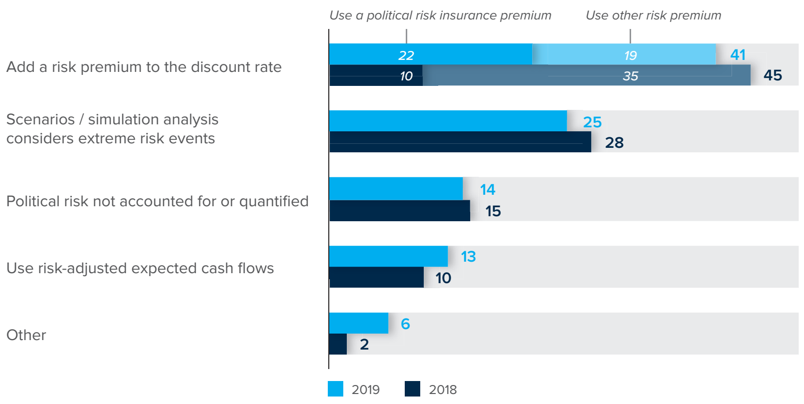
How do companies seek to manage and mitigate political risk losses? We found striking differences in approach depending on whether a company had experienced a significant political risk loss event in the past.

We first asked our survey respondents about how they quantify political risk (as business strategy guru Peter Drucker famously put it, “what gets measured, gets managed”). We found a broad continuity with last year’s results. The most popular method for valuing political risk was to add a risk premium to the rate of return; the second-most popular method was scenarios or simulation analysis. This year we found more respondents drawing on political risk insurance markets to obtain risk premia – although that may be because more of the respondents to this year’s survey worked in the risk management function, and would have ready access to such data.

Although the risk premium approach was most popular, it was not for everyone. One panellist from the manufacturing sector noted that they had shifted towards a more qualitative approach. “With time, we have come to realise that we need to better account for risk mitigation before investing,” he said. “The question is how we can holistically analyse the situation.” A risk premium is useful in evaluating returns, but a narrow financial analysis might not have any impact on whether an investment in a challenging geography succeeds or fails. To increase the chances of success, an up-front analysis of the likely effectiveness of risk mitigation strategies often can be useful.

How companies value political risk when making decisions (%)

Note: All respondents; 2019 n = 41; 2018 n = 40; multiple responses permitted

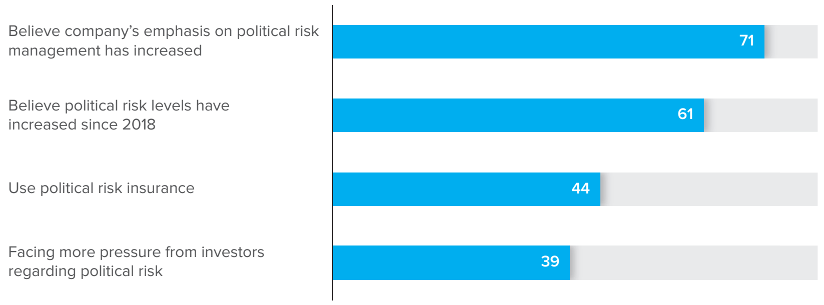


Source: Oxford Analytica

The vast majority of our respondents, 71%, believed that emphasis on political risk management at their company had increased since last year. Partly, this change has been driven by rising risk levels – a majority felt that political risk levels had increased globally since 2018. In addition, nearly 40% felt that they were facing more pressure from investors regarding political risk management. "The risk factors are the same, but the stakes are higher," said a panellist in the mining sector. "China-US rivalry has led to sanctions, etc. – political risk is now more tangible." A panellist in the food and beverages sector also remarked on the higher stakes: "from a central position, there is a lot more conversation about long-term strategic risk," he said. "We think about disruptive political change."

Responding to political risk (%)

Note: All respondents, n = 41

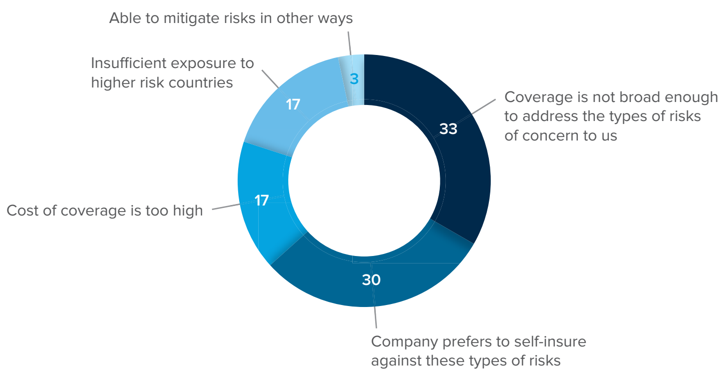


Source: Oxford Analytica

Slightly less than half of all respondents reported using political risk insurance to address these increasingly high-stakes geopolitical threats. For those that did not, we asked why. The most commonly reported response was that coverage was not broad enough (which was the second-most popular response last year). However, new types of political risk cover, and broader policy wordings, are evolving rapidly to respond to new risks and new investor demands.

Why not use political risk insurance? (%)

Note: Respondents who reported not using political risk insurance, n = 23; multiple responses permitted

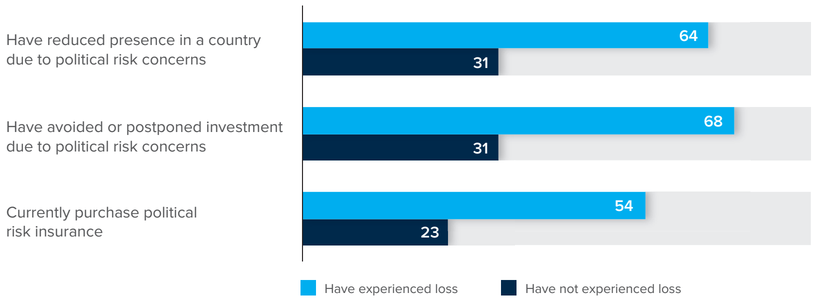


Source: Oxford Analytica

We also noted a significant difference between companies that had experienced political risk losses and those that had not. For instance, companies that had previous experience of losses were much more likely to report that they had purchased political risk insurance products. In addition, companies that had experienced loss were more likely to report reducing their international presence. One panellist in the oil and gas sector reported undertaking a major strategic shift, in part to avoid such losses: "One theme has been a rationalization of our geographic exposure driven by the desire to operate in more predictable, less corrupt and more transparent markets."

Responses to political risk are impacted by loss experience (%)

Note: For respondents who reported losses, n = 28; for respondents who reported no losses, n = 13



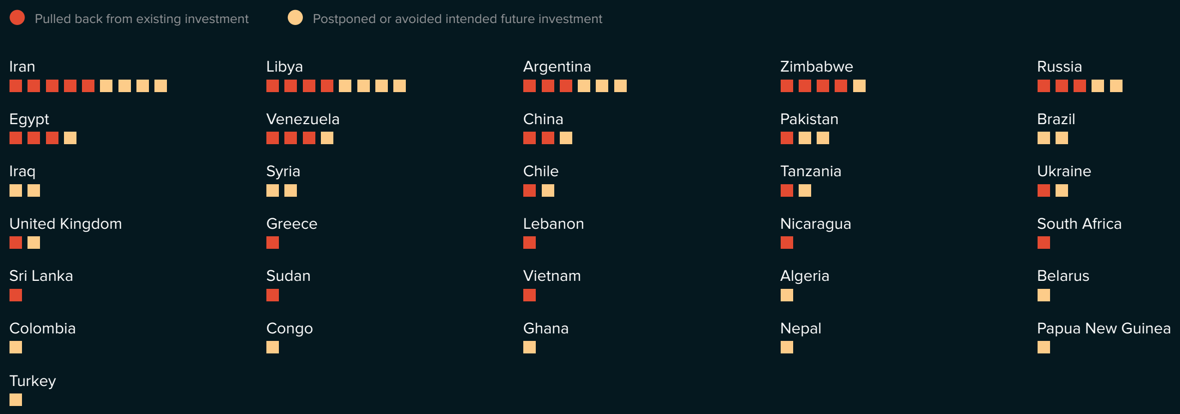
Source: Oxford Analytica

Companies differed significantly in their approaches to political risk management decision-making. In part, these differences appeared to correspond to differences in overall operating models. While most companies we spoke with located responsibility for political risk in a centralized function such as security or enterprise risk management, a food and beverages company noted its country managers were charged with taking decisions on political risk. "We try to keep decision-making as close to the action as possible," he noted. "We try to be a local business everywhere we operate."

Finally, we asked survey respondents about the geographies where they had either scaled back operations or avoided investment due to political risk concerns. The results match our map of countries where respondents had experienced losses, with high-risk geographies such as Iran and Venezuela at the top of each list. That said, a few countries were mentioned more often as areas where investment had been avoided than as areas where political risk losses had been sustained – notably Libya, Argentina, Russia and Egypt.

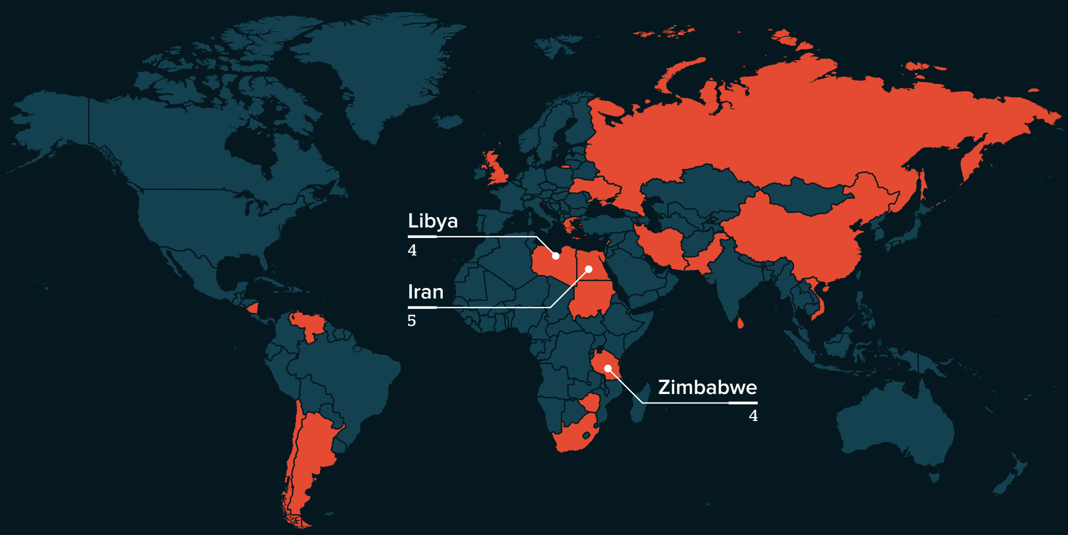
In which countries have you either scaled back operations or avoided investment due to political risk concerns?
(number of mentions)

Note: All respondents



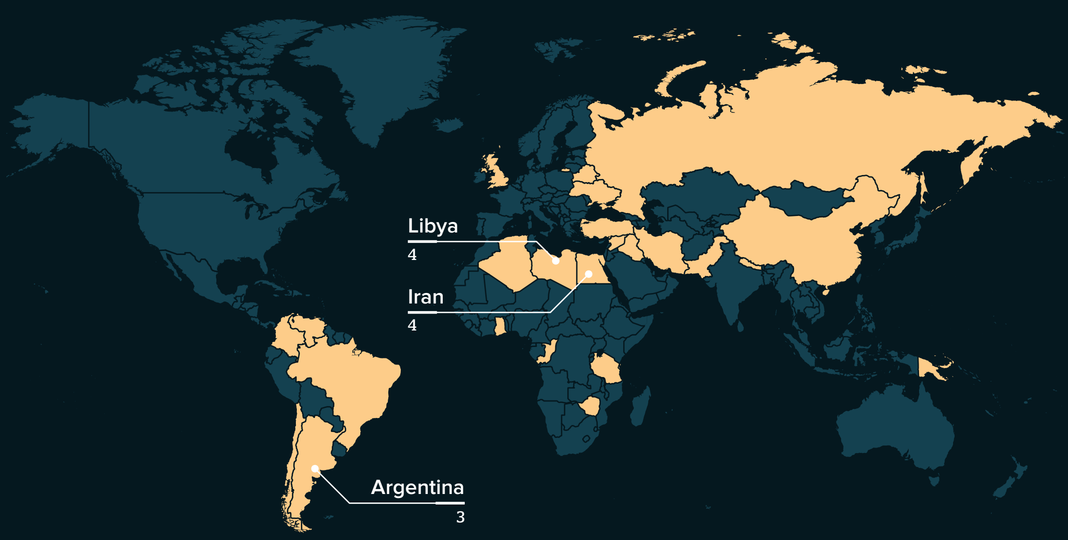
Countries where companies had scaled back operations (countries mentioned once or more)

Note: Top three shown in white



Countries where companies had avoided investment (countries mentioned once or more)

Note: Top three shown in white



Source: Oxford Analytica

05 Emerging risks of concern for 2020 and beyond

Each year we have conducted this study, we have asked the panel members an open-ended question about emerging political risks in the coming year. The results have been prescient. Three years ago, panellists' top concerns related to protectionism, US sanctions policy, and an end to the globalization consensus of the past three decades. That is arguably the world we are now living in. Two years ago, panellists worried about sanctions, protectionism and emerging-market debt crises. This past year saw more than ten emerging economies suffer sovereign defaults or enter international bailout programs, the largest being Argentina and Pakistan. So, what are our panellists worried about for 2020?

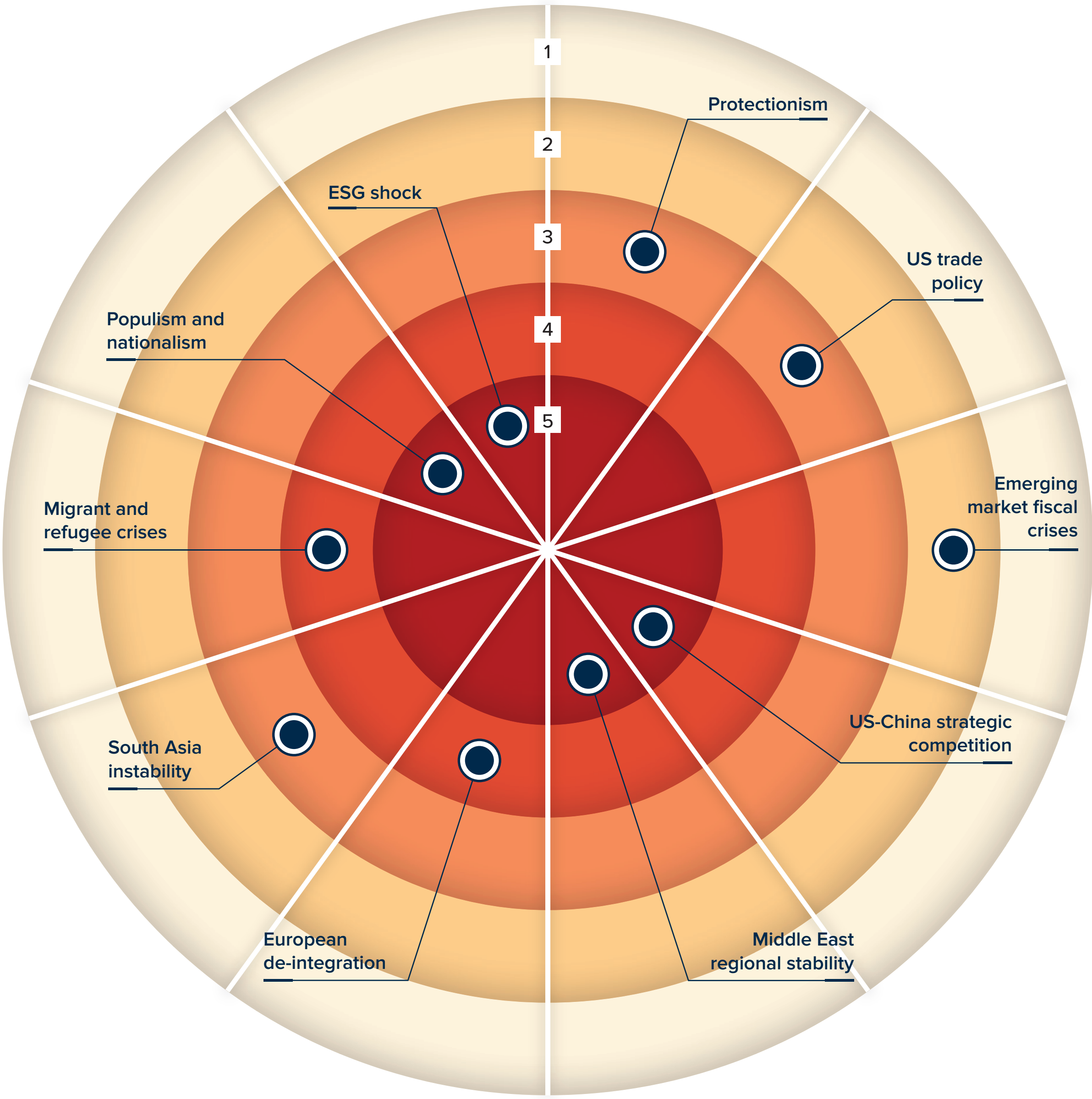
Some of last year's concerns remain at the top, including protectionism and US trade and sanctions policy. A few specific threats have risen dramatically, however: the dangers associated with US-China strategic competition rose from the bottom of our top ten list to become a top risk for 2020. Regional stability in the Middle East also rose from the middle of the list to the top. Concerns about Central Asian succession featured on last year's list with justification, as in 2019 an arguably delicate succession process began in Kazakhstan. However, "the transition seems to have been managed for now," as an oil and gas panellist noted. "We are monitoring stability closely."

In part, the risks at the top of the list earned their position because they have global consequences. "Tension in the Middle East and subsequent oil price implications could potentially fuel a global recession," as a panellist in the oil and gas sector noted. A panellist in the manufacturing sector pointed out that the "US-China trade war has an impact on foreign exchange [volatility] and the general health of the global economy."

Concerns about nationalism and populism also rose slightly from last year's list – perhaps unsurprisingly considering the results of recent elections in Mexico and Brazil. And yet concern in this area also focused on advanced economies. "Most [political risk] issues previously related to 'third-world problems,' said one panellist. "However, increasingly I have more concerns about the US and the UK." A panellist based in Mexico agreed: "The political risks we see in more mature economies are longer term and perhaps more fundamental in nature. There is a crisis in democracy and institutions, and the opposition isn't from traditional parties; it's from populist parties and civil society."

Worries about populists turning businesses into political targets also fed into a new arrival on this year's risk list: an "ESG [environmental/social/governance] shock." But this risk reflected more fundamental concerns as well. "Ironically, the economic

Risk radar for 2020 (number of mentions)



Source: Oxford Analytica

success of emerging markets is bringing more people into an unsustainable world," noted one interviewee, as rising incomes bring growing demand for personal automobiles, airplane flights and meat consumption. A panellist in the mining sector warned: "Droughts will create severe conflicts as business, government and people compete for resources." In general, there was a sense that societies would come up against difficult trade-offs regarding sustainability, leading to societal demands on business that would be both extreme and volatile. "All the regulatory targets are highly ambitious unless people accept a change in lifestyle, which seems highly unlikely," said one panellist. "For us, this introduces regulatory uncertainty and increases the potential risk of stranded assets."

Another new risk relates to migration. Panellists worried about the economic costs of an anti-immigrant backlash and the impossibility of managing refugee flows from crisis-hit countries. These concerns have made headlines in the US and

> All the regulatory targets are highly ambitious unless people accept a change in lifestyle, which seems highly unlikely

Europe, but panellists expressed global concerns. “Egypt and Jordan are going to have huge difficulties integrating refugees,” noted one panellist. Hotel and mining sector panellists also referred to the rising challenges associated with so-called “xenophobic attacks” in South Africa, which pit South Africans against migrant laborers.

US trade policy – including sanctions policy – appeared farther down the list this year, but was also associated with new risks, most notably tariff threats by the US administration against allies such as Europe and Mexico. “Such actions could have a meaningful impact on economic growth, and cause problems for consumer spending, particularly amongst the low and low-middle income groups,” a food and beverages sector panellist commented.

A final new risk amongst the top 10 related to the situation in South Asia – perhaps partly because the survey was conducted in the wake of terror attacks, allegedly sponsored by Pakistan, that led to an Indian military response. Panellists expressed concern that Indian policy might head in a more “populist” direction, both on security and on tariffs. An aerospace panellist likened the challenges to a juggling act. “We have so far managed Russia, China, Japan and the US very well,” he noted. “But could a more assertive India cause this to collapse?”

06 Conclusion

The overall impression from this year's study was of internationalized companies caught up in nationalist politics. Some such challenges have been long-standing. "Conflicts between Israel and Palestine create a complex operating environment because we serve both constituents," noted a manufacturing sector panellist. Other challenges are newer, and more fundamental to global supply chains: "Both China and the US are major clients/consumers for us," an oil and gas panellist lamented. In a similar vein, a mining sector panellist said: "The biggest problem is US-China trade war. Supply chains oriented towards China will suffer. 'Made in China' could cause you problems."

Are such nationalist tensions driven by populist administrations who may soon be replaced? Or do these tensions reflect longer-term geostrategic realities that will inevitably turn trading partners into military competitors? Companies are facing a difficult strategic choice: to maintain their globalized business models, while accepting, mitigating or transferring the associated political risks; or to attempt to realign themselves with the emerging shape of a new and apparently more nationalist global landscape. "We will need to constantly progress our operating model to account for ongoing change," as one manufacturing-sector interviewee put it.

Some companies were optimistic that – like the CEOs of the Business Roundtable – they could take a more active political approach, pushing back against global political trends they saw as harmful, and changing the role of business in society. "It is an opportunity to contribute to the broader well-being," said one mining sector panellist.

We thank the survey participants and interview panellists for their time and insights.

About Willis Towers Watson

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