Into the fallout zone

There may be little businesses can do to control political risk, but its escalation, particularly for UK companies, makes acting to mitigate the effects a better response than ignoring it

The economic recovery is gathering pace and economic risk declining, but political risk is on the rise. Mike Rake, president of employers' organisation the CBI, identifies three specific political risks ahead: the Scottish independence referendum, the upcoming general election and Britain's place in the EU. 'The uncertainty they engender is climbing up businesses' risk registers, becoming a factor in investment decisions,' he said at the CBI's Annual Dinner in May.

▲ **THE YES MINISTER**
Scotland's first minister Alex Salmond wants a yes vote in the independence referendum

If Scotland goes

While the CBI reports that most businesses across Britain want Scotland to stay in the UK, Vistage's Confidence Index shows that only 26% of medium-sized businesses think a Scottish independence vote may have negative implications for them, and 66% are currently not concerned with the potential impact of the vote.

'This is one of those instances when businesses may be holding their breath, waiting to see what happens,' says Petros Fassoulas, head of policy, Europe and Americas, at ACCA. 'But whichever way the vote goes, companies north and south of the border will need to look at their business strategies in relation to tax, employment law, location and so on.'

If Scotland leaves the union, Scottish businesses may lose the benefits of free and unhindered trade within it. English, Welsh and Northern Irish companies will feel the pain too. 'Scotland's biggest export market, constituting 65% of all exports, is the rest of the UK,' said Rake. 'Drawing an international border between us would create costs for businesses on both sides.'

Further risk comes from being less than a year away from the next general election. 'The Coalition could become dysfunctional or break up entirely in the run-up to the election, leading to unpredictable and poor-quality policymaking based on crude horse trading between the Tory and Lib Dem leadership,' says John Rowland, executive director at communications agency Cicero Group. As for who wins, Rowland says the 2015 general election is the hardest to call in a generation but coalition or minority government could become the new normal at Westminster. 'There's a risk that the 2015 election results in a minority government with a weak mandate, unable to move its agenda and manage the economy effectively,' he adds.

A report from Cicero and the Chartered Insurance Institute (CII) predicts a Labour-Lib Dem coalition is a real possibility too, in which case an EU membership referendum would take place only in the event of treaty change, while another Conservative-Lib Dem coalition would definitely mean EU membership renegotiation and a possible in/out referendum in 2017.

Rake said: 'Even the possibility of the referendum happening has caused uncertainty for business, with the risk of fewer inward investments than would otherwise have been made.'

Many are in no doubt the UK must stay in Europe, albeit Europe reformed and fit for the needs of today's business world. ACCA sees staying in Europe as a no-brainer too, says Fassoulas. 'Major overseas businesses including Nissan have set up shop in the UK because it is part of the EU. If the UK were to leave, they would have to reconsider their investment » choices. The UK can't survive without these overseas companies. Apart from the many British businesses in their supply chains losing out, what about the 6,100 staff at Nissan's Sunderland factory?'

Fassoulas adds that UK businesses, especially SMEs, could benefit from greater EU integration: 'By lifting any remaining barriers we could increase trade between the UK and EU by 45% for SMEs.'

While the Conservatives are still effectively in power, their immigration controls may be holding back recovery by restricting the employment of non-EU nationals to close the skills gap. 'Britain needs talent, particularly in engineering where the skills gap is preventing growth. The success of our financial industry has been in part due to immigration too,' says Fassoulas.

Regional risk

Conflicts around the world also pose political risks for UK businesses with international links. The turmoil in Ukraine, street protests in Turkey and Brazil, anti-China riots in Vietnam and Thailand's coup will have had some businesses looking nervously at their supply chains. Supply chain risks have also taken on new and unexpected forms such as pillage (see page 38).

In general, there are two types of political risk – macro and micro. Macro risks, such as the threat of war in Ukraine, destabilise the business environment for all companies. Micro risks – for example, anti-brand protests or loss of social licence to operate – affect a particular sector or business.

The riskiest political environments are traditionally emerging markets. Earlier this year Aon Risk Solutions increased its political risk rating for all five BRICS (Brazil, Russia, India, China and South Africa). Brazil was downgraded 'as economic weakness had increased the role of the government in the economy', Russia because of Ukraine, India due to ongoing corruption and China because of an increase in political violence. South Africa's rating went down because of recurrent strikes.

Risk repercussions

Companies could lose a lot of money if they do not tackle political risk head-on. Shaistah Akhtar, litigation partner at King & Wood Mallesons SJ Berwin, says: 'As we witnessed with the recent Russia/Ukraine crisis, and previously with the unprecedented economic freeze on Iran, the scope and impact of economic sanctions can have a profound legal and commercial impact on businesses dealing with sanctioned entities and countries.'

Yet many businesses underestimate political risk. Only 39% of respondents to Accenture's *Global Risk Management Study 2013* expect political risks to rise over the next two years, and are more worried about legal, business, regulatory, credit and operational risks. This could be because they are ignoring what they cannot control. 'But although businesses can't necessarily shape what's happening in the political sphere, they can set themselves up to guard against fallout,' says Fassoulas.

Recognition is the first step. 'Companies looking to mitigate these risks must ask themselves who owns the political risk calculus within their decision-making processes and is tasked with ensuring that threats are identified,' says Will Stockdale, manager of business intelligence and investigations at Salamanca Group.

Designing appropriate assurance and risk management systems is next. Means of mitigation include providing security on the ground and buying political risk insurance, although the latter can become scarce in highly volatile territories.

Attempts to avoid or mitigate political risk succeed only if businesses are proactive and act swiftly. When the EU extended sanctions against Russia from individuals to corporates, Akhtar says her firm recommended that all businesses with operations or investments in the region revisited their relationships, contingency planning and potential exposure. 'In circumstances where sanctions are a threat or are imposed, businesses should first establish mechanisms to identify relationships with any blacklisted persons or entities by introducing suitable due diligence and screening procedures,' she says.

'Particular attention should also be paid to contractual obligations and dealings with counterparties in sanctioned regions. Businesses can often experience delays with transfers of payments and deliveries of goods as a result of sanctions so it's vital that their interests are protected contractually,' she adds.

Over the next few years the BRICS will continue keeping everyone on their toes. 'A lot will depend on how governments in those countries respond to the growing overseas interest,' says Fassoulas. In Europe, the future of the EU will have far-reaching consequences. 'Should the UK withdraw from the EU, many EU trade agreements, including the US-EU trade agreement will be beyond the reach of UK companies,' says Fassoulas. ■

▲ **OUT, OUT, OUT...**
The UK's continuing membership of the EU is in doubt

Iwona Tokc-Wilde, journalist