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Marc-Felix Otto

Management of Political Risks

Fundamentals and Tools for Executives and Entrepreneurs

Springer

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1 Introduction

Why a book about managing political risks? The short answer is: First, because they are on the rise, sometimes even threatening the very existence of companies. Accordingly, it becomes more important to manage them professionally. Second, because new opportunities are arising regarding the handling of these risks. Those who do not use the opportunities may miss out on critical value potential. And third, because the topic has not yet been comprehensively addressed: The existing literature focuses on political investment risks in developing countries. For industrialized countries, political risks are considered only from the compliance management perspective.

Why are political risks becoming more significant? Geopolitical risks have recently come to the forefront. These risks can take on drastic proportions and endanger companies, entire industries, or even national economies. Even if the consequences are not always so severe, actions such as sanctions can substantially weaken companies with business partners in rival jurisdictions.

In addition to geopolitical drivers, increased regulation plays an important role. In the USA, for example, the volume of applicable national legislation (such as the Code of Federal Regulations) has grown steadily

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over the past fifty years from about 20,000 pages to now over 180,000 (Regulatory Studies, n.d.). In Switzerland, as another example, legislative activity is steadily increasing; the annual volume of new regulatory code is now almost 40% higher than in 1980 (Parlament, n.d.). This does not even consider the cumulative effect of adding to existing legislation. Such a development has definite consequences for companies. According to a study by the consulting firm McKinsey, the costs of regulatory risk management for banks increased by about 40% in the period from 2014–2017 alone (Mckinsey, n.d.).

Other prominent indicators of political risk are sovereign debt and inflation. Sovereign debt is well above 60% of gross domestic product in many Western countries. Highly indebted entities tend to focus more on the short term, often exhibiting erratic and radical behavior. In recent decades, vital deflationary drivers such as globalization and digitization have compensated for the inflationary effects of rising public debt, yielding overall stable consumer prices. More recently, with stagnating or declining globalization, inflation has been rising in many countries.

Finally, in the World Economic Forum's Global Risk Report, the risk of eroding social cohesion shows the largest increase of all risks recorded during the Covid years. In many countries, the way that governments dealt with the situation directly threatened many companies' existence. In conclusion, it is assumed that political risks will continue to increase or at least remain at the current high level.

What opportunities arise in connection with these risks? Besides the classic approach of avoiding or reducing risks, there may be options to create a competitive advantage. One option aims at influencing the political actors. Such lobbying has been well-known for many decades and has been increasing, especially since the 2008 financial crisis, apparently with success. For example, the Strategas agency has defined a lobbying index of publicly traded companies that includes the leaders in terms of effort spent on influencing policy. This index has systematically beaten the S&P 500 index for a long time (Barrons, n.d.). A look at Europe shows that the number of high-level meetings between EU Commission officials and company representatives has doubled over the period from 2012–2018 (Welt, n.d.; FAZ, n.d.).

On another level, political upheaval may improve the market position of companies that exhibit a high level of resilience. Resilience can be strengthened locally, for example by a culture and values that promise reliability and security to employees, suppliers, and customers. Specific redundancies, such as additional inventories of critical semi-finished goods or an additional data backup layer, can increase resilience on a regional or global level.

Another fundamental option for dealing with political risks is to make the company more geographically flexible and thus less dependent on its current location. A company with a high degree of geographic flexibility can select the most suitable jurisdictions and develop a significant advantage over competitors. This applies to the location of individual corporate functions as well as the headquarters. Digitization creates new ways to achieve this goal. In the service and knowledge sector in particular, geographic flexibility is often easy to implement—but other companies can benefit as well.

Some companies have already implemented active, strategic political risk management. Others, especially those in the "new economy," have even been established on this basis. The first step is to understand the company as an independent institution, not as subordinate to the current home state. The relationship with the jurisdiction is then on the same level as the relationships with suppliers, service providers, and customers.

In a sense, geographic flexibility continues the trend of globalization at a time when international supply chain vulnerabilities have become more apparent. In recent decades, the share of international companies in global value creation has steadily increased. This puts pressure on corporate tax rates and, in some cases, reduces market intervention in multiple jurisdictions. This trend may now be reversing. The current geopolitical crisis surrounding the Ukraine war and tensions off the coast of China are causing economic unbundling and a return to more regional, redundant value chains. Additionally, jurisdictions undertake increased efforts to reduce tax competition. Importantly, the OECD's Base Erosion and Profit Shifting (BEPS) initiative has been formulated as a response to digitization. Another example is the tightening of German exit taxation. Ultimately, such political developments have an impact on the options for managing political risks. Nonetheless, with new complexities come new opportunities as well.

Companies that closely follow these trends and leverage them can significantly reduce their exposure and add value. Rapid, effective use of new technology and holistic consideration of options for alternative jurisdictions play an essential role.

How has the topic been addressed so far? Comprehensive political risk management in industrialized countries has not been adequately treated yet. Rather, since the 1980s, literature has focused on risks in developing countries. While this focus may be narrow, we can build on the risk categories developed there. We can also employ the various established methods of general risk management. From these starting points, we develop a comprehensive approach to dealing with tactical and strategic political risks. However, we focus not only on the concept. Rather, this book aims to give owners, decision-makers, and risk managers practical options for action and implementation. This purpose is served by illustrative examples and tools as well as references to further literature and knowledge sources.

1.1 Objective and Structure

The basic task of managing political risks is to avert or limit their negative impact on enterprise value. This book aims to sensitize corporate decision-makers to political risks, to give them the tools they need to deal with them, and to show them strategic options about how their company can create value in connection with the risks.

In a broader sense, it can also be read as a guide about how to handle personal or individual political risks. When interpreted this way, some aspects, like the optimal organizational structure, become irrelevant. However, the basic approach and method still apply.

At the basic level, the book is divided into two parts: In the first part, we define and categorize political risks (Chap. 2) and introduce essential general risk management methods (Chap. 3). We then discuss how to create transparency on the risks affecting the company. This includes both risk identification and evaluation (Chap. 4).

The second part focuses on dealing with political risks in practice. In Chap. 5, tactical political risk management is presented. Chapter 6 answers the question of how to deal with political risks from a strategic perspective. Chapter 7 then delves into an important option of strategic political risk management, the geographic flexibility of the company. Chapter 8 contains a short synthesis of the essential methods and shows possible fields to expand the discipline.

The concepts and methods are illustrated by three practical examples. While these are not actual real-life examples, they are based on the experience of the author and his company. They are introduced in Chap. 4 and continually elaborated on from there (Fig. 1.1).

1.2 Delimitation

This book does not intend to address the topic from every conceivable angle. The perspective we adopt is the viewpoint of entrepreneurs or business leaders who act independently and do not consider themselves as a part of public institutions. We also devote only a small amount of attention to a sub-aspect that has already been widely studied, the specific risks to foreign investment by multinational corporations. In Sect. 2.1.3, we briefly discuss this special topic and list several references.

Furthermore, we treat corporate governance as a single entity and assume that there are no conflicting objectives between owners and executives. In other words, we assume that the principal and agent are congruent at the top level of corporate management. Accordingly, we do not understand risk management as a formal bureaucratic requirement, but as a value-adding function that can significantly influence corporate strategy and success. Consequently, we only provide a basic discussion of risk management standards such as ISO or COSO ERM.

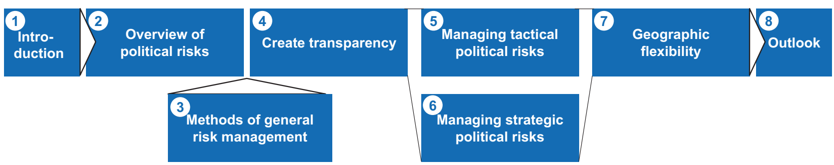

Fig. 1.1 Chapter structure

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2 Overview of Political Risks

The term political risk was coined in the Anglo-Saxon sphere in the second half of the last century. Although the term appears to be broad, the focus was and still is primarily on risks to foreign direct investment (FDI) in developing countries and emerging markets. For an overview, see (Weimer, 2000) or (Giambona et al., 2017). By contrast, evolving rules of the game in industrialized countries are often included under the term regulatory risk. We hold that this kind of distinction is no more appropriate in the globalized economy.

We start in Sect. 2.1 with a comprehensive definition of political risks. The fact that politics can unilaterally change the rules of the game is essential. By contrast, activities of political actors that conflict with applicable law do not usually fall under the concept of "politics." Hence, risks arising from this should not be referred to as political risks.

Politically charged issues often provoke partisan and emotional spokespeople. Differentiated, polarized discourse in the digital age often reinforces positions. We pursue a neutral, fact-oriented approach. The goal is to help corporate decision-makers more easily identify and assess political risks and to avert or at least reduce the damage they threaten to cause to the company. It is obvious that this can lead to corporate strategies that

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are not in the interests of some political players. An unbiased observer will easily recognize the side of the debate where value creation is endorsed. Accordingly, in Sect. 2.2, we also address the ethical and normative dimension of the issue.

In accordance with our objective, we structure political risks in Sect. 2.3 with the financial value drivers of the company in mind. For the sake of completeness, we also present alternative structures or classifications that may be useful in practice. The description of political risks relating to financial value drivers can be used to describe companies as a portfolio of investments with different risks. We briefly present this approach in Sect. 2.4. In Sect. 2.5, we examine the scope and likelihood of certain political risks from a general perspective.

2.1 Definitions

2.1.1 Power, Politics, State, and Jurisdiction

In order to obtain a definition of political risks, we need to clarify some basic social science concepts. This book is not intended to give a holistic approach. That is why we draw on classical works that are still valid and useful today. We refer to Max Weber to define the concept of *power* as "the probability that one actor within a social relationship will be in a position to carry out his own will despite resistance, regardless of the basis on which this probability rests" (Weber, 1921). Politics, again according to Weber, are then "striving for a share of power or for influence on the distribution of power" (Weber, 1992). Alternatively, Machiavelli formulates that "politics are the sum of the means necessary to come to power, to hold on to power, and to make the most useful use of power" (Pfetsch, 2003).

Max Weber sees the *state* as "a human community that successfully claims the monopoly of the legitimate use of physical force within a given territory" (Weber, 1972). In this context, the state or territorial entity typically consists of the three elements of the legislative, executive, and judicial branches.