

The Global State of Political Risk in the Wake of the Financial Crisis: A Question and Answer with Control Risks



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This interview of Control Risks was conducted by MIGA.



1. What is the impact, if any, of the current financial crisis on the political risk environment around the world? How have sovereign ratings changed and what are the implications for “traditional” political risk?

The events of the latter half of 2008 mean that “political risk” may be a term less frequently reserved for descriptions of emerging or semi-emerged economies. Unprecedented state interventions in those business sectors that had formed the true embodiment of apolitical free markets (banking, insurance, retail and manufacturing) may have somewhat re-defined political risk. Even if the “rising tide of Western protectionism” some have predicted does not occur, there will be, at the very least, an inevitable impact on the insurance market’s pursuit of new political risk business. Developed states’ responses to the financial crisis have also ended the traditional insurer’s portrayal of political risk, which may no longer fit the conventional scenarios such as an autocrat in a less developed country arbitrarily decreeing state ownership over foreign-owned business assets. Beyond the global investment community, emerging economies themselves will have to come to terms with a new kind of political risk. Having succeeded over the last decade in divorcing their national image from that of the stereotypical autocracy, and after years of appreciating assets, many emerging economies now face a new confluence of challenges. Of course the heterogeneity often associated with emerging markets was always something of a misconception, but there is now an ever-urgent need for investors - particularly insurers - to pay close attention to the political risks posed by each and every country in which they look to do business.

With asset prices collapsing, credit in short supply and conflicts smoldering in several regions, many investors

view 2009 as a year to retrench and evaluate their existing emerging market exposure. Emerging markets that have posted rapid growth rates over the last five or ten years – and even some mature, industrialized countries – suddenly look economically and politically fragile. Equity and commodity markets continue their rollercoaster rides, while fixed-income assets seem increasingly vulnerable to default. All in all, companies see a much more precarious business environment, and are understandably wary. But the impact of the financial turmoil will vary, depending on both a country’s exposure and its government’s response. Attractive investment opportunities can still be found, with the crisis likely to generate new prospects for mergers and acquisitions, market entry and operational partnerships. However, there will be a premium on closer monitoring and evaluation of the changing operational environment, and a strategic attitude to complex emerging security and political risks. Rather than punishing investors generally, 2009 will reward those companies poised to capitalize on effective risk management and seize good deals.

2. Control Risks is currently launching their annual Risk Map report. Considering the challenging global financial environment, how has the timing of the report’s release affected the structure and relevance of the report? Does the publication profile the impact of the financial crisis?

Control Risks’ Risk Map is an annual forecast produced by our expert country analysts of upcoming political and security risk trends for 202 countries worldwide. It also encompasses numerous thought pieces regarding transnational issues. In their assessments, analysts incorporate all relevant recent events as well as the long term country developments into their assessments. The financial crisis will be included in

the analysts' assessments of their countries' risk landscapes for 2009 along with other more structural economic and political trends, including propensity for political reform, fiscal policy, transparency and good governance.

As well as a map of the globe illustrating 2009's locations of risk, the written output for Risk Map involves a series of front-lining articles and succinct country-by-country projections for the forthcoming year. Last year, looking forward to 2008, Control Risks' front-lining piece for Risk Map was entitled the "Return of Risk." Not only did this piece expost the "drawing to a close" of the boom of the early years of the new century, it predicted that even for commodity producers - who had seen themselves somewhat immune from sub-prime turmoil in 2007 - "it would be unwise to assume that the demand side (for commodities) is structurally robust enough to weather a downturn in liquidity and economic activity."

3. What is the response that Control Risks has seen in the marketplace? Are investors moving forward with projects? Is there a heightened sense of political risk? Are clients seeking risk mitigation tools, such as political risk insurance?

Innovative professionals in the insurance community will be looking to formulate policy packages that capture new political risks and opportunities. Understanding and definition are the keys here, and an accurate, expert assessment of political risk is more necessary than ever before. In general, markets are learning to respond much more rapidly to political risks. In the wake of its military invasion of Georgia, for example, global investors withdrew more than \$25bn from Russia on perceptions of increased political risk and the prospect of US or European retaliatory measures. Russia, however, remains open for business: the financial crisis is actually removing some impediments to investment as the government learns from the pitfalls of perception and seeks to incentivize foreign capital, including offering better contract terms and paving the way for some international acquisitions. If political risks seemed inconsequential

during the asset boom years, when markets appeared to defy gravity, the Georgia crisis suggests they will be decisive in an era of collapsing asset prices and more savvy markets. But it also indicates a need for fine-tuning risk assessments, so that good deals do not fall by the wayside under a generic mantra that a particular region is becoming more risky.

Clients are increasingly seeking more comprehensive political risk insurance packages that capture the new risk landscape and often over longer periods of time. Although an excellent and tested method of mitigating risk, insurance is, in its rightful place, the last resort of risk mitigation. Political risk insurance is a necessary stage of risk mitigation for those clients who have taken all other measures to limit their exposures to adverse political events. Similarly, you can only buy insurance against writing-off your car once you have mitigated the risk of crashing by passing your driving test. In this vein, many well-prepared companies are seeking independent political risk assessments and recommendations in order to lower identified risks, prior to insurance purchase. Comparatively, in the interests of building a robust book of "quality" business, as well as to satisfy internal reporting requirements and the need to report their due diligence to re-insurers, political risk underwriters are beginning to demand this of their clients.

4. What is Control Risks' outlook in terms of the longer-term implications of the financial turmoil on perceptions and management of political risk?

Control Risks foresees a growing emphasis on detailed, country-specific political risk assessment as investors emerge from retrenchment to find opportunity with more caution. Cautious risk management will likely involve a flight to quality over the next few years but this need not constitute a flight to the already-known. What this means is that, with proper risk management processes and tools, companies can still enter new markets and not retrench into markets where they are already present. Therefore, as long as political risk insurers and

the wider investment community keep research, assessment and planning at the forefront of their business model, new risks in lesser-known economies can continue to contribute to a healthy income.

In summary, Control Risks includes some tips for successful political risk assessments in the coming year:

- Don't ignore due diligence. With capital outlays under severe stress, it's important to make each investment count. Thorough due diligence investigations of prospective partners, suppliers and customers is essential.
- Be sector specific. Countries that are very bad at managing their power utilities may be very efficient when it comes to oil and gas, even during an economic downturn. Similarly, risks and opportunities will differ between strategic sectors, which may be subjected to high-level political risks like expropriation, and non-strategic sectors, where routine business risks like fraud and corruption will predominate.
- Drill down to local politics. Dealing directly with central government ministries is great, until you realize that their power ends at the city limits and all practical decisions are actually made in the provincial governor's office. Similarly, while the official license to operate may reside with the department of industry, the social license to operate sits with the local community - a fact that is all the more relevant as economic growth slows.
- Pull aside the curtain of surface risks. Underlying drivers of political and operational risk are as important to understand as the specifics. Piracy around Somalia is a perfect example: while the day-to-day focus is on offshore security threats, it is economic and political collapse onshore that enables piracy. Without addressing the underlying issues, it is very unlikely that the superficial situation will improve on its own.