FT SPECIAL REPORT

# Risk Management

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## Politics are often the most unpredictable element

A late surge for the Yes campaign in the Scottish referendum caused panic, writes *Alistair Gray*

The empire is quaking in its boots," shouted a man into his megaphone. Twelve hours before polls opened for the historic referendum to determine whether Scotland was to remain in the United Kingdom, the supporters of independence had good reason to be upbeat.

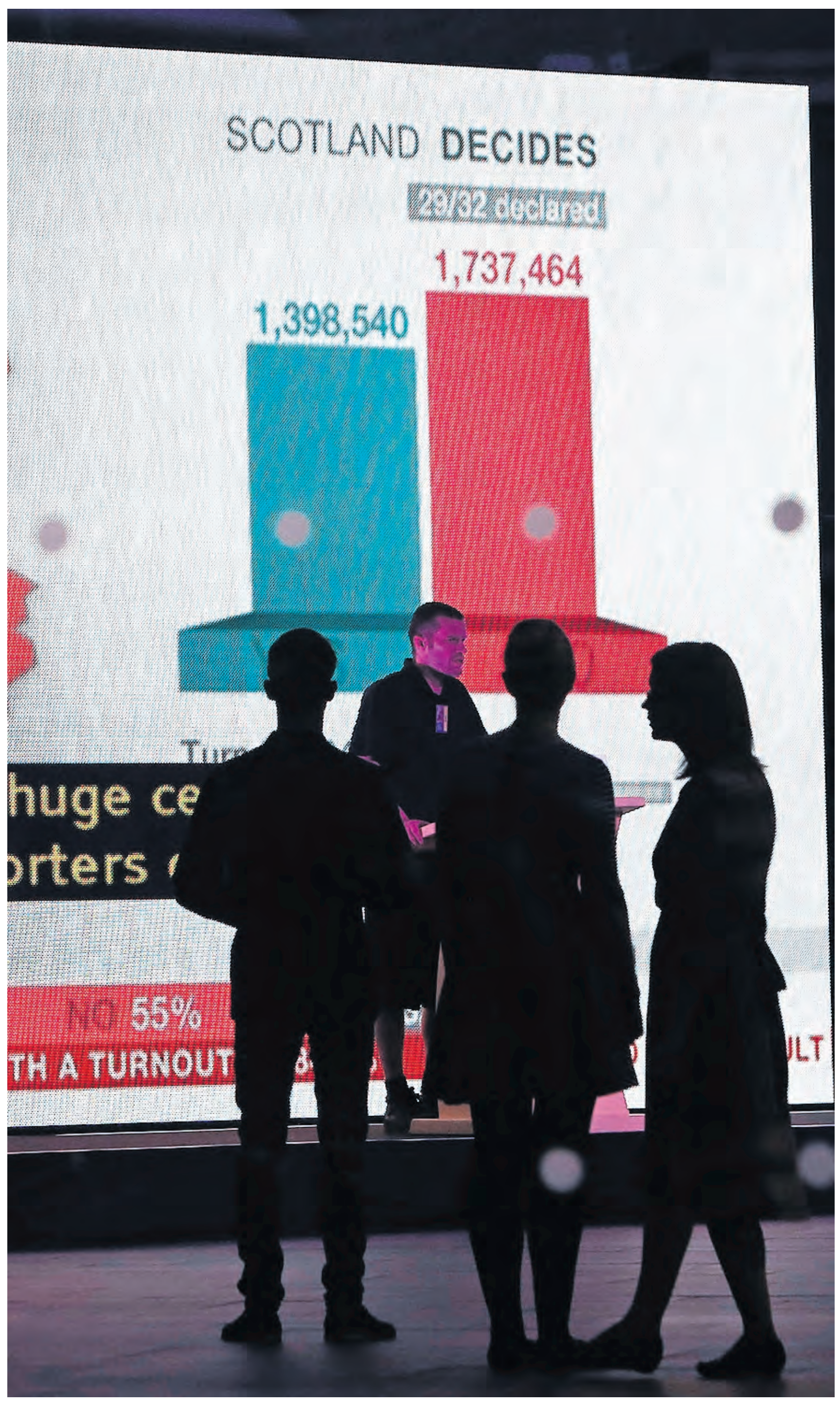
Having lagged behind by as much as 20 points just weeks earlier, the latest opinion polls were indicating the Yes movement was close to victory.

Hundreds of campaigners had flocked to George Square, Glasgow, for a noisy afternoon of music, speeches and dancing. A packed saltire-waving crowd belted out *Flower of Scotland*, the national anthem. "Bannockburn 1314, Ballot Box 2014" read a flag, referring to the 14th-century battle in which the Scots beat the English. Nervous-looking people in suits peered out from the offices above.

A break-up of the UK, the world's sixth-largest economy, was likely to cause a sharp sell-off in sterling and disrupt capital markets. And yet, just a month before the plebiscite, the risk had barely appeared on the radar of most global companies and their investors.

In the end, the 307-year-old union survived – although a swing of just 5 per cent of the vote would have been enough to end it.

"The Scotland episode is a perfect example of how political risk can manifest very suddenly," says Tom Wales, director of analysis at the consulting group Oxford Analytica.




**The public vote: businesses were caught unawares when the Yes campaign edged ahead just days before Scotland voted on independence** — PA

When it comes to geopolitics, the tools that companies typically employ to assess and manage risks have serious limitations.

To be sure, companies can buy insurance to limit the fallout from adverse political developments. However, the protection on offer from political risk policies covers only specific perils – and is largely confined to emerging markets.

"It's a fairly specialised, niche area," says Andrew van den Born, head of political and trade credit risks at Willis, the insurance broker.

Most insurers are only willing to protect against a "well-established phenomenon", he says. This might include confiscation of assets in unstable jurisdictions. The highest profile recent example came two years ago, when the Argentine government, led by Cristina Fernández de Kirchner, renationalised YPF, a subsidiary of the Spanish oil and gas group Repsol.

Companies can also buy protection against the risk that they will struggle to convert local currencies, that state bodies will fail to meet their contractual obligations, or that operating licences are revoked. Furthermore, they can protect themselves against political violence and terrorism, in both emerging and developed markets. Payouts have recently been made after Hamas fired rockets into Israel.

Geopolitical instability in the Middle East and Ukraine has had only a limited impact on financial markets. Even so, cautions Mr Wales: "Markets tend to be really, really bad at assessing political risks." Companies are taking them more seriously, say consultants.

"Five years ago, most companies were looking at these types of risks exclusively for emerging markets," says Jonathan Wood, director at Control Risks.

"Since the [financial] crisis, there's been a sharp uptick in interest in developed world political risks."

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### Inside



## Tide of cheap capital lowers cost of terrorism insurance

Reinsurance

The industry could find itself exposed to huge claims, as it was after September 11, reports *Brian Bollen*

It might seem counterintuitive to the lay person, absurd even, but terrorism insurance rates are languishing at low levels and look set to stay there, despite recent events in the Middle East and elsewhere.

The principal reason given by insurers is simple: while there is an apparent dearth of capital in the retail insurance market, the reinsurance world is awash with capital. The low interest rate environment is pushing institutional investors into unfamiliar areas in the search for yield, creating fresh sources of capital for reinsurers to access, and increasing competition for new business.

Julian Enoizi, chief executive of Pool Re, whose sole business is reinsurance says: "Terrorism reinsurance rates have steadily declined from their height 10 years ago, because there have been relatively few serious events since September 11, 2001. That lower incidence of events has made terrorism insurance and reinsurance appear more profitable and means that rates are competitive," he adds.

The cost of reinsurance claims has also dropped: although localised violence is killing people in a number of countries, it is property claims and disruption to commerce that are traditionally much more expensive.

This does not mean, however, that the industry can afford to take undue risk, warns Justin Balcombe, UK head of general insurance consulting at KPMG. In 1993, he dealt with claims arising from the Bishopsgate bombing in London. More recently he has worked on claims arising from political issues in the Middle East and Africa.

All have underlined the commercial danger of not having the correct insurance values, including adequate business interruption coverage.

"The reinsurance industry is well capitalised and capable of responding to major claims events. However, that doesn't mean that cover should be reduced or diluted just because there hasn't been a trigger event. Fortunately, we have seen nothing of the magnitude of 9/11 in recent years, [but] we should not become complacent. Risks have become far more technical, complex and in many areas, highly unpredictable. This, in turn, presents a plethora of challenges for the entire insurance market and value chain," Mr Balcombe says.

James Hannan, an underwriter of terrorism and political insurance and reinsurance at Antares, a Lloyd's of London syndicate, notes that terrorism cover is increasingly included in property catastrophe insurance policies as a standard peril – as it was in the days before September 11 2001. (Afterwards, the industry, reeling from more than $40bn of losses, realised the risk was not being properly valued, and began to charge separately.)

"The growth in competition brings not only pricing pressure but greater breadth and depth of coverage in contracts," he says. "When something is offered that wasn't before, that is further indication of a softening market."

Partly echoing these concerns, AM Best, a global credit rating agency that focuses on the insurance industry, released its annual review of the reinsurance sector in September. This includes a ranking of reinsurers and geographic breakouts of reinsurance segments. In the report, How Relevant is the Underwriting Cycle?, the company states that capital continues to be drawn to the reinsurance industry, even though income is falling while costs are rising.

The report explains how downward pressure on investment yields and underwriting margins will ultimately place a drag on financial strength.

AM Best recently revised its ratings outlook on the reinsurance industry to negative from stable. "This reflects the longer-term competitive outlook," explains Catherine Thomas, London-based director, analytics. "It may be well capitalised now, but market dynamics are going against it," she concludes.

While the firm does not foresee a significant number of negative outlooks or downgrades in the very near term, "the market headwinds at this point present the industry with significant longer-term challenges".

### Danger money
Premiums for high-risk travel

For all the talk of highly competitive pricing, there is no such thing as a publishable terrorism insurance rate card for insuring people, says Peter Bellwood, managing director of specialist broker Bellwood Prestbury; each case is decided individually.

Located in Cheltenham, the UK town that is home to the government's GCHQ listening post, Bellwood Prestbury takes a number of factors into account when calculating rates. However, Mr Bellwood will go so far as to say that some insurances that cost $15 a day two to three years ago will now cost below $5. There are many contributing factors and not all pricing will have changed to the same extent.

"As a broker, our job is to secure the best price for the client with a good insurer. We usually work with a client's human resources department and look at the client's location, the travel destination, the proposed length of stay, security arrangements travelling to and from and during the visit, accommodation and security arrangements, and the amount required," he explains.

Occupation also has a bearing, he adds. A journalist in the field will be in more danger than someone sitting at a desk in Baghdad, he says.

Recent events in the Middle East and elsewhere cannot be ignored. In August, for instance, Bellwood Prestbury wrote business for a number of clients at higher levels of cover than previously. "We can cover for death, dismemberment, total and permanent disablement, temporary total disablement, medical expenses and repatriation," he says, before adding almost as an afterthought: "We can also do kidnap and ransom."

# Conflict demands a strategy for an uncertain world

**Opportunity** Desire to keep one step ahead has created an industry, says *Barney Thompson*

Brandishing colour-coded maps and complex scoring systems and boasting an array of top-level government contacts, political risk consultancies can charge large sums for their analysis and reports.

Once an adjunct to more lucrative services such as security and due diligence, political risk is now a growth industry in its own right. On-the-ground operations, supply chains, investments, regulation, contract negotiations, tax – almost everything can hinge on knowing when the revolution is coming.

But if the CIA's army of analysts could not predict the fall of the Soviet Union, do any of these firms really have the insight to justify their fees? Is it even possible to foresee events such as the Arab spring, the conflict in Ukraine or the coup in Thailand?

Political risk consultancies argue that their job is less about predicting exact events and more about identifying threats and sources of disruption so their clients can prepare for the worst. The consultancies create "a mindset of anticipation and analysis", as one risk analyst put it, by presenting a range of scenarios of varying likelihoods.

"With the Arab Spring, there were underlying factors that were creating unstable environments – geriatric autocrats without a legitimate political base," says Jonathan Wood, head analyst at Control Risks Group.

"It was clear that at some point, with the death of the dictators or economic collapse, this arrangement would come under pressure. On Iraq, we were saying for some time that, looking at the pattern of attacks in Fallujah and Anbar Province, it was fairly apparent that Islamic State had the territorial ambitions and tactical capability to take control of cities across [the region] – therefore, we considered it a significant threat."

Charles Hecker, CRG's global research director, adds "no one would say they had predicted events in Ukraine – the Maidan protests, the annexation of Crimea by Russia and the current situation".

But once the crisis was unfolding, he says CRG did well at charting the course of sanctions on Russia – increased Russian support for the separatists, meaning tighter sanctions, meaning Russian troops on Ukrainian territory, more sanctions, and so on.

Most political risk analysts claim this is where they offer value – not in forecasting the exact date of seismic events, but in warning of inherent instability and therefore giving companies time to prepare for how to react if and when the shocks take place. "We make projections, rather than predictions," says John Drake, head of intelligence and risk mitigation at AKE Group.

"A lot of our clients are looking at specific assets or deals, rather than general politics, and want to know what's going to happen to those assets now and what could happen in five years' time."

The tools of the trade are similar across consultancies, with charges increasing according to the depth of analysis. There is a shared love of coloured maps of varying sophistication, plus score ratings on factors ranging from political stability to environmental problems.

> 'There will always be shocks . . . The question companies ask us is: should we stay?'

Those scores are generated both by trawling open-source materials and cultivating in-country sources, from taxi drivers and journalists to high-ranking bureaucrats, bankers and politicians. Asking consultancies who their "assets" are at this level will tell a potential client a lot about how privileged their information is going to be.

Most consultancies operate on a basis of "forewarned is forearmed". Yet at least one believes it is building up a data set to make more precise predictions – or, at least, to identify sources of instability more reliably.

Alyson Warhurst, founder and chief executive of Maplecroft consultancy, says: "We have found that long-term societal risk factors are a leading indicator of political risk – in particular, specific human rights issues such as security force violations. If you look at the characteristics of a number of countries – Egypt, Libya, Syria, Ukraine, Thailand – before they underwent regime change, all of them had growing middle-class populations alongside worsening political freedoms and growing corruption."

At that point, she says, governments behave in certain ways. They may try to pacify a society that is not seeing the benefits of investment by confiscating foreign assets, changing tax regimes or requiring greater benefits to the local population, or they may resort to outright repression. Only those that are nimble enough constantly to reform, the theory goes, will manage to survive.

"What is important is not just where a country is, but where it is going," Ms Warhurst says. "In China's case, for example, I don't envisage a 'jasmine revolution', because the government knows it has latent political/social tensions and so it is reforming . . . to offset them – increasing wages, improving conditions, giving migrant workers more rights and fighting corruption."

It is also worth remembering that how companies treat all this advice is entirely different from how news outlets and aid agencies would react. For example, when Isis tore through western and northern Iraq, big oil groups will have been focused on threats to specific oilfields, and routes to market.

"There will always be shocks," says one senior industry analyst. "The questions companies ask us are: should we stay in the country? Is it going to be impossible to operate? What are the practical challenges? It is our job to challenge the consensus and the blanket conclusions of the media."

The fight goes on: the battle against the Islamic State in Iraq and the Levant has spilled over to encompass Syria and threatens neighbouring countries — AFP

## Caught in the crossfire Weighing up the pros and cons of working in areas with severe instability

Jonathan Wood of Control Risks forecasts "material progress" in the continued nuclear negotiations with Iran. The Iranians may not get everything they want in terms of the lifting of sanctions and development of the country's oil sector, but he expects negotiations to continue to a broader and more comprehensive deal.

As for the confrontations between Asian powers in the South and East China Seas, he fears "more fireworks" and that this region will be a renewed cause for heightened tension before the end of the year, although he thinks it is unlikelyto spark serious conflict.

Alyson Warhurst of Maplecroft, a risk analysis company, highlights rising political violence – with a quarter of countries exhibiting a significant increase in the past four years – as posing a threat to a number of markets. In Nigeria, increasing terrorist attacks and an upcoming election campaign – scheduled for 2015 – are likely to increase tensions. Severe instability and conflict in Libya will continue to affect security in Egypt, Tunisia and Algeria. The Islamic State will be difficult to dislodge from Syria and Iraq, with significant security implications for countries including Jordan and Turkey. The political risk "wild card" is Russia, a revisionist power with a leader willing to take big gambles.

John Drake of AKE expects a big transformation of the Iraqi state over the next decade, probably with moves towards greater federalisation – if not violent disintegration. Companies operating in an area with one backer will have difficulties operating in another area with a rival power supporting it.

# Banks increase efforts to stay on right side of law

**Sanctions**

The imposition of swingeing penalties has led to a much greater spend on compliance teams, says *Sam Fleming*

If there was any doubt in bank executives' minds about the perils of falling foul of US sanctions, it was decisively scotched on Monday, June 30.

BNP Paribas's guilty plea to violations of sanctions against Sudan, Iran and Cuba was accompanied by a blockbuster fine of nearly $9bn – plus a one-year ban on conducting certain transactions in dollars.

The swingeing punishment prompted frenetic levels of work in the financial sector as firms try to avoid following the sorry trail blazed by BNP Paribas.

The stakes have since risen further, as the US and EU impose fresh rounds of sanctions on Russian companies and individuals in retaliation for the country's incursions into Ukraine.

"The cost of not being squeaky clean is phenomenal," says Ross Denton, a London-based partner with Baker & McKenzie, a law firm.

Staying on the right side of the rules is proving an increasingly complex task, say consultants and lawyers. Russia presents a particular challenge, given the opaque structures companies use.

One expert compares working there with combing through the complex empire of Robert Maxwell, the disgraced media magnate whose empire unwound after he died in 1991.

As a result, costs are rising fast. BNP Paribas, for example, took a €200m charge related to an overhaul of compliance procedures as it responded to its fine by setting up a special unit in New York, aimed at ensuring that it stays on the right side of US rules.

Macquarie, the Australian investment bank, announced in May that its direct compliance costs had tripled in three years, to A$320m.

The recruitment market for people schooled in sanctions and anti-money laundering (AML) is red hot as a result, says Brian Dilley, a partner at KPMG. HSBC took on 1,500 extra compliance staff in the first half of the year, lifting its compliance spend by about $150m.

"AML and sanctions are where the big fines are," Mr Dilley says. "Banks have armies of people doing this work and there is a real premium on people who can interpret the rules properly."

Lenders are also leaning heavily on outside firms to navigate the sanctions minefield, leading to a busy advisory market. Stroz Friedberg, which bought investigations firm Billiter in 2013, says it has increased its Russia team by 50 per cent in the past year.

The practical difficulties of staying on the right side of the law are legion. There are thousands of names on sanctions lists, and banks have to screen their customers and counterparties using "fuzzy matching" in order to catch misspellings, says Mr Dilley.

Staff members also need to screen carefully for false positives; for example, ensuring a scuba diving club is not picked up as having anything to do with Cuba, which is on US sanctions lists.

David Buxton, who helps run a small firm called Arachnys providing emerging markets compliance, says it is not enough for a company to ensure its counterparties are not formally named on a banned list. "You need to know who owns it to make sure you are not dealing with the subsidiary of a banned company," he says. "Indirect relationships can be just as damaging."

This is particularly tricky when working with Russian parties. "The way in which Russian business has conducted itself in the west is through a complex and disparate system of companies. It is difficult obtaining information, and the due diligence is of a higher level and more complex," says Mr Denton.

He says banks are seeking more legal opinions on whether a deal falls on the wrong side of sanctions, as well as updating the standard wording of contracts to ensure they deal with sanctions violations rather than relying on traditional *force majeure* clauses to back out of deals.

The latest rounds of US and EU sanctions on Russia suggest the pressure will not abate. "Sanctions are a more important part of foreign policy than they have ever been," says Steve Ganis, a partner at Mintz Levin, a law firm.

Any entity that wants to do business in dollars needs to be particularly careful – as BNP Paribas discovered to its cost.

"In the past, some financial institutions did not recognise the extraterritorial reach of sanctions in dollar transactions," Mr Ganis continues. "That has now changed. People are looking at sanctions compliance harder than I have ever seen."

## West slow on Swift

The latest overhaul in US sanctions on Russia came on September 12, with the US saying it would prohibit Bank of Moscow, Gazprombank, Russian Agricultural Bank, Sberbank, VEB and VTB from securing dollar-denominated debt of greater than 30 days' maturity – rather than 90 days as was the case previously. The US also widened a ban on the export of goods, services and technology for Russian oil projects to embrace Gazprom, Gazprom Neft, Lukoil, Surgutneftegas, and Rosneft.

However, one step the western countries have shied away from so far is denying Russia access to the Swift system of international banking payments, a step taken against Iran in 2012.

Belgium-based Swift – the Society for Worldwide Interbank Financial Telecommunication – is the secure communication system used by most of the international banking system, processing about 500m messages a month.

Removing access to the system would force Russian banks to find other methods of sending and receiving money across borders, meaning that every payment would take significantly longer to process.

One adviser calls shutting off access to Swift "the nuclear option of financial sanctions". It is a formidable weapon in the west's armoury – yet one it appears to be wary of using at present.

**SF**

# Foreign investors need to step up to a newly demanding, emerging region

**Latin America**

Anti-corruption, antitrust and environmental policies are increasingly coming under the microscope, writes *Amy Stillman*

The map of Latin American risk is changing. True, countries such as Venezuela, Bolivia and Argentina still carry the hazard of asset expropriation; the mining-rich Andean region has its share of social unrest; and in Mexico, Colombia and much of Central America, violence remains a problem. But things are improving with the growth of Latin America's middle class, a long period of democratisation and changing external conditions.

"Investors' risk mitigation strategy has to be very different from even five years ago because the demands on policy makers are changing radically," says Christopher Garman, Eurasia Group's emerging markets and Latin America director.

Last year's "taper tantrum" – when many Latin American currencies devalued sharply as a result of the US Federal Reserve's tapering of quantitative easing – is a strong reminder that the region is still vulnerable to external shocks.

Brazil's interventionist fiscal policy in response to these woes has had negative effects, with the country now plunged into a technical recession. In the more fragile economies of Venezuela and Argentina, financial risk has soared. And even business-friendly Chile and Mexico have implemented tax measures to shore up state revenues amid lower growth.

Yet Latin America is also more economically and politically stable than it has ever been, with most governments in the region strongly adhering to market policies. All this is borne out in the sharp rise in foreign direct investment, which reached a record high in Latin America and the Caribbean last year, at $185bn, according to the Economic Commission for Latin America and the Caribbean, a UN agency.

Alejandro Solorzano, the multilatinas regional leader of Marsh & McLennan, the global insurance broker, says: "We're seeing a big jump in capital flows to Chile, Colombia, Peru, Mexico and Brazil because investors favour countries that are more stable, that have structural reforms and strong democracies."

Risk mitigation is also improving with new mapping systems that rely on "big data" to crunch large amounts of information, allowing investors to pinpoint perilous areas more accurately.

Still, while expanding one's Latin American footprint need not be that risky (so long as you tread with care), there are also important changes that require new risk management solutions.

Increasingly, anti-corruption, antitrust policies and the environmental regulations in Latin American countries are coming under the microscope.

"A decade ago you wouldn't pay much attention to environmental standards and companies could pretty much do what they pleased," says Jaime Trujillo, a managing partner at Baker & McKenzie's Bogotá office in Colombia. "Now they run significantly greater risk of prosecution."

> 'A decade ago, you wouldn't pay much attention to environmental standards'
>
> Jaime Trujillo

Indeed, it is perhaps telling that Marina Silva, a leading contender in the Brazilian presidential race, is an environmental activist raised by rubber tappers in the Amazon jungle. Ten criminal charges brought by Brazil against Chevron for a 2011 oil spill off the coast of Rio de Janeiro – which was much smaller than BP's Deepwater Horizon oil spill in the Gulf of Mexico – threatened to result in jail terms for some of its employees.

The criminal charges were dropped in February last year, but two charges related to pollution and failure to notify authorities in a timely manner have been reinstated on appeal. Mr Garman says the Brazilian government's action was "symptomatic" of the changing times. Many viewed the incident as a warning to other companies hoping to exploit Brazil's deep sea oil reserves.

The issue of corruption is also becoming more salient. This year Brazil introduced the Clean Company Act, which imposes fines of 20 per cent of gross annual revenue on companies found guilty of graft. Similar anti-corruption laws were introduced in Mexico in 2012 and Colombia in 2011.

Moreover, Latin America faces greater international scrutiny as trade has ticked upward. A number of actions taken over the past few years under the US's Foreign Corrupt Practices Act occurred in the region. Foreign companies operating in Latin America are also liable to face sanctions under the UK's Bribery Act and anti-corruption measures under European law.

"International businesses have to be much more careful with whom they do business," says Dwight Dyer, a Mexico City-based analyst at Control Risks, a consultancy.

Informality in Latin America, where many companies are privately run and family-owned, is a related problem. According to Mr Trujillo, conducting extensive due diligence is a prudent safeguard before choosing local partners. "Rushing into deals is a recipe for failure," he warns.

The same holds true when considering investments in greenfield projects, particularly in extractive industries. Work sites are usually in remote areas and projects are often reliant on local authorities and communities. According to Donnie DiCarlo, Marsh's head of credit and political risk, pitfalls are so common that banks often factor in delays when providing project finance.

Local bureaucracy often bogs down projects in red tape, for example, making environmental permits more difficult to obtain. Social conflicts are also complex.

As rural communities become more powerful politically, it is no longer enough for foreign companies to invest in one-off, local community projects, says Mr Garman.

"The private sector needs to work with the public sector on systemic solutions."

# UK could find itself tied to EU rules but with no say

**Brexit** The prospect of a referendum on leaving the trade bloc creates business uncertainty, writes *Brian Groom*

If investors are nervous about the prospect of Britain holding a referendum that could lead to it leaving the EU, they are not yet panicking – perhaps because any vote is unlikely before 2017. Foreign investment has been flowing strongly into the UK, helped by cuts in business taxes.

In 2013-14, the UK attracted the largest number of inward investment projects since records began in the 1980s, up 14 per cent on the previous year, according to UK Trade and Investment, the trade promotion agency.

EY, the professional services firm, found that Britain extended its lead last year as Europe's top destination for global investors. And according to the UN, the UK remained second only to the US for the cumulative stock of inward investment, up 8 per cent at $1.6tn.

Yet there is undoubtedly concern in boardrooms. According to a poll by Deloitte, chief financial officers in large companies worry more about an EU vote than about higher interest rates or a housing bubble.

Sir Mike Rake, president of the CBI, the biggest business lobby group, warned recently that uncertainty over an EU referendum was "increasingly causing real concern for business regarding their future investment". Foreign investors, especially in the City of London and in manufacturing, are among the most anxious.

Wall Street banks such as Bank of America, Citigroup and Morgan Stanley have been considering plans to move some London-based activities to Ireland – partly because the eurozone's impending banking union threatens to isolate Britain, but also in the case of a UK exit from the EU. Most US and Asian banks base their European operations in the UK, giving them an automatic passport to operate in all 28 EU countries.

Executives fear the UK would be unlikely to receive the same "passporting" rights if it left the EU.

The UK hosts more than 250 foreign banks. In a poll by TheCityUK, a lobbying group, more than a third of business chiefs in financial and professional services said they would relocate staff to somewhere within the single market if Britain ended up outside it.

Britain's £60bn car industry, mostly foreign-owned, has been vociferous. In a KPMG survey for the sector's lobby group, 90 per cent of companies said leaving the EU would hurt their business, while 75 per cent said an exit would negatively affect future investment.

Carlos Ghosn, chief executive of Nissan, the UK's biggest carmaker by output, said last year it would be forced to reconsider any future investment if the UK left the EU. Japan's Hitachi has also said the future of its large investments in nuclear and rail could be in doubt.

Companies trying to assess the risk of "Brexit" face difficult questions, not least whether a referendum will happen. David Cameron, prime minister, has pledged to negotiate reforms and hold an in-out referendum by 2017 if the Conservatives win next year's general election. But Labour and the Liberal Democrats support a vote only if there is a further shift of powers to Brussels.

A referendum is assured only if the Tories win an overall majority, which they have not achieved since 1992. Mr Cameron says a referendum would be a precondition of any coalition negotiations, but Nick Clegg, deputy prime minister, has refused to say what he would do. Then there is the issue of whether Mr Cameron can renegotiate successfully. So far, he has urged steps such as curbing access to benefits for migrant workers, a greater role for national parliaments in EU policy making and an exemption from the goal of "ever closer union". Some think these could be met without treaty change, but they are unlikely to satisfy eurosceptics who want repatriation of powers such as employment and immigration policy.


**In or out? David Cameron has pledged a referendum on Europe by 2017** — Getty

In a previous referendum in 1975, opinion polls initially showed a majority for withdrawal but eventually the UK voted by two to one to stay in. Polls today also indicate that if Mr Cameron secured favourable terms, there could be a majority vote to stay.

More uncertain still is what deal the UK could get if it left. Options would include a Swiss-style arrangement based on bilateral accords with the EU; a customs union of the kind Turkey has with the EU; or, like Norway, membership of the European Economic Area, giving Britain access to the single market but no formal ability to shape the rules.

Pro-EU figures warn that the UK's bargaining power would be limited without it being freer from regulations.

Investors do not welcome this lack of clarity. "It's an unnecessary risk," says one. "Foreign investors come to the UK to access the European market. The uncertainty may lead some to cancel or defer decisions."

# Investors must prepare for worst case scenarios

**GUEST COLUMN**

Mina Toksoz

In today's international environment, investors need to be prepared for "worst case" scenarios becoming the base case.

Political risk is now more complex and multidimensional, requiring wider policy analysis. In addition, geopolitical risk has risen because of current international global conditions.

Political risk is difficult to predict. In *Why Nations Fail*, a study of institutional development, authors Daron Acemoglu and James Robinson speak of "critical junctures" in history when the social, political and institutional trajectory of a country is interrupted and it shifts.

Usually, it is only possible to identify a critical juncture after it occurs. This was the case with the overthrow of long-term autocrats in Tunisia, Egypt and Libya in 2011. Many analysts understood that these regimes were unsustainable and that these leaders' overthrow was likely to create a power vacuum resulting in deep civil strife.

However, because they had lasted for so long, it was impossible to tell when, or how, they would fall.

Ian Bremmer and Preston Keat argue in *The Fat Tail* that "pure bolts from the blue hardly ever occur". For example, they disagree that the 1917 Russian Revolution and subsequent debt default was a random and unexpected event. The British knew the Germans were funding the Bolsheviks and the Russians knew Lenin would prove a threat.

> Geopolitical and strategic risks build up gradually over a long period, so they tend to be underpriced by financial markets

But it seems that the complacency of the European elite, who thought the first world war would never happen, also extended to the possibility of a Bolshevik revolution.

Almost a century later the Russian default of August 1998 took place, with creditors lending right up into that summer – underestimating the fragility of Russia's institutions, on the grounds that "superpowers don't default".

Because geopolitical and strategic risks build up gradually over a long period, they tend to be underpriced by financial markets.

And they have increased in the current international environment: older powers are preoccupied with recovery from the economic crisis, while emerging powers are testing their strength.

As a result, potential geopolitical risks could pan out as worst case scenarios, as seen in Ukraine and Syria. Also, the complex, interrelated global and regional threats seem to require a new range of policy instruments.

The increasing use of economic sanctions, as against Russia over Ukraine, creates its own risks, as evident in the smuggling and corruption that they spawn, and the potential for fragmenting the global economy.

Political risk is usually not high on the list of threats in advanced economies with mature political institutions and the flexibility to respond to domestic and global pressures. But in recent years, such countries have witnessed an increase in political risk not seen since the 1970s.

The US has to contend with Congressional political gridlock, gerrymandering of electoral constituency boundaries, the power of Washington lobbyists, and the deterioration in income distribution.

The EU's institutions face high youth unemployment and the rise of xenophobic and protectionist political currents. Separatism – first in Scotland, then Catalonia – is another element.

Given the maturity of political institutions these conflicts are mostly – though not always – mediated peacefully. But, as seen with the decline of sterling in the lead-up to the Scottish referendum, they increase uncertainty.

In rapidly growing emerging markets, political risk is a large element of cross-border risks that investors must manage. Institutional development inevitably lags behind rapid social and economic change, increasing political tensions.

Institutional weaknesses persist because of political ruptures, such as military coups, social revolutions, or civil wars. Thus institutions are often grafted top-down, which interrupts the gradual evolution and maturing of institutions reflecting local conditions. Examples include Argentina and Thailand, or southern European countries such as Portugal, Spain Greece and Turkey with their periods of military rule.

Resource-rich developing countries often have oligarchic and authoritarian political structures. State authority is based on the control of vital resources, as with the royal families of the Gulf, or a narrow elite, as seen in central Asia.

This fosters corruption and lack of transparency, and the risks associated with leader succession are high. Political unrest tends to be met with a combination of repression and state handouts. Budget reliance on tax revenues tends to be minimal. Hence such governments are under little public pressure for more transparent or representative forms of rule.

Thus, international investors today face a broader range of political risks than in the 1960s and 1970s, when classic political risks of CEND – confiscation, expropriation, nationalisation and deprivation – were predominant (though they have not gone away, as seen with the renationalisation of YPF in Argentina).

Risks such as breach of contract require a broader analysis of the political and institutional trends. In addition, given the shifts in the contours of the global economy, geopolitical risks have a tendency to play out as worst case scenarios.

Expert analysis can help identify the political and geopolitical pressures building up to a sharp political break, and their associated risks. And by at least eliminating incorrect scenarios, it can help manage the risks.

*Mina Toksoz is the author of* The Economist Guide to Country Risk, *which will be published by Profile Books in November 2014*

# Don't take sides and have a plan for every contingency

**Energy groups** Nerves of steel and taking the long view are useful attributes, says *Michael Kavanagh*

Strategic alliance: ExxonMobil and Rosneft joined forces in an exploratory oil-drilling expedition into the Kara Sea

As if the technical challenges of managing oil and gas fields, nuclear power stations and electricity grid systems were not enough, recent events in Europe and the Middle East have pushed political risk to the top of the agenda for energy suppliers.

This week, Christophe de Margerie, chief executive of Total, the French oil group, repeated his warning that escalating tensions between western powers and Russia over Moscow's support for separatists in Ukraine could threaten gas supplies across Europe this winter.

In Iraq, meanwhile, the IS insurgency has prompted temporary withdrawals and the redeployment of staff by companies such as Hess of the US, London-listed Genel and Norway's DNO, which are backing the autonomous Kurdistan region of Iraq in attempts to deliver recent oil and gas discoveries to market.

But the latest geopolitical upsets also demonstrate some of the tactics used by energy companies to ensure that life goes on as normally as possible in times of heightened risk for themselves, their customers and their investors.

The crucial strategy is to avoid taking sides in public to minimise offence to each party to a conflict while engaging with protagonists and ensuring contingency plans are in place.

French-owned EDF Energy stressed in a highly diplomatic message to staff this month that it had no recommendation to workers at its two nuclear power stations in Scotland on the issue of independence. Vincent de Rivaz, chief executive, added that detailed discussions had taken place with both sides about where the company might stand, depending on the vote's outcome.

He revealed he had met Scotland's first minister Alex Salmond twice in previous months to seek assurances on the future operation of its Hunterston and Torness plants in the light of a "yes" vote, while meetings had also taken place with leaders of the Better Together campaign, including Alistair Darling and Gordon Brown.

EDF's aim was, according to Mr Rivaz, to be "ready to be fully engaged in a constructive way to tackle [uncertainties] in the interests of our business".

Total, one of the North Sea's biggest operators, also declined to be drawn into the Scottish independence debate. But following the vote, Mr de Margerie said the group had remained perfectly willing to commit billions of dollars to new offshore developments. "We never said anything about the referendum," he said last week. "Did we think it was something that would change our decision to invest in the North Sea? No."

> Global leaders of energy companies are well-versed in assessing, but not being daunted by, political risk

Such remarks demonstrate a steely attitude among global leaders of energy companies well-versed in assessing, but not being daunted by, political risk.

The global oil and gas industry, in particular, is notable for the extreme swings in its sale prices, the constant threat of tax rises or outright expropriation by sometimes hostile regimes, and a history of multibillion-dollar over-runs that have wrecked the economics of highly complex projects.

Set against these factors, the outcome of a well-flagged democratic vote over Scottish independence does not appear to have impinged on spending decisions in a mature oil basin where, in spite of declining output, new investment hit a high of £14bn last year.

Most attention on political risk facing western energy groups continues to focus on the impact that US and EU sanctions may have on investments already committed within Russia, and Russian leverage over European energy supplies.

ExxonMobil, Chevron, BP, Total and Royal Dutch Shell have interests in Russia that are threatened by further sanctions against the country, prompted by its annexation of Crimea and support for insurgents in eastern Ukraine.

This month, ExxonMobil said it was winding down its drilling programme in the Russian Arctic in response to recent sanctions. But analysts point to BP as being most at risk of souring relations with Moscow, because of its 20 per cent stake in Rosneft, the Russian oil group.

In July, BP became the first big western company to state that sanctions against Russia could have a material adverse impact on its business.

Bob Dudley, its chief executive, called for investors to hold their nerve and view its exposure to the world's largest oil- and gas-producing country "through a 30 year window".

Meanwhile, bosses of Russian state nuclear power company Rosatom insist that life is proceeding as normal in its sector, undisturbed by political crises.

Board member Kirill Komarov, who was in London this month for an industry conference, said that realpolitik had so far prevented nuclear energy becoming embroiled in industrial or diplomatic clashes over Ukraine.

Amid interruptions to gas supplies to Ukraine, Rosatom was keen to portray itself as a reliable supplier. While Russian gas would normally account for 8 per cent of Ukraine's energy supply, nuclear plants installed by Russia account for 50 per cent of its power needs, according to Mr Komarov.

"We have never stopped any shipment of fuel to Ukraine's power plants," he says.

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# Hedge funds move from the margins into the mainstream

**Alternative investments**

Assumptions about risk reduction need a rethink, writes *Miles Johnson*

As hedge funds have evolved from tiny pools of private capital to hulking investment houses, so too have their clients.

Some hedge funds are now larger than those of conventional "long-only" asset managers – and much more complex.

Hedge fund investors used to be rich individuals seeking higher returns. But today, according to Towers Watson, the consultancy, more than a third of hedge fund assets come from pension funds seeking to diversify by placing money in "alternative" assets.

As many large hedge funds run several investment strategies simultaneously, determining their risk profiles has become more difficult. "The number of sub-strategies is huge," says David Barenborg of BlackRock, one of the world's largest allocators to hedge funds.

Calpers, the largest US public pension fund, recently decided hedge funds had become too complex and costly and withdrew its $4bn investment.

For Max von Bismarck, partner at SkyBridge, which has $10bn in hedge funds, alternative investment vehicles help manage risks, as they are not correlated with the rest of its portfolio.

Yet this argument has been tested, as hedge funds pursue similar strategies, potentially amplifying losses even within a diversified portfolio. Several funds lost money when highly valued technology shares they held fell.

Coatue Management, run by Philippe Laffont, saw its flagship fund fall 8.7 per cent in March after being burned by a reversal in technology shares, but later managed to recover some of its losses later in the year.

**$4bn** Calpers, the largest US pension fund, withdrew $4bn from all hedge funds, citing complexity

**$10bn** For SkyBridge, which has $10bn invested, hedge funds help manage risks

A number of hedge funds were hit by betting on the outcome of several large takeovers during the summer, such as 21st Century Fox's offer for Time Warner, and Sprint's attempt to buy T-Mobile US. The collapse of these deals wrongfooted several funds that specialise in trading on takeover situations, known as risk arbitrageurs, or "arbs". The resulting "Arbageddon" was a further reminder to investors of the dangers of investing in hedge funds that are all chasing the same trades.

More recently, a number of large hedge funds made bets on so-called "inversion" mergers, where US companies buy a rival domiciled in a country with a lower tax base.

As the Obama administration has become more vocal about stopping this practice, arguing that it is an abuse of the US tax system, the shares in companies involved in inversions have gyrated, leading to a choppy time for the many hedge funds that own them.

# Political uncertainty is often underestimated, yet can be the most unpredictable element

*continued from page 1*

However, this has yet to stimulate a market for insurance in such areas. "The insurance market is loath to provide [cover] that's too broad," says Stephen Kay, leader of US political risk at Marsh, the insurance broker.

He adds that after the Deepwater Horizon oil spill in 2010, energy companies asked whether they could buy protection against the risk of adverse regulatory actions by US authorities. It was generally unavailable.

Similarly, says Mr van den Born, in the run-up to the Scottish referendum, some companies asked whether they could buy insurance to protect themselves against the fallout from a Yes vote. Again, none was available.

"They [insurers] have been disinclined to look at those risks because they're so difficult to assess," he says.

Corporate insurance buyers face the same problems. Political risks, as Mr Wales puts it, are "inherently unpredictable".

"The past is never a reliable prologue," he adds. "You can have decades of stability, punctuated by disaster."

Misjudging geopolitics can not only lead to nasty surprises, it can also put companies and their investors at risk of missing out on potentially lucrative opportunities.

Myanmar, for instance, was blighted for decades by military dictatorship.

More recently, the energy-rich south-east Asian country has enacted a series of economic reforms at an unexpectedly rapid pace – although there are signs its transition to democracy is faltering.

Mr Wales argues companies should be wary of using quantitative analysis – and so-called big data – to try to predict political shocks. "The smartest companies tend to avoid an overly quantitative approach," he says.

Instead, he urges clients to seek the counsel not only of financiers and economists, but also of those with a range of backgrounds – from sociologists to anthropologists.

Tommy Helsby, chairman of Kroll Consulting, highlights that political risks can have similar consequences – such as severe staff shortages – as other perils, including disease or environmental catastrophe.

Thus, he says, companies should focus on preparing for the consequences of such risks – irrespective of the underlying cause. "Political risk is an important issue. But you [as a business] need to think, 'How will this actually change things?'"

Back in Scotland, as supporters of independence remain unsatisfied, corporate concerns are growing that the country faces a "neverendum".

Some companies are considering enacting contingency measures they had drawn up for independence – such as operating from the legal entities they set up south of the border to serve customers in the rest of the UK.

"You can do that extremely easily," says Mr Wales. "Some companies may conclude they want to hedge their bets. You're likely to see an increase, rightly or wrongly, in the perceived risk profile of Scotland."