Political risk and corporate performance: Mapping impact

Executive summary

Purpose

Global companies have long operated in markets regulated and influenced by governments, political actors and social movements. Political risk is not new. Yet there is a recognition that technological, political and demographic shifts have introduced a new level of complexity.

To bring insights to how companies can manage this complexity, EY has embarked on a multistage exploration of the relationship between political risk, corporate performance and political risk management, beginning with this deep dive into academic research.

This white paper identifies key findings in academic studies on political risk and corporate impact — with the goals of defining areas of political risk, understanding the material impacts of political risk on firms and highlighting resulting insights for political risk management.

Our intent is to provide a bridge from the formal study of political risk assessment, impact and management to the business community actively looking for ways to mitigate political risk and create value.

Design

In this evaluation, we carefully identify the sources of political risks across transnational, national and societal levels, and the wide-ranging impact of such risks on areas of corporate activity, including sales, production, operations, research & development, security, corporate finance, regulatory compliance, human capital, governance, and reputation.

Approach

This is a joint effort between the EY Geostrategic Business Group (Mary K. Cline, Kyle P. Lawless and Sven Behrendt) and Witold Henisz, the Deloitte & Touche Professor of Management at The Wharton School, with the assistance of Rakhimov Abdurakhim.

This research team evaluated over 300 academic articles published since 2000 from highly ranked scholarly journals, bridging management, political science, economics, finance, accounting, ethics, operations, marketing and law. These articles were identified via a comprehensive literature review seeking the most widely cited articles that analyzed the impacts of political risk on organizations emanating from transnational, national or societal levels.

The authors of this report synthesized the findings and compared and contrasted them with their own accumulated insights from 30 years of consulting and fieldwork on political risk to generate insights into political risk management strategies.

Key findings

A) Empirical evidence suggests that the incidence of political risk has increased dramatically in the past decade and, in particular, over 2016–18 — by many measures, to post–WWII highs. Furthermore, the measurement of political risk has become increasingly sophisticated. While academics once relied primarily on
qualitative case studies or crude proxies for political risk, the field is increasingly drawing on finer-grained, comprehensive and strategically useful data sets.

B) The impacts of increasing levels of political risk are heterogeneous and potentially interdependent. Corporations face political risk from a variety of sources and levels and can experience the impact as:

- A loss in sales [Sales]
- Shifts in operational scope/investment [Production, Operations]
- Disruption to supply chains and/or market access [Production, Scope of Operations, Market-Entry]
- Intellectual property theft [Research & Development]
- Increased security costs [Operational Security]
- Higher cost of capital [Corporate Finance]
- Increased risk mitigation costs [Regulatory Compliance]
- Corporate governance challenges that reduce transparency and accountability [Governance]
- Damage to the social license to operate [Reputation]

C) The research also reflected a fragmentation in the study of political risk. Political risk is a complex concept, incorporating risks on the transnational level (e.g., state-to-state tension) to the local level (e.g., social protests), which can materially impact a range of corporate activities. Scholars tend to focus on discrete risks and discrete impact, rather than approach the risk environment, and potential management of those risks, holistically.

D) A more holistic cross-functional approach to the management of multiple sources of political risk is required. However, the appropriate management response to political risk highly context dependent, including the impact to the company and its previous strategic choices. Designing such a contextually contingent strategy is a high-level strategic coordination function. The most sophisticated firms will deploy its political risk management ability not only to manage downside risks but also to seize upside opportunities, making the case for value-enhancing changes in core functions and practices.
Mapping impact

The context

The world in which businesses have grown for the past 70 years is in flux. Businesses have always been vulnerable to competitive disruption and technological change, and have long confronted political risk, but in today’s world these challenges come at increasing speed and complexity.

**Though the importance of political risk is recognized, exactly how politics impacts corporate activity, and what can be done about it, is more uncertain.** Typical political risk analysis focuses heavily on the highly contextualized nature of political events and is detached from strategic advice, leaving leaders asking, “So what?”

Furthermore, what advice is offered is often limited to reactive strategies to a discrete risk rather than proactive strategies that could alter the likely incidence of political risk events or the magnitude of their costs and opportunities. During the era of fast-paced, confident and expanding globalization, such an approach may have been enough. But in an era increasingly defined by new political challenges and potentially systemic changes, a more holistic approach to political risk management provides an opportunity to strategically manage or even proactively influence outcomes in an increasingly complex global environment.

The wealth of academic literature, however, documenting and exploring the relationship between political risk and corporate performance can inform strategy development and ultimately leaders’ critical choices in this era of flux.

Our framework

**Levels of political risk**

To begin, the literature was analyzed and tagged according to three levels of political risk: *transnational*, *national* and *societal*. **Transnational** or geopolitical risks, in the broadest sense, emerge when the interests of countries in defined policy arenas collide, or when the international system at large is undergoing a transformation. **National** or country risks emerge when the national political environment, the stability of the government and institutions, legislation, or the regulatory environment has measurable economic consequences for domestic markets and corporations acting in those markets. **Societal** risks emerge when groups such as nongovernmental organizations (NGOs), trade unions and consumer groups develop a collective political identity and interests that subsequently drive their public activism and, in turn, have consequences for markets and companies operating globally. These risks typically occur at a local level but can transcend local boundaries and take on national and transnational characteristics.

**Types of political risk**

<table>
<thead>
<tr>
<th><strong>Level</strong></th>
<th><strong>Examples</strong></th>
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<tbody>
<tr>
<td>Transnational</td>
<td>Political conflict, trade wars, sanctions, retreat from multilateral accords, social movements, military conflict, terrorism</td>
</tr>
<tr>
<td>National</td>
<td>Political (regime) transitions, policy shifts, lack of law enforcement, civil conflict, buy-national policies, corruption</td>
</tr>
<tr>
<td>Societal</td>
<td>Boycotts, protests, disruptions of production or supply chains, corporate espionage, local violence</td>
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</table>
Elements of corporate activity

For each level of risk, we looked at the impact on specific areas where corporate activity can be compromised, including sales, production, operations, research & development, security, corporate finance, regulatory compliance, human capital, governance, and reputation.

We explored the findings of the academic literature in over 300 published articles on political risk over the last 18 years, with specific interest in identifying the relationship between politics and business outcomes — and consequences for one or several corporate performance indicators.

Assessment

Political risk is on the rise — measurement options vary but are increasingly sophisticated

Our research found important methodological progress in measuring transnational, national and societal risk. Historically, academic research in this area relied primarily on qualitative case studies or crude proxies for political risk but is increasingly drawing on finer-grained, comprehensive and strategically useful data sets. One of the benefits of this effort is an ability to more conclusively compare the exposure of companies to political risk over time.

Regardless of the approach taken, empirical evidence suggests that the incidence of political risk has increased dramatically in the past decade and, in particular, over 2016–18 — by many measures, to post–WWII highs.

Transnational risk

At the transnational level, political risk is most commonly measured by:

- **Periods or dates of conflict and the number of fatalities reported in those conflicts.** The global number of armed conflicts is rising at state and non-state levels. In 2017, the total number of conflicts was 164,\(^1\) the highest on record (from 1946 to 2017). Annual fatalities averaged over 110,000 in the last four years, exceeded only by the year of the Rwandan genocide (1994).\(^2\)

![Number of conflicts (1989–2017)](chart)

Source: Uppsala Conflict Data.

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\(^1\) Uppsala Conflict Data.

\(^2\) Uppsala Conflict Data.
Bilateral trade and investment barriers. The number of discriminatory trade interventions implemented globally peaked in 2018, to 1,308 — a 149% increase from 2013. Policies restricting foreign direct investment (FDI) have risen in each of the last 10 years, outpacing the growth in liberalizing measures.3

Source: Uppsala Conflict Data.

Source: Global Trade Alert.

Media content analysis, describing the verbal and material interactions between national governmental and opposition representatives. The Global Database of Events, Language and Tone (GDELT) tracks news reports across print, broadcast and the web in over 100 languages and across every country since 1979. According to GDELT data, cooperation between government and opposition actors declined to a 33-year low in 2011, with little recovery in recent years, remaining well below historical levels.

![Graph showing media reported cooperation-conflict between government and opposition actors](image)

Source: Global Database of Events, Language and Tone.

National risk
At the national level, a wide array of metrics have been used to proxy for the credibility of a national political regime, including:

- **The World Bank Worldwide Governance Indicators (WGI).** WGI capture six dimensions of governance: political stability, government effectiveness, voice and accountability, regulatory quality, rule of law, and control of corruption. Overall, the global average score of all these indicators except for control of corruption and voice and accountability steadily improved up to approximately 2015, though they have plateaued or reversed in recent years. Voice and accountability measures are declining, while corruption has remained consistent.5

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4 There are many ways to measure national risk; this list is not meant to be exhaustive. Other measures may include The Political Constraint Index, CHECKS as established by the Database of Political Institutions, executive constraints or state fragility and state failure as measured by the Polity Database and Systemic Peace Project, various measures of constraints on government power within the V-Dem database, International Country Risk Guide, or the Transparency International Corruption Perceptions Index.

Worldwide Governance Indicators (2002-2017)\textsuperscript{6}

\begin{itemize}
  \item **Measures of trust.** In recent years, the Edelman Trust Barometer has reported that “trust is in crisis around the world,” citing broad declines in the general population’s trust in business, government, NGOs and the media.\textsuperscript{7} The 2019 Trust Barometer found that the gap of trust between the informed public and the mass population has grown to reach a record high.\textsuperscript{8}

Other measures highlight continued challenge to liberal democracy. According to Freedom House, the democracy scores for 113 countries have declined since 2006.\textsuperscript{9} Recent analysis from Deutsche Bank finds that support for populism, or anti-establishment, nationalist political movements, is at its highest levels since World War II.
\end{itemize}

\textsuperscript{6} This chart reflects the number of countries with scores greater than and less than zero (standard deviation of -2.5 to +2.5). The higher the positive standard deviation, the better it is, and the higher the negative standard deviation, the worse it is.


Societal risk
At the societal level, many different measurement approaches exist, including:

- ** Strikes or terrorist attacks.** As reported in the Uppsala Conflict Data Program, non-state violence shows a continued rise, with 82 conflicts in 2017, the highest on record.\(^{10}\) Over the last 18 years, an average of 2,800 people died annually in high-casualty terrorist bombings, compared with an average of 300 in the 1990s.\(^{11}\)

- ** Media content analysis** of the tenor of verb phrases in millions of sentences appearing in news articles in which a company or business is the object. This shows a decline in cooperation with foreign business beginning a few years before the financial crisis of 2009 and continuing through 2019.\(^{12}\)

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\(^{10}\) Uppsala Conflict Data Program, [https://ucdp.uu.se/](https://ucdp.uu.se/), accessed April 2019.


\(^{12}\) [https://www.gdeltproject.org/](https://www.gdeltproject.org/)
Building the relationship between political risk and corporate performance

We’ve seen how transnational, national and societal risks, rooted in political change, are rising. But where and how do they affect corporate performance? And how can business leaders filter through the noise to assess what really matters?

The study of political risk shows us that actions or inactions of political actors can impact the performance and value of companies through many potentially interdependent channels. Tariffs impact sales. But more indirect risks, such as societal risks that damage reputation, can also materially impact sales over time.

Political risks can be categorized and accounted for, but their impacts are highly company and context specific. Violent conflicts and shifts in diplomatic or political relations and trade or investment policies can differ in their magnitudes, as can changes in political institutions, the efficacy of an NGO campaign, and localized civil-society-based violence or attacks on corporate reputation. Companies vary in their exposures to the resulting political risk according to the characteristic of their investments and, critically, their *ex ante* strategies to protect themselves against political risk. As a result, it is not possible to extract exact predictions from the academic research about the relative magnitude of impact. But we can use the examples and studies gathered in this research to inform more generally on how firms face material consequences from political risk.

Political risk affects corporate activities and operations across the following areas.

Sales
Transnational political risks are often found to have a material impact on multinational corporate sales through channels such as boycotts, tariffs, political conflict and political

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13 For more detail on these strategies, see the next section of this report.
instability. However, the magnitude and duration of these effects varies substantially across studies.

<table>
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<tr>
<th>Firms with strong political connections to Indonesia’s Suharto struggled in the aftermath of the efforts to eradicate cronyism, corruption and nepotism.</th>
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<tr>
<td>In a study of White House visitor logs, firms with access to the Obama Administration experienced significantly lower stock returns after the 2016 presidential election than otherwise similar firms.</td>
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- In 2012, the ~20% market share of Japanese vehicle brands in China plunged by a stunning 60% within one quarter. In 2012, the ~20% market share of Japanese vehicle brands in China plunged by a stunning 60% within one quarter. 
- German auto sales dropped 15% (3.4 percentage points from 23.0 to 19.6 percent) over a 12 month period in Greece amid frustration over budget talks with the European Union (in which the German Government was seen as a leading driver, after taking a tough stance in the 2010-2014 Greek debt negotiations). 
- In 2006, Danish companies lost 18.8% of their sales in Muslim countries within one year after the September 2005 publication of by a Danish newspaper published comics perceived as offensive to the Muslim faith.
- Similarly, the 2003 American boycott of French wines, motivated by French opposition to the Iraq War, led to an estimated loss of $120 million in sales: 26% lower weekly sales at the boycott peak and 13% lower sales over six months. Overall, the worsening relations between the US and France reduced bilateral trade by about 9% in 2003 as compared to the previous year — without any change in trade barriers.
- The Iraq War was also found to negatively impact the sales of emblematic American beverage products in Arab countries, with US sales growth lagging foreign competitors’ by 21.2% in 2002–03. Less “American” products, such as laundry detergent, were not impacted in the same way.

On a national level, government policies, such as tariffs, quotas or regulation, also lead to direct sales loss. And a turnover in government and leaders, either by elections or otherwise, can be harmful to firms that derive benefits from their connections to the past government or leadership (e.g., those that depend on public procurement or finance).

### References

• In the US, a study of the 1994 mid-term elections, firms with boards connected to the losing US congressional party were found to experience a decrease of $77m in procurement contracts after the election.23

Research shows that civil society organizations mobilized to promote animal welfare, protect the environment, defend workers’ rights, or oppose oppressive regimes or nuclear power have been able to impact sales performance in some cases, but on average these effects have historically been modest and short-term.

• The rising price of cottage cheese in Israel led to a 2011 consumer boycott, organized on a major social media platform. Demand dropped 30% within two weeks, and demand elasticity shifted permanently.24
• In 1995, when an oil and gas company decided to dispose of an oil platform in the Atlantic Ocean’s North Sea, Greenpeace led a campaign that resulted in a 70% reduction in sales in some German outlets in a matter of days.25
• In 1989, social activism against Iceland’s whaling operations caused losses to the Islandic fishing industry of up to $50 million.26

Production and operations
Shifting from the question of where products are sold to where they are made and where companies establish operations, a wide body of research demonstrates a medium- to long-term negative impact of political risk on foreign direct investment and the magnitude of M&A. More of the research focuses on national-level political risks, particularly those caused by uncertainty over future policies in countries with few checks and balances on political discretion.

• In a study of Chinese overseas acquisitions over 27 years, stronger institutions increased the odds a merger was completed by 20%–38%. In countries with weaker institutions, prior experience in that country moderated the negative impact of weaker institutions on the probability of deal completion.27
• The outbreak of violent conflict near a subsidiary increased the likelihood of divestment by 52% in a study of 670 Japanese multinationals over 19 years.28
• A study of foreign investments by Spanish firms over a 22 year period found that in regulated physical infrastructure sectors (e.g., electricity, water, communications), shifts in the party controlling the government doubled the risk of divestment by investors.29
• A 46-year study of 86 developing countries found that leftist rule led to an average increase in resource expropriation by 124%–129%, with a range from about 700% (if the

26 Ibid.
government faced no political constraints) to 0% (when the new government was fully constrained by checks and balances).\textsuperscript{30}

- Shortfalls in physical infrastructure in a potential host country reduced predicted FDI flows by 75% in a study of 77 developing countries. Capital market financing constraints reduced FDI by 33%.\textsuperscript{31}

- Firms appear to react more strongly to clusters of negative experiences. Having a dispute with a host country government was associated with an 11% likelihood of divestiture in one study. That likelihood increased to 18% if the firm also had a dispute with another country in the same region.\textsuperscript{32}

Transnational agreements, accords and institutions (e.g., the World Trade Organization, the European Union or the North American Free Trade Agreement), as well as bilateral political and military alliances, govern national-level risks by reducing uncertainty and establishing a consistent set of rules of the game. The incentives to undertake a fixed investment in a given country are clearly influenced by the recourse investors have to the web of international treaties and agreements for dispute resolution or indirect political influence.\textsuperscript{33}

- In countries with high levels of political risk, IMF agreements were found to reduce expropriation risk by 20%–40%\textsuperscript{34} and increase the flow of FDI by over 2.2%.\textsuperscript{35}

- Investment, defense and human rights treaties have been found to increase the flow of FDI by $24m–$25m,\textsuperscript{36} $69m–$96m\textsuperscript{37} and $1m,\textsuperscript{38} respectively. Violations of investment treaties were found to reduce FDI by up to $792m.\textsuperscript{39}

\textsuperscript{35}Biglaiser, G. et al. (2016)
\textsuperscript{36}Biglaiser, G. & DeRouen, K. (2010)
\textsuperscript{38}Li, Q. & Vashchilko, T. (2010)
\textsuperscript{39}Garriga, A. C. (2016)
\textsuperscript{40}Allee, T. & Peinhardt, C. (2011)
State-owned enterprises may mitigate expropriation risk by leveraging the political and economic influence of their home governments.  

Transnational or civil society conflict, particularly over deep-seated issues that spill over into violence, are another important source of risk. Workers and civil society organizations have both been shown to create political risk material to a firm’s investments, including but not limited to legal liabilities from worker lawsuits and for alleged complicity in human rights abuses.

The outbreak of military conflict between two countries has been found to reduce FDI flow between them by $160 million on average in a study of 58 countries over 1980-2003.

In a study of 71 large European MNC and their subsidiaries, terrorist activity was associated with a 5%-20% likelihood of divestment, with the effect size depending strongly upon the strength of national political institutions.

If a country experiences one standard deviation reduction in diplomatic relations with the home country government of an investor, one study found that investors experience costs equivalent to a 15%-25% increase in taxation, on average.

Economic activity between the US and other countries declines significantly if diplomatic relations deteriorate. An increase of 1% in the fraction of votes cast by a country in opposition to the US position in the United Nations was found to be associated with an average decrease of $92 million in quarterly investment in US corporate securities from that country.

Territorial disputes create political risk for firms, disrupting the flow of goods and supplies. Border disputes have been found to reduce the predicted stock of FDI, though savvy investors have found opportunities; in some cases, FDI accrues at higher rates pre-settlement as investors seek to “get in on the ground floor.”

Not all firms are impacted equally by political risk. Politically well-connected firms with more experience in managing political risk show less impact. Sourcing from or partnering with other in-country firms, as well as the mere presence of peers from the same home country, can moderate the impact of political risk. In one study, expropriation risk in Russia

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declined sharply as the percentage of domestic suppliers rose.\textsuperscript{50} Experience matters too. Japanese companies with experience in risky countries were far less sensitive to political risk than their less experienced peers.\textsuperscript{51} Size matters too. A study of private companies in China found that as firms grow, their expropriation risk increased until the point that they became large enough that it changed the calculus for the host government.\textsuperscript{52} Highly strategic assets or unique resources are also particularly sensitive to political risk,\textsuperscript{53} as is M&A.\textsuperscript{54}

- Experience in a country and familiarity with the political system and its players has been found to reduce the threat of failure by 80%. But political regime change can turn this into a liability increasing the threat of failure by 25%.\textsuperscript{55}
- Companies from countries with higher levels of political risk have been found to be less deterred from expansion in other politically risky countries, suggesting a learned agility from their home system that applies in their investment strategy elsewhere.\textsuperscript{56}
- Research from China suggests that the benefits of local sales may be contingent upon the location of those sales. Increasing sales from one facility to other provinces initially increased the risk that levies would be imposed by about 25% due to the reduction in local focus and benefits. But once a firm reached a certain national scale (e.g., about 40% sales to other provinces), out-of-province and national political allies began to help to reduce province-level political risk, and the risk that levies would be imposed began to decline, falling below the baseline rate when out-of-province sales reached 80% of the total.\textsuperscript{57}

**Entry-mode strategies**

While political risk influences where products are made and where operations are established, the opportunities these markets provide continue to beckon investors, with companies organizing their operations in politically risky countries in a manner that limits their downside exposure. Entry-mode strategies include decisions around ownership structures, equity shares and partnering approaches. Strategies range from low-commitment structures, in which the multinational corporation delegates local autonomy to a third party (e.g., a sales subsidiary, licensee or agent), to high-commitment structures (e.g., wholly owned subsidiaries and R&D facilities) that facilitate greater coordination.\textsuperscript{58}

\textsuperscript{50} Once local supply exceeds 50%, foreign subsidiaries report no concerns that contract breach could lower value or lead to a transfer of ownership (Johns, L. & Wellhausen, R. L. (2016)).
\textsuperscript{55} Henisz & Delios (2004).
\textsuperscript{58} Some more recent studies use more fine-grained measures of trade or flows between subsidiaries rather than just organizational proxies for the degree of commitment or coordination. (Feinberg & Gupta, 2009; )
Surprisingly, there is little attention on transnational political risk in this regard and, until recent years, relatively little on civil society. One study modeled the vulnerability this creates, arguing that supply chain risk models should incorporate geopolitical risk.\(^{59}\) And qualitative studies on fast fashion,\(^{60}\) electronics,\(^{61}\) industries impacted by modern slavery,\(^{62}\) palm oil,\(^{63}\) and apparel\(^{64}\) show that retailers and suppliers should coordinate more to manage environmental and social risk throughout their supply chain. Empirical analysis is scant beyond documenting that just-in-time supply chains are less common in countries with high political risk.\(^{65}\)

The focus has been on national factors, with an extensive body of research showing that higher levels of political risk are associated with lower-commitment mechanisms and weaker coordination ability (e.g., joint ventures) vs. higher-commitment mechanisms (e.g., mergers and acquisitions).\(^{66}\) While this may seem counterintuitive (in high-risk situations, one would seek more control), the institutions that protect higher-level commitments, such as detailed contracts,\(^{67}\) and legal recourse are weaker and less effective. Lower commitment may provide more flexibility, particularly for companies that do not rely on long-lived capital investments.\(^{68}\)

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65 When the US extended Permanent Normal Trade Relations to China in 2000, shipments between the US and China that were at greater risk of being subject to tariffs became 13% smaller in quantity, 4% more expensive and more frequent.


67 Increasing the rule of law of the host country by one standard deviation increases the likelihood of entering via merger or acquisition by 298% but only increases the likelihood of entering via a joint venture by 29%. Also: Delios & Henisz (2003): In countries with low political risk, Japanese firms are twice as likely to begin their entry sequence with a sales distribution facility than a joint venture but, in countries with high political risk, they are 50% more likely to begin with a joint venture.

## Political risk considerations by FDI type

<table>
<thead>
<tr>
<th>Type of investment</th>
<th>Political risk</th>
<th>Rationale</th>
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<tbody>
<tr>
<td>M&amp;A</td>
<td>High</td>
<td>“M&amp;A investors face the greatest investment risk because their stakes are completely in harm’s way and may be subjected to host-country hostility. M&amp;A investors, then, have ample reason to consider investing in countries that lower risk through political institutions that respect and adhere to the rule of law, contain multiple veto players, and have a history of democratic stability. Other forms of FDI have advantages not present for M&amp;As.” (Lee, Biglaiser &amp; Staats (2014))</td>
</tr>
<tr>
<td>Joint ventures (JVs)</td>
<td>Medium</td>
<td>“JVs share investments with multiple players, and sometimes with the government itself, thereby lessening the impact of loss on the foreign investor and making it less likely that the government will attempt to renegotiate contracts or expropriate assets” Lee, Biglaiser &amp; Staats (2014)</td>
</tr>
<tr>
<td>Greenfield investments (GIs)</td>
<td>Low</td>
<td>“GIs typically create new jobs, making it more likely that the host government will offer upfront incentives and treat such investors with care both before and immediately after entry” Lee, Biglaiser &amp; Staats (2014)</td>
</tr>
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</table>

- More explicit, specific and precise buyer-supplier contracts (i.e., contract specificity) were found to reduce contract violations by 67% in low-risk, highly globalized countries. However, as political risk increases and/or the country becomes less exposed to globalization, the impact rapidly dwindles. 69
- Countries that assure democratic political stability, with a strong rule of law and multiple veto players, have been found to attract all FDI types more easily, particularly M&As. Increasing the rule of law of the host country by one standard deviation increased the likelihood of entering via merger or acquisition by 298% (but only increased the likelihood of entering via a joint venture by 29%). 70 For example, in a separate study, Japanese firms entering a country with low political risk were twice as likely to begin their entry sequence with a sales distribution facility than a joint venture. But in countries with high political risk, they were 50% more likely to begin with a joint venture. 71
- As political risk increases from its minimum to maximum, firms have been found to respond by internalizing their revenue streams. For firms with limited to moderate experience deploying political strategies, the share of intercompany sales to overall sales increased substantially, doubling from 8% to 16%. More experienced firms, who are argued to have superior political risk capabilities and practices due to organizational learning over time, were found to respond more moderately, increasing the share of intercompany sales from 13% to 17%. 72

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70 Lee, H. et al. (2014)
Once again, the impact of political risk varies across firms. State owned-entrants face greater scrutiny. But, again, experience and knowledge matter: firms can learn to manage political risk or the institutional environment of the home country, allowing higher commitment amid higher risk.

**Research & development**

The Fourth Industrial Revolution heightens the imperative of research and development as a competitive advantage both for companies and countries. In countries with high levels of political risk, corporations have intellectual capital stolen and potentially used in competing products. Political risk increases costs for R&D and the potential to lose market share to competitors. This is particularly acute for technologically leading firms, which, in one study, were eight times more sensitive to political risk than their technologically lagging counterparts. And evidence suggests that international institutions (such as the WTO) have not been successful in mitigating the risk. Becoming a member of the WTO was associated with only a 2% improvement in de facto IP protection in the joining country.

Firms seek to mitigate this risk by developing interdependencies, such as working with inventors from countries with weak intellectual property rights in cross-country collaborations. Compensatory strategies also include choosing a technology that depreciates (i.e., must be replaced) more rapidly or for which the host country is dependent upon the multinational company for maintenance, first-mover, secrecy, informal enforcement mechanisms and relational contracting. Both formal IP rules or regulations and informal practices (e.g., enforcement) are important for investors to assess.

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78 Zhao, M. (2006) Conducting R&D in Countries with Weak Intellectual Property Rights Protection. *Management Science*. 52 (8), pp. 1185–1199. Mg. Patent data with at least one inventor from weak IP rights (IPR) countries shows cross-country collaborations occur in 51% of the cases, and 47% involve at least one US inventor. The numbers are 25% and 11% for patents that have at least one foreign inventor but none from weak IPR countries.
Pressure for stronger IP protection from domestic interest groups (e.g., domestic owners of intellectual property and the groups that represent them) can moderate this negative relationship\textsuperscript{81} – something we are seeing today in China, with large, domestic tech companies advocating for increased property rights protection. And country-level data seems to provide a clear incentive: countries that succeed in dramatically improving their IP protection \textsuperscript{z} receive 26\%–117\% more FDI than peers who do not make similar policy changes.\textsuperscript{82}

**Security**

Corporations facing political risk often face security risks to their staff and to physical equipment. Conflict at all levels of risk — transnational, country and societal — present real physical danger. The studies reviewed show that violence by non-state international actors that successfully target global companies has been a growing and understudied material threat\textsuperscript{83} and serves as a deterrent to foreign direct investment.\textsuperscript{84}

In addition to the devastation caused by the loss of human life, financial costs are significant, with damage to physical equipment that may disrupt access to supplies or markets, leading to operational halts or delays.

*The average terrorist incident, according to a study of 123 developing countries over 28 years, resulted in a loss of $15.8 million.\textsuperscript{85} In another, supply chain disruptions as a result of terrorist incidents were found to have a negative stock market reaction equal to 9\% of market capitalization.\textsuperscript{86} Individual cases show more significant and devastating costs, as was clearly the case with the 11 September 2001 terrorist attacks in the U.S.\textsuperscript{87}*

Domestic and civil conflict also present a physical threat to companies and their workforces, to which they respond with interventions ranging from private security to negotiations to peace-building.\textsuperscript{88} However, these actions can introduce their own risks, such as the $25 million fine that a global produce distributor agreed to pay after giving a right-wing paramilitary group $1.7 million to protect its assets in Colombia.\textsuperscript{89}

The influence companies have here may be underestimated. A growing body of recent work on peace-building and conflict resolution considers the role business plays and argues for the


\textsuperscript{82} Jandhyala, S. (2013)


\textsuperscript{85} Ibid.

\textsuperscript{86} (Schneider, 2002.)


\textsuperscript{89} Getz, K. A. & Oetzel, J. (2009)
need to undertake due diligence on conflict dynamics, to mobilize networks and resources to catalyze positive relationships, and to facilitate constructive action toward peace.90

Corporate finance
Investors and creditors perceive corporations facing political risk as riskier, raising their cost of capital. In studying this relationship, the academic community draws upon a wide range of financial information, including corporate bond yield spread, firm betas, loan spreads, leverage ratios, the likelihood of bailouts, abnormal equity returns, prices paid for comparable assets (e.g., oil fields), the price of political risk insurance, and expenditures on political foundations, entertainment and travel costs.

Transnational risks, including terrorism, military conflict and trade wars, are found to be material to companies and to their market valuation.

- A six-country study of the impact of terrorist attacks on publicly traded firms revealed declines in market capitalization between 1% and 17%. Furthermore, the impact of major events (e.g., the 11 September 2001 attacks) persisted into the long-term effect.91
- A survey of similar empirical studies92 calculating the abnormal return on targeted or affected firms resulting from terrorist attacks including
  - -3.34% for the Korean air bombing in 1987
  - -7.14% for 9/11
  - -4.6% for attacks on Israeli non-defense companies during 1998-2000 Palestinian-Israeli conflict.
  - -0.83% as the average impact of 75 terrorist events in 11 countries
- The prospect of potential military conflict is viewed as highly material in South Korea. Geopolitical uncertainties in South Korea have negative macro-economic outcomes: a 1% increase in the uncertainty measure related to potential future conflict induces a roughly 0.25% decrease in the stock index, and a 0.2% depreciation of the exchange rate. The short-term foreign capital inflows decrease by 80 million USD, with this effect fading after three months.93
- The financial market effects of the US-China trade dispute have signaled substantial potential material harm though the ongoing negotiations and confidence that a trade-war will be averted have made it difficult to ascertain the full nature of the expected impact (i.e., the market seems to price the probability of a trade war as low with the exception of a few dates)94
  - The S&P 500 dropped 2.5% on 22 March 2018, when the Trump Administration announced a trade war against China.
  - 78% of the study’s US sample firms suffer from losses in the three days centered around the announcement.
  - The market reaction in the China market showed a similar pattern. The CSI 300 Index dropped by 2.9% on the event date and 4.5% in the three-day event window, with 86% of Chinese sample firms having negative returns.

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90 Miller, B. et al. (2019) A Seat at the Table: Capacities and Limitations of Private Sector Peacebuilding. SSRN Electronic Journal, PS
92 Karolyi (2006)
93 Lee & So (2018)
Markets also responded subsequent events: on 2 April, when China’s Ministry of Commerce rolled out the tariffs on the 128 US products as proposed on 23 March, the US stock market index dropped by 2.2% and China market index dropped by 0.6%.

Analysts were also concerned about the impact on future earnings. Corporate America is increasingly discussing trade wars on the earnings calls, with one study showing some sectors (such as materials and industrials) discuss trade disruption concerns on up to 28% of the calls.

When it comes to assessing the impact of national political risk on corporate financing conditions, the literature suggests that investors, creditors and insurers are highly sensitive to a wide variety of impacts. National political risk is usually priced by the market, such as in the yield spread between US-dollar-denominated debt and US Treasury bonds predicted by global and national macro factors, national bond liquidity and political risk. Spreads are predictive of country-level outcomes, including future equity returns. The academic community has found that an increase in political risk in emerging markets is significantly related to a corresponding increase in the cost of capital.

- A 1% reduction in political risk spreads is associated with a 12% increase in net inflows of FDI.
- Increasing political risk from the 25th to the 75th percentile is equivalent to approximately a 3% increase in the cost of capital.
- Betas for regulated firms are correlated with market predictions of political risk, as is the volatility of regulated firms’ equity returns.
- Loan spreads for project financing in developing countries are negatively related to the quality of institutions, government stability and democracy. To help mitigate political risk, development banks are more likely to participate in financing in politically risky countries.
- Equity (and credit) markets recognize the benefits of:
  - Political and corporate appointments. One study found that US companies whose officials are appointed to government office and who appoint government

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officials experience an immediate (i.e., within 1-2 days) increase in their market value by $122m–$123m and $97m–$140m, respectively.103

- US-backed coup authorizations. Publicly traded US companies that had experienced nationalizations (during the Cold War) experience a cumulative abnormal return of 9% over 4 days and 13% over 16 days in the aftermath of such an authorization.104

- Equity (and credit) markets recognize the negative consequences of:
  - Country-level spikes in political risk105
  - Announcements of insider transactions106
  - Resource nationalism on the value of oil and gas reserves107 or stakeholder conflict and gold mine returns108 in the politically riskiest markets, which are discounted over 70% in both cases.

- Political risk insurance pricing decreases in countries with strong checks and balances109 and increases in resource rents.110

- Given potential financial consequences, dividend suspensions are likely in the aftermath of a political risk event.111

[Graphics Note: Consider the following call-out quote: “It used to be the case that the value of a gold mine was based on three variables: the amount of gold in the ground, the cost of extraction, and the world price of gold. Today, I can show you two mines identical on these three variables that differ in their valuation by an order of magnitude. Why? Because one has local support and the other doesn’t.” (Yani Roditis, former COO Gabriel Resources, interview by authors) (Henisz, W. J. et al. (2013)).

Firms with political connections financially outperform their peers in the presence of political risk:

- 7% of corporate foundation giving is politically motivated, a sum that is nearly four times as much as corporate contributions to political action committees (PACs). Such charitable giving mirrors trends seen in PAC contributions. For instance, if a congressional

111 Huang, T. et al. (2015)
representative joins a certain committee that has policy implications for a firm, that firm’s foundation is more likely to give grants to charities within the representative’s district.¹¹²

- Politically connected firms borrow 45% more and have 50% higher default rates suggesting that firms lacking such connections face a disadvantage in terms of their access to capital and the binding nature of their capital constraint. The economy-wide costs of the misallocation of capital identified are estimated to be 0.3%–1.9% of GDP every year in Pakistan¹¹³ and 0.2% lower in Brazil.¹¹⁴

- In a study of 450 politically connected firms from 35 countries, politically connected firms were found to be significantly more likely to be bailed out than similar firms lacking such connections: 11.3% of politically connected firms received an aid package from their home government, compared with 4.4% of unconnected firms.¹¹⁵

The opinion and actions of stakeholders at the sub-national level,¹¹⁶ as well as firm strategy toward them,¹¹⁷ can also influence market capitalization, particularly at the time of important events (e.g., announcements of agreements or opposition campaigns). In turn, financial markets are responding to likely substantial variances in future revenue or costs (e.g., lawsuits, regulatory actions, suspended operations).¹¹⁸

- In a study of mining companies operating in Canada, community benefit agreements between firms and indigenous communities resulted in a one-standard-deviation increase in the strength of property rights, and in turn, that was associated with a 35% increase in cumulative abnormal returns for the company after the announcement. The effects were found to be further strengthened if the community had a history of mobilization.¹¹⁹

- Without stakeholder support, investors discount the announcement of appropriately discounted future cashflows from foreign gold mines by as much as 72%.¹²⁰ The value of that stakeholder support is particularly important during periods where the mine is under attack or criticism from other stakeholders.¹²¹

- Celebrity endorsements increase the amount of media attention a boycott receives by a factor of 3.9. Firms in the upper quantile of Fortune’s Most Admired Companies rankings

¹²¹ Dorobantu, S. et al. (2017)
have a rate of additional media coverage 4.4 times that of unranked firms, 3 times that of firms in the lower quantile, and 6 times that of firms in the middle quantile.122

- In response to the recent failures at tailings dams, observers are recognizing that poor performance on environmental, safety, social and governance criteria will “make it harder to attract capital the industry needs to keep supplying the raw materials that touch every facet of modern life,” A study says. An RBC Capital Markets analyst was quoted as saying, “You will see a lowering of the cost of capital for those [mining] companies that can proactively address the issues that ESG investors want them to look at.”123

Regulatory compliance

Setting rules of the game in the form of reliable legislation and regulation is essential for smoothly operating markets. Yet, at the same time, rules can change, and sometimes in an arbitrary way. The reasons for that can be traced back to shifting political preferences of governments, which might prefer for the markets to operate in a different way. Companies perceive certain shifts in policy and corresponding regulatory changes as risks that need to be dealt with. And most often, the most eminent challenge is to ensure regulatory compliance.

The academic literature on political risk and regulatory compliance has generally applied a more descriptive, qualitative approach, without entirely dismissing quantitative analyses. Within transnational risks, studies have shown that transnational civil society networks are vital for forming international norms when formal international treaties or agreements are absent, studies show.124 Such norms are founded on voluntary agreements and effective forms of private sector self-regulation (most notably on topics like corporate social responsibility).125 In that context, it is also of note that firms that have a better reputation on societal (i.e., CSR) issues are also given more standing in national policymaking (for instance, through US congressional testimony).126

But corporations seek to influence regulatory outcomes too and construct broad networks or coalitions of advocates (adopting public interest frames) to shield regulators from perceptions of favoritism or insider-dealing.127 A foreign corporation is less at risk for being sued for labor violations when it has a relatively higher number of host country directors on its board.128

Overall, civil society organizations has a large impact on pushing companies to improve environmental performance and due diligence over supplier conduct,129 though such inputs

122 King, B. G. (2011)
are moderated by firm-level characteristics such as costs, competitive position, reputational sensitivity, the preferences of its own workers and executives, other stakeholders, and its ethical culture.

Governance
Corporations facing political risk are associated with weaker corporate governance, in which some primary stakeholders are more able to benefit themselves at the expense of others or of secondary stakeholders. A wide range of governance measures or outcomes are explored to demonstrate how these constructs are linked. These include poor or suspect accounting data, inefficient resource allocation, insider graft, self-censorship, politically motivated hiring, and greater legal fines or judgments.

- As evidence of political nepotism in Indian public procurement, the share of Indian road construction contractors whose surname matches that of a winning politician increases by 83% (from 4% to 7%) in the term after a close election compared to the term before.
- Firms involved in lobbying have a significantly lower hazard rate of being detected for fraud and are able to evade detection 117 days longer than firms not involved in lobbying. Furthermore, regulators are 38% less likely to detect fraudulent firms involved in lobbying activities than those who do not lobby. In addition, fraudulent firms spend 77% less likely to detect institutional

Lehne et. al. (2018)
more on lobbying expenses than non-fraudulent firms, and they spend 29% more on lobbying during their fraudulent period than non-fraudulent period.\textsuperscript{140}

In the absence of effective regulation, pressure from civil society organizations can also shift governance, particularly on CSR topics\textsuperscript{141} and transparency in the disclosure of climate-related risks.\textsuperscript{142} There may also be a dark side, however, with firms capitulating to demands for corruption from local government officials in return for government contracts and subsidies.\textsuperscript{143}

**Reputation**

In today’s media society, corporate reputation is a valuable asset. When they lose the trust of stakeholders, corporations can trigger political reactions and eventually lose their social license to operate. Much of the early research in this domain is based on qualitative data or surveys. More recently, measurement has turned to (social) media content coding of the interactions between a firm and its stakeholders.

Key drivers of stakeholder conflict include negative environmental spillovers, displacement of homes, distrust, lack of political voice, in adequate compensation, corruption, criminal activity, inadequate planning and state bias in favor of industrial development.\textsuperscript{144} Multinational firms, in particular, are at relatively higher risk due to the liability of being foreign\textsuperscript{145} and private\textsuperscript{146} in association with environmental and social issues as well as a history of dealing with such issues via coercive strategies\textsuperscript{147} or clearly signaling their unimportance.\textsuperscript{148} Key individual characteristics that predict opposition to multinational activity include gender (women are more skeptical), youth, income, lower skills and education, and nationalism.\textsuperscript{149}

Building corporate reputation and strengthening the broader license to operate can be hugely beneficial. A major logistics corporation’s success story in liberalizing the air freight transport

\textsuperscript{140} Yu & Yu (2011)
market in the United States is substantially related to its investments in political relational capital (i.e., soft money, PAC disbursements, lobbying and corporate philanthropy) with key congressional representatives and senators — as well as in their districts — who subsequently supported deregulation.150

Management

*Corporate (geo)strategy*

Senior executives repeatedly report that they struggle to develop an integrated and systemic capability to sense risks emanating from the external political environment and to mitigate their myriad impacts or seize the opportunities that they may offer.151 This review — together with its authors’ decades of experience in the field of political risk management, spanning academic and practitioner perspectives — suggests an important underlying constraint to improving those corporate capabilities: the fractured nature of the impacts of political risk across functions and fields of inquiry.

Substantively, while the same transnational, national and societal triggers are at the root of political risk, the mechanisms by which these impact a firm and the precise nature of those impacts are widely varied. Political risk affects:

- Consumers’ willingness to pay or protest
- Government decisions on fiscal policy, including procurement, taxation, permits, …
- The evaluation by corporate business development, analysts and financiers of the future profitability of an investment
- The governance of overseas subsidiaries
- The management of supply chains
- The location and modularity of research and development
- The allocation of the budget for legal enforcement and security
- The cost of capital and insurance
- The government and public affairs strategy
- The ability to attract and retain workers
- The incidence of corruption and fraud
- The nature and durability of a firm’s reputation

**Political risk management is inherently cross-functional in its impacts.**

In our review, we found no substantive guidance in the academic literature on how to manage this complex system of relationships. While our literature review captured the full range of political risk impacts, it was notable that doing so required spanning multiple academic disciplines and fields, each of which specialized in a narrow subset of political risk types and impacts. Political risk research is interdisciplinary and fragmented.

[Graphics Note: Insert graphic highlighting disbursement across academic disciplines]

While there is some logic to the choice of impact studied by each field or discipline — for example, there should be little surprise that marketing scholars study lost sales and finance scholars look for financial harm — the focus on one level or another of political risk seems more arbitrary. Why are bilateral relations and other transnational forms of political risk and opportunity not examined more within management, finance and accounting, operations or law? Why are national sources of political risk underweighted in ethics and operations? Why are civil society factors largely ignored in political science, economics, finance and accounting?

Given these omissions, there are relatively few studies about transnational political factors on where to produce and where to undertake R&D, for example, or on corporate reputation. Similarly, the impact of national-level political risk on lost sales, operational security and corporate reputation is understudied, as is the impact of political risk emanating from civil society on entry mode and investments in human capital.

As a result, academic insight into this increasingly important fragmented has not heretofore been assembled into a coherent whole. A more holistic academic analysis of political risk would identify the best strategic responses for a given constellation of political risk drivers and impacts.

The fragmentation identified within the literature mirrors the treatment of political risk in practice. A more holistic and strategic management of political risk could help to protect firm value and increase growth opportunities. A key finding of our research is that the study and practice of political risk is unnecessarily fragmented and a more holistic cross-functional approach to the management of multiple sources of political risk is required.

We have demonstrated that transnational, national and societal political risks can each impact performance through myriad channels. Yet each of these channels is typically the focus of a different functional manager and academic field. The impact of political risk on sales is managed and studied by individuals separately from that on the scope and continuity of operations, on research and development, on corporate finance, on regulatory or legal compliance, on human capital, on governance, and on reputation. As a result, a political risk management strategy should choose between strategic responses that include (but are not limited to) changes in:

- Pricing or sales strategy more broadly to overcome shifts in customer willingness to pay
- The geographic location of economic activity, including manufacturing, R&D and sales (each of which may be pursued by M&A, greenfield expansion, alliances, licenses or contracts)
- The governance of the existing network of international economic activity
- Security protocols and processes
- Information provided to investors, analysts and creditors, or the financing strategies pursued with them
- Government or public affairs strategies
- The balance between expatriates and national staff and the best means to ensure inclusiveness and diversity nationally as well as across the company
- Efforts to root out corruption, fraud and rent-seeking
- Investment to build and maintain corporate reputation
To further complicate this choice, the academic research shows that firms will differ in their political risk management strategy based upon their:

- Degree of identification with home nation in the eyes of foreign stakeholders
- Political connections to current and past government officials, the military, and other politically powerful stakeholders
- Environmental, social and governance performance
- Value-added contribution to their home and host countries
- Experience in a given host country or in host countries with similar risk profiles
- The political profile of a foreign or domestic partner, licensor, or agent in the host country
- The degree of asset specificity (i.e., the difference between the value of a given asset at risk in its current and next best use, which may confer bargaining power on a counterparty)
- The degree of power, legitimacy and urgency of stakeholders opposed to the company
- The degree of historical grievance toward the company and among key stakeholders of the company
- The degree of attention paid by financiers and creditors to political risk in a given host country or region, or globally

So, while the core transnational, national and societal drivers of political risk are the same, the appropriate management response to political risk is highly context dependent varying in the nature of the impact and the prior strategic choices of the company.

When considered in isolation, managers responsible for sales, business development, operations, research, finance, compliance, human capital, governance and reputation rationally treat political risk as a complication they must react to, while they have little control over it or incentive to build capacity.

However, if the impact of political risk is considered holistically at the corporate level, the cumulative impact on the organization is much larger. Furthermore, the ability of the firm to influence the incidence and magnitude of these impacts also grows. The negative impact on sales might be altered through strategic response in sourcing. The negative impact on regulation could be altered by additional hiring domestically. The threat of corruption could be mitigated by a different regulatory strategy.

To achieve such cross-functional, real-time coordination, responsibility for political risk likely must lie in a cross-functional office tasked with coordinating the strategies for all external stakeholders (i.e., government affairs, regulatory affairs, communications, reputation, community affairs, sustainability), and it should have a voice in the design and implementation of initiatives in the enterprise’s key functions (e.g., finance, operations, marketing, human capital, R&D). Political risk management is a high-level strategic coordination function.

[Graphics Note: Consider a web or org chart type graphic with the functions above]

In most organizations, such an effort would be led by the CFO, but, in some cases, it could be done by operations or strategy leaders or the general counsel. In any case, the executive responsible would have an interest and the authority to draw in information on the many impacts of political risk and mechanisms for mitigating its negative impacts — or even for seizing opportunities and coordinating the organizational strategy to balance these tradeoffs.
Such an effort would transform political risk management from a support function or a firefighting approach (i.e., loss mitigation after a negative event) to a proactive strategic coordinator of activity across functions that enhances value.

While the CFO or another senior executive might share this vision now, or may come to share it in the aftermath of a risk event, they are likely unaware of the range of tools available to implement a corporate-level political risk strategy. Our literature review across the three levels of political risk reveals the following components of such strategies:

**Strategies across the levels of political risk**

At the **transnational level**, corporate strategies are most limited. Corporations tend to be risk takers in this area, though strategies include monitoring potentially adverse shifts in international relations and adjusting the location of global operations accordingly to minimize the financial harm of conflict. No one firm or even collection of firms can sway a government’s short-term decision to impose tariffs on China or to exit a multilateral agreement. Perhaps, collective action can, over the medium to longer term or on nationally vital decisions, make a difference to the outcome (e.g., WTO accession for China or NAFTA passage), but these are likely important exceptions that prove the overall rule regarding firms as reactionary bystanders in the face of transnational political risk.

At the **national level**, political risk management expands to encompass reactive strategies and proactive shifts in the structure or content of global operations — or government affairs or corporate social responsibility practices — that alter the likelihood or magnitude of conflicts between a company and a host country’s government. As described above, many choices will collectively alter the incidence and magnitude of national political risk regarding:

- To whom to sell
- Where to produce
- How to organize
- Where to locate high value added activities (e.g., manufacturing, R&D and headquarters)
- How to ensure security
- Whom to hire (and on what terms and with what long-term commitment)
- How to finance
- How to govern
- How to win the hearts and minds of external stakeholders

As Brexit, the US-China tariff disputes and the Venezuelan crisis unfold in parallel in 2019, firms in the same sector with exposure to these events differ radically in their potential losses and management approaches because of choices they made before the current crises began.

At the **societal level**, strategies are similar to those at the national level but necessarily expand the scope of stakeholders to include communities, civil society organizations, and other less powerful or influential groups and organizations, many of which may have historically been marginalized or excluded from participation. Oil, gas and mining companies have been on the front lines of adapting to the need to secure their social license to operate in recent years, but that need has expanded to include a wider array of sectors whose production impacts climate change, human rights, data privacy, diversity and inclusion, and other environmental, social and governance issues.
**Political risk management**

Studies of the incidence and impact of political risk have considered a range of potential reactive and proactive strategic responses.

- The most passive strategies are the (implicit) acceptance of lost sales and revenue, devalued assets, disrupted supplies, delays, a higher cost of capital, risks to workers or governance challenges.
- Slightly more proactive strategies include avoiding riskier host countries for foreign direct investment, sourcing and R&D, or pricing in risk.
- Intermediate strategies include enhancing the redundancy, depreciation or interdependence of capital or technology at risk and allocating greater resources to due diligence and monitoring.
- Finally, and most proactively, companies can change their entry strategy to enhance the strength of relationships with politically influential stakeholders, including by providing equity ownership, top management team authority and other desired local value-adds in the hope of aligning interests with politically powerful stakeholders.

Firms will choose from this menu of political risk management strategies based upon the maturity of their political risk capabilities.

[Graphics Note: Consider a table for the above]

The least capable firms have no choice but to accept the negative outcomes of political risk that repeatedly surprise them. As firms become more sophisticated, they will begin to develop the capacity to effectively monitor or sense risks in the external environment and engage more proactively. Early efforts will focus on monitoring externally sourced information, followed by hiring specialists in the area and, eventually, having senior leadership engage external stakeholders on an ongoing basis.

Next, firms will develop the capability to link what they learn to what they do. In other words, signals from the external environment will be recognized as leading indicators of risk and opportunity and will be tied to key performance indicators. Initially, such systems will treat each type of political risk and each impact as a discrete risk to be mitigated or opportunity to be seized. Eventually, the strategies adopted to address these risks will draw upon the expertise and capacity of private sector, public sector and civil society partners with whom the local firm and its management develop trusting relationships.

Even more advanced firms will recognize the linkages across transnational, national and societal risks and across the impacts and respond to the full spectrum in an integrated manner. The most sophisticated firms will deploy these abilities not only to manage downside risks but also to seize upside opportunities, making the case for value-enhancing changes in core functions and practices in response to real-time signals from the external environment, including the capacity to sift through subtle dynamics in coalitions, issues and interdependencies.
Conclusion and next steps
The research summarized here emphasizes the materiality of political risk as well as its distinct sources and impacts that are frequently addressed in isolation rather than in an integrated manner. Political risk may emanate from transnational, national or societal actors. It may impact sales; choices of where to invest and what activity (i.e., production, sales and R&D) to undertake in which market (with which local or foreign partners); the integrity or depreciation of physical capital and human capital; public affairs strategies; and governance and stakeholder engagement strategies. More sophisticated political risk management practices are dynamic, proactive, and integrative across political risks and impacts, as well as across functional responses.

How firms can achieve this more sophisticated level of political risk management (i.e., geostrategy) capability is the subject of the next steps of our research program. Achieving this higher level of capability requires collecting new data, adopting new tools and successfully implementing organizational change efforts to ensure their strategic use across functions.

To assess the experiences of firms advanced in this transition, we will undertake a broad-based benchmarking survey of political risk management practices. We will conduct detailed interviews with firms at every level of capacity building, but high-performing firms will be oversampled. Insights from this survey and these case studies will be shared with academics, managers and advisors in a thought leadership summit on the topic of political risk management, as well as in an annual report.
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