

Integrating Political Risk Into Enterprise Risk Management*



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Why Political Risk Matters

A Letter from Samuel A DiPiazza Jr and Ian Bremmer

Enterprise Risk Management (ERM) has entered the mainstream of corporate consciousness over the past decade. Corporations and financial institutions globally have spent a great deal of money to develop and implement systems and processes to assess and manage risk more effectively. The basic “no surprises” mission of ERM is to help protect companies from preventable losses. Identifying, measuring, and continuously monitoring risks are the core competencies of ERM.

Yet, beyond capital protection, ERM can serve a more strategic function. In understanding clearly where and how risk arises in a business, management can drive higher-quality returns to the bottom line.

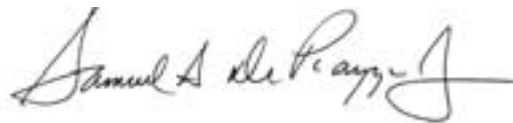
Now for the first time, PricewaterhouseCoopers (PwC), a market leader in the field of ERM, and Eurasia Group, a leader in political-risk research and consulting, have joined forces to develop a framework to help executives understand the political-risk dimension within the context of ERM's core competencies.

While many companies have developed metrics that estimate how their profitability might be impacted under varying financial scenarios, most have struggled to find a comparative and rigorous means of incorporating the range of outcomes that might arise from the political risk inherent in their international business activities. Political risk relates to the preferences of political leaders, parties, and factions, as well as their capacity to execute their

stated policies when confronted with internal and external challenges. Changes in the regulatory environment, local attitudes to corporate governance, reaction to international competition, labour laws, and withholding and other taxes, to name but a few, may all be influenced by hard to discern shifts in the political landscape. Political risk even incorporates a government's capacity and preparedness to respond to natural disasters.

PwC and Eurasia Group have brought together a team of experts to build a Political Risk Assessment (PRA) diagnostic and monitoring methodology that enables companies to isolate and assess the contribution of political risk to their overall risk profile. The complete Political Risk Assessment also incorporates recommendations that enhance a company's internal capacity to manage these risks, as well as to identify and capitalise on unexploited opportunities.

The interrelation and interdependencies of global markets will continue to increase. Businesses that reach for new manufacturing and sales opportunities in countries far from their home base and experience are truly at the forefront of globalisation. At the same time, they are vulnerable to the reactions of countries that seek to temper the pace and impact of globalisation on their institutions and workforce. PwC and Eurasia Group's political-risk assessment offering helps business leaders to understand the nature of political risk and its impact on their international investments, and to seize the opportunities it affords.



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Political Risk as Opportunity

Globalisation is a process of rising acceptance of political risk in search of greater economic rewards. Economic success has bred acceptance of ever-greater political-risk exposure.





Global automakers have pinned their hopes on China as a way to save an industry plagued by surplus capacity. Original equipment manufacturers (OEMs) are building assembly plants there to achieve cost savings and bolster their bottom lines. Often pressured by OEMs, component manufacturers are following closely behind. Automakers are also seeking to penetrate China's domestic market—the fastest-growing auto market in the world.

Although the cost savings can be significant, and the lure of China's dynamic domestic market infectious, China's auto sector poses considerable regulatory and commercial risk. China is increasingly pressuring foreign investors to transfer technology to local producers, which could erode the patent protections and competitiveness of well-meaning investors. But this is not the only risk to the automotive sector.

As they focus on shifting growth from exports to domestic consumption, China's leaders may withdraw tax benefits for foreign investors. Infrastructure bottlenecks and strong upward pressures on government-controlled electricity and fuel prices also create considerable uncertainty around manufacturing efficiency and operating expenses. At the same time, sporadic fuel shortages and worsening urban gridlock inject ambiguity into forecasts for domestic auto demand growth. In short, low-cost manufacturing and vast potential domestic demand are offset by uncertainty in regulatory and infrastructure capacity. This makes China a potentially higher-risk, higher-reward investment destination.

CEOs and business strategists seeking to invest in China and other emerging markets routinely consult economic-risk analysts. But basing global investment decisions on economic data without considering the political context is like making diet decisions based on calorie counts without reading the nutritional labels. While most companies are already charting the murky waters of globalisation, many corporate leaders lack a framework for understanding how

local political and market dynamics affect foreign ventures. China, for example, holds tremendous promise as an automotive manufacturing centre and market, but CEOs may be unaware of social, regulatory, and energy issues around the next curve in the road. Political-risk analysis allows leaders to contemplate not just broad, easily observable trends but also the nuances of society and the quirks of personality that can affect a venture's success.

Looking forward, even investors in "stable" countries must be concerned with political risks that arise in emerging markets. For example, consider the current concern about rising interest rates in the United States. Countries with positive current account balances, like China and Japan, buy US debt, which in turn supports low domestic interest rates. Any political move that shifts foreign investment preferences away from US bonds, such as China's decision to liberalise the renminbi's peg to the dollar, could upset the US balance of payments and cause an increase in American interest rates and inflation.

What might shift foreign governments' preferences for US debt? Will countries that are debtor nations to the United States grow fast enough to afford higher interest rates? How quickly and smoothly can emerging markets tied to the United States adjust their monetary policy? Being aware of political dynamics abroad helps even the most local companies anticipate macro-level shifts that could affect their interests.

Politics is everyone's business. Global financial markets are more interconnected than ever before. Offshoring and outsourcing have radically altered industry cost structures, forcing more and more companies overseas. Even companies without intentions of expanding abroad are dependent on international flows of raw materials and capital. Evaluating a company's exposure to risky political events, and assessing their impact, should be key components of any company's ERM strategy.

Frightened Capital? The Case of China

Economic theory argues that capital should chase the highest return on investment, and returns should be highest in countries with relatively low levels of capital stock where investment is needed. Why then do emerging markets like China enact policies that send funds to capital-rich countries like the United States?

Two explanations are commonly given to account for this trend, and both are driven by politics.

- First, money flows to wealthy countries because political risks are lower in established democracies with predictable regulatory and political processes.
- Second, high savings in emerging markets is increasingly used to balance current accounts across the Pacific Ocean. By bolstering the dollar, China is preserving American consumers' ability to buy their goods.

But the key explanation is likely rooted in domestic Chinese politics. By sending dollars back to cover the United States's global current account imbalance rather than converting them into renminbi, China is serving its export-oriented sector and protecting its fragile financial industry with a weaker currency. The political consequences of correcting this imbalance could be tremendous, but over time it will have to happen. Political dynamics will steer the impacts of the correction.

Political Risk:

Any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives.

Why Politics in Business Matters: Turning Uncertainty into Risk

Politics influences how markets operate. Often the most unpredictable economic events are political in origin, the result of flagging political willingness or capacity to maintain a consistent and predictable economic environment.





Today, four trends dominate the global investment environment: the interconnection of financial markets, increased reliance on offshoring, deteriorating national security, and energy dependence. Anticipating the risks associated with each of these trends requires asking the right questions about how institutions' and leaders' preferences determine policy choices and, in turn, economic outcomes.

Politics can make many economic decisions look foolish in hindsight. This is especially true in countries where autocratic leaders seem to personally steer policy and where quantitative data is often adulterated. Yet it also applies to developed nations where targeted lobbying efforts can sway policy decisions. How does one separate newspaper hype from the underlying forces that affect the business

environment? When do economic figures fail to tell the whole story? How does a company predict the severity of shocks, like unforeseen transfers of political power or the 2004 tsunami, on its overseas holdings? Conducting a political-risk analysis turns uncertainty into calculable risk.

Because businesses are often affected by political decisions in the countries where they operate, at home and abroad, all companies factor the political environment into planning scenarios. However, political risk can seem so amorphous that many business leaders lack a framework for evaluating their exposure. But like other elements of enterprise risk, political risk has systematic components that can be isolated by analysts who understand variation across political systems.

East Asian Crisis Rapidly Spreads Across the Pacific

Right up to the 1997-98 East Asian financial crisis, economic data revealed few risks to further investment in Southeast and East Asia. In retrospect, the immediate, underlying cause of the Asian financial crisis was economic: a sudden outflow of funds occurred after the collapse of speculative bubbles throughout the region, largely in the imprudently regulated financial and real estate sectors. Political conditions, however, magnified the effects of the crisis. Weak political institutions were unable to implement policies that would have prevented risky lending and were incapable of convincing markets that they could implement credible policies in reaction to the growing crisis. As a result, the crisis took more than a year to run its virulent course, threatening markets from Latin America to Russia.

Investors worried about how governments across East Asia would respond to the crisis. Political-risk analysts would have asked questions to help them gauge national reactions, such as:

- Which governments were most stable domestically or had elections approaching? (Both of these factors mitigated the political pressures brought on by the crisis.)
- Where were social tensions highest, with the consequent potential for unrest?
- Which governments could credibly respond with what were perceived by markets to be proper policies?

Analysis of the answers would have helped investors foresee that:

- Mahathir Mohammad, Prime Minister of Malaysia, would survive the crisis due to his stranglehold on domestic politics and the inclusion of a substantial portion of the population as beneficiaries of the single-party political regime.
- The Philippines and South Korea would manifest public discontent largely through nonviolent elections.
- Thailand's fragmented democracy would provide the country the flexibility it needed to alter its constitution to stabilise itself.
- In Indonesia, too few people had any incentive to defend President Suharto's highly centralised regime from destruction.



Globalisation and Contagion

Global financial markets have become inextricably linked, which raises the likelihood that shocks in one country will cascade across a region. “Shocks” can be internal to a country, like the death of a dictatorial leader, or external, like a natural disaster. As the connections between the financial crises in East Asia, Russia, and Latin America made clear, it is no longer enough for a company seeking to mitigate the effects of shocks to simply diversify. Shocks can touch holdings in geographically dispersed countries. When they do occur, fixed-asset investments face longer-term risk than do more liquid investments.

Crisis Contagion

The East Asia crisis provides a clear example of how investors can misperceive risk when diversifying investments across regions. East Asia’s capital outflow and the subsequent currency devaluations of the East Asia crisis put significant pressure on the currencies of Brazil and Argentina, both of which had adopted fixed-exchange-rate regimes that were susceptible to currency speculation.

In 1999, Brazil’s currency peg was the first to fall. Brazil had employed a crawling-peg exchange rate that was more vulnerable to speculative attacks than was Argentina’s, which was tied to the American dollar. The Brazilian Social Democratic Party (PSDB) leader, Fernando Henrique Cardoso, was elected president in 1994 on a campaign that focused on stabilising the economy. Consequently, the government was reluctant to permit currency devaluation in the run-up to Cardoso’s reelection campaign in late 1998. Shortly after the election, economic authorities could no longer sustain the currency’s value. The subsequent devaluation considerably weakened Cardoso’s second administration, diminishing the capacity of his government to embark upon a legislative reform agenda.

Argentina’s currency resisted devaluation longer than did Brazil’s, as its more rigid fixed-exchange rate gave speculators a bit less room to maneuver against it. While Argentina’s and Brazil’s fixed-exchange-rate regimes reduced the possibility of speculative attack on their currencies, they also increased the economic costs of devaluation. After successive and failed attempts to cut back fiscal expenditures, Argentina’s currency suffered significant devaluation in 2001, generating a severe economic recession. The devaluation led to a short period of serious instability and the successive resignation of three Argentinian presidents.

Offshoring

Any shift abroad in productive capacity can be considered offshoring, from manufacturing auto parts in Mexico to providing financial analysis in India. Businesses export jobs to locations where labour is cheaper but not necessarily the cheapest. Businesses optimise along a variety of dimensions, including access to raw materials, human capital, and predictability of the regulatory environment. Where cost and quality of the workforce are comparable, the political environment can determine investment decisions.

The Case of Slovakia: When Political Environment Sways Investors

Central and southeastern European companies compete head-to-head for lucrative Western investments. Their proximity to Western Europe and comparable labour costs often mistakenly make them seem broadly similar. However, differences in each country's actual cost structures and political developments can have far-reaching effects on companies' location decisions.

Beginning in 1998 and continuing following his re-election in 2002, Slovakian Prime Minister Mikulas Dzurinda was able to form a multi-party center-right coalition favourable to pro-growth policies. This political development allowed Slovakia to make a decisive break with the authoritarian and anti-integration prerogatives of the previous government.

The Dzurinda government delivered a series of key market reforms, reducing the corporate income tax in 2002 from 40 percent to 25 percent, and instituting an across-the-board flat-tax structure in 2004. In addition to the benefits of the 19 percent income-tax rate, the new system was seen as less complex than those in countries like Poland. For Kia Automotive, which chose to locate a manufacturing facility in Slovakia instead of Poland, the predictability and clarity of the system was an important factor.

Several large-capitalisation companies have had success in negotiating attractive incentives in central and southeastern Europe. Yet, in Slovakia's case, it was the broader political climate that enabled the construction of a pro-growth coalition, which in turn instituted business-friendly policies. At the same time, one election is not enough to guarantee that a favourable business climate endures.

Security Concerns Rising

Understanding political risk is increasingly important as terrorism and conflicts in the Middle East and Northeast Asia generate new security-policy concerns. For better or worse, the United States is now a major driver of international risk, and Washington's new willingness to preempt threats to American security and national interests has changed risk calculations everywhere. Companies must identify whether domestic, regional, or global security threats will affect the cost of doing business. How will those costs compare with doing business elsewhere?

South Korea is a prominent example of how security concerns can overshadow a country's economic outlook. Placed in Western Europe or North America, South Korea would fit in as just another industrial democracy. But caught between regional and increasingly antagonistic goliaths—Japan and China—and facing its politically unpredictable and well-armed counterpart to the north, South Korea has security risks that cloud the economic decisions of potential investors.

Escalating Tension in the East China Sea

The dispute between China and Japan over control of natural-resource rights in the East China Sea threatens to spill over into political conflict that could damage economic interactions within the region and beyond. Japan claims that the exclusive economic zone (EEZ) boundary between China and Japan is the median line, equidistant between the Chinese mainland and the Okinawan archipelago. China claims that its EEZ is the entire continental shelf extending from the Chinese mainland nearly to Okinawa.

The contested region between these two imaginary lines has been left alone by both governments until recently. Now China has begun development of the Chunxiao natural gas field on what is the uncontested Chinese side of the median line, but in a field that Japan claims could cross that line into disputed territory.

Decisions on this dispute are being driven in part by national politics. If Japan determines from its test drilling that the gas reservoirs the Chinese are developing do not cross the median line, Japan will likely refrain from pursuing development, at least until May 2009, when the UN Law of the Sea process will receive submissions of precise claims made by all coastal countries. But if Japan determines that the Chinese are currently exploring gas reservoirs that span the median line, the Japanese could push forward with development. If there are attempts to disrupt experimental drilling, tensions could quickly arise.

Energy Dependence

All energy-importing countries share an interest in diversifying their oil supply, both away from an increasingly unstable Middle East and toward alternative sources of fuel. Common objectives in energy coordination include increasing efficiencies in energy transfer and use and promoting infrastructure efficiencies that avoid bottlenecks and diminish regional variation in energy costs. Understanding how local, regional, and global energy concerns can affect investment decisions requires country-specific knowledge of how political actors will respond to energy shortages.



The Response to Venezuela's 2002 Oil Strike

In December 2002, a general strike in Venezuela, a major supplier of oil to the United States, brought crude production and refining activity to a halt. The strike lasted several weeks, but its impact on production was considerably longer due to field damage and the loss of expertise that occurred as a result of a massive purge at the national oil company, Petroleos de Venezuela. Although US refiners, faced with a sudden loss of feedstock supply, expected a release of crude oil from the Strategic Petroleum Reserve, the Bush administration refrained from taking such a step. Saudi Arabia, which had initially taken a wait-and-see attitude, eventually agreed to make up for the disruption in Venezuelan supply, but Saudi relief took months to arrive. US crude oil inventories plummeted, which drove up prices.

Anticipating Sources of Risk

The Committee of Sponsoring Organizations (COSO) of the Treadway Commission's ERM framework encourages companies to measure risks and make trade-offs based on their risk appetites. For investors exploring emerging markets, the potential for rapid political shifts makes calculating those trade-offs a moving target. Global and country-level politics can act independently or interactively to alter the economic environment.



Macro-Level Risks

Macro-level risks are widely discussed in the media. Such risks include terrorism, energy-price volatility, political instability in the Middle East, weapons proliferation, Northeast Asian security instability, and the role of China in the global marketplace. Political-risk analysis differs from reporting because analysts sift through the information overload to inform business leaders of how these events will directly affect financial markets and long-term foreign investments. Analysts who study world leaders' will and their capacity to respond to macro-level shifts are also able to anticipate ripple effects across countries.

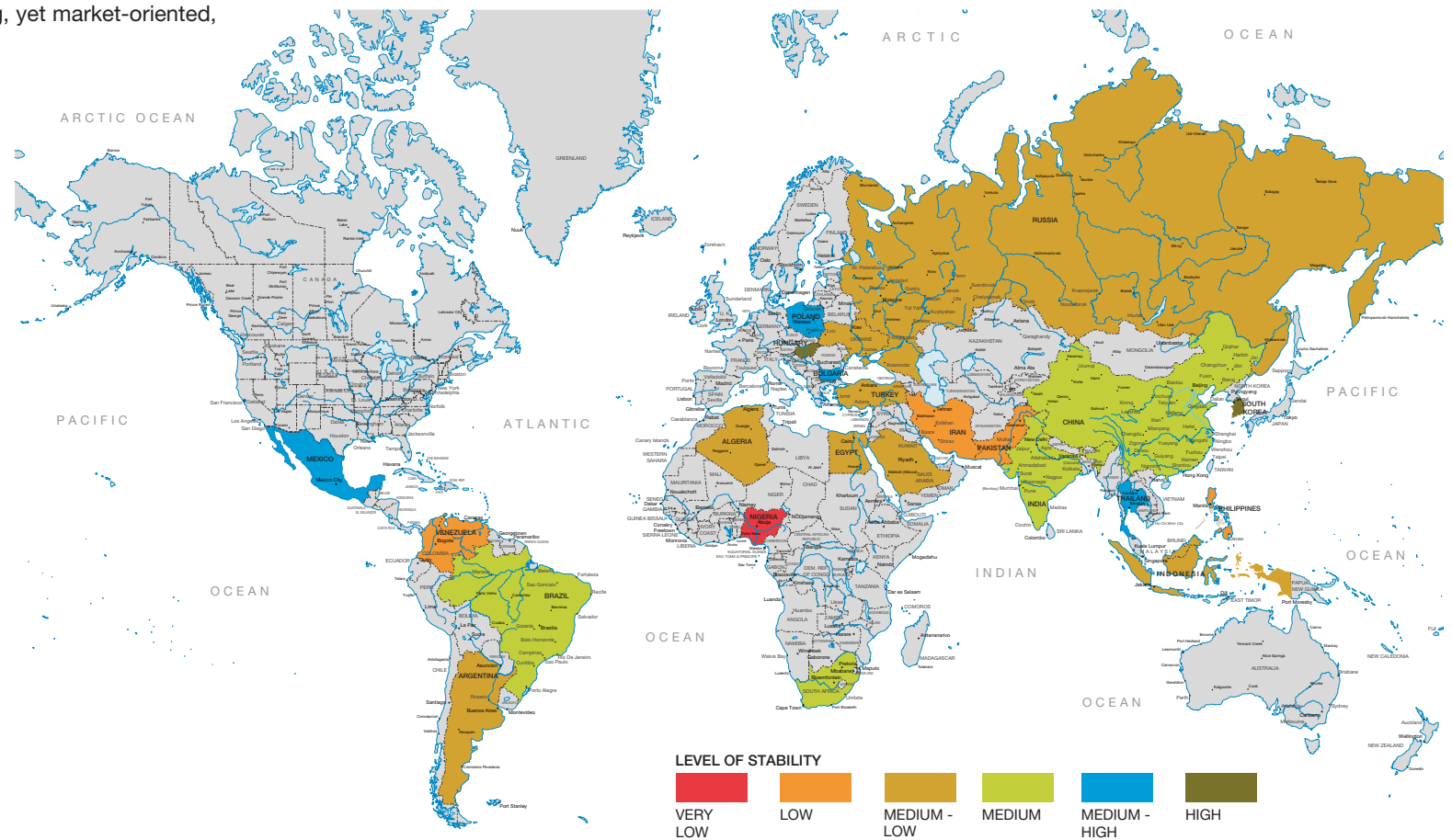
Political Marketplace Risk Rising in Russia

Over the past five years, the investment climate in Russia has undergone a major transformation. From January 2000 to June 2003, Russia reached a post-Soviet-era peak in terms of political stability. President Vladimir Putin increased investor confidence by pushing through a number of important structural reforms. He created a stable political environment through his steady leadership style and control of parliament, forged a relationship with big business that was relatively transparent, and eliminated interregional barriers to trade, which helped reduce the Yeltsin-era asymmetrical relationships between Russia and the states of the former Soviet Union that had skewed markets. The combined impact of these policies was the informal blessing of major joint ventures between Russian and foreign companies, such as TNK-BP, and the continuing post-1998 economic recovery. This seemed to suggest that Russia was moving in the right direction.

However, these reforms did not completely institutionalise a market democracy in Russia, as the state still maintains a large role in the Russian economy, especially in the all-important natural-resources sector. Recent moves among powerful leaders on the national and regional level—such as the dispute at the beginning of 2006 between Russia and Ukraine over natural gas—suggest a renewed emphasis on statist policies.

Political stability is linked to economic vitality

Looking at a map highlighting many of the world's developing nations, the countries with the strongest economies also tend to be the most politically stable. This is true even where political stability is a result of a strong, yet market-oriented, autocratic regime.



Country-Level Risks

By their nature, emerging markets are places where political decisions have a greater effect on markets than economic trends, thus diminishing the value of employing economic guideposts to investment decisions. In politics, risks are more difficult to identify, to measure, and to hedge. Consequently, investors ranging from hedge funds to extractive industries are extremely concerned with the risks of nationalisation, weak legal systems, corruption, and regulatory stability. Corporations exposed to these risks must weigh the trade-offs associated with investing in China versus Brazil or Germany versus Japan.

Corporations doing business in or with some of the world's fastest-growing economies, especially China and India, require a framework for navigating the challenges associated with working in high-growth countries, which typically have rapidly evolving political and legal frameworks. Companies that outsource labour, for example, would benefit from understanding the degree to which local

government regulates and intervenes in the labour market. Likewise, it is crucial to be aware of existing social tensions that may result in work stoppages or civil unrest. In other instances, intellectual-property rights may be an issue of concern. Not only is it essential to know that a country has regulations in place to protect intellectual-property rights, but it is even more important to know if those laws are enforced and what legal avenues are available for addressing disagreements. Political-risk professionals consider a wide range of issues like these in order to assist companies in anticipating and mitigating such challenges.

Domestic Politics

Investment abroad requires local knowledge. Local politicians often have considerable sway over the tenor and ease of foreign direct investments. And they often face incentives that are distinct from those of a "rational" economic actor, because they are judged on their ability to meet political goals such as attracting investment to their

region. Sovereign-debt analysis conveys, for example, whether a country can remain financially able to pay its bills, but it cannot reveal whether a country will be politically capable of covering its debts when payments compete with social-programme spending that keeps constituents happy.

There are three types of domestic political stability: policy, government, and regime. The likelihood of these factors changing over time varies greatly, and with them so does political risk. Regime instability occurs when the institutions of government or the rules of the political game change. Government instability arises when the actors who control the institutions of government change. Policy changes can occur when the preferences of those who control government change; when those who control the institutions of government change; or when the institutions of government are altered, which in turn changes the preferences of those who control government.



Identifying Key Actors for Regulatory Reform

There are three principal actors involved in all structural reforms: executives, legislators, and political and economic actors outside the legislative process. Analysing possible legislative-process trajectories requires that one identify which legislators stand firmly on an issue, which remain undecided or can be swayed, and which actors are capable of influencing legislators.

Knowing which legislators are undecided is critical for predicting the passage of reforms. Political profiles of each legislator unveil political allegiances and vulnerability to pressure. Important factors that can reveal personal preferences include education, former jobs, electoral constituency, and posts within a party or legislature.



An Example from Mexico: Deputy Luis Antonio Ramirez Pineda

Luis Antonio Ramirez Pineda, from the Institutional Revolutionary Party (PRI), is publicly against most structural reforms. His stance reflects his political roots in Oaxaca, whose legislators tend to contest reform, and his father's leadership position in the PRI's agrarian sector, which also opposes reform. However, Ramirez Pineda is on the legislative finance committee, which has to manage many fiscal problems produced by the present system. In addition, he has a BA in Economics from Instituto Tecnológico Autónomo de México (ITAM), and so he may be receptive to certain reform arguments. He is also a pivotal figure for advocates of reform, because his position within the party allows him to influence other PRI members.

Assessing Risk

Stable industrial democracies can face politically driven economic problems, as Japan did in the 1990s. By contrast, countries such as China, with a high potential for instability, can become **magnets for external investment**, despite poorly specified regulatory and legal protections. Both China and Japan are attractive investment targets. Their risks to investors vary in magnitude and timing.



How Likely Are the Risks You Face?

Russia's 1998 financial crisis and Brazil's election of President Luiz Inácio "Lula" da Silva reveal how changes in the individuals who control governing institutions affect a country's "stability." The same concerns influenced markets while Hu Jin-tao's consolidation of power in Beijing was incomplete. By contrast, unexpected shifts in power do not have a substantive effect on markets in "stable" countries, which are characterised by enduring state institutions, meaningful opportunities for citizens to participate in politics, and predictable political procedures.

Anticipating and Responding to Shocks

To assess a nation's stability, an analyst looks at two factors: the capacity of political leaders to implement the policies they want even amid shocks, and the ability to avoid generating shocks of their own. A country with both capabilities will always be more stable than a country with just one. Countries with neither are the most vulnerable to political risk. In political-science parlance, these translate into "decisiveness" and "credibility" or "predictability." These factors represent a difficult trade-off: how can a regime optimise both decisiveness and policy stability?

Understanding how this trade-off is managed across countries is an important facet of anticipating variation in political risk.

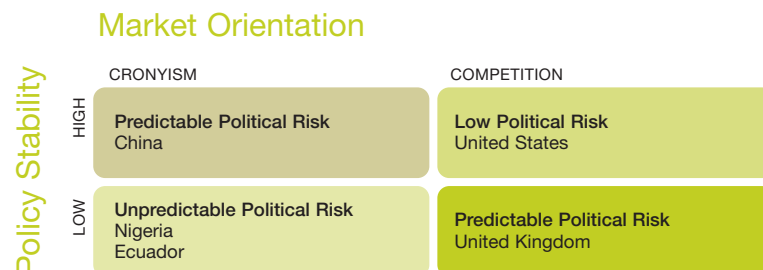
Decisiveness represents the capacity to change policy rapidly, and it is necessary in the face of any crisis. But decisiveness implies unpredictability in that leaders who demonstrate a high level of decisiveness can quickly shift the political environment.

Countries with high levels of policy stability will stay the course when times are good and avoid bad policy choices. Of course, countries with political institutions that promote policy stability can find themselves in dire straits when policy change is necessary but the political system finds it impossible to adapt. For example, Argentina saw indicators of a financial crisis as far back as 1998, three years before its default, but political constraints prevented legislators from enacting reforms that would have taken pressure off the peso.

A regime's market orientation is equally important to understanding how a country will respond to shocks.

The preferences of political leaders can lean toward helping friends or promoting market competition. All countries strike a balance between competition and cronyism, but political systems tilt the scales. The nearer that balance is struck to favouring competition, the less likely politics will influence market outcomes and impinge on economic decisions.

By comparing a country's level of policy stability to its market orientation, one can assess the predictability of government responses to shocks. For example, because of the United Kingdom's high concentration of government power in the House of Commons, the country can enact rapid policy shifts, a sign of low policy stability. But the country's high market orientation means that the process leading up to change tends to be transparent and that new policies are generally economically rational. By contrast, China's consolidation of political power in Beijing creates a high level of policy stability, but it may mean that policies are sometimes influenced by non-market factors.



A Unique Methodology

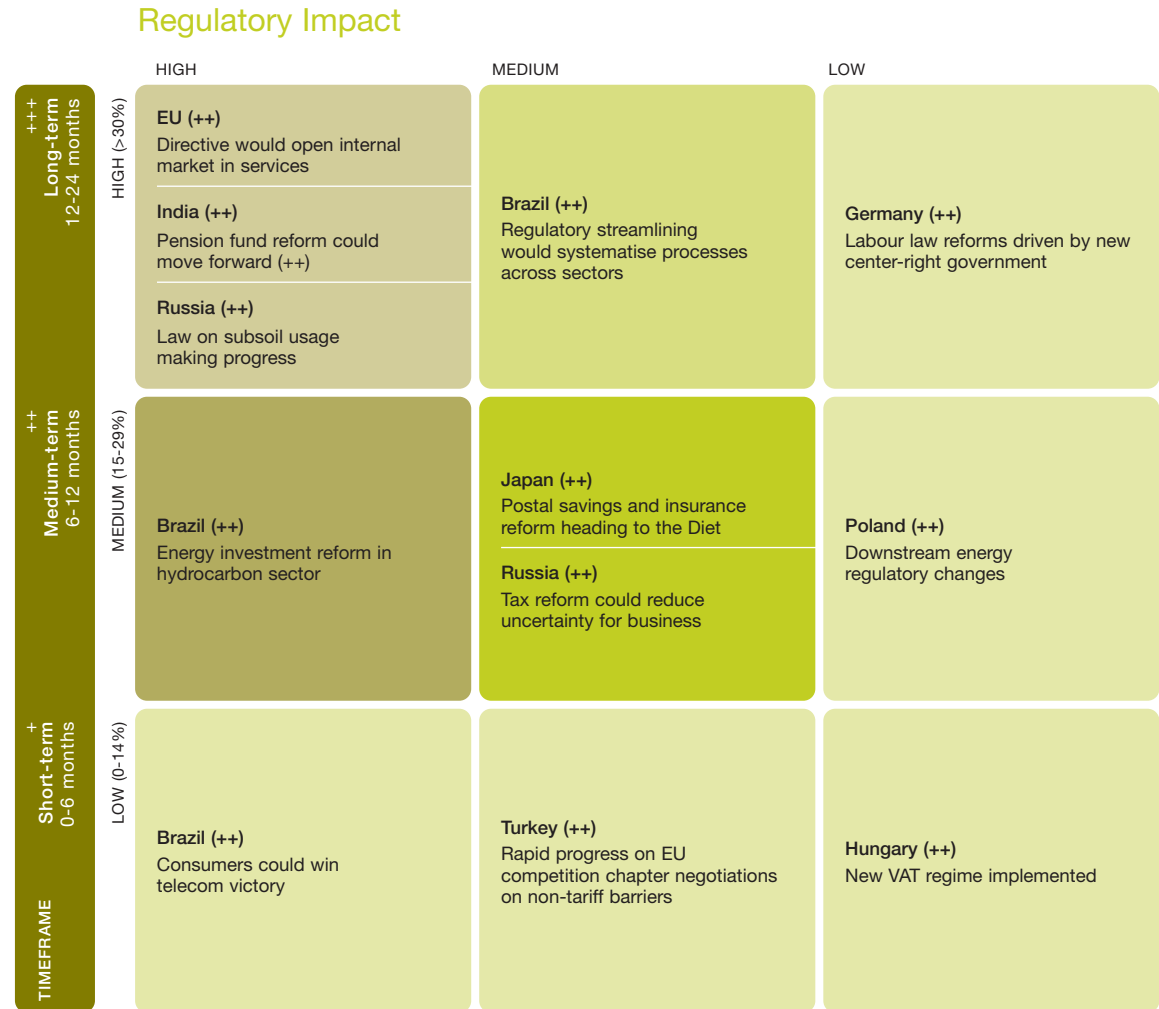
Eurasia Group's methodology marks the first systematic effort to integrate political-science theories and financial-markets expertise into robust, comparative frameworks for use by both financiers and corporate leaders.

Knowledge of variation in political behaviour across sectors or regions within a country is an invaluable resource for wise planning. Certain political figures, ministries, and regulatory departments matter more than others, and it is not always immediately evident who pulls the strings in any given sector or on any particular issue. Political-risk analysts possess an intimate knowledge of the countries they cover and the underlying institutional make-up that adds necessary context and direction.

Eurasia Group brings together political scientists with a broad range of country expertise, which enables them to provide comparative country analysis. PwC brings together ERM specialists and business advisors with deep sector experience to recommend practical approaches for mitigating identified risks, enhancing opportunity, and evaluating alternative courses of action.

Eurasia Group's Regulatory Riskwatch service is one example of the ways in which the company provides a comparative and forward-looking platform for thinking about risk. Regulatory Riskwatch estimates three key dimensions of regulatory change: impact, probability of the regulatory change, and time horizon. By considering these elements, business leaders can adjust strategy to deflect adverse affects on operations or take advantage of opportunities.

Probability





Political-Risk Analysis Strategies

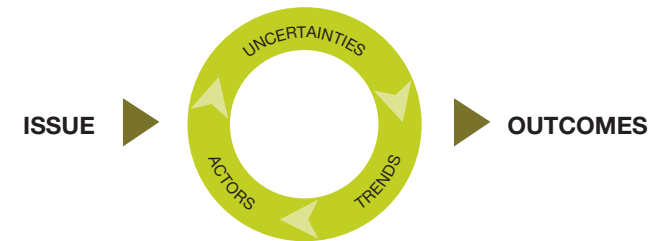
Global corporations, governments, and others concerned with the impact of a transnational issue, such as terrorism or energy supply, need methodical, system-wide analysis to complement country-specific coverage. One of the main challenges for leaders confronting global issues is identifying from the overwhelming body of available information the specific indicators of risk. To address this, political-risk analysts have built customised frameworks for organising complex, cross-national phenomena into manageable, actionable typologies. Scenario planning is also employed to help leaders plot strategy in situations where there may be a variety of outcomes. By leveraging the intellectual capital of economists, political analysts, and social scientists around the world, political-risk analysts can generate forward-looking analysis on political risk in emerging and developed markets.

Scenario Planning

Corporate investors take a long-term view when they enter a new market. They seek analysis that provides insight into what the global political and social landscape may look like—not just in the next few weeks or months but in the years ahead. Scenario planning is a tool analysts use to map out potential political, economic, and social trajectories, thus allowing companies to consider a range of strategic scenarios and identify critical risks as well as opportunities. Scenarios don't attempt to predict the future. Instead, they help companies anticipate challenges and opportunities by serving as a roadmap. Looking to the future, there are many potential ways to get from point A to point B, but the road taken will be characterised by its own set of landmarks. Scenarios attempt to enable the user to recognise critical "signposts" as they occur.

Key to the process of scenario planning is a determination of "driving forces" that may propel global affairs down a particular path. These drivers may include market factors, social trends, technology developments, and patterns of coercion or regulation by the state. Mapping out scenarios involves assessing the impact of drivers along with other "certainties" that are known about the future, such as population trends and gross national product projections. What emerge are very different stories about the future, depending on the particular dominance of certain drivers and the available trade-offs.

The Scenario Planning Process



Scenario planners look for how the interrelationships between actors, trends, and uncertainties affect potential outcomes of an issue and then test the extremes.

Timing Risk: Capitalising on Market Misreading of Relative Political Risk

Capitalising on market misreading of relative political risk offers opportunities for cheaper, more profitable investments. Following potential changes in government, either through elections or other means, is one way to time opportunities or to anticipate future difficulties. Such analysis requires committed, continuous coverage combined with detailed historical and institutional knowledge of prominent political actors as well as the incentives and constraints they face.

Preparing for Uncertainties

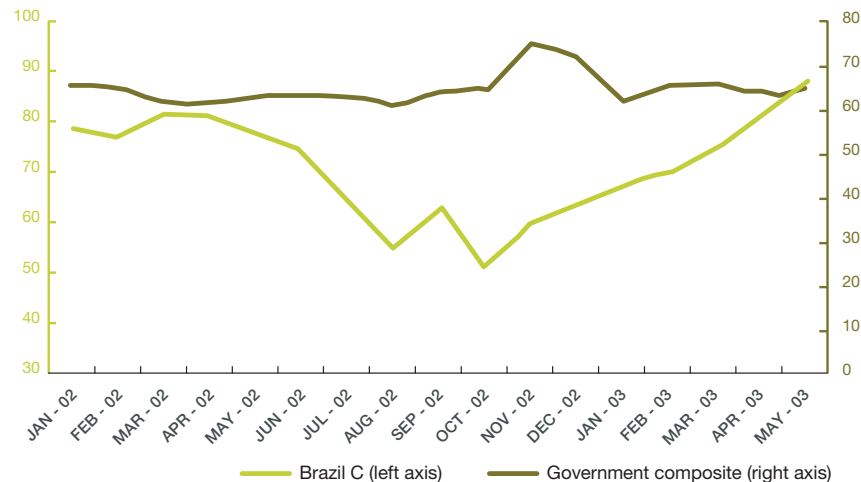
By understanding the underlying context for each story, companies can better anticipate how the world might adjust when uncertainties are introduced. For example, an uncertainty such as a terrorist attack might stimulate increased state regulation and a prioritisation of security measures over social equities. Such a shift has immediate financial and legal effects, as well as implications for consumer and market behaviour. When the baseline model for such a scenario is mapped out in advance, companies are better prepared to recognise the trajectory toward which they are moving and can likewise identify the potential impact of uncertainties as they occur. As such, they will be better able to adjust their business strategies in response to uncertainties.

Brazil's President Luiz Inacio "Lula" da Silva: How Investors Read the Signals Wrong

The victory of Luiz Inácio "Lula" da Silva in Brazil's 2002 presidential race provides a clear example of how investors can misread political trends. Investors feared the perennial Worker's Party (PT) candidate would adopt fiscally irresponsible policies. Brazil's currency was devalued and inflation increased to levels not seen since 1994. Few investors anticipated Lula's pragmatism, which has strong electoral roots given the moderate profile of Brazilian voters. Lula's government quickly took measures to dispel market fears. As a result, the economy grew by 5.2 percent in the second year of his administration as the risk premium, exchange rate, and inflation returned to more normal levels. The fear of Lula's election and resultant market volatility are excellent examples of emerging-market susceptibility to political risk and illustrate clearly how markets can misperceive risk.

Political-risk analysis has to differentiate between classes of investors. While financial-sector investors were able to quickly benefit from Lula's pragmatic macroeconomic policy, investors in regulated sectors like telecom and power utilities had to wait longer. Given that the costs of a poor regulatory environment are only felt in the medium term through lower investment, governments are slower to react. The Lula administration, for example, began with worrisome statements over the need to abolish independent regulatory agencies. But within two years of taking office, his government recognised the need for stable rules to attract investment, which was positive for corporate interests.

Eurasia Group's Government Stability Rating and Brazil's C-Bond



Integrating Political Risk into an Enterprise Risk Management Process

No matter how local a business, global politics can have an effect on success. By integrating political risk into the company's ERM process, executives can better understand the global exposures and balance the company's risk appetite against achievement of corporate objectives.



Managing Risk to Attain Objectives

COSO's Enterprise Risk Management (ERM) Framework provides a comprehensive approach to helping businesses and other entities assess and enhance their internal control systems. COSO defines enterprise risk management as:

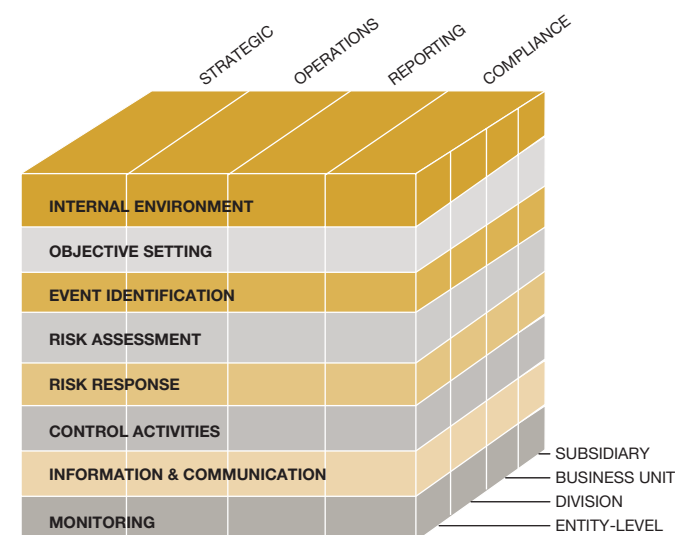
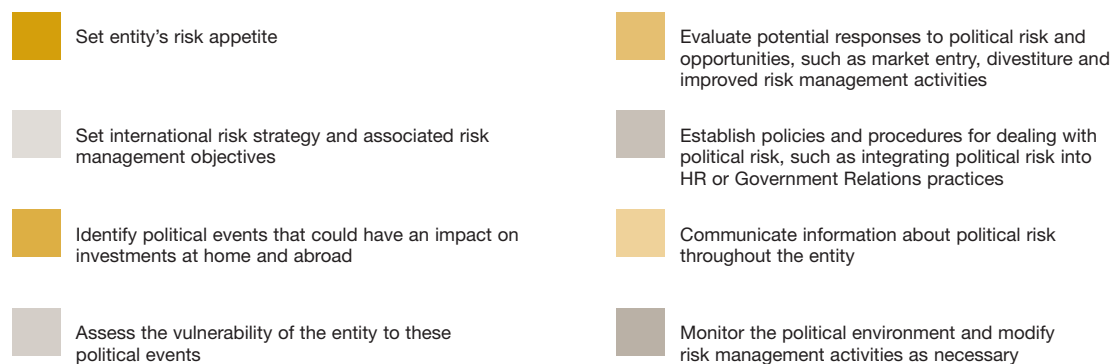
“A process, effected by an entity's board of directors, management, and other personnel, applied in a strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

COSO's framework is designed to help companies align their risk appetite and strategy, enhance risk-response decisions, reduce operational surprises and losses, identify and manage multiple and cross-enterprise risks, seize opportunities, and improve capital deployment. COSO identifies eight components of the risk-management process, which span four key corporate objectives:

- alignment of strategic goals
- operational efficiency
- reliability of reporting
- compliance with applicable laws and regulations.

Political risk represents an indispensable part of this larger puzzle. Political risks are part of the external risks that need to be identified as companies assess their as-is environment, and global strategies should be designed to maximise trade-offs in investment-location decisions and continuously monitor the political environment. Political risks also affect companies' abilities to comply with headquarters-country and local regulatory regimes. Where regulatory environments are loose, companies that don't anticipate a new government's interpretation of existing statutes may be saddled with back-tax assessments or unanticipated environmental compliance costs. And, where regulations are most stringent, as in the post-Sarbanes-Oxley environment, companies that don't know how their operations interact with local political leaders may face fines or worse. Integrating political risk into an ERM effort allows leaders to anticipate external sources of risk to identify how they might create risks to corporate value.

Political risk management overlaps with almost all ERM components along each of the four objectives categories.



Committee of Sponsoring Organizations of the Treadway Commission, *Enterprise Risk Management — Integrated Framework*, 2004.

The Political Risk Assessment

PricewaterhouseCoopers and Eurasia Group have joined together to offer a Political Risk Assessment (PRA) diagnostic and monitoring methodology, which helps executives monitor their international exposures. The PRA is a systematic approach to understanding and anticipating how current and future political events could materially affect a company's organisation, and thereby helps the company better manage its international exposures. The PRA has three phases:

Risk Assessment – Analysts look at the company's current and future international investments, global supply chains, and key foreign commercial relationships. They map these against global trends, macro-level country risks, and industry-specific risks to create a comprehensive picture of risk exposure. This phase also provides a check against the company's internal assessment of risk.

Impact Analysis – Analysts assess the company's vulnerability to risks and the potential economic and strategic impacts of risks on costs and revenues. Advisors work with the organisation to test qualitative and quantitative risk scenarios and strategic responses.

Recommendation – Advisors work with the company to develop a plan for mitigating identified risks, pursuing potential opportunities, or seeking alternative strategies. Strategy shifts may include improving risk-management processes or decisions to enter or exit markets or to shift sourcing strategies. PwC and Eurasia Group complement this phase with ongoing monitoring of political risks and business-compliance issues.

Integrating the Process

Companies want to avoid surprises when they enter new markets. They want to know that regulations will be enforced and business partners will act in a predictable fashion. In the most popular global markets today, these are not givens. Incorporating political risk into the company's ERM framework compels executives to keep an eye outside their company, outside of the economic environment, and on the political marketplace. PwC and Eurasia Group can help companies dispel the uncertainties of new markets and capture opportunities.



Authors

Samuel A DiPiazza Jr

Chief Executive Officer, PricewaterhouseCoopers International Limited

Samuel A DiPiazza Jr has served as Chief Executive Officer of PricewaterhouseCoopers International Limited since 2002. Prior to that he led the PricewaterhouseCoopers US Firm as Chairman and Senior Partner and was a member of the Global Leadership Team.

Mr. DiPiazza joined Coopers & Lybrand in 1973 and became a partner in 1979. He was elected to the Firm Council in 1986 and headed the Birmingham, Alabama, and Chicago offices before being named Midwest Regional Managing Partner in 1992. Two years later he became the Regional Managing Partner of the New York Metro Region with a dual role as Client Service Vice-Chairman. Following the merger of Coopers & Lybrand and Price Waterhouse in 1998, Mr. DiPiazza was named the Americas Leader for Tax and Legal Services for PricewaterhouseCoopers and in 2000 he was elected Chairman and Senior Partner of the US firm.

Mr. DiPiazza currently serves as a Trustee of the International Accounting Standards Committee Foundation. He is a Vice Chairman of the World Business Council on Sustainable Development and an Executive Committee member of The Conference Board and the International Business Council of the World Economic Forum. Mr. DiPiazza is also a member of the Council on Foreign Relations' Committee on Corporate Affairs, the Aspen-based G100 Group (CEO Academy) and has served as a Trustee for the Financial Accounting Foundation.

Very active in civic affairs, Mr. DiPiazza is the Global Chairman of Junior Achievement Worldwide, and serves as a member of the Executive Council of the Inner City Scholarship Fund and the Board of Directors of the New York City Ballet. He is also a member of the Audit Committee of the World Trade Center Memorial Foundation as well as past President of Big Brothers/Big Sisters of New York City.

Mr. DiPiazza received a dual degree in Accounting/Economics from the University of Alabama and an MS in Tax Accounting from the University of Houston. He has been honoured as Accountant of the Year by the Beta Alpha Psi Society and is a recipient of the Ellis Island Medal of Honour and the INROADS Leadership Award.

In 2002, Mr. DiPiazza co-authored *Building Public Trust: The Future of Corporate Reporting*.

Ian Bremmer

President, Eurasia Group

A dedicated intellectual entrepreneur, Ian Bremmer's career spans the academic, investment, and policymaking communities. His focus has been global emerging markets—those countries where political will matters at least as much to the market as economic fundamentals. His work to define the business of politics has accordingly focused on making political science relevant to global decision-making.

Dr. Bremmer received his PhD in political science from Stanford University in 1994, specialising in nation- and state-building in the former Soviet Union. He went on to the faculty of the Hoover Institution where, at 25, he became the Institution's youngest-ever National Fellow. He has held research and faculty positions at Columbia University (where he presently teaches), the EastWest Institute, Lawrence Livermore National Laboratory, and the World Policy Institute, where he has served as Senior Fellow since 1997.

Dr. Bremmer's research focuses on states in transition, global political risk, and US foreign policy. His five books include *Nations and Politics in the Soviet Successor States* (Cambridge University Press, 1993), which has become the standard college text on the post-Soviet states, and *The J Curve* (Simon and Schuster, 2006). He has also published over 150 articles and essays in *International Affairs*, *Harvard Business Review*, *The New Republic*, *The New Statesman*, *Fortune*, *The Los Angeles Times*, *The Wall Street Journal*, *The International Herald Tribune*, and *The New York Times*. He is a columnist for *The Financial Times*, contributing editor at *The National Interest*, and a political commentator on CNN, FoxNews, and CNBC.

In 1998, with \$25,000 in hand, Dr. Bremmer founded the research and consulting firm Eurasia Group. Today, Eurasia Group is the preeminent global political-risk consultancy, with 70 full-time employees in New York, London, and Washington, as well as 480 experts in 65 countries worldwide. Widely respected for its objectivity, Eurasia Group has worked with multinational corporations, government leaders, and opposition leaders throughout the world.



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Eurasia Group is the world's leading global political-risk advisory and consulting firm. It covers political, social, security, and economic developments worldwide.

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