CLIFFORD CHANCE

POLITICAL RISK – A GROWING THREAT TO BUSINESSES

– THOUGHT LEADERSHIP

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Geopolitical uncertainty and volatility are the new norm and businesses are increasingly susceptible to governmental interference and protectionism. It is an issue that is increasingly important on the corporate agenda, as illustrated by a recent report we commissioned in partnership with the Economist Intelligence Unit. Here we look at the growing risks and the attitude of businesses to those risks.

What is political risk?

Political risk covers a range of risks which essentially arise from the possible actions of at least one government (often more than one government). The classic examples of political risks – which are generally insurable risks – are nationalisation events; for example, the oil and mining nationalisations seen in the second half of the twentieth century in South America and Libya. This type of risk is often referred to as "expropriation" risk and may, if there are applicable treaties in force – and if the expropriation is unlawful – give rise to a right of compensation for affected foreign investors. To be lawful, generally, expropriations must be carried out in a transparent, non-arbitrary manner, be done in accordance with due process and – crucially – with payment of adequate compensation.

Expropriations take a range of forms – from the taking of an asset to more subtle measures, such as gradual tax rises, which have the effect of reducing the value of the investment to nothing. This is often described as resource nationalism – where governments take back control of resources subject to foreign interests.

Political risks can also take other forms, such as civil unrest, industrial action, acts of war, sudden regulatory change or politically motivated trade restrictions. Business interests can also be strongly affected by border disputes, which are a continuing source of friction, particularly in the Asia-Pacific region. For example, if you have an interest in offshore hydrocarbons in an area subject to a border dispute, the potential risks to development of that project are severe.

Matthew Newick, Global Head of Litigation and Dispute Resolution at Clifford Chance, says: "Political risks matter and, as we know, the international business climate is hugely affected by geopolitical uncertainty and volatility, which is fast becoming the new norm. This means that even for jurisdictions that are perceived currently as relatively low in terms of political risk, there is less confidence amongst businesses that such places will remain low risk, particularly in the context of a potentially long-term investment".

Boards must manage and mitigate this political risk to remain competitive – this means enhanced levels of due diligence, diversification and dexterity to prevent financial losses or reputational damage. It also means being creative about managing political risk – because, as has always been the case, some of the best business opportunities are in politically risky environments. So, whether it is through investment treaty protection, political risk insurance or simply by commercial negotiation and engagement, companies are increasingly aware of the political risks associated with the environment in which they operate.

Why is it important now?

Despite recent rises in geopolitical tensions, political risk is not yet top of the agenda for businesses. Clifford Chance recently worked in partnership with the Economist Intelligence Unit on a report on attitudes towards risk and found that only 23% of the study's respondents listed political risk among their top three focus areas.

However, political risk does look set to rise up the agenda, as more than half of the respondents suggested that political risk would be more important in two years' time. US foreign policy (economic sanctions and trade wars) is a top source of political risk. However, risks associated with US policy are felt more commonly in APAC and Europe than in the US itself.

There are also ongoing risks around the direction that may be taken by China, including potential deterioration of

relations between China and the US, as well as the relationship between China and its neighbours in Asia, including Hong Kong and Taiwan. And there are political risks that are intertwined with other big risks, such as climate change risks, which will put pressure on governments, both in terms of energy security and environmental policy. The tensions between these areas often lead governments to take actions that, rightly or wrongly, adversely affect investors; for example, because of regulatory measures penalising particular behaviours or because they make resource nationalism a more compelling domestic policy.

What are corporates doing about political risk?

Corporate boards are taking action to develop strategies to mitigate political risk. Our report indicates that 50% of respondents will seek to manage political risk through enhanced corporate governance, while 41% may seek to limit new or additional investment in one or more countries that are "deemed difficult". "That's a very interesting choice of words – "deemed difficult", says Clifford Chance Counsel, Peter Harris. "Firstly, it reflects the reality that political risk is an area that is all about perception. In today's world, the status of which jurisdictions are deemed difficult and which jurisdictions are deemed "safe" is in constant flux. For example, one year ago, while there may have been concerns around the future of Hong Kong as an investment destination, the last year has seen the perception of Hong Kong change significantly in terms of political risk."

The variety of ways in which companies plan to deal with political risks is interesting. Our report shows that 38% will mitigate political risk through engagement with local governments, while others will simply avoid particular jurisdictions or try to manage through corporate governance.

Corruption risks, or risks relating to social licence, may be mitigated by having robust and transparent corporate governance. But corporate governance can only take you so far when confronted with a government that may be embracing resource nationalism or subject to a violent coup. In those circumstances, engagement is more likely to be an effective measure. "Legal protections such as political risk insurance or ensuring investment treaty coverage are also crucial – and I am not sure either of those really falls neatly into corporate governance, engagement or avoidance", Harris says.

Our research and experience also indicates that there are important differences in terms of the degree to which political risk exposure will be managed differently by businesses in different regions. In this regard, businesses in APAC are the least likely to deal with political risks simply by avoiding risky jurisdictions. That makes sense, given the political profile of the region as well as the profile of the capital exporting countries in APAC.

In particular, Chinese investors, supported by the Chinese state, are quite "broad shouldered" when it comes to political risk. Japan also has a tradition of using its economic power to smooth the way for Japanese investors in South East Asian countries. Australia, too, has a history of entrepreneurial explorers who focus more on the potential opportunities, rather than on potential problems with the government.

Companies in APAC and Europe are understandably bracing themselves for the full impact of the US's increasingly aggressive trade policies, and 63% of firms in APAC have taken action to address the risk of disruption to business from trade policies. Companies in Europe are doing the same, but slightly fewer, at only 54%. Brexit is also adding to that uncertainty, including in relation to Japanese investors. The Japanese government has been very clear that Japanese interests were strongly in favour of Remain, so it will be interesting to see whether Japanese investors in the UK find ways of working within the new relationship between the UK and the EU (whatever that may look like) or whether they move elsewhere.

The impact on investment

Perhaps the most surprising insight from the report is that 30% of companies globally, say that political risks will actually stop them from investing, or cause them

to limit their investment, in jurisdictions they consider to be risky. This means that almost a third of respondents are saying, essentially, that there are jurisdictions where the perception of political risks outweighs any perception of opportunity.

“Notwithstanding global uncertainty, in an era where there are multiple international investment treaties, guarantees, insurance and other ways of dealing with political risks, it seems incredible that companies are so risk averse when it comes to political risk – particularly given that it is all about perception. No doubt, there are countries where not investing on the basis of political risks is a very sensible course of action – but I think the list of countries that fit this description is actually relatively low”, says Newick.

However, it must be recognised that the degree of political risk is in the eye of the beholder – what may seem very risky for a small mining exploration company with a limited track record of investing in developing economies may seem relatively vanilla for a major oil company with a lot of investments in the jurisdiction.

What’s happening now?

- There is greater interest in investment treaty structuring – setting up an investment so that it can take advantage of investor-state dispute settlement rights. This can also be done through state agreements, but the possibility of obtaining a contractual right of recourse requires the business to have sufficient leverage.
- Political risk insurance – there are lots of claims which may, in turn, lead to high premiums and, potentially, high project finance costs more generally. Insurers will also be seeking to limit their exposure and may require, for example, the insured to establish that the relevant government has breached international law before it will pay any compensation.
- Investor-State Dispute Settlement is on the rise.
- Sophisticated governments are executing indirect expropriations, for example, by purporting to protect the environment or bringing in tax measures that, slowly but surely, erode the value of the investment.
- Governments are increasingly worried about how to balance the right to regulate with potential exposure to treaty claims.

Our View From the Top 2019 report in partnership with the Economist Intelligence Unit is available here: www.cliffordchance.com/risk.

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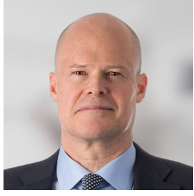

Matthew Newick
Global Head of L&DR
London
T: +44 20 7006 8492
E: matthew.newick@
cliffordchance.com

Peter Harris
Counsel
Tokyo
T: +81 3 6632 6635
E: peter.harris@
cliffordchance.com

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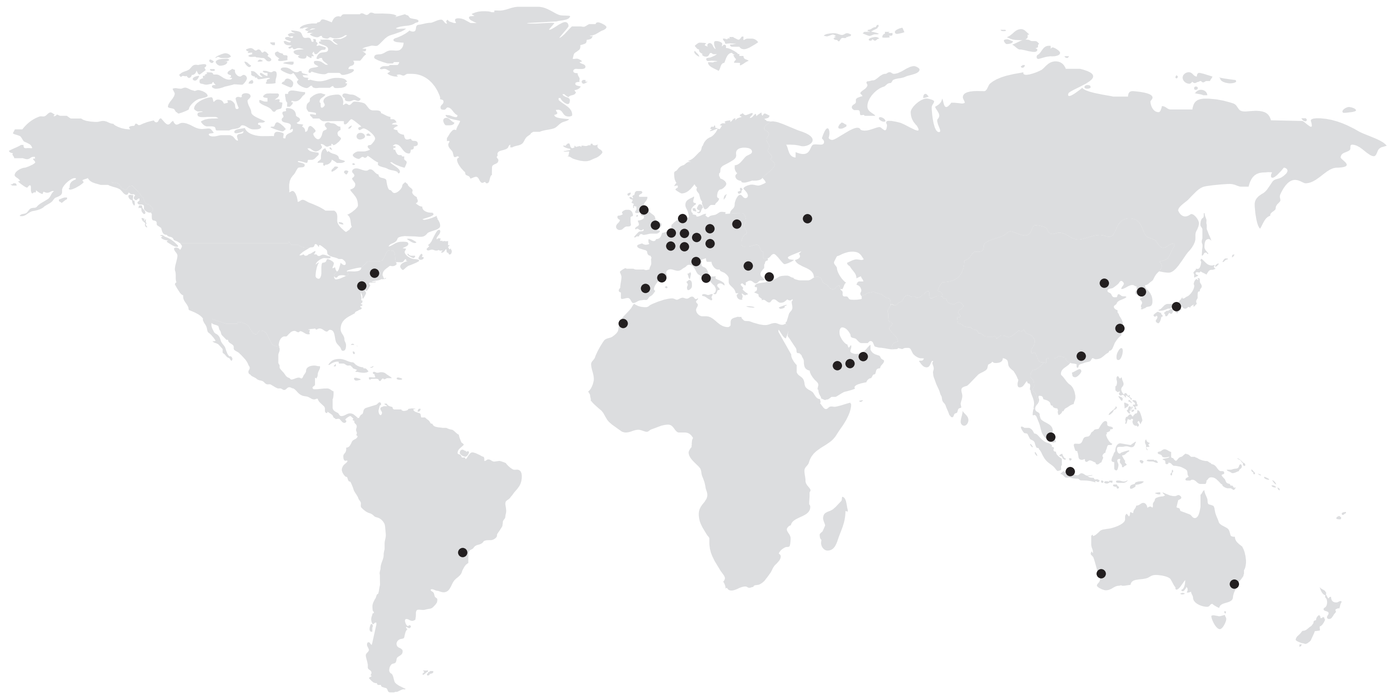

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