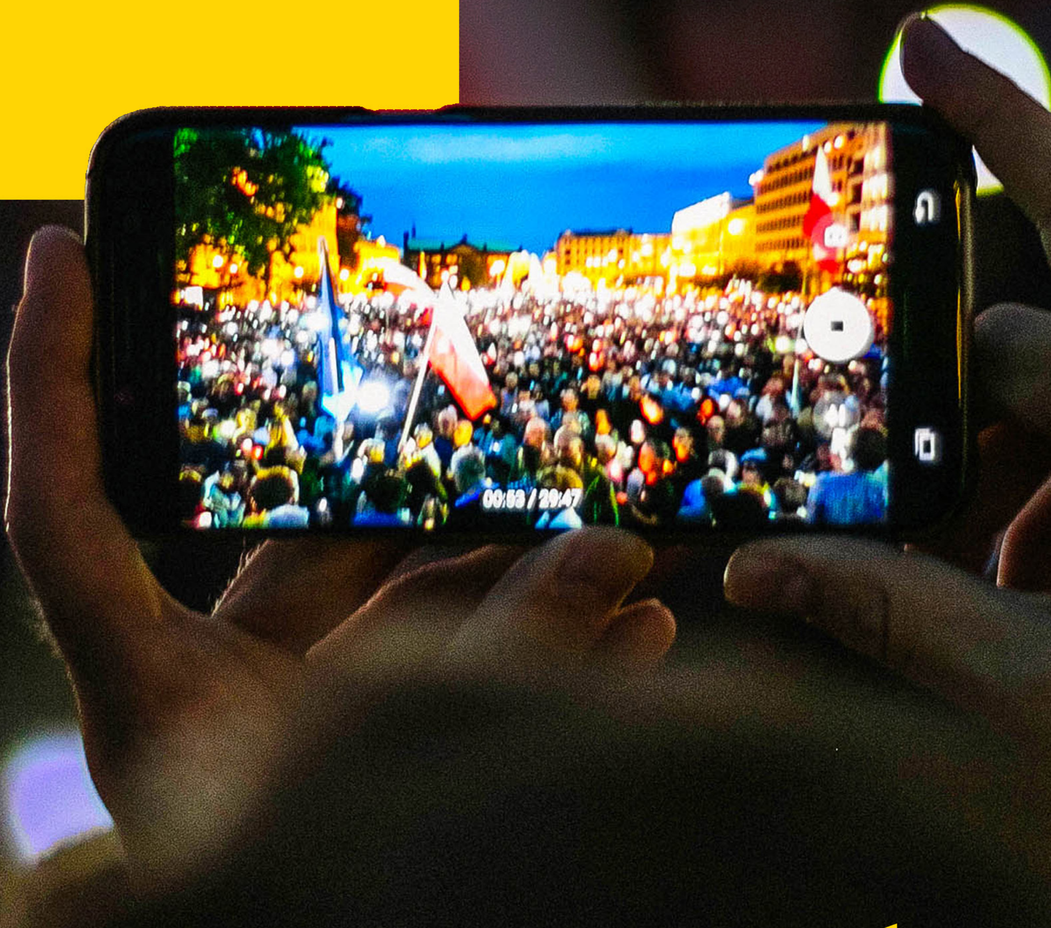
August 2019 | ey.com/geostrategic

Academic literature review

Political risk and corporate performance: mapping impact

Geostrategic Business Group



Building a better working world

Foreword

Mary K. Cline, PhD
Director, EY Geostrategic Business Group, Ernst & Young LLP

Witold J. Henisz, PhD
Deloitte & Touche Professor of Management, The Wharton School
University of Pennsylvania

How is political risk impacting corporate performance?

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 less clear. Typical political risk analysis focuses heavily on the highly contextualized nature of political events and is detached from strategic advice, leaving leaders asking, "What does this mean for my company?" and "What can I do about it?"

Companies are 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.

While political risk, as an external risk, is difficult to predict, the historical experience of its impact on corporate performance is well documented. The wealth of academic literature, which we explore here, 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.

About this study

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 and operations, research and development, security, finance, regulatory compliance, human capital, governance and reputation.

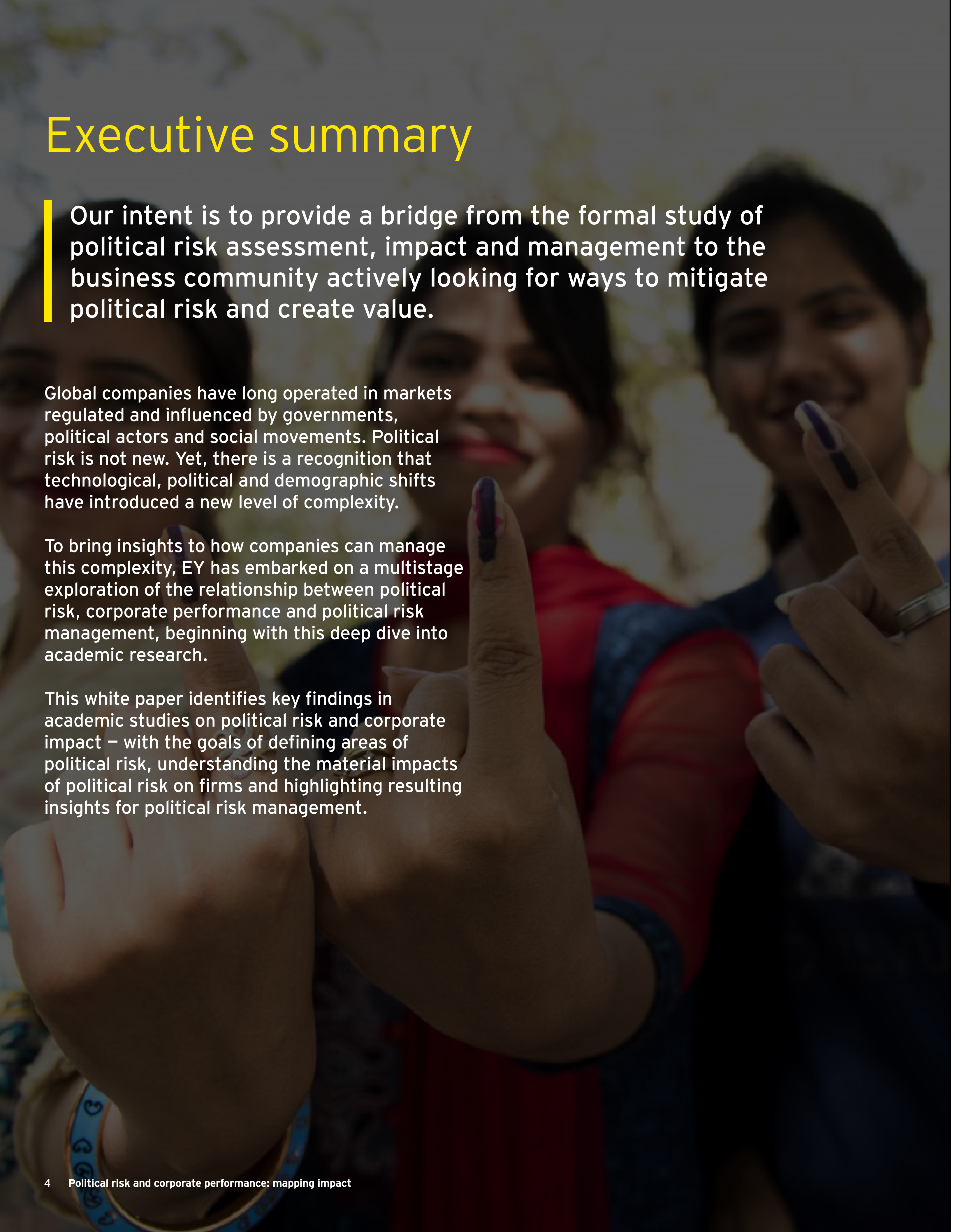
Approach
This is a joint effort between the EY Geostrategic Business Group and Witold J. Henisz, PhD, the Deloitte & Touche Professor of Management at The Wharton School, with the assistance of Rakhimov Abdurakhim.

This research team evaluated more than 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.

Contents

Note: Unless otherwise noted, all figures are in US dollars.



Executive summary

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.

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.

Key findings

Companies can be more systematic about the monitoring and management of political risk – and will have to be. As with many areas of strategy, organizations need to increasingly think cross-functionally and communicate, respond and iterate in a more dynamic way.

Political risk is rising.

Evidence suggests the incidence of political risk has increased dramatically in the past decade and, in particular, between 2016–2018 – by many measures, to post-World War II highs. Furthermore, the measurement of political risk has become increasingly sophisticated.

Political outcomes have a material impact on firms.

The consequences of increasing levels of political risk have a material impact on firms – in the short, medium and long term. This is multidimensional – with impact on sales, production and operations, research and development, security, finance, regulatory compliance, governance, and reputation.

Fragmentation exists in the study and management of political risk.

Political risk is a complex concept, incorporating risks from the transnational level to the local level. Both the academic and corporate community tend to focus on discrete risks and discrete impact, rather than approach the risk environment, and potential management of those risks, holistically.

A more strategic approach could protect firm value and increase growth.

A more holistic cross-functional approach to the management of multiple sources of political risk may be required – this is a high-level strategic coordination function.

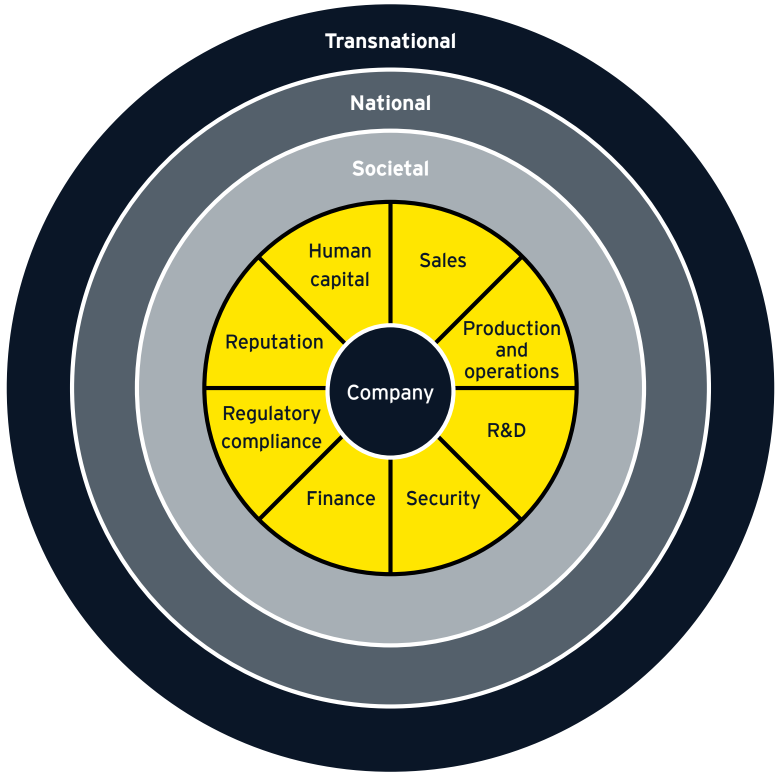
Framework

We explored the findings of the academic literature in more than 300 published articles on political risk from 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.

Political risk was defined as events and trends in international relations (security, economic and societal relations between states) and the transnational space (across states), on national levels (country risk), and in subnational settings, such as social activism.

EY Political Risk Framework

Mapping the political risk environment to the corporate footprint and areas of impact



Source: EY Geostrategic Business Group

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.

Examples include: political conflict, trade wars, sanctions, retreat from multilateral accords, social movements, military conflict and terrorism.

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.

Examples include: political (regime) transitions, policy shifts, lack of law enforcement, civil conflict, buy-national policies and corruption.

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.

Examples include: boycotts, protests, disruptions of production or supply chains, corporate espionage and local violence.

Areas 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 and operations, research and development, security, finance, regulatory compliance, human capital, governance, and reputation.

Examples include:

- *A loss in sales*
- *Shifts in operational scope and investment*
- *Disruption to supply chains or market access*
- *Intellectual property theft*
- *Increased security costs*
- *Higher cost of capital*
- *Increased risk mitigation costs*
- *Corporate governance challenges that reduce transparency and accountability*
- *Damage to the social license to operate*

Political risk is rising

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.

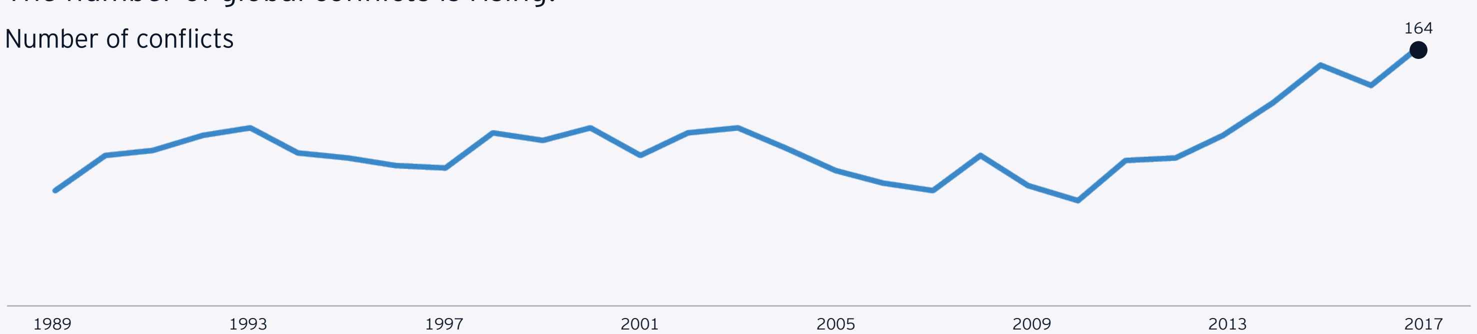
Regardless of the approach taken, empirical evidence suggests that the incidence of political risk has increased dramatically in the past decade and, in particular, over 2016–18 — by many measures, to post–World War II highs.

Transnational risk

At the transnational level, political risk is most commonly measured by (i) periods or dates of conflict and the number of fatalities reported in those conflicts, (ii) bilateral trade and investment barriers or (iii) media content analysis, describing the verbal and material interactions between national government and opposition representatives.

The number of global conflicts is rising.

Number of conflicts



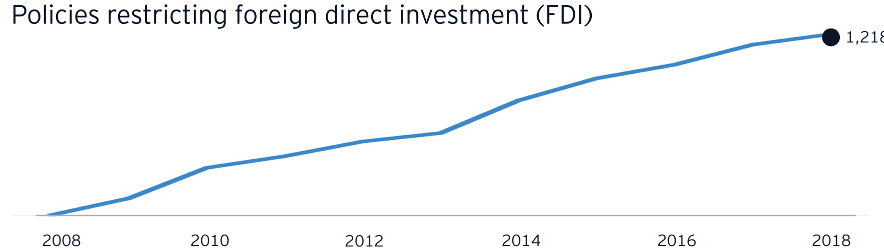
Source: Uppsala Conflict Data

Trade and investment barriers have risen in the last 10 years.

257%

The percentage increase in discriminatory trade interventions from 2009 to 2018[1]

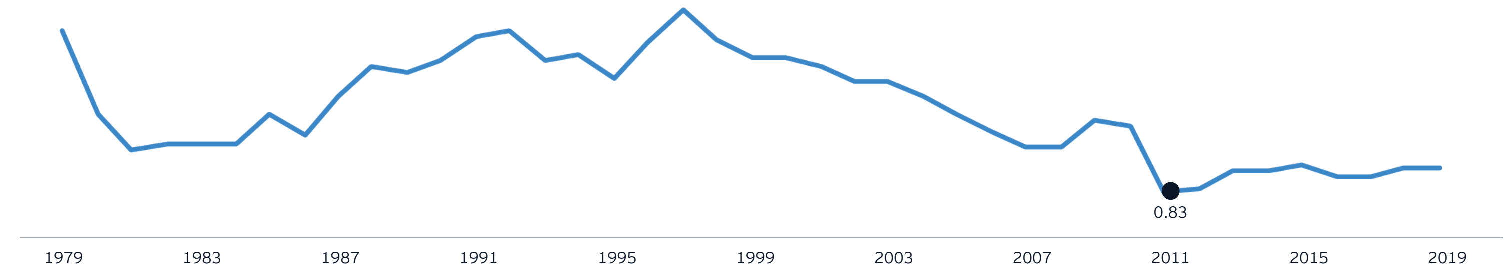
Policies restricting foreign direct investment (FDI)



Source: Global Trade Alert

Cooperation between government and opposition actors declined to a 33-year low in 2011.

Media-reported cooperation-conflict between government and opposition actors



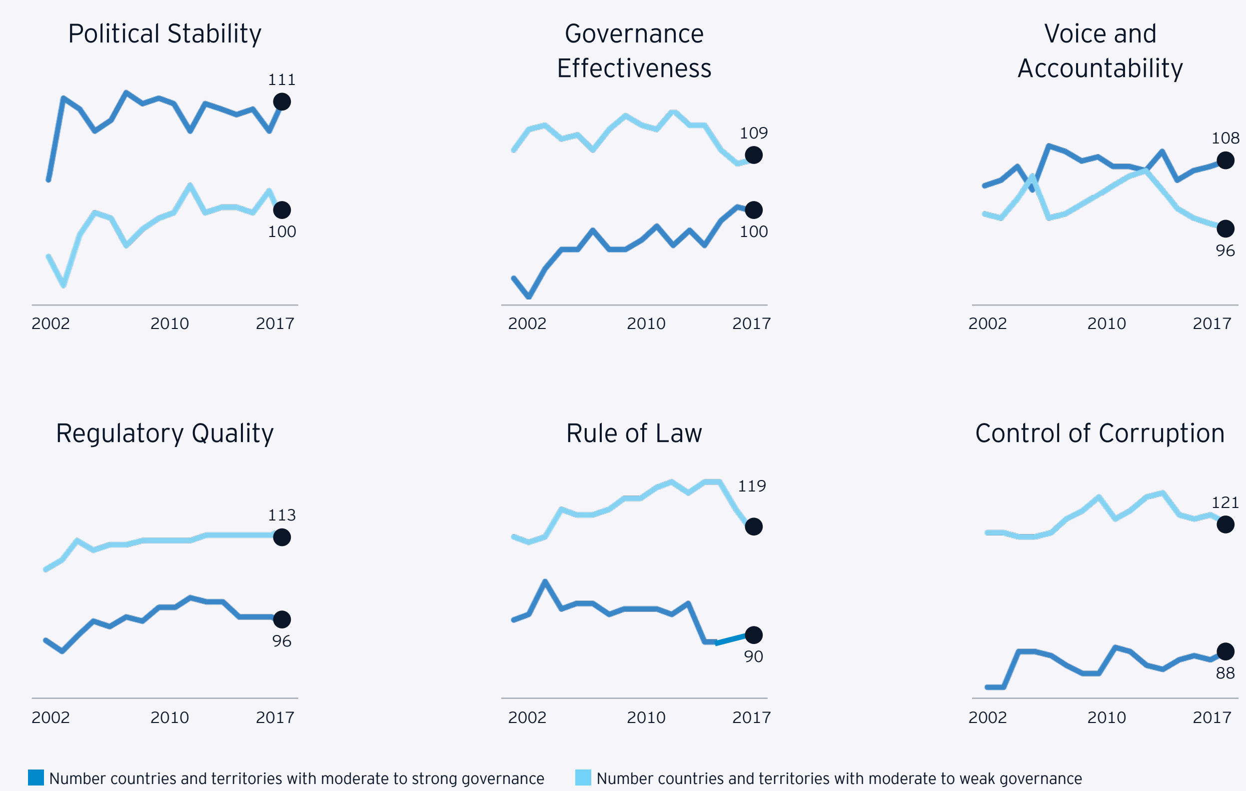
Source: Global Database of Events, Language and Tone

National risk

At the national level, a wide array of metrics[2] have been used to measure the stability and effectiveness of a national political regime, including (i) the World Bank Worldwide Governance Indicators (WGIs), (ii) measures of trust or (iii) other measures of national political development.

World Bank Worldwide Governance Indicators

WGIs capture six dimensions of governance: political stability, government effectiveness, voice and accountability, regulatory quality, rule of law, and control of corruption. During the period 2002–2017, a preponderance of countries had neutral to weak governance scores for four of the six indicators: government effectiveness, regulatory quality, rule of law and control of corruption. Gaps between weak and strong performers were particularly notable in regard to dimensions of corruption and regulatory quality.[3]



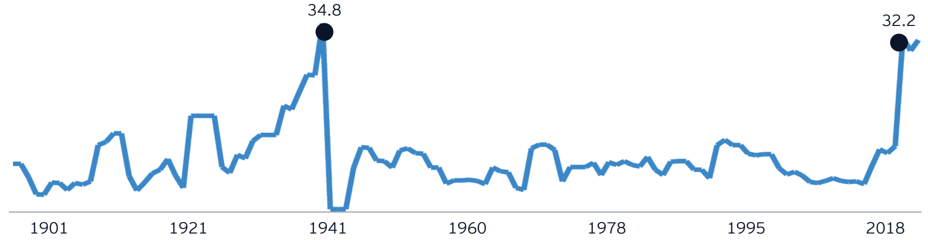
Source: World Bank

Backsliding in democracy as support for populism hits highest level since World War II.

116

According to Freedom House, the democracy scores for 116 countries have declined since 2006.[4]

Deutsche Bank's global populism index (% support)



Source: Deutsche Bank Research

A growing lack of trust in institutions.

In 2017, the Edelman Trust Barometer 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.[5] 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.[6]

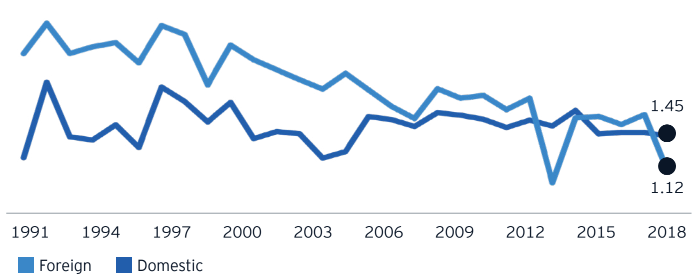
> "Trust is in crisis around the world.
>
> **Edelman Trust Barometer**

Societal risk

At the societal level, many different measurement approaches exist, including (i) strikes or terrorist attacks and (ii) media content analysis of the tenor or verb phrases in millions of sentences appearing in news articles in which a company or business is the object.

A decline in cooperation with foreign business that began before the financial crisis has continued.

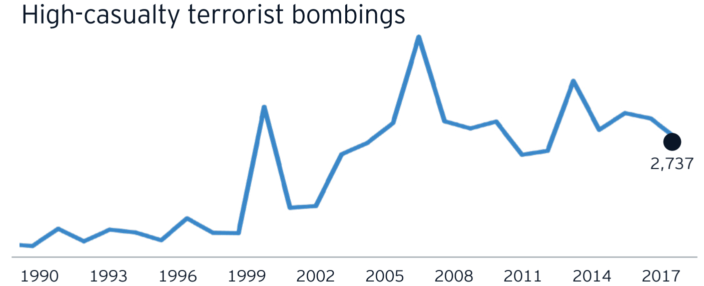
Foreign (vs. domestic) businesses



Source: Global Database of Events, Language and Tone

Over the last 17 years, an average of 2,800 people died annually in high-casualty terrorist bombings, compared with an average of 300 in the 1990s.

High-casualty terrorist bombings



Source: Center for Systematic Peace

82

Non-state conflict, or the use of armed force between two groups, neither of which is a government, shows a continued rise, with 82 conflicts in 2017, the highest on record.[7]

Political outcomes have a material impact on firms

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 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 how firms face material consequences from political risk.

Sales

Reduction in sales and revenues

Corporations facing political risk lose sales to customers who are willing to pay less due to the national origin or reputation of the seller or who are forced to pay more due to government policy (e.g., tariffs, quotas or regulation). In addition, the actions of civil society targeting specific companies or products has been shown to negatively impact sales and revenue.

21.2%

Reduction in 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.[8]

2 weeks

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.[9]

Production and operations

Disruption to FDI and M&A

A wide body of research demonstrates the medium- to long-term negative impact of political risk on foreign direct investment[10] and the magnitude of M&A.[11] Diplomatic conflicts can increase the costs of doing business[12] and M&A activities are more likely to be completed in countries with stronger political institutions.[13]

The impact of political risk varies across firms. But, experience and knowledge matter:[14] firms can learn to manage political risk or the institutional environment of the home country, allowing higher commitment amid higher risk.

Experience in a country and familiarity with the political system and its players has been found to reduce the threat of failure by 80%.[15] 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.[16] Highly strategic assets or unique resources are also particularly sensitive to political risk,[17] as is M&A.[18]

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.[19]

Surprisingly, there is little attention on transnational political risk in the academic literature and, until recent years, relatively little on civil society. Yet transnational risks can create real supply chain vulnerability, suggesting supply chain risk models should incorporate geopolitical risk.[20] Similarly, political risk impact on fast fashion,[21] electronics,[22] industries impacted by modern slavery,[23] palm oil[24] and apparel[25] show that retailers and suppliers should 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.[26]

Research and development

Rising costs and intellectual property theft

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.[27]

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.[28] 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.[29] Both formal IP rules or regulations and informal practices (e.g., enforcement) are important for investors to assess.[30]

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.[31] Country-level data seems to provide a clear incentive: countries that succeed in dramatically improving their IP protection receive 26%–117% more FDI than peers who do not make similar policy changes.[32]

Security

Increased security costs, FDI and market capitalization impact

Corporations facing political risk often face security risks to their staff and to physical equipment. Conflict at all levels — transnational, country and societal — presents 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[33] and serves as a deterrent to FDI.[34]

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.

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.[35] 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 need to undertake due diligence on conflict dynamics, to mobilize networks and resources to catalyze positive relationships, and to facilitate constructive action toward peace.[36]

Finance

Higher cost of capital

Investors and creditors perceive corporations facing political risk as riskier investments. 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.[37]

The opinion and actions of stakeholders at the subnational level,[38] as well as firm strategy toward them,[39] have been found to 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).[40]

72%

Without stakeholder support, investors have been found to discount future cashflows by as much as 72%.[41]

"

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.

Chief Operating Officer
Canadian mining company[42]

Regulatory compliance

Increased risk mitigation

Reliable legislation and regulation are essential for smoothly operating markets. 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 confirm regulatory compliance.

The academic literature on political risk and regulatory compliance has generally applied a more descriptive, qualitative approach, without entirely dismissing quantitative analyses. Studies have shown that transnational civil society networks are vital for forming international norms when formal international treaties or agreements are absent.[43] Such norms are founded on voluntary agreements and effective forms of private sector self-regulation (most notably on topics like corporate social responsibility or CSR).[44] 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).[45]

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.[46] 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.[47]

Overall, civil society organizations have a large impact on pushing companies to improve environmental performance and due diligence over supplier conduct,[48] though such inputs are moderated by firm-level characteristics such as costs, competitive position, reputational sensitivity, the preferences of its own workers and executives,[49] other stakeholders,[50] and its ethical culture.[51]

Governance

Corporate governance challenges that reduce transparency and accountability

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,[52] inefficient resource allocation,[53] insider graft,[54] self-censorship,[55] politically motivated hiring,[56] and greater legal fines or judgments.[57]

In the absence of effective regulation, pressure from civil society organizations can also shift governance, particularly on CSR topics[58] and transparency in the disclosure of climate-related risks.[59] 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.[60]

Reputation

Damage to the social license to operate

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, inadequate compensation, corruption, criminal activity, inadequate planning and state bias in favor of industrial development.[61] Multinational firms, in particular, are at relatively higher risk due to the liability of being foreign[62] and private[63] in association with environmental and social issues as well as a history of dealing with such issues via coercive strategies[64] or clearly signaling their unimportance.[65] Key individual characteristics that predict opposition to multinational activity include gender (women are more skeptical), youth, income, lower skills and education, and nationalism.[66]

Building corporate reputation and strengthening the broader license to operate can be hugely beneficial.[67]

Fragmentation in the study and management of political risk

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.[68] A whole company approach is difficult because 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:

- Consumer behavior
- Projections of investment profitability completed by analysts, financiers and business development teams
- 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 an organization's reputation

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 a 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.

The study of political risk is uneven and fragmented

This chart shows the number of articles that the research team reviewed for each level of risk and impact, showing the contrast between areas that are well studied and those that are under-researched.

Areas of corporate activity

Levels of political risk	Sales	Production and Operations	Research and development	Security	Finance	Human capital	Regulatory compliance	Governance	Reputation	Total
Transnational	38	35	2	3	7	0	3	0	3	91
National	3	66	10	2	32	2	3	26	5	149
Societal	8	13	8	1	7	0	8	4	27	76

0–5 6–25 26–50 51–75 76–100 101–150

Source: EY Geostrategic Business Group

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 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.

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.

> "Academic insight into this increasingly important fragmentation 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.
>
> **Witold J. Henisz, PhD**
> Deloitte & Touche Professor of Management,
> The Wharton School

Adjusting to protect value and increase growth

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.

Myriad impact of political risk

The literature has 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

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.

Cross-functional, real-time coordination

To achieve such cross-functional, real-time coordination, responsibility for political risk likely lies 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.

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.

> “
> To deploy a systematic approach to political risk, it is useful to anchor political risk management in a cross-functional office tasked with coordinating risk management instruments and developing a robust, growth-oriented geostrategy.
>
> **Sven Behrendt, PhD**
> Senior Advisor, EY Geostrategic Business Group

Strategies across the levels of political risk

At the **transnational level**, the ability of corporations to engage proactively in political risk management appears to be quite limited. At the same time, they need to carefully balance risks with opportunity, and deploy their risk management instruments accordingly. They can decide to stay in a market that might be affected by geopolitics and take the risk, to reduce their exposure, or, if they see opportunity, to even increase the stakes. They can avoid markets that appear to be too volatile to them. They can build a geopolitical risk-adjusted investment portfolio, mapping their exposure to the geopolitical risk landscape and decide what risks to take and which to avoid. Selling or pooling risk represents yet another option. Overall, they need to appreciate that geopolitics and transnational risks are moving markets, and become more systematic about geopolitical risk management, if they want to remain globally exposed.

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 verify 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

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.

Firms may choose from a menu of political risk management strategies

Often political risk seems so unpredictable that firms without strategies are resigned to accept the negative outcomes of political risk that repeatedly surprise them. There is an opportunity for firms to begin to develop the capacity to effectively monitor or sense risks in the external environment and engage more proactively. Early efforts typically have focused on monitoring externally sourced information, followed by hiring specialists in the area and, eventually, having senior leadership engage external stakeholders on an ongoing basis.

Firms can develop the capability to link what they learn to what they do. In other words, signals from the external environment can be recognized as leading indicators of risk and opportunity and can be tied to key performance indicators. The innovation is going from a system that treats each type of political risk and each impact as a discrete risk or opportunity to a more holistic, strategic management of the external environment, where in some cases risks can be managed actively through drawing on the understanding of stakeholder impact and the successful development of trusted stakeholder relationships.

Ultimately, the strategic management of political risk would recognize the linkages across transnational, national and societal risks and across the impacts and respond to the full spectrum in an integrated manner. This approach would allow firms to 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

Political risk is at post-World War II highs. Yet, research finds that despite the wealth of studies that show the material impact of political risk, guidance in managing the complex system of relationships remains elusive.

The materiality of political risk as well as its distinct sources and impacts 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 research and development) 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.

Next steps

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 organizations 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, placing particular emphasis on high-performing firms. 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.

Authors

Mary K. Cline, PhD
Director, Geostrategic Business Group
Ernst & Young LLP

Witold J. Henisz, PhD
Deloitte & Touche Professor of Management,
The Wharton School
University of Pennsylvania

Sven Behrendt, PhD
Senior Advisor, Geostrategic Business Group
Ernst & Young LLP

Kyle P. Lawless
Assistant Director, Geostrategic Business Group
Ernst & Young LLP

Rakhimov Abdurakhim
Research Assistant, The Wharton School
University of Pennsylvania

Contacts

Jonathan Shames
New York
jonathan.shames@ey.com

Cherie Faiella
Paris
cherie.faiella@fr.ey.com

Scott Sarazen
Boston
scott.sarazen@ey.com

Adam Barbina
Washington
adam.l.barbina@ey.com

Mary K. Cline, PhD
Washington
mary.k.cline@ey.com

Oliver Jones
London
oliver.jones@uk.ey.com

Nobuko Kobayashi
Tokyo
nobuko.kobayashi@jp.ey.com

Kyle P. Lawless
Boston
kyle.lawless@ey.com

Marc Lhermitte
Paris
marc.lhermitte@fr.ey.com

Endnotes

[1] Global Trade Alert

[2] 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.

[3] "Worldwide Governance Indicators (WGI) project," *World Bank*, http://info.worldbank.org/governance/wgi/#home, accessed April 2019.

[4] "Freedom in the World 2019," *Freedom House*, https://freedomhouse.org/sites/default/files/ABRIDGED_FH_FITW_2019_Report_FINAL.pdf, accessed April 2019.

[5] "2017 Edelman Trust Barometer," *Edelman*, https://www.edelman.com/research/2017-edelman-trust-barometer, 21 January 2017.

[6] "2019 Edelman Trust Barometer," *Edelman*, https://www.edelman.com/trust-barometer, 20 January 2019.

[7] Uppsala Conflict Data

[8] Sofronis Clerides et al, "National Sentiment and Consumer Choice: The Iraq War and Sales of US Products in Arab Countries," *The Scandinavian Journal of Economics*, 117 (3), pp. 829–851, 2015.

[9] Igal Hendal et al, "Consumers' activism: the cottage cheese boycott," *The RAND Journal of Economics,* 48 (4), pp. 972–1003, 2007.

[10] Quan Li, "Foreign Direct Investment and Interstate Military Conflict," *Journal of International Affairs*, 62 (1), pp. 53–66, 2008.

[11] Jianhong Zhang et al, "Completion of Chinese overseas acquisitions: Institutional perspectives and evidence," *International Business Review*, 20 (2), 226–238, 2011.

[12] Rodolphe Desbordes, "Global and Diplomatic Political Risks and Foreign Direct Investment," *Economics & Politics*, 22 (1), pp. 92-125, 2010.

[13] Jianhong Zhang et al, 2011.

[14] The predicted equity ownership stake for Japanese multinationals fell from 80%–87% in countries with low political risk to 58%–62% in countries with high political risk, with inexperienced firms most sensitive to political risk (Andrew Delios and Witold J. Henisz (2003); Eugene D. Hahn et al, "The Evolution of Risk in Information Systems Offshoring: The Impact of Home Country Risk, Firm Learning, and Competitive Dynamics," *Management Information Systems Quarterly*, 33 (3), pp. 597–616, 2009; Daphne Yiu and Shige Makino, "The Choice Between Joint Venture and Wholly Owned Subsidiary: An Institutional Perspective," *Organization Science*, 13 (6), pp. 667–683, 2002.

[15] Witold J. Henisz and Andrew Delios, "Information or Influence? The Benefits of Experience for Managing Political Uncertainty," *Strategic Organization* 2(4): 389–422, 2004.

[16] Guy L. F. Holburn and Bennet A. Zelner, "Political capabilities, policy risk, and international investment strategy: evidence from the global electric power generation industry," *Strategic Management Journal*, 31 (12), 1290–1315, 2010.

[17] Li Dai et al, "Caught in the crossfire: Dimensions of vulnerability and foreign multinationals' exit from war-afflicted countries," *Strategic Management Journal* 38 (7), pp. 1478–1498, 2017.

[18] Hoon Lee et al, "The Effects of Political Risk on Different Entry Modes of Foreign Direct Investment," *International Interactions*, 40 (5), pp. 683–710, 2014 ; Cristina Lopez-Duarte and Esteban Garcia-Canal, "The Effect of Firm and Host Country Characteristics on the Choice of Entry Mode: Empirical Evidence from Spanish Firms," *Journal of Management and Governance,* 6 (2), pp. 153–168, 2002.

[19] 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 and Gupta (2009))

[20] Eskinder Demisse Gemechu et al, "Geopolitical-related supply risk assessment as a complement to environmental impact assessment: the case of electric vehicles," *The International Journal of Life Cycle Assessment*, 22 (1), pp. 31–39, 2017; Eskinder D. Gemechu et al, "Import-based Indicator for the Geopolitical Supply Risk of Raw Materials in Life Cycle Sustainability Assessments," *Journal of Industrial Ecology* 20 (1), pp. 154–165, 2016.

[21] Patsy Perry and Steve Wood, "Exploring the International Fashion Supply Chain and Corporate Social Responsibility Cost, Responsiveness and Ethical Implications.: John Fernie and Leigh Sparks, *Logistics and Retail Management*, 5th Edition, Kogan Page, 2019.

[22] Peppi-Emilia Airike et al, "Corporate motives for multi-stakeholder collaboration – corporate social responsibility in the electronics supply chains," *Journal of Cleaner Production,* 131, pp. 639–648, 2016.

[23] Alexander Trautrims et al, "Modern slavery challenges to supply chain management," *Supply Chain Management: An International Journal,* 20 (5), pp. 485–494, 2015.

[24] Julia Wolf, "The Relationship Between Sustainable Supply Chain Management, Stakeholder Pressure and Corporate Sustainability Performance," *Journal of Business Ethics*, 119 (3), pp. 317–328, 2014.

[25] Haesun Park-Poaps and Kathleen rees, "Stakeholder Forces of Socially Responsible Supply Chain Management Orientation," *Journal of Business Ethics*, 92 (2), pp. 305–322, 2010.

[26] 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 (Heise et al. (2017)).

[27] Witold J. Henisz and Jeffrey T. Macher, "Firm- and Country-Level Trade-Offs and Contingencies in the Evaluation of Foreign Investment: The Semiconductor Industry, 1994-2002," *Organization Science*, 15 (5), pp. 537–554, 2004.

[28] Minyuan Zhao, "Conducting R&D in Countries with Weak Intellectual Property Rights Protection," *Management Science*, 52 (8), pp. 1185–1199, 2006. 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.

[29] Marcus M. Keupp et al, "Enforcing Intellectual Property Rights in Weak Appropriability Regimes," *Management International Review,* 50 (1), pp. 109–130, 2010; Marcus M. Keupp et al, "How managers protect intellectual property rights in China using de facto strategies," *R&D Management*, 39 (2), pp. 211–224, 2009; Andreas Schotter and Mary Teagarden, "Protecting Intellectual Property in China," *MIT Sloan Management Review*, pp. 40–49, 2014; Deli Yang et al, "Intellectual Property Abuses: How should Multinationals Respond?" *Long Range Planning*, 37 (5), pp. 459–475, 2004; Minyuan Zhao, 2006.

[30] Srividya Jandhyala, "Property rights and international investment in information technology services," *Strategic Management Journal,* 34 (7), pp. 877–889, 2013.

[31] Srividya Jandhyala, 2015; Peter K. Yu, "From Pirates to Partners (Episode II): Protecting Intellectual Property in Post-WTO China," *American University Law Review*, 55, pp. 901–1000, 2005; Peter K. Yu, "From Pirates to Partners (Episode II): Protecting Intellectual Property in Post-WTO China," *American University Law Review*, 55, pp. 901–1000, 2005.

[32] Srividya Jandhyala 2013.

[33] Subhash C. Jain and Robert Grosse,"Impact of Terrorism and Security Measures on Global Business Transactions: Some International Business Guidelines," *Journal of Transnational Management*, 14 (1), pp. 42–73, 2009; Erwann Michel-Kerjan et al, "Corporate Demand for Insurance: New Evidence From the U.S. Terrorism and Property Markets," *Journal of Risk and Insurance*, 82 (3), pp. 505–530, 2014.

[34] Matthew Powers and Seung-Whan Choi, "Does transnational terrorism reduce foreign direct investment? Business-related versus non-business-related terrorism," *Journal of Peace Research*, 49 (3), pp. 407–422, 2012.

[35] Kathleen A. Getz and Jennifer Oetzel, "MNE Strategic Intervention in Violent Conflict: Variations Based on Conflict Characteristics," *Journal of Business Ethics*, 89 (4), pp. 375–386, 2009; Jennifer Oetzel et al, "The Role of Multinational Enterprises in Responding to Violent Conflict: A Conceptual Model and Framework for Research," *American Business Law Journal*, 44 (2), pp. 331–358, 2007.

[36] Ben Miller et al, "A Seat at the Table: Capacities and Limitations of Private Sector Peacebuilding," *SSRN Electronic Journal*, 2019.

[37] Campbell R. Harvey, "Country Risk Components, the Cost of Capital, and Returns in Emerging Markets," *SSRN Electronic Journal*, pp.1–40, 2004.

[38] Witold J. Henisz et al, 2013; Brayden G. King, "The Tactical Disruptiveness of Social Movements: Sources of Market and Mediated Disruption in Corporate Boycotts," *Social Problems*, 58 (4), pp. 491–517, 2011; Bernadette M. Ruf et al, "An Empirical Investigation of the Relationship Between Change in Corporate Social Performance and Financial Performance: A Stakeholder Theory Perspective," *Journal of Business Ethics*, 32 (2), pp. 143-156, 2001.

[39] Sinziana Dorobantu et al, "Not All Sparks Light a Fire: Stakeholder and Shareholder Reactions to Critical Events in Contested Markets," *Administrative Science Quarterly*, 62 (3), pp. 561-597, 2017; Sinziana Dorobantu and kate Odziemkowska, "Valuing Stakeholder Governance: Property Rights, Community Mobilization, and Firm Value," *Strategic Management Journal,* 38 (13), pp. 2682–2703, 2017.

[40] Tamara Bekefi et al, "Social Risk as Strategic Risk. *Corporate Social Responsibility Initiative," Working Paper No. 30*, pp. 1–20, 2006; Daniel M. Franks et al, "Conflict translates environmental and social risk into business costs," *Proceedings of the National Academy of Sciences*, 111 (21), pp. 7576–7581, 2014.

[41] Witold J. Henisz, Sinziana Dorobantu and Lite Nartey, "Spinning Gold: The Financial and Operational Returns to External Stakeholder Engagement," *Strategic Management Journal,* 35(12):1727–1748, 2014.

[42] Witold J. Henisz et al, 2014.

[43] David Vogel, "The Private Regulation of Global Corporate Conduct: Achievements and Limitations," *Business & Society,* 49 (1), pp. 68–87, 2010.

[44] David Antony Detomasi, "The Multinational Corporation and Global Governance: Modelling Global Public Policy Networks," *Journal of Business Ethics*, 71 (3), pp. 321–334, 2007.

[45] Timothy Werner, "Gaining Access by Doing Good: The Effect of Sociopolitical Reputation on Firm Participation in Public Policy Making," *Management Science*, 61 (8), pp. 1989–2011, 2015.

[46] Shon R. Hiatt and Sangchan Park, "Lords of the Harvest: Third-Party Influence and Regulatory Approval of Genetically Modified Organisms," *Academy of Management Journal,* 56 (4), pp. 923-944, 2013.

[47] John M. Mezias, "Identifying liabilities of foreignness and strategies to minimize their effects: the case of labor lawsuit judgments in the United States," *Strategic Management Journal*, 23 (3), pp. 229–244, 2002.

[48] Patsy Perry and Steve Wood, "Exploring the International Fashion Supply Chain and Corporate Social Responsibility Cost, Responsiveness and Ethical Implications. In: Fernie, J. and Sparks, L. eds," *Logistics and Retail Management*, 5th Edition, Kogan Page, 2019; Sarah Roberts, "Supply Chain Specific? Understanding the Patchy Success of Ethical Sourcing Initiatives," *Journal of Business Ethics*, 44 (2), pp. 159-170, 2003; Judith Schrempf-Stirling et al, "Ever Expanding Responsibilities: Upstream and Downstream Corporate Social Responsibility: Adam Lindfreen et al, eds, *Sustainable Value Chain Management: Analyzing, Designing, Implementing, and Monitoring for Social and Environmental Responsibility*, Farnham, Ashgate, pp. 353-368, 2012; Alexander Trautrims et al, "Modern slavery challenges to supply chain management," *Supply Chain Management: An International Journal*, 20 (5), pp. 485-494, 2015.

[49] Magali Delmas and Michael W. Toffel, "Stakeholders and environmental management practices: an institutional framework," *Business Strategy and the Environment*, 13 (4), pp. 209-222, 2004.

[50] Julia Wolf, "The Relationship Between Sustainable Supply Chain Management, Stakeholder Pressure and Corporate Sustainability Performance," *Journal of Business Ethics*, 119 (3), pp. 317-328, 2014.

[51] Carsen Reuter et al, "The impact of stakeholder orientation on sustainability and cost prevalence in supplier selection decisions," *Journal of Purchasing and Supply Management*, 18 (4), pp. 270-281, 2012.

[52] Paul Chaney et al, "The quality of accounting information in politically connected firms," *Journal of Accounting and Economics*, 51 (1-2), pp. 58-76, 2011; Christian Leuz and Felix Oberholzer, "Political relationships, global financing, and corporate transparency: Evidence from Indonesia," *Journal of Financial Economics*, 81 (2), pp. 411-39, 2006; Qian Wang et al, "State ownership, the institutional environment, and auditor choice: Evidence from China," *Journal of Accounting and Economics*, 46 (1), pp. 112-134, 2008.

[53] Shimin Chen et al, "Government intervention and investment efficiency: Evidence from China," *Journal of Corporate Finance*, 17 (2), pp. 259-271, 2011; John S. Earle and Scott Gehlbach, "The Productivity Consequences of Political Turnover: Firm-Level Evidence from Ukraine's Orange Revolution," *American Journal of Political Science*, 59 (3), pp. 708-723, 2014; Jonathan Lehne et al, "Building connections: Political corruption and road construction in India," *Journal of Development Economics*, 131, pp. 62-78, 2018.

[54] Charles JP Chen et al, "High-level politically connected firms, corruption, and analyst forecast accuracy around the world," *Journal of International Business Studies*, 41 (9), pp. 1505-1524, 2010; Pei Sun et al. "The Dark Side of Board Political Capital: Enabling Blockholder Rent Appropriation," *Academy of Management Journal*, 59 (5), pp. 1801-1822, 2016.

[55] Joseph D. Piotroski et al, "Political Incentives to Suppress Negative Information: Evidence from Chinese Listed Firms," *Journal of Accounting Research*, 53 (2), pp. 405-459, 2015.

[56] Andrew C. Eggers and Jens Hainmueller, "MPs for Sale? Returns to Office in Postwar British Politics," *American Political Science Review*, 103 (4), 513-533, 2009; Jackie Zheng Yan and Sea-Jin Chang, "The contingent effects of political strategies on firm performance: A political network perspective," *Strategic Management Journal*, 39 (8), pp. 2152-2177, 2018.

[57] Frank Yu and Xiaoyun Yu, "Corporate Lobbying and Fraud Detection," *Journal of Financial and Quantitative Analysis*, 46 (6), 1865-1891, 2011; Jian Zhang, "Public Governance and Corporate Fraud: Evidence from the Recent Anti-corruption Campaign in China," *Journal of Business Ethics*, 148 (2), pp. 375-396, 2018.

[58] Peppi-Emilia Airike et al, "Corporate motives for multi-stakeholder collaboration- corporate social responsibility in the electronics supply chains," *Journal of Cleaner Production*, 131, pp. 639-648, 2016; David Antony Detomasi, "The Multinational Corporation and Global Governance: Modelling Global Public Policy Networks," *Journal of Business Ethics*, 71 (3), pp. 321-334, 2007.

[59] Anthony P. Cannizzaro and Robert J. Weiner, "Multinational investment and voluntary disclosure: Project-level evidence from the petroleum industry," *Accounting, Organizations and Society*, 42, pp. 32-47, 2015.

[60] Karen Jingrong Lin et al, "In the name of charity: Political connections and strategic corporate social responsibility in a transition economy," *Journal of Corporate Finance*, 32, pp. 327-346., 2015.

[61] Marta Condea and Philippe Le Billon, "Why do some communities resist mining projects while others do not," *The Extractive Industries and Society*, 4 (3), pp. 681-697, 2017.

[62] David Antony Detomasi, "The Political Roots of Corporate Social Responsibility," *Journal of Business Ethics*, 82 (4), pp. 807-819, 2008.

[63] Zahra Bhanji and Joanne E. Oxley, "Overcoming the dual liability of foreignness and privateness in international corporate citizenship partnerships," *Journal of International Business Studies*, 44 (4), pp. 290-311, 2013.

[64] Leanne A. Farrell et al, "A clash of cultures (and lawyers): Anglo Platinum and mine-affected communities in Limpopo Province, South Africa," *Resources Policy*, 37 (2), pp. 194-204, 2012; Lite J. Nartey et al, "Status Climbing vs. Bridging: Multinational Stakeholder Engagement Strategies," *Strategy Science*, 3 (2), pp. 367-392, 2018.

[65] Deanna Kemp and John R. Owen, "Community relations and mining: Core to business but not "core business," *Resources Policy*, 38 (4), pp. 523-531, 2013; John R. Owen and Deanna Kemp, "Social licence and mining: A critical perspective," *Resources Policy*, 38 (1), pp. 29-35, 2013.

[66] Ayse Kaya and James T. Walker, "The legitimacy of foreign investors: Individual attitudes toward the impact of multinational enterprises," *Multinational Business Review*, 20 (3), pp. 266-295, 2012.

[67] Jill E. Fisch, "How Do Corporations Play Politics?: The FedEx Story," *Vanderbilt Law Review*, 58 (5), pp. 1493-1570, 2005.

[68] External affairs," *McKinsey*, https://www.mckinsey.com/~/media/McKinsey/Business Functions/Strategy and Corporate Finance/Our Insights/Strategy and corporate finance special collection/Final PDFs/McKinsey-Special-Collections_ExternalAffairs.ashx, April 2017.

How EY can help

Political disruption is creating both challenges and opportunities for global organizations. With a growing imperative to develop more strategic approaches to managing political risk, the EY Geostrategic Business Group exists to help companies understand the impact on business and how to effectively navigate this volatile global landscape.

Geopolitics affects every global organization from strategy to supply chain. Yet many companies struggle to assess and manage the ever-changing disruption and direct impact on their business. The EY Geostrategic Business Group helps organizations incorporate the risks and opportunities of the shifting global landscape into their business strategy. By harnessing our global footprint and local knowledge, we help organizations translate geopolitics into business strategy.

EY member firms collaborate with third-party firms to bring an added independent political risk perspective. Together with the breadth of our strategic and operational expertise, our teams translate geopolitical trends into actionable plans that guide you through new ways of monitoring and mitigating risk.

Geostrategy: Geopolitics + Strategy

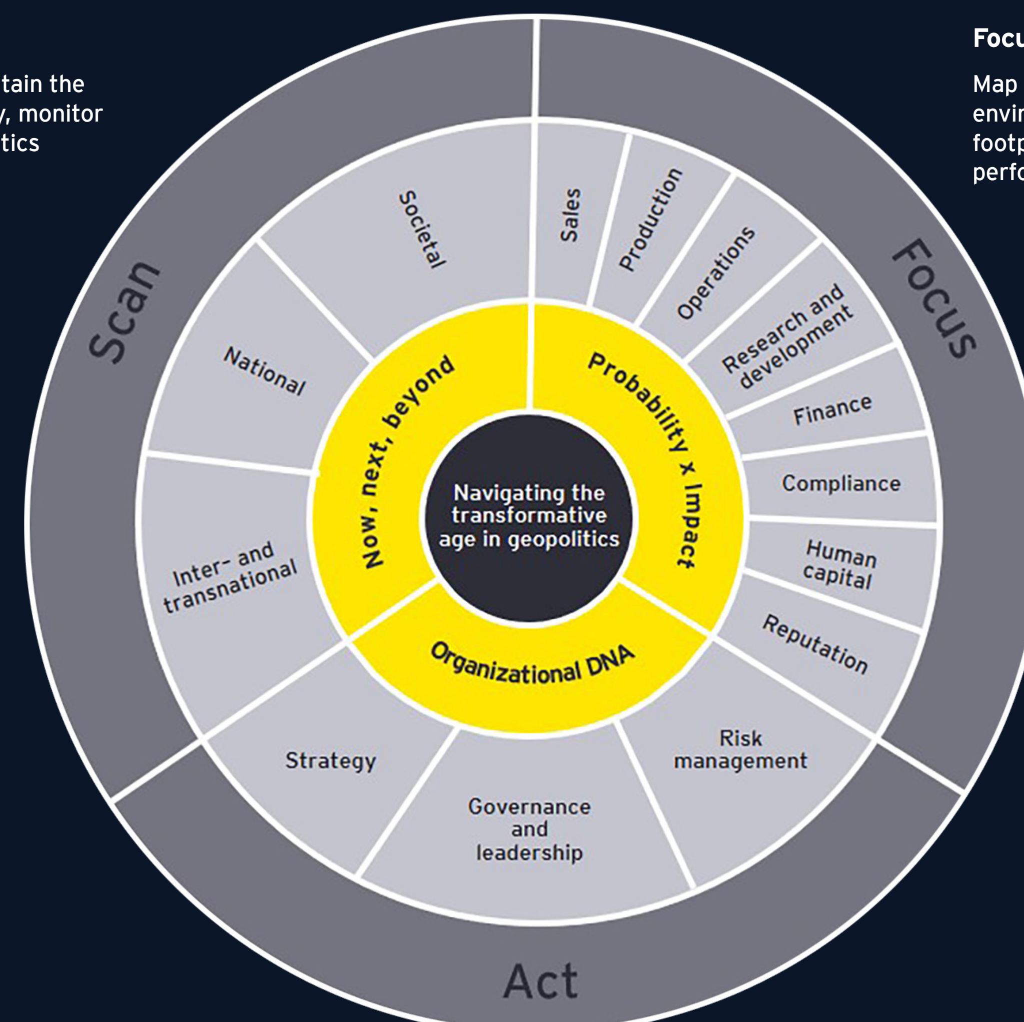
To thrive in today's changing world, we believe businesses need a geostrategy. To get there, we help companies scan the environment, focus the impact on key performance indicators and act in building a growth-oriented geostrategy.

Scan

Establish and maintain the capacity to identify, monitor and assess geopolitics

Focus

Map the geopolitical environment to company footprint and key performance indicators



Act

Develop a portfolio of robust geopolitical risk management instruments and build a growth-oriented geostrategy

1904-3144001

003771-19Gbl
ED None

ey.com/geostrategic