Who Will Want to be a Compliance Officer?

Also in this issue
- Trying to Improve Corporate Governance
- So Who Needs Technical Due Diligence?
- The Changing World of Political Risk
- What Happened to Risk Management?
- What is Risk Appetite?
The Changing World of Political Risk

Risk Reward Group CEO Dennis Cox, BSc FCA CFSI, is a global banker, Big Four chartered accountant, risk management and bank internal audit specialist, as well as an international lecturer and noted published author. Here he ponders the changing world of political risk.

From even a cursory view of the news you will see that we are living in what might be easily referred to as interesting times. A thought process which followed the end of hostilities after the so called World War 2 has broken down. Changing politics in countries as diverse as the UK, USA, Australia, Greece, Russia and much of the Middle East render political risk of much greater importance than has ever been the case before.

For us political risk means trying to understand what the political undercurrent is and to try to ride it as best you can. This impacts all companies and individuals since political risk can make a significant difference to the opportunities and threats that will exist in the future. This means that firms will need to change their strategies in the light of such challenges and individuals alter their investment approaches and wealth expectations taking these changes into account.

In previous articles we have indicated that we are at the end of an economic cycle that started in 1946, peaked in 1982 and ended around 2008. We also indicated that when you leave an economic cycle this leads to uncertainty and unrest prior to the next economic sustainable trend commencing leading fairly naturally to an elongated period of growth – albeit with limitations. We also indicated that unrest and change whilst certain in general could not be predicted and that outcomes were likely to be surprising.

Political risk seeks to look into the impact of such changes in the political arena to enable readers to appreciate the impacts that such changes are likely to have upon their personal and corporate strategies. At its best it seeks to understand the economic and social changes that are occurring and synthesise these into a map of political uncertainty.

Some commentators suggest that uncertainty is a constant but this is clearly not the case. When you are at the end of a trend, the consensus that may have applied almost without question for many years no longer tends to remain valid. Not all parts of the global economy recognise this at the same time and the political impacts are generally both inconsistent and piecemeal. That is what is happening at present as harbingers of false dawns seek to lead minority aspirants to a non-existent promised land.

The problem with political risk is that it works primarily by analysing the status quo and then looking at a series of events that have previously occurred to consider their impact upon the current situation. However I have indicated that the current cycle started around 1946 and that this then would of course have followed a period of uncertainty. In reality this started around 1928 and only ended in 1946. It was a period of 18 years which included turmoil and major change. It was not an easy time to do business and hyperinflation and high unemployment were a continual curse.

So where are we at present? We are now in a world where the expectations are that at some stage interest rates will rise, although the date when this will occur is far from certain. Interest rate rising scenarios are generally negative economic cycles when it is difficult for growth to be achieved. Companies and countries contract and this has an impact on political movements. In a negative economic environment not all companies perform badly. Indeed some do very well, but these tend to be the minority rather than the majority. As interest rates rise there is generally a negative impact upon consumption which causes reductions in commodity prices and reduced inflation. This actually tempers the need for interest rate rises...
The Changing World of Political Risk

yet time and again we have seen our political masters making mistakes exacerbating a difficult situation.

Political risk is therefore heightened at present due to the lack of global growth, the collapse in commodity prices and the level of international unrest that is currently occurring. This is the point at which we and what might be termed traditional political risk diverge. It is our view that in most countries of the world totally unexpected outcomes can be expected. It is this that leads to the emergence of Donald Trump in the USA as a formidable force and the election of Jeremy Corbyn by the UK labour party. It leads to anti-establishment parties being elected, an increase in nationalism and anti-establishment personalities suddenly taking the reins of power.

**It doesn’t work. It never works.**

Unfortunately by the time people realise it cannot work there will have been significant damage wrought on the relevant economy. There can in some cases also be major international impacts. Inside this analysis the activities throughout the global environment do exhibit a commonality. Why this is able to occur is that it is actually a minority that are interested in politics in the first place. They are able to drive an agenda and actually stifle the majority. The majority view is rarely newsworthy and a soothsayer can sound pretty persuasive when whatever they say rarely matters. Then they suddenly have the levers of power without an ideology that could possibly work or the mechanisms to support their success.

However as I have said they are likely to take control. In my view at present this is more likely to be protectionist right facing political groupings than left wing, although in some cases left wing groups will take power but again they will generally last for little more than a year prior to their collapse.

A number of issues arise as a result of this analysis. Firstly it is clear that political risk becomes an increasing risk for firms and needs to be clearly addressed in their risk analysis. Advice needs to be gathered from multiple sources, not only regarding the home politics of the Head Office country, but also the secondary effects. Clearly any changes in the Chinese economy or the US economy impact upon companies in the UK, for example.

Secondly the firm needs to consider what changes are likely and which are plausible. Rising interest rates, for example are likely, whereas declining rates are plausible. Whilst rising rates tend to presage inflation, declining rates below zero generally lead to stagnation. Not great options really. In the financial services sector much of the product suite is dependent upon the state of the global and local economy meddled by government policy. Rising taxation is the likely scenario with stagnant taxation being the plausible scenario. Rising capital requirements for banks are the likely scenario with even greater rising levels of capital and liquidity being the plausible option.

It makes life difficult for banks. At present banks are the whipping boys of the global economy. The mistakes that they have made have resulted in their being easy targets and in many cases their senior management have not conducted themselves with any credit. That such mistakes are continuing to occur is clearly a source for concern. However banks will need to think through what their role is likely to be in the on-going global economy. They will need to see where they will add value then stress test this though a series of political scenarios. This will look like this:

1. Assume that there is a left wing labor government in the UK and a right wing government in the USA with a protectionist regime in Russia and a reduced growth expectation for China

2. Assume that the EU breaks apart and there is further global unrest with Oil prices dropping to $24 per barrel and a general reduction in commodity prices and interest rates rising by at least 50% per annum.

Notice in these two scenarios there are a series of events that occur. In political risk it is not sensible to look at countries in isolation. They import and export, being part of the global economy. Consequently there tend to be multiple effects rather than single impacts and these need to be taken into account. One of the concerns that clearly exists is that stress testing is too focussed on a unitary concern and misses these composite issues which really cause the problems we see.

In terms of the regulatory structure there is no doubt in my mind that in the negative financial market we are moving into there is a need for a reduction in capital and liquidity rules to enable the financial community to undertake their roles with a likelihood of success. The enhanced capital will cause an increase in funding rates and create unemployment and a low growth economy. Of course bodies such as the Bank for International Settlements are not tasked with achieving growth. Rather they are seeking to avoid contagion.

What is certain is that the current direction of travel of global regulation will exacerbate political risk and will potentially result in series of unintended consequences which will benefit nobody.