Dealing with political risk

What FTSE-100 companies say

June 2016

Global Counsel

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About the authors

Dr Gregor Irwin is Chief Economist at Global Counsel and a former Chief Economist of the British Foreign Office.

Thomas Gratowski is a specialist in analysis of emerging markets and the Middle East. He advises clients on sanctions, macroeconomic risks and political risks.

India Lucas is a research associate with particular expertise in the tech sector and international relations.

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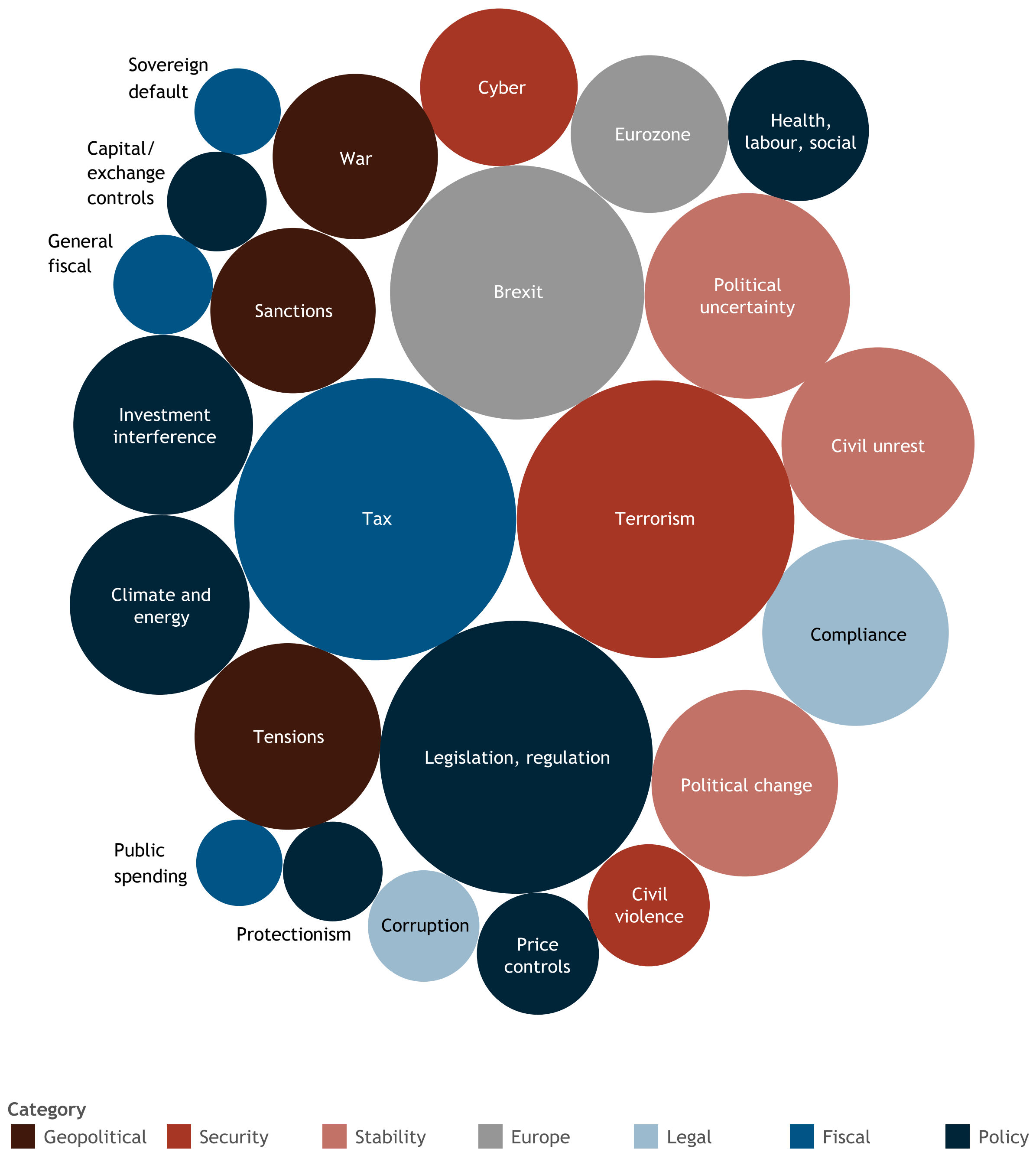
Figure 1: The FTSE-100 political risk map in 2015



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Executive summary

- In this report we assess what FTSE-100 companies are saying about political risk in their annual reports. We look at hard risks from security threats, political instability and geopolitical tensions. We look at soft risks from major changes to regulation, fiscal policies and the way legislation is enforced that at least in part reflect political pressures. We also look at a third, sui generis category – Europe risk – that has both hard and soft elements.
- We have identified just over 300 significant political risks reported by FTSE-100 firms in their 2015 annual reports. Some are generic descriptions. But most – over 60% – are specific and refer to a particular country, event or aspect of policy. These are typically the most immediate and tangible political risks for companies.
- We find that soft risks are more prevalent than the hard risks that might traditionally be associated with political risk. When we look at specific risks only we find that for every five hard risks, eight soft risks are reported. Both are important, but for many firms managing soft risks is a bigger and more important challenge for their commercial success.
- The most frequently reported soft risk is tax, while among hard risks it is terrorism. When we focus on specific risks we find that Brexit is the biggest risk, well ahead of tax or terrorism.
- The most important geographic source of hard risk in 2015 was Russia, reflecting its conflict with Ukraine, the sanctions that have followed and geopolitical tensions with other countries. Turkey, Syria, Iraq, Iran, Egypt, South Africa and China also feature prominently.
- Hard risks are not only to be found in emerging and developing countries. In Europe, terrorism is a growing source of risk, particularly following recent attacks, with France and the UK identified by some firms as locations where they are exposed to the risk of attack or its consequences.
- The spread of soft risks is wider, with the UK and the US the most important. Concerns in the UK include climate change policy and several other areas of regulation. The focus on the UK may reflect its importance as a market for many FTSE-100 firms. Compliance risks regarding anti-bribery, anti-money laundering or sanctions enforcement are more concentrated in the US.
- The sectors most exposed to political risks are oil and gas, healthcare, and banking, while the sectors least exposed are utilities and telco and tech. The high exposure of healthcare and banks partly reflects a broad geographical footprint and the regulatory intensity of each sector, particularly as in some areas this has become politicised. The exposure of oil and gas reflects the need to invest over long horizons in difficult, often insecure locations.
- Just over a quarter of FTSE-100 firms reported on Brexit risk in 2015, although more may have done so earlier or since. Most companies focus on the economic uncertainty that is likely to result rather than particular risks to their sector. Eurozone risks are fewer but more detailed. Four sectors alone account for almost all reports of Europe risk – with the proportion highest for financials and telcos and tech.

- Sanctions are one of the most tangible geopolitical risks for firms, with Russia, Syria and Iran the biggest concerns. The relaxation of sanctions against Iran provides one of the few areas of up-side risk. Some firms identify geopolitical tensions in the Middle East as a source or risk, but surprisingly few have anything to say about China's disputes with her neighbours or the US.
- A small but significant number of firms identifies concerns about politically-motivated cyber threats. These range from state-sponsored attacks to hacktivism or attacks directed at critical national infrastructure. Approaches to dealing with threats vary, but include working with governments or security agencies.
- Risks to political stability are seen in several countries, including South Africa and Turkey. The firms most exposed to political instability are in the basic materials sector, reflecting the sunk cost nature of their investments. While firms have little or no direct influence over political stability, they can limit their exposure when making investment decisions and subsequently through the relationships they build in the country.
- Many firms face legal risks that are in no way political. However, there is a trend towards judicial authorities seeking large punitive fines for legal breaches relating to government policy objectives in areas such as sanctions, the environment or finance. Firms may also face challenges doing business legally in some countries due to corruption. This category of risk is relatively small, with exposure higher in healthcare than any other sector.
- There are several policy risks. Protectionism is one that features surprisingly infrequently. Sugar has joined tobacco and alcohol as a target for health policy interventions. Utilities and property developers in the UK are among those identifying home-grown political risks to their business.
- The tight fiscal environment, first in mature economies and now in commodity producers, has swollen fiscal risks. The greatest concern is tax and the biggest risk is from new international rules to prevent base erosion and profit shifting. Few companies say they attempt to influence tax policies, but some are engaged in regular dialogue with tax authorities.
- Among the companies that stand out for the depth and breadth of their reporting of political risks are AstraZeneca, Barclays, BP, HSBC and Old Mutual. These companies may provide a model for others that find they are increasingly exposed to political risks.
- Companies have a legal obligation to report on the principal risks to their business, including political risks. Despite a high level of political uncertainty – globally, in Europe, and in the UK – the quality of reporting is variable, with an excessive tendency to report risks in a generic form that provides investors and other stakeholders with little information to evaluate their importance.

Introduction

Political risk takes many forms and is not easily defined, but it is high and rising by just about any standard. Governments are under pressure or have been forced out of office in countries as far apart as Venezuela, Brazil, Turkey, South Africa, Malaysia and Thailand. Armed conflicts have becomes entrenched in the Ukraine, Syria and the Sahel. Geopolitical tensions are high in the South China Sea, between Iran and the Gulf countries, and between North Korea and neighbouring states. The number of terrorist incidents recorded in 2014, the last year for which data is currently available, was nine times as high as in 2000.[1]

It is not just emerging and developing countries that are the sources of political risk. Populism is on the rise in Europe, with mainstream parties being squeezed in recent elections in Spain, Austria, and Germany. Migration has become a toxic political issue that is overriding and distorting other policy decisions by governments. The UK may soon choose to leave the EU, with uncertain consequences. In the US, the primaries for the presidential election have been more polarised than at any time in recent memory, with protectionism and populist policies moving to the centre of the political debate.

The prevalence of political risks, the varied forms they take, and their changing nature are complicating the business environment for many firms, particularly those with a large international presence. In this report we assess what FTSE-100 companies are saying about political risks in their annual reports. Our aim is to identify the most important sources of political risk, to see how this varies across sectors, and to establish the different ways in which companies are responding to these risks.

The analysis is intended to be useful for the companies themselves as they seek to improve their capability to identify, evaluate and mitigate political risks. It may also be helpful to investors who want to understand how their exposure to political risks is correlated across sectors and which companies appear best able to manage political risk. It also provides a resource for policymakers who want to reduce political risks.

Under the Companies Act (2006) annual reports must contain “a description of the principal risks and uncertainties facing the company”. This creates a legal obligation to report on political risks, if these are among the principal risks, although there is no obligation to identify which risks might be regarded as political, or indeed any established methodology for doing this.

In this report we make two methodological innovations. One is to look both at what we call hard and soft political risks. Hard risks are from security threats, political instability and geopolitical tensions. Soft risks are from significant changes to regulation, fiscal policies and the way legislation is enforced that at least in part reflect political pressures. We also look at a third category of risk – Europe risk – which has both hard and soft elements and is sui generis. The other innovation is to distinguish between generic descriptions of risk – sometimes in list form – and specific risks, which typically refer to a particular country, event or aspect of policy. As we show in the following sections these distinctions are critical to understanding who is exposed to political risk, where, and how they are responding.

[1] Global Terrorism Database, University of Maryland, https://www.start.umd.edu/gtd/.

An overview of FTSE-100 political risks

In our review of 2015 annual reports we have identified just over 300 significant political risks that were reported by FTSE-100 companies.

A little over one tenth of these – 36 in total – are Europe risks, with the remainder split between hard and soft political risks. Figure 1 provides a map of the risks broken down into different categories and sub-categories. Hard risks are shown in shades of red and soft risks are in shades of blue. Figure 2 identifies the top-ten categories of risk, with tax the biggest, followed by terrorism, legislation and regulation, and then Brexit.

This ranking changes when we strip out generic risks and focus only on those that are specific in the description of the risk. When we do this we find that the top risk - reported by over a quarter of firms - is Brexit. When we focus only on the specific risks we find that soft risks (like climate and energy policy) tend to move up the ranking, while hard risks (such as terrorism) move down. In total 66% of soft risks are specific, compared to just 45% of hard risks.

Figure 2: Top-10 political risks

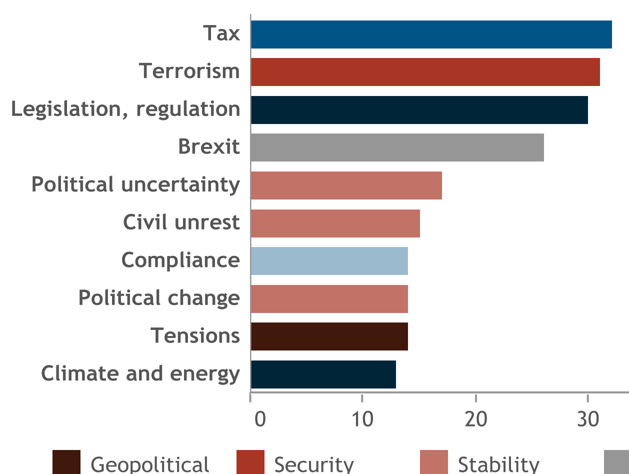
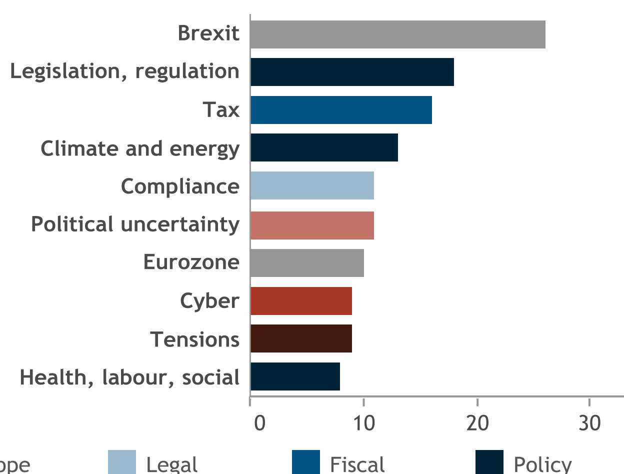


Figure 3: Top-10 specific political risks



Many companies do not describe the political risks they face in any level of detail. This may be because they struggle to identify and assess political risks. Or it may be because they are reluctant to describe political risks in much detail, perhaps because they are concerned this may damage their relationships with governments or policymakers. The deficiency appears to be greater for hard risks. There are notable exceptions to this general conclusion, however. As we explain below, some companies describe the political risks they face in considerable detail.

In the later sections of this report we assess the context for each category of risk, what firms are saying about the risks, and how they are responding. In the remainder of this section we set out the main findings across the different risk categories.

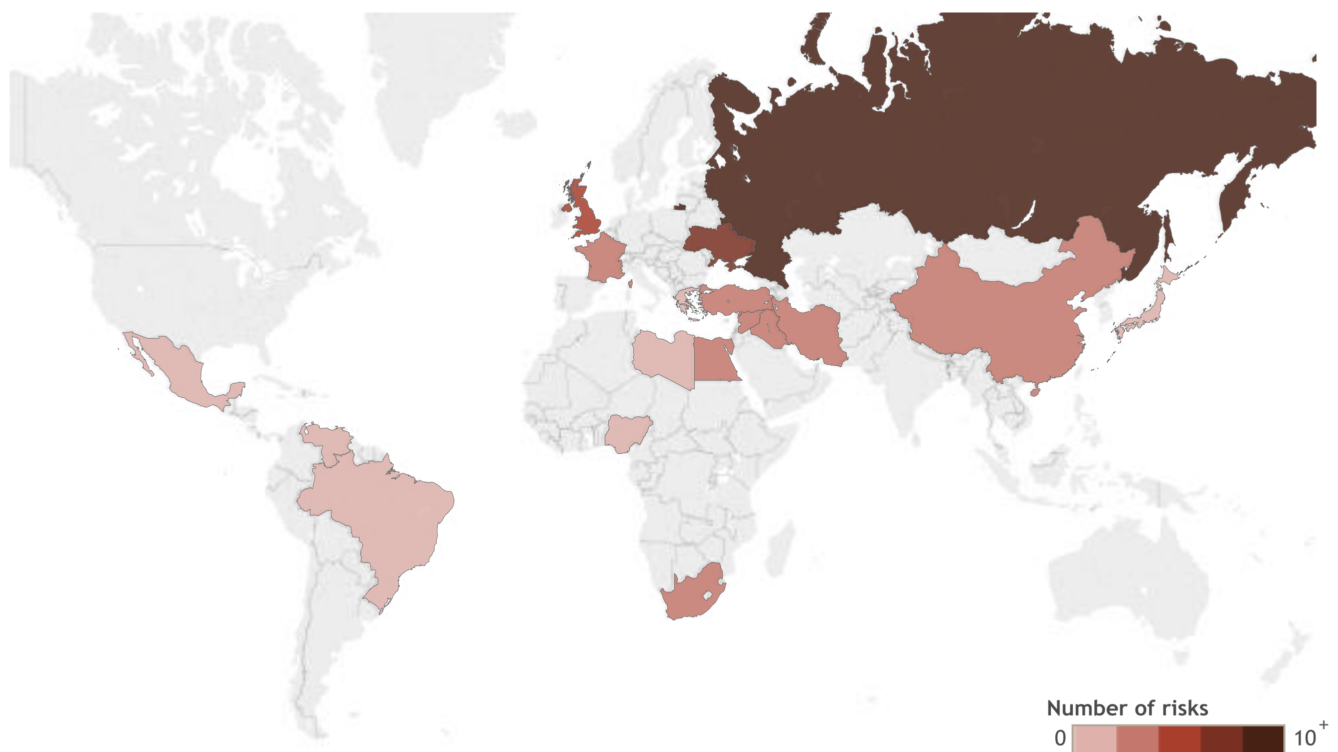
Where are political risks most prevalent?

The usual assumption is that political risk is mostly an issue in emerging or developing economies, with mature economies such as those in Europe or the US providing a much more stable political

environment for businesses to operate in. We find that this generalisation is far from true. This is partly evident from Figure 3, which shows that the top-ranking risk is Brexit. However, it is equally evident when the geographical sources of the other categories of risk are also considered.

Figure 4 shows the sources of hard political risk, where these are reported. The sources of hard risk are geographically widespread, but the single most important is Russia. This reflects Russia's conflict with Ukraine, the sanctions against Russia that have followed, and the wider geopolitical tensions between Russia and other countries. Turkey, Syria, Iraq, Iran and Egypt also feature prominently, although for different reasons, with terrorism and the security situation being the most important along with concerns about political stability. In South Africa the concerns are more about civil unrest and political uncertainty, while in China the hard risks are more geopolitical.

Figure 4: Distribution of specific hard risks by country

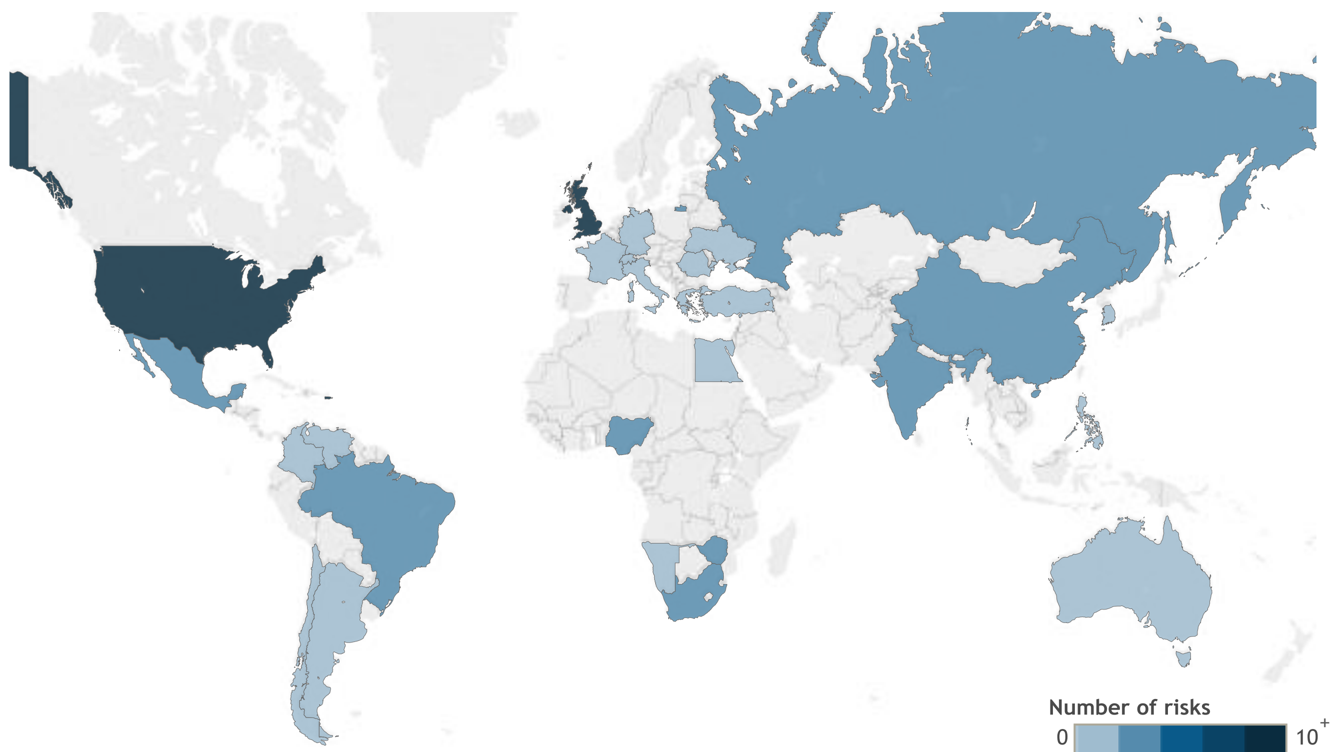


Two European countries – the UK and France – are, however, among the biggest sources of hard risk. Indeed, the regions that are most frequently cited as the source of hard risk are the Middle East, North Africa and Europe. In the case of the UK this partly reflects its importance as a core market for many FTSE-100 firms. Hard risks linked to the UK range from terrorism to the continuing uncertainty about Scottish independence. In France the concern is more narrowly focused on terrorism.

Figure 5 shows the geographical sources of soft political risks, where these are reported. These are also geographically widespread, but the distribution is quite different than for hard risks, with Europe and the US featuring much more frequently. Some risks, such as capital and exchange

controls, are concentrated in emerging and developing economies. Others, such as fiscal risks, are geographically widespread. The same is true for price control risks, although these are mostly concentrated in one particular sector, healthcare.

Figure 5: Distribution of specific soft risks by country



There are other risks, however, which tend to be narrowly concentrated in mature economies. For example, while climate change is clearly a global issue, the risks associated with climate change that are reported by FTSE-100 firms are in many cases linked to UK policy. A very high proportion of country-specific references to risks about regulation or legislation are also connected to the UK. In both cases this will, as noted above, reflect the importance of the UK market to many FTSE-100 companies. Compliance risks, which relate to anti-bribery, anti-money laundering and sanctions enforcement, tend to be disproportionately concentrated in the US, reflecting the strict approach that the judicial authorities there have taken to the enforcement of rules in these areas.

When this is considered alongside the fact that the biggest single risk category is Europe it is clear that political risk is not just an issue about small, volatile, developing countries. It is also a substantial issue in mature economies in Europe and the US. That is most evidently true for soft risks, but is also true – at least in Europe – for hard risks, particularly terrorism.

Which sectors are most affected by political risk?

The FTSE-100 includes companies with starkly different levels of international exposure and operating in a wide range of industries. We have used the standard industry classification to divide companies into nine sectors. Figures 5 and 6 show that these sectors are exposed to different levels

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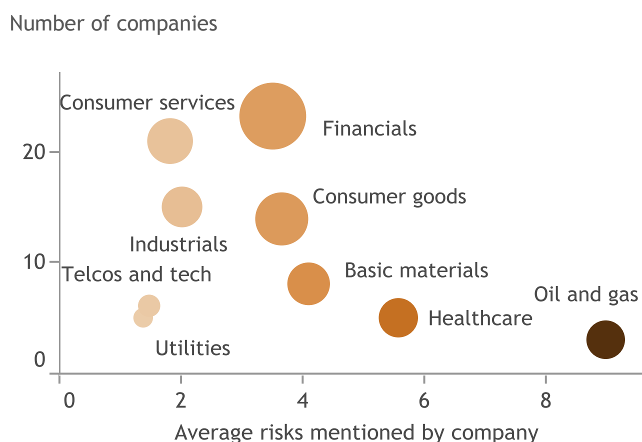
and types of political risk. Of the 100 companies we looked at, 82 report at least one significant political risk.

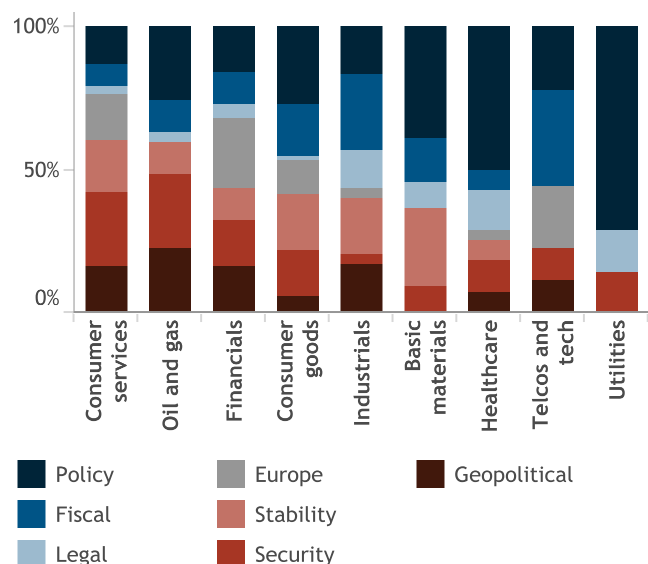
Figure 6 shows that the industry reporting the largest number of risks per company is, by some margin, oil and gas. This reflects the need for companies in the sector to operate in some of the most difficult geographies that are affected by political instability, security problems and geopolitical tensions. Moreover, the Middle East and Russia, two important areas for the sector, have both become greater sources of political risk in recent years. The exposure of the sector to political risk also reflects the long-term and sunk-cost nature of the investments that are made by companies, which means they are more exposed to changes in external circumstances that are beyond their control. It may also reflect a more recent increase in political risk in some locations due to the impact of falling energy prices, although this effect was only beginning to be felt during the 2015 reporting cycle.

Figure 6: Risk density by industry



Note: bubble size indicates number of risks mentioned

Figure 7: Risk distribution by industry



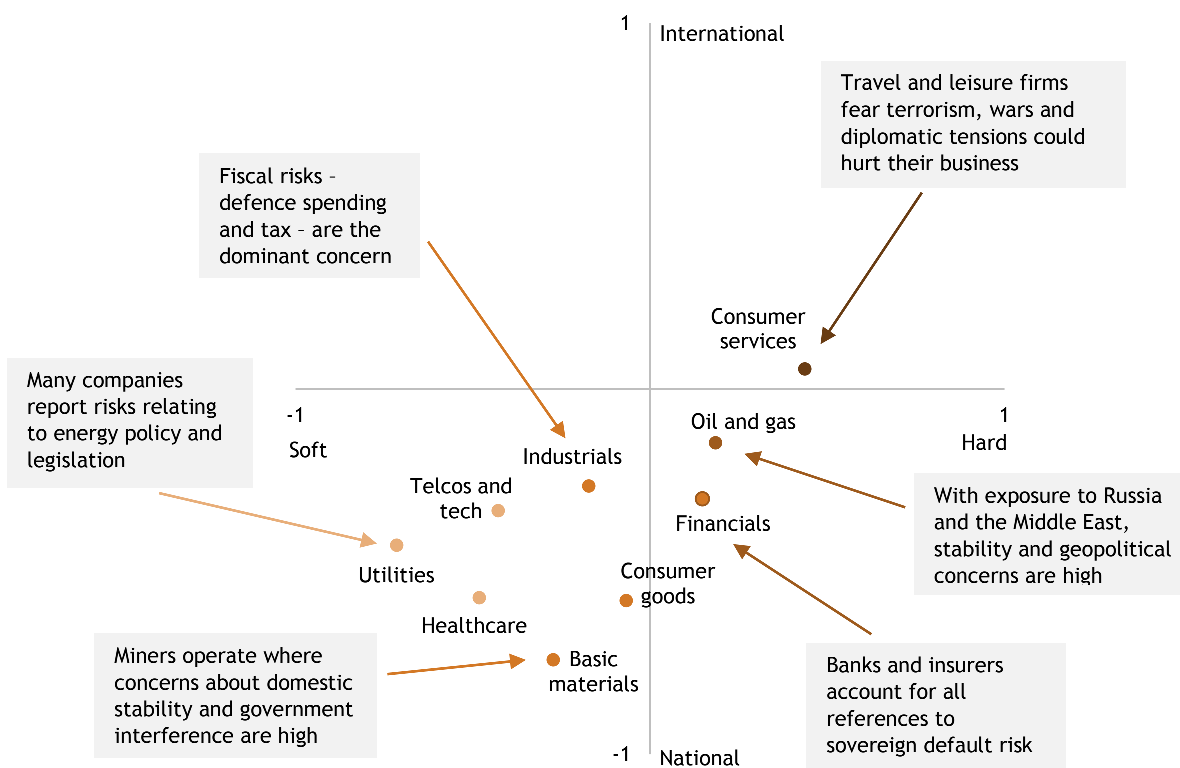
The next most exposed sector, after oil and gas, is healthcare. This is largely due to the complex regulatory environment that companies in this sector operate under and the additional pressures that have been created in recent years by growing fiscal pressures, which has driven down or capped the growth in healthcare budgets in many countries.

The biggest sectors – financials, consumer services, industrials and consumer goods – are all moderate reporters of political risks, but because these sectors are big they account for a large share of overall risks, with the financial sector alone accounting for one sixth of the total. What Figure 6 does not show is the variation in reporting within sectors. In some of the larger sectors this is substantial. For example, in financial services the banks are relatively prolific reporters of political risk, reflecting the increasingly complex political environment they operate in. By contrast non-life insurers typically report very few political risks.

At the opposite end of the spectrum are the utilities and the telcos and tech sectors, in which companies report less than two political risks each on average. These sectors are also small, meaning that they account for only a very modest fraction of the total political risks identified in this report. The seven firms in the healthcare sector report four times as many political risks in total as the same number of firms in the utility sector.

Figure 7 shows there are very stark differences between the types of political risk that firms in each sector report. Four sectors alone account for almost all reports of Europe risk – with the proportion highest for financials and telcos and tech, followed by consumer services and then consumer goods. Europe does not appear to be an issue at all for the oil and gas, basic materials and utilities sectors. These differences make sense. The first group is made up of companies with a high propensity to trade and invest across European borders, whereas the second group includes the extractive sectors, which have a broader geographic exposure that is mostly outside of Europe, and utilities, which are more likely to be focused on the domestic market alone.

Figure 8: Industry differences in risk characteristics



Note: The x-axis shows the balance between soft and hard risks on a sliding scale between -1 (soft risks only) to +1 (hard risks only). The y-axis shows the balance between national and international risks. National risks concern a single country, whereas international risks concern the relationship between two or more countries.

There is also a notable variability in exposure to hard versus soft risks. This can be seen in Figures 7 and 8. Firms in consumer services, financials and oil and gas are relatively more exposed to hard

risks than soft risks, whereas the reverse is true in the other six sectors, with firms in the utilities sector almost exclusively focused on soft risks and in particular policy risks.

Figure 8 also shows the extent to which risks tend to be national in nature – concerning one country only – or international and concerning the relationship between two or more countries. Across all sectors it is clear that national risks are by far the most important. But this shows that international risks are still important for companies in many sectors, including consumer services, industrials, and oil and gas. International risks are important for consumer services in part because of the large number of travel and tourism firms in this sector.

Which companies are among the best at reporting political risks?

Five companies stand out for the breadth and depth of their reporting on political risks. This in part reflects the nature of their business and the sectors they operate in. It may also reflect good internal processes and culture for managing political risks.

- AstraZeneca provides one of the clearest assessments of principal risks, which includes political risks, and which is supplemented by a more comprehensive analysis of the risks it faces and how they impact on the business.
- Barclays takes a slightly different approach, putting the emphasis on its governance structure and the work of its risk committee, but this is also supplemented with a clear statement of principal risks, including political risks.
- BP puts the emphasis on its governance and management of risk, including political risks, which was strengthened in 2015 by the creation of a new geopolitical committee tasked with identifying and managing geopolitical risks faced by the business.
- HSBC also has a board level geopolitical risk committee and the management of political risk internally is supported by a geopolitical risk unit, which may be one reason why the company stands out for the clarity and specificity of its reporting on geopolitical risks in particular.
- Old Mutual is notable for separately identifying political risks among the principal risks affecting the business and providing a detailed description of the risks it faces in the most important geographies for the company.

These companies may provide a model in terms of governance, management and reporting of political risks for other companies that are finding that they too are increasingly exposed to political risks.

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Europe risks

Before the 2008 financial crisis Europe was a haven of political stability. Eight years later and political risks in Europe are now sufficiently high to warrant being treated as an entirely separate category of political risk in our report.

Three related developments have contributed to this. One is the eurozone crisis, which has seen many countries introduce radical austerity programmes, in some cases with the support of the International Monetary Fund and European bail out facilities, and in the case of Greece at least, raising continuing questions about the sustainability of the debt stock and the country's membership of the eurozone.

The second is a rise in populism, as parties that were on the political margins increasingly threaten the traditional parties. In France the Front National is now a serious electoral threat to both mainstream parties. In Germany, where support for the Christian Democrats (and their Christian Social Union affiliates in Bavaria) and Social Democrats has now dipped below 50% in opinion polls for the first time,[2] the government is particularly concerned about the rise of the eurosceptic Alternative für Deutschland, contributing to criticism from within Chancellor Merkel's own party of her handling of the migration crisis. In Spain elections at the end of last year failed to produce a conclusive result as two new parties – Podemos and Ciudadanos – have up-set the duopoly of power by the socialists and the centre-right Partido Popular for the past 40 years.

The third development is Britain's referendum on Europe. This is both a reflection of these wider trends, particularly as the populist UKIP has taken votes from the Conservatives and Labour, and a potential contributing factor to risks elsewhere, given the uncertain consequences that a vote for Brexit might have on euroscepticism in other European countries. Prime Minister David Cameron's motive for calling the referendum was partly to unify his party, but it is now more likely to have the opposite effect and could substantially weaken his government.

These three threats together – institutional weaknesses and fragility in the eurozone, political populism across Europe, and the risk of a break-up of the EU that may not end with the UK – mean that Europe that is the single biggest geographical source of political risk for FTSE-100 firms.

What are the risks?

We distinguish between Brexit and eurozone risks. The latter are smaller in number, but potentially serious for some companies. The country mentioned most is Greece, with Dixons Carphone noting that a possible exit from the eurozone could have a significant impact on its Greek business. Barclays notes the risk of a breakup of the eurozone alongside the risks of stagnation and entrenched deflation. Vodafone notes that eurozone instability could have a "prolonged impact on capital markets" that could impact on its refinancing requirements. Greece is not the only source of concern, however, with Standard Chartered noting the risk that "slow progress on reforms, especially in France and Italy, depresses confidence and limits growth potential."

Just over one quarter of FTSE-100 firms identified Brexit risk as a source of concern in their 2015 annual reports. The majority are worried about the impact on the economy. Lloyds Banking Group notes that uncertainty could "impact companies' investment plans". LSE Group notes Brexit could increase the level of market volatility and have an unpredictable effect on its business. WPP is

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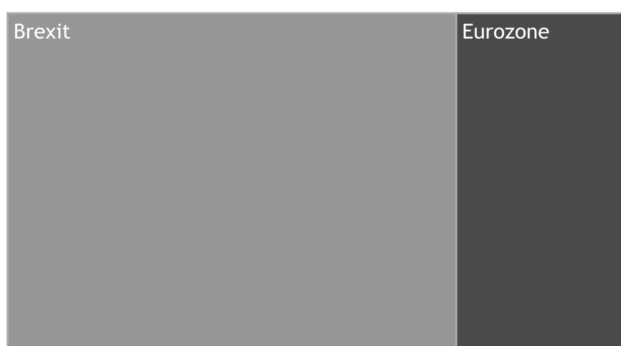
[2] Financial Times, 31 May 2016, https://next.ft.com/content/4d3475ca-2734-11e6-8ba3-cdd781d02d89.

among those that are blunter in their assessment, concluding that Brexit could mean "real damage to the UK economy", while HSBC is one of the most specific when it notes that "a disorderly exit could force changes to HSBC's operating model, affect our ability to access ECB and high value euro payments, and affect our transaction volumes due to possible disruption to global trade flows."

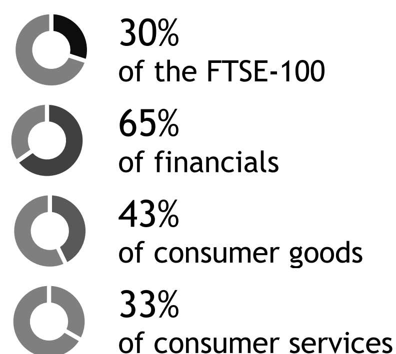
Some firms note the impact on the rest of Europe. Reckitt Benckiser says Brexit "may be a catalyst for further changes to the regulations and/or structure of the EU" that would in turn impact on the conditions it faces. Worldplay Group similarly observes that a "significant proportion" of the regulatory regime it operates within comes from the EU and that "an exit may also change the framework applicable to our European operations."

Figure 9: Europe risks in summary

36 risks reported in total:



Industry exposure:



The spread of the 30 companies reporting political risks in Europe is notably different from most other categories of risk. The heaviest concentration by far is in the financial sector, with 15 companies reporting Europe risks. By contrast only one of 15 industrial companies and none of the 16 firms in the oil and gas, basic materials or utilities sectors report significant Europe risks.

How are firms responding?

Despite Brexit risks being far more prevalent, we found that companies typically provide more detail about the ways they are dealing with Eurozone risks, particularly regarding Greece. This most likely reflects both the fact that Grexit risk has been an issue for longer than Brexit risk, allowing companies to understand it better and to formulate more detailed responses, and that companies typically have a narrower and well-defined exposure to Grexit, which makes it easier to implement and articulate a mitigation strategy. It may, however, also reflect a reluctance by companies to detail their responses to Brexit risk precipitously, due to a concern that they may be drawn into the public debate.

One of the most detailed explanations of how Eurozone risks are being dealt with is provided by Vodafone. The company says it is monitoring the situation and has detailed business continuity plans, as do many other FTSE-100 firms. In addition, it has minimised its exposure to "euro-denominated monetary assets". It describes its operations in Northern and Southern Europe as providing a "natural offset in terms of the translation of euro revenue into sterling". Vodafone also notes that it has "credit facilities with 29 relationship banks that are committed for a minimum of

five years and total £5.5bn." Among other firms, Aviva is one that discloses using "temporary increases in equity hedges" to offset risks.

GSK is among the few companies that is in any way specific about how it is responding to Brexit risk. The company says it has "plans in place" to deal with the uncertainty, added complexity and short-term disruption from Brexit and that it does not "currently believe that there would be a material adverse impact on the Group's results or financial position." Barclays note it has run stress tests as part of a "detailed evaluation" of any risks from the EU referendum.

Hard Risks

We distinguish between three types of hard risk – geopolitical, security and stability – which are each considered in turn below.

Geopolitical

In recent years several geopolitical developments have impacted on the environment international businesses operate in. The most direct impact for many has come from the deterioration in relations between Russia and the West and linked to this Russia's dispute and conflict with Ukraine. This has led to the imposition of sanctions on Russia, which are unlikely to be relaxed soon, particularly as the US and EU say this remains conditional on the implementation of the Minsk agreements, which remains patchy. EU exports to Russia have fallen 40% over the past two years, while Russian exports to the EU have fallen by even more.[3]

The longest standing issue for many businesses is the geopolitical tensions in the Middle East. This takes many forms, but the biggest structural factor is the rivalry between the Sunni Gulf states led by Saudi Arabia and Shia Iran. This division lies behind or is contributing to many of the security problems in the region, such as the civil wars in Syria and Yemen. The nuclear deal between Iran and a US-led group of states has created both opportunities and risks for businesses: opportunities from the removal of international sanctions against Iran; but risks from the uncertainty created to the political balance in the region.

The most important geopolitical development, however, is China's growing international weight. This is creating intense economic rivalry with the US and Europe, which often has a strong political tinge. This can be seen in the debate over China's market economy status, unease about the support for Chinese industry through subsidies, and the increasing use of trade defence instruments by both sides, which is disrupting trade flows. It has also intensified security and military rivalries, particularly around the South and East China Seas, with China engaged in protracted territorial disputes with several neighbouring states. These diplomatic tensions have on occasion spilled over to impact on economic relations, most notably with episodes in which the products of particular countries, such as Japan, have been boycotted by Chinese consumers.

What are the risks?

At the most extreme the risk that concerns international companies is the risk of war. However, in almost all cases when FTSE-100 firms identify the risks posed by war they do so in a generic way, without identifying the specific conflict areas that are a source of concern. AstraZenca is an exception, noting that "operational risks in Ukraine have increased due to growing political and economic uncertainty in the region" and using this as an example of how instability and violence has the potential to disrupt its business.

A larger group of companies identifies geopolitical tensions, which may not be as extreme as outright war, as a source of risk. In the majority of cases companies are more specific about the nature of the risks to their business and its source. Three banks – HSBC, Standard Chartered, and

[3] Eurostat.

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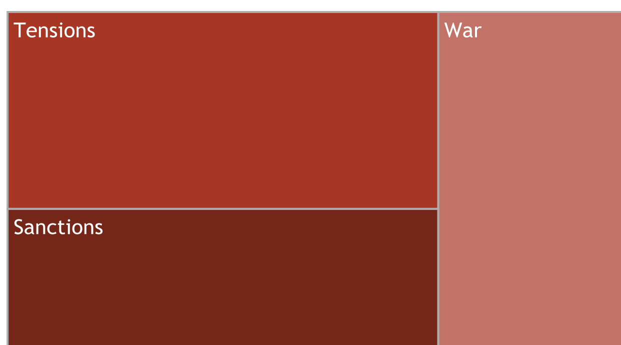
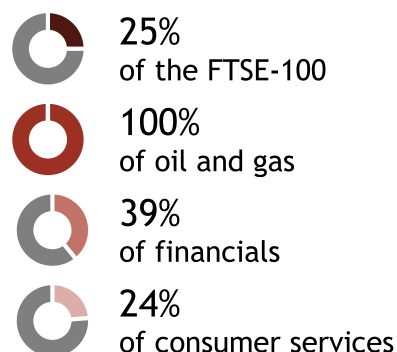
Barclays – all identify either Ukraine or Eastern Europe as a source of concern, as does investment firm 3i, which notes the damaging impact geopolitical uncertainty has on market confidence and risk appetite. Other firms to identify Ukraine or Russia as a source of concern include M&S, WPP and Schroders. The same three companies are also among firms to identify the Middle East or North Africa as a source of geopolitical tension. HSBC is unusual in that it is one of the very few to comment on the strained relationship between China and Japan, no doubt reflecting the importance of business in East Asia to the company.

Figure 10: geopolitical risks in summary

36 risks reported in total:



Industry exposure:



25%
of the FTSE-100

100%
of oil and gas

39%
of financials

24%
of consumer services

Three countries account for the majority of references to sanctions risks – Russia, Syria and Iran. HSBC judges that US and EU sanctions against Russia have "damaged the economy". BP is specific about the risks posed to its business by sanctions against Russia, reflecting the importance of its interests in the country, including its stake in state-backed oil producer Rosneft. Royal Dutch Shell, by contrast, focuses on the financial and legal consequences of a violation of a sanctions regime, rather than the direct operational impact on its business. Two companies, WPP and HSBC, note that sanctions against Iran have been lifted, although in HSBC's case this is caveated with the observation that this "has done little to calm regional tensions."

Only a quarter of FTSE-100 firms report geopolitical risks of any description, with none of the 13 firms in either the basic materials or the utilities sectors doing so.

How are firms responding?

As in other areas the reporting on responses is variable. The companies that appear to have the most developed approaches are, perhaps not surprisingly, to be found in the sectors that are long-accustomed to dealing with geopolitical risks to business.

Rolls Royce is one group that does explain its general approach. This includes locating facilities and supply chains in countries with a low level of political risk, diversifying operations "to avoid excessive concentrations of risk" and/or maintaining "dual capability".

BAE Systems notes its contracts are often long-term which, it says, may allow it to mitigate risks "over the terms of those contracts". In addition, the company notes political risk insurance is held "in respect of export contracts not structured on a government-to-government basis."

HSBC has a dedicated Geopolitical Risk Unit and provides one of the more detailed explanations of its approach. This includes monitoring the outlook where it has material exposures and/or a physical presence. The bank has a system of internal credit risk ratings for sovereign counterparties, which takes geopolitical factors into account. It adjusts country limits and exposures to "reflect our risk appetite and mitigate risks as appropriate." HSBC also runs stress tests on its portfolios "that take into account geopolitical scenarios, such as conflicts … or political developments that could disrupt … operations".

Security

2015 was the bloodiest year in over a decade for terrorism in western Europe,[4] with the assault on the French satirical magazine Charlie Hebdo in January and more attacks in Paris in November. Several developments have increased the actual and perceived threat level. The strategy of the Islamic State in Iraq and Syria (ISIS) has evolved from seizing territory in countries where civil wars have created power vacuums to simultaneously committing attacks in Europe and especially in Turkey. ISIS and other Islamist terror organisations have been able to recruit European Muslims who feel disenfranchised. And the large influx of refugees from the Middle East and Africa – largely the result of civil wars and failing states – has increased the perception of vulnerability. Events in Belgium this year have confirmed the severity of the threat level and shown how hard it is for national security institutions to prevent or respond effectively to terrorism.

Outside of Europe the physical security of firms is particularly threatened where there has been a breakdown of state institutions, as in countries such as Syria, Libya and Iraq. There are, however, threats in many other countries including, for example, in regions of Mexico where drug cartels are in open conflict with the security forces and are challenging public order, or in parts of Nigeria where the state has largely lost control. Companies that can avoid doing business in these areas will. But not all companies can, particularly those in the extractives industry.

The security risks to international companies are not only physical threats to staff or facilities. Cyber-crime has also grown in importance and is now one of the most widely reported and discussed risks facing large corporations. The damage that can be done by a successful cyber-attack, either financially, to a company's intellectual property, or to its reputation, can be severe. In most case the motive is not political, but in some cases it is linked to geopolitics or sponsored by states. There is also increasing concern in many countries about the threat posed by cyber terrorism, particularly where this is directed at critical national infrastructure.

Cyber threats are not bounded by geography in the way that physical security threats can be. They are a concern for businesses that operate exclusively in the UK or Europe as well as companies with a presence in countries that may tolerate or even sponsor cyber attacks.

What are the risks?

Terrorism is by far the most prevalent form of security risk reported by firms. In most cases – 25 out of 31 – this is in a generic form. EasyJet, for example, is typical when it identifies terrorism as one of several factors that could disrupt its network, alongside the likes of extreme weather and

[4] The Economist, 16 November 2015, http://www.economist.com/blogs/graphicdetail/2015/11/daily-chart-10.

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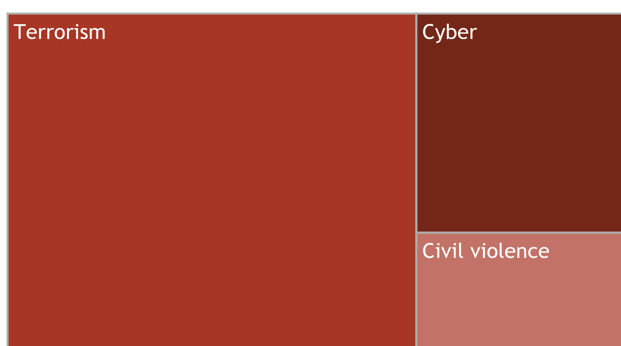
volcanic ash, while GSK lists terrorism as one of several factors that could expose its international operations to disruption, alongside Ebola, a storm or an earthquake.

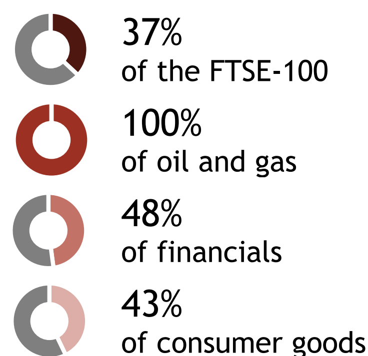
Among those reporting specific exposures to terrorism both Intu and Land Securities note that shopping centres in Europe are now being directly targeted. Both Intu and Hammerson link their assessment of the risk to the attacks in Paris. TUI Group and Merlin Entertainment – which both operate in the holiday and leisure sector – identify the risk that their business is disrupted in any city that is targeted by terrorism, with TUI Group noting the impact the attacks in Tunisia had on the tourism industry there.

Figure 11: security risks in summary

47 risks reported in total:



Industry exposure:



37%
of the FTSE-100

100%
of oil and gas

48%
of financials

43%
of consumer goods

The number of firms reporting the risk that civil violence poses to their business is much smaller, but in some cases these risks are very specific. Mining company Fresnillo, for example, notes that the security situation in Mexico, which is the location for most of its operations, is a "critical issue, particularly in remote areas." BP reports that civil unrest in Libya has made it "impossible" to operate "safely and securely", while in Iraq access to the Kirkuk field has been restricted due to the security situation. BP does, however, note that its operations continue "as planned" in the south of the country "despite the instability and sectarian violence."

Almost all firms in the FTSE-100 report on cyber-crime risks. The nature of the threat is different, as it is digital assets and data rather than physical assets or staff that are exposed, but the scale of the threat is nonetheless large. Ten FTSE-100 firms note a political dimension to this risk and these are included in this report. IAG notes that the risk may originate with foreign governments and BG Group refers to "state-sponsored industrial espionage". Barclays refers to a "geopolitical cyber threat". AstraZeneca notes the risk that 'hacktavists' may pose. Both the LSE Group and National Grid say they may be particularly exposed as they operate systems that are regarded as critical national infrastructure.

As with many other types of risk the sector that is most exposed to security risks is the oil and gas sector. Among the others, utilities, telcos and tech and particularly industrials stand out for their relatively low exposure. Just one out of 15 industrial companies in the FTSE-100 reports a significant security risk in its annual report.

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How are firms responding?

Many companies now have highly developed approaches to dealing with cyber security threats, although the changing nature of the threat means those companies that are most at risk and the best prepared must frequently reassess their approach. Several companies – including BP and LSE Group – report that they work closely with government and/or law enforcement agencies, while GKN notes that it has been briefed by “a senior former British security and intelligence officer … on the increasingly global perspective of the cyber security threat."

IAG says that in 2015 cyber risk was identified as a “principal risk” and that it held “monthly reviews and initiatives to ensure that there are consistently robust defences and incident response plans throughout the Group.” The company takes advice from industry experts, seeks to ensure that it is up to date with industry standards and addresses identified weaknesses, but nevertheless acknowledges that “the fast moving nature” of the risk means it will “always retain some vulnerability”.

EasyJet has a business continuity programme in place to deal with disruptions including terrorist incidents, which is typical of the approach set out by many companies. One particular element of EasyJet’s approach to dealing with incidents is to form a “business disruption team”, which includes relevant senior management, to determine and initiate required action. The company notes the importance of having “clear roles and responsibilities” across the business, in order to manage significant disruption.

Rexam notes the importance of assessing risks early in due diligence reviews prior to investment and in “continuing business reviews and risk assessments.” It is also one of a number of firms that uses “on the ground” market and country intelligence from local management and external advisors. Rexam also ensures that business continuity plans are “in place at individual plant, sector and group level, and these plans are reviewed, benchmarked and tested during the year.”

Stability

The stability of governments or even political systems can pose risks for business, as it makes the economic, social and political environment they operate in unpredictable.

Political instability may sometimes result from civil unrest that takes a violent form. This may create risks for companies even in the absence of a direct security threat to its people or facilities. In recent years, violence in parts of the Middle East and North Africa, in particular, has in many cases been associated with changes of governments or unstable governments.

Political instability may sometimes instead be a consequence of wider social or economic stresses without involving violence. This has been particularly evident in Europe recently (see separate risk category) although not all political instability risks in Europe are about Europe. Independence movements in some countries are one such potential source of risk.

Non-violent political instability is also a factor in some emerging economies, including those exposed to falling commodity prices, such as Brazil, Venezuela and South Africa. In many countries it is not only the rate of growth that matters, but how the benefits of growth are being distributed, with inequality adding to social and political strains.

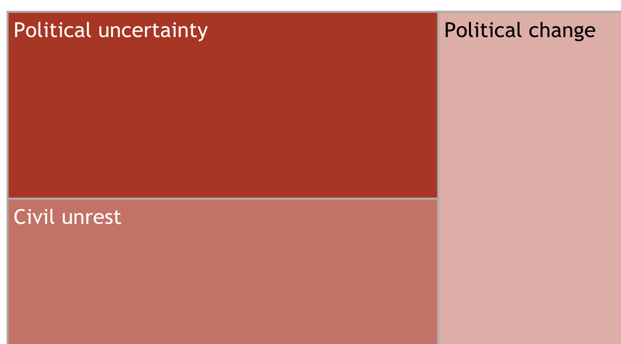
These social and economic stresses could potentially increase in the years ahead and put other governments under strain. Over the past decade, many emerging and developing countries have experienced very strong growth, partly on the back of China's rapid development and more recently the very loose monetary conditions in the US and Europe, which has seen capital flow freely to emerging and developing countries. Both of these supports for growth are now diminishing. As they do, and growth rates moderate in many countries, the risks to political stability are likely to increase for some.

What are the risks?

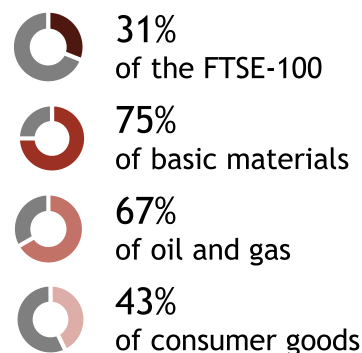
We distinguish between three types of risk that are identified by businesses. One is about civil unrest, often described in quite generic terms, which may or may not pose an immediate direct threat to the government. The second is political uncertainty, which is substantial enough for a business to note that it has the potential to impact materially on the environment it operates in and thus warrant including in its annual report. The third – which is typically the most substantial form of risk – is that of political change, where a government or political system is directly threatened. In most cases this will be regarded negatively, because of the disruption it implies for business, particularly in the short run, but in some cases businesses may see potential benefits from political change and report on this as an up-side risk.

Figure 12: stability risks in summary

46 risks reported in total:



Industry exposure:



Imperial Tobacco Group notes its results have been affected by "market size declines and by difficult trading caused by the conflict in Iraq and Syria." Royal Dutch Shell picks out Nigeria as among the countries where "social and civil unrest" is affecting its operations. In most cases, however, civil unrest is identified as any one of a number of factors affecting the political environment that can impact on a business.

The geographic scope of political uncertainty impacting on businesses is much wider, spanning developing, emerging and mature economies. Mondi, for example, notes that the profitability of its Turkish business has been "negatively impacted by ongoing political turbulence in the region affecting demand growth, domestic cost inflation and the weaker Turkish lira", while Old Mutual notes that in South Africa there is "political uncertainty and a risk of populist economic policy that could harm longer-term investment and growth." Old Mutual also notes that its exposures include

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the "substantial business … from collective labour organisations in South Africa, which could be adversely impacted by a change in sentiment." On the up-side, Old Mutual notes that Brexit could mitigate its South Africa risks by causing the rand to appreciate against sterling.

Some UK-focused banks also report on more home-grown risks. RBS notes that a vote for Brexit could create further uncertainty about Scottish independence, while Barclays noted the risks created by the UK general election and budget statements.

Companies judging risks to be more severe – with the potential for change of government or other forms of political instability – tend to focus on many of the same countries. TUI Group notes that travel companies are particularly exposed to political volatility in the markets where they operate, citing Egypt as a recent risk. Barclays notes that instability in general can weaken growth prospects and have an "adverse impact on customers' ability to service debt." The company also observes that the recent changes in Finance Minister in South Africa have "added to the domestic challenges".

The highest concentration of stability risks is to be found among basic materials firms and oil and gas producers reflecting the long-term and high sunk-cost nature of their investments.

How are firms responding?

Mitigating risks to political stability is challenging for most firms as they have little control over these risks. British Land, for example, says it is not able to influence "the outcome of significant political events" but it can and does "take the uncertainty related to such events and the range of possible outcomes into account when making strategic investment and financing decisions." British Land also says it uses public affairs consultants to ensure it is "properly briefed on the potential policy and regulatory implications of political events." The company notes that "where appropriate" it sometimes collaborates with other industry participants to "influence the debate on these policies."

Unilever is one of a number of firms that emphasises the breadth of its "portfolio and … geographic reach" to offset its exposure "to any particular localised risk to an extent." The company also says that its "many years of exposure to emerging markets" gives it "experience of operating and developing … business successfully during periods of economic, political or social change." Randgold Resources is more specific when it notes that "relationships with governments, senior in-country officials and other key external stakeholders are built and maintained" as part of its approach to dealing with political stability risks. It also notes in this context the importance of meeting "the terms of its agreed and signed licences and conventions", illustrating how the behaviour of companies and the standards that they apply can potentially provide some protection against the impact of political instability on its operations. Randgold's annual report also notes that the group "monitors regulatory and political developments as well as the country risk ratings on a continuous basis."

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Soft risks

We distinguish between three types of soft risk – legal, policy and fiscal – which are each considered in turn below.

Legal

Large international companies often face legal risks that are in no way political. This category, as much as any other, shows how the line between political risks and other risks can sometimes be a fine one. The legal environment facing international firms is, however, evolving in ways that suggest that legal exposure is becoming an important channel for political risk.

One is a trend for judicial authorities to seek large punitive fines for legal breaches relating to government policy objectives, in areas such as sanctions, the environment or financial regulation. In some cases this may be motivated by a policy objective of discouraging firms from potentially operating where there is ambiguity about the scope of prohibitions or the interpretation of legislation. This is particularly true in the US, where it has been suggested the judicial process has become more 'politicised' and there are concerns that foreign firms are being targeted disproportionately.

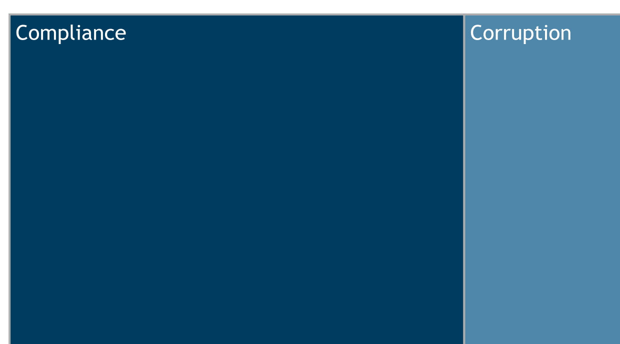
A second area where the legal environment has changed substantially is the international policy framework for bribery and corruption. In recent years the OECD has encouraged its members to introduce legislation that puts the onus on senior management in parent companies and subsidiaries to ensure that their operations around the world are clean. The UK and US governments are now among those with much more demanding legislation in place than was the case a few years ago.

What are the risks?

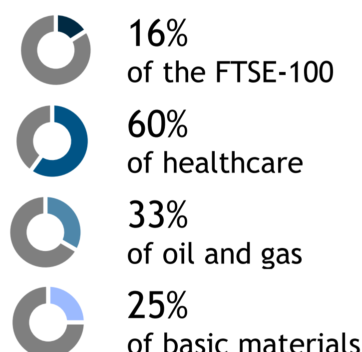
Several companies report risks relating to corrupt practices, as opposed to compliance with anti-bribery legislation. Merlin Entertainment says that it is operating "increasingly within territories with a historically higher propensity to bribery and corruption" while Fresnillo notes that the "perceived level of corruption" in Mexico "remains high". BHP observes that a refusal to make "so-called facilitation payments" can cause delays or disruption to business in its sector.

Figure 13: legal risks in summary

19 risks reported in total:



Industry exposure:



16%
of the FTSE-100

60%
of healthcare

33%
of oil and gas

25%
of basic materials

The majority of reported legal risks reported are, however, to do with compliance issues and the US is the country that is most often referred to when these risks are identified by FTSE-100 companies. Several firms note potential exposures from a failure to meet obligations under anti-bribery laws if their compliance procedures prove to be less than fully effective, with Rolls Royce noting that it has been under investigation by the Serious Fraud Office in the UK since 2013 for alleged bribery and corruption in overseas markets. GSK notes that the US authorities are still conducting an industry-wide enquiry into breaches of its Foreign Corrupt Practices Act.

Among the other legal issues identified by firms are compliance with internationals sanctions regimes and anti-money laundering (AML) legislation, which are particularly important for banks. HSBC is currently subject to AML and sanctions “remediation plans” and notes their “complexity creates significant execution risk”. Lloyds Banking Group describes AML and anti-terrorism laws as “increasingly complex and detailed” and says its procedures “may not always be effective in preventing third parties from using the Group as a conduit for money laundering, terrorist financing or breaches of financial crime regulations” with potential financial and reputational implications. RBS reports that it is still involved in a number of class action litigations and investigations that relate to alleged malpractices exposed in the sector following the financial crisis.

Reporting on legal risks is unusually highly concentrated in a small number of sectors, with healthcare top of the list. Legal risks are very rarely identified by firms in the consumer goods, consumer services, or utilities sectors.

How are firms responding?

Babcock’s approach to dealing with corruption risks is typical in many respects. At its core is ensuring that there is a clear chain of responsibility for communicating and implementing its anti-bribery policies. In addition, the group requires its employees to take online training courses in anti-bribery and corruption risks.

Several companies, including Merlin Entertainment and Tesco, have whistleblowing policies, often supported by external organisations to ensure that issues are treated confidentially and staff are treated fairly. Rio Tinto’s programme – called “Speak-OUT” – enables staff to raise anonymously a wide range of potential concerns they may have about business integrity or financial reporting.

Some companies, including Merlin Entertainment, extend their approach to third-party suppliers. In Merlin’s case all suppliers are required to sign standard terms and conditions which capture the group’s policies in areas such as anti-bribery. The company says it independently audits certain categories of suppliers who produce Merlin Entertainments branded products.

Several companies embed their approach to anti-corruption in a broader approach to addressing standards and ethics in business. Some companies, including Compass Group, SABMiller and Mondi, are signatories to the United Nations Global Compact, which encourages businesses to adhere to human rights, labour, environment and anti-corruption standards.

Policy

The most extensive category of risk included in this report is policy risks, which covers broad areas of regulation, different forms of intervention such as price or capital controls, protectionism or

even direct interference in the ability of a company to control its investments. As in some other areas of political risk there is a grey area between risks that are overtly political in nature and those that might be regarded as regular commercial issues facing a business. We have attempted to distinguish between the two by focusing only on those risks that appear to be at least partly a consequence of significant political choices that governments or other public authorities are making, especially where there is evidence these are related to broader political trends.

In the aftermath of the 2008 financial crisis there was widespread concern that this would lead to a global re-emergence of protectionism. The worst fears expressed then have not materialised, but there are still concerns now, particularly as global excess capacity in some industrial sectors, such as steel, has seen international prices fall sharply and led to allegations that China and other countries that subsidise producers are distorting the market. There continues to be widespread use of trade defence instruments that, while legal under WTO rules, disrupt trade.

The financial crisis also led to a wave of new regulation for the financial services sector, reversing what had been a well-established trend towards light-touch regulation. A concern for business is whether this may also have encouraged greater regulatory activity in other sectors by making the political climate for regulation more conducive.

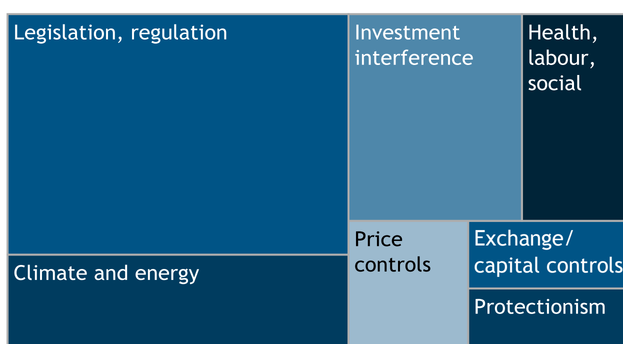
Regulation and market interventions to address climate change are a significant issue and a source of uncertainty for many businesses. The policy environment in large part reflects the political choices that are made by countries through international negotiations – most importantly the UN-sponsored process which produced a landmark deal on tackling climate change in Paris in 2015. There are, however, considerable uncertainties for businesses about how what is agreed internationally is subsequently implemented through policies that are set nationally.

What are the risks?

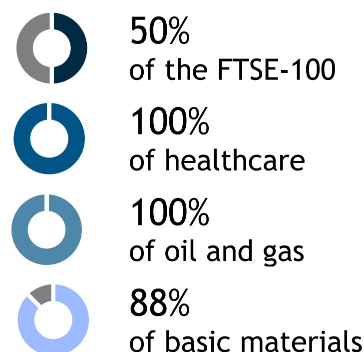
The breadth of this risk category means it is also the largest, accounting for just over a quarter of the political risks we have identified.

Figure 14: policy risks in summary

78 risks reported in total:



Industry exposure:



One of the main themes regarding climate change is political and regulatory uncertainty. BHP notes the risk that some of the assets on its balance sheet could become "stranded" if their value was

substantially reduced by "technology, regulatory or market responses to climate change." Johnson Matthey is among a smaller number of firms that sees up-side risks, noting that "further tightening of global emissions legislation generally requires improved technological solutions and … can create opportunities for the group."

Risks concerning labour and social policies tend to be more specific to the market and are more prevalent in mature economies. In the UK, the Royal Mail notes that it is particularly vulnerable to changes in labour regulations, given the size of its workforce. In Switzerland, healthcare company Mediclinic International notes that the recent referendum calling for migration restrictions could impact on its ability to hire staff.

Three consumer goods companies, all offering very different products, note that public health interventions could impact on their business. For British American Tobacco the concern is increasing controls on tobacco products, while for SABMiller it is "increasing restrictions on the availability and marketing of beer" and for Coca Cola it is the potential introduction of sugar taxes.

Capital or exchange control risks are most widespread among financial sector firms, such as Old Mutual. Consumer health business Reckitt Benckiser identifies several emerging countries where it has concerns, including South Africa, China and India.

Price control risks are concentrated in the healthcare sector. GSK, for example, notes that pricing reform for healthcare products is likely to be an issue in the US presidential elections "and beyond". AstraZeneca's concerns about price controls for medicines include "mandatory discounts, clawbacks and price referencing rules" and appear to be greatest in European countries. The company links this to budget pressures in France and the "challenged economy" of Italy, which suggests these pressures may in part be cyclical.

FTSE-100 companies identify a number of broader risks from regulation or legislation. Several of these relate to the UK. Utility companies Severn Trent and SSE note that changes to the regulatory environment for water and energy respectively could impact on the sustainability of their business planning, with SSE directly linking this to the general election last year. Property developers Berkeley Group and Taylor Wimpey note risks emanating from housing, planning, environment and tax policies affecting their sector. Lloyds Banking Group and Standard Life meanwhile identify Scottish devolution as an issue for their business.

How are firms responding?

The approaches that companies take to mitigating policy risks are as varied as the risks themselves. There are, however, some common themes.

The approaches taken by property developers and utility firms are illustrative of how many firms engage with the UK authorities in a complex regulatory environment. Berkeley Group says the "effects of changes to government policies at all levels are closely monitored by operating businesses … and representations made to policy-setters where appropriate." Taylor Wimpey says it consults "with government agencies and opposition parties on housing policy, both directly and indirectly as a member of industry groups, to highlight potential issues and to understand any proposed changes to regulations." Utility firms Severn Trent and SSE also engage regularly with government and regulators both to understand policy developments and to make their views known

on the implications for their business and the sectors they operate in, while also contributing to public policy debates in other ways. Severn Trent has contributed to the establishment of OpenWater, which will oversee competition in the non-household retail market. This type of investment gives the company more credibility when dealing with public authorities. SSE has taken a more direct approach by setting out its own manifesto called "Proposals to deliver affordable, secure and low-carbon energy". These examples show there is a wide range of direct and indirect ways in which public authorities in the UK can be engaged and in which companies can contribute to and influence public policy debates.

Dealing with policy risk in multiple countries simultaneously is more complicated, as the approach must be tailored to local conditions. Some industries, such as airlines, face the dual challenge of influencing international and local regulations impacting on their business. In EasyJet's case it manages this through a Regulatory Affairs Group, which co-ordinates its efforts to influence regulations affecting the industry, alongside "country oversight boards" which raise "awareness of potential changes and impacts" in its main markets. Like many companies it uses industry bodies and advisers in-country to understand and develop appropriate responses to new legislation.

Pearson is one company that is expanding its global public affairs capability. It works with industry associations, policy research organisations and other advocacy groups. In the US it participates in advisory boards and is represented on standard setting committees. It is also collaborating with America's Promise Alliance in a campaign to raise high school graduation rates. Like SSE and Severn Trent in the UK this is at least partly about broadening the conversation that a company has with regulatory authorities and establishing credibility. The approach must, of course, be tailored to the company and the countries it is operating in, if it is to be seen to making a genuine contribution towards meeting public policy objectives.

Fiscal

The fiscal environment has faced two successive negative shocks that are impacting on firms. The first came in the aftermath of the 2008 crisis as many developed economies, including the UK and most European economies, introduced long-term austerity programmes to reduce fiscal deficits and public debt levels, with the burden shared between higher taxes and lower public spending. The second, which is more recent, is the impact that lower commodity prices have had on the fiscal position of many commodity producers.

These economic changes, which have led to profound fiscal policy pressures at the national level, have also had wider political implications and led to potentially far-reaching policy changes at an international level. As tax policy has become much more politically contentious, the tax practices of large international companies has come under more scrutiny. Particular controversy surrounds whether international firms with highly valuable intellectual property are able to exploit this to shift profits to low tax jurisdictions using practices that, while legal, may be objectionable both to tax authorities and the public in many countries. As a consequence, many governments are collaborating through the G20 and the OECD to agree new rules on tax transparency and prevent 'base erosion and profit shifting' (BEPS). The OECD estimates that between 4% and 10% of global corporate income tax revenues are currently being lost, amounting to $100bn to $240bn.[5]

[5] OECD/G20 Base Erosion and Profit Shifting Project Final Reports: Executive Summaries, 2015, http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf.

What are the risks?

Just under half of the firms that report fiscal risks do so in a formulaic manner, typically noting that while their tax bill is a significant factor impacting on the bottom line for shareholders it is largely beyond their control. However, almost a quarter of the FTSE-100 reports on specific fiscal risks that are more interesting.

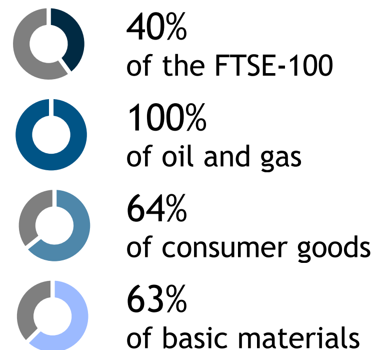
For a small number of companies, particularly in the defence sector, the main issue is not tax, but public spending. Both Rolls Royce and BAE Systems note the importance to their sector of defence spending, which has been under pressure in many countries in recent years.

Three financial companies identify default risk as an issue for them. Prudential notes that governments can use a "variety of techniques" to manage down their debt burdens, short of technical default. Old Mutual notes specific concerns about its exposure to the Zimbabwe government. Barclays' concerns are more general, but "may result in increased impairment charges".

Figure 15: fiscal risks in summary

42 risks reported in total:

Industry exposure:



40%
of the FTSE-100

100%
of oil and gas

64%
of consumer goods

63%
of basic materials

The biggest concern by far, accounting for over three quarters of fiscal risks, is tax. There are a number of specific concerns that companies have. Some firms in the extractives sector, including Fresnillo, are worried about the impact of lower commodity prices on the fiscal positions of the countries they operate in and what this means for tax policies. Some other firms worry about excise taxes. These range from the obvious, on a product like tobacco, to newer targets for taxation, such as sugar, which is a concern for Coca Cola.

The tax issue that is most frequently identified as a specific source of risk is, however, the changes to international tax rules that could emerge from the BEPS initiative, with ten firms identifying this. AstraZeneca is the most detailed in its assessment and notes that "changes to patent box regimes, restrictions on interest deductibility and revised transfer pricing guidelines" could all impact on the Group. Real estate company Hammerson worries that its sector "could be adversely affected by misdirected regulation designed to stabilise financial markets, such as the proposed OECD BEPS project." BAE Systems notes the issue, but is relatively relaxed and does not expect to be "materially impacted".

Lloyds Banking Group and L&G both note that further Scottish devolution could have implications for taxation. Under the terms of the Scotland Act (2016) the Scottish government obtains control over income tax rates and bands on non-savings and non-dividend income.

The sectors that are most exposed to fiscal risks are oil and gas, consumer goods and basic materials. The two sectors least exposed are consumer services and utilities.

How are firms responding?

Many companies note that they retain external advisors on tax matters and monitor developments in tax policy closely, as might be expected. Some note that they engage in “reasonable” tax planning around the world while some others have established statements of principle regarding the tax that they pay.

Few companies have much to say about whether and how they seek to influence tax policies. One that does is GSK, whose approach is similar to others that do. The company says it seeks “to maintain open, positive relationships with governments and tax authorities worldwide”, that it monitors “government debate on tax policy in … key jurisdictions to deal proactively with any potential future changes in tax law” and that “where relevant” it is “active in providing relevant business input to tax policy makers.”

Vodafone, which has an “ongoing dispute” with the Indian government over tax, takes a more active approach. It says that “authoritative and timely intervention is made at both national and international level in respect of legislative, fiscal and regulatory proposals” which Vodafone feels are “disproportionate and not in the interests of the Group.” Vodafone says it works with trade groups “to understand underlying political pressures” and that it maintains a “constructive but robust engagement with the tax authorities and relevant government representatives”.

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Annex: methodology

This report is based on a review of the annual reports produced by FTSE-100 companies for years ending in 2015. While BG Group published its financial results for 2015 it did not produce a full annual report so we have reviewed the company's 2014 report instead.

We have grouped companies into industries according to the Industry Classification Benchmark, which is also used by FTSE-100. However, we merged the four telecommunications companies and the two technology companies into a single 'telcos and tech' sector, because they have similar industry characteristics and include only a small number of companies. This gives us nine sectors in total.

We have examined the 100 company reports by scanning more than 15,000 pages for 45 key words, which we judged were best suited for this purpose. This allowed us to identify just over 300 political risks, which were then classified into seven categories. It is possible that there are additional risks which are described in ways that do not involve any of our key words and which have therefore not been identified by this approach.

The exercise has required judgement. Companies are often not specific about the political risks they face. We have therefore distinguished between specific risks, typically where there is a reference to a particular country or event, and generic descriptions of risk. This criterion has been applied flexibly as the context often matters when determining whether a risk is specific or generic.

Generic descriptions of risk are sometimes presented as a list and can often be categorised in several ways. We have tried to avoid using the same text to describe more than one risk within the same category. Instead we have used judgement to choose the most appropriate descriptor for the risk based on the context in which it is presented. In a small number of cases the decision has been somewhat arbitrary.

We have used a broad definition of political risk, which includes both what we term hard and soft risks. The latter relate to government policies, legal risks and fiscal risks. We only include risks that we judge to have a political dimension to them that is either explicit or implicit from the description or the context. We do not include risks that might be regarded as arising in the normal course of business in a stable and predictable political environment.

We have included some cyber risks in this report, but only where a link is made to political motivations, state actions or threats to critical national infrastructure. This means that the majority of cyber-crime risks reported by FTSE-100 firms are excluded from this report.

The full list of risks can be accessed through this link.

Global Counsel

Global Counsel

5 Welbeck Street, London, W1G 9YQ

T: +44 [0]203 667 6500

E: info@global-counsel.co.uk

W: www.global-counsel.co.uk

Lead author: Gregor Irwin, Chief Economist, g.irwin@global-counsel.co.uk

Additional authors: Thomas Gratowski and India Lucas

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