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Political risk: Not just the investor's affair*

by

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Political risk[1] is one of the most important risks that investors face in their transnational investments. There is abundant literature showing how political risk affects FDI by increasing the uncertainty faced by firms in a foreign location. Political risk consultancies are thriving, and tools to assess risks abound in the marketplace.

Assessing political risk is a necessary but not sufficient step. The key question is: how to manage and minimize risks. One sometimes hears the view that political risk is a matter for investors only: if MNEs want to invest abroad, they have to get proper advice on the legal structure of their projects and, if they view the risks as excessive, they can either not invest or buy political risk insurance (PRI). Due diligence is imperative, and insurance can help—although it has a non-negligible cost, covers only certain risks, caps recovery (and often limits recovery to "book value" rather than market value), and is not always economical to smaller investors.

More importantly, host country governments are not disinterested parties. Stating that this is not their concern is analogous to claiming that governments have no role in combatting the risk of fire, and that people should just buy an insurance policy. Governments can and should take many actions (e.g., sound forest management, firefighting capabilities, zoning, building regulations).

Similarly, addressing political risk should be a shared responsibility. Countries that want more FDI should make minimizing political risks an integral part of their strategy. What can they do?

A good starting point is trying to understand investors' concerns over political risk. Investor surveys are useful tools to translate a rather abstract concept into specific concerns. Surveys also show that, while some political risks are difficult for host country governments to foresee or control (war, terrorism, political strife), others result from government actions (adverse regulatory changes, breach of contract, expropriation, current transfer restrictions).[2]

This finding points to a first possible course of action: if host country governments can take these actions, they can also refrain from taking them, or at least be more careful about certain actions.

For instance, when governments need to expropriate investors, they should ensure that the four criteria for lawful expropriations are met (public interest, due process, absence of discrimination, fair compensation), paying special attention to how compensation is assessed. When changing laws or regulations that affect investors, governments should pay attention to the process: give proper notice to the business community, solicit comments, take comments into account, etc. Changing how host country governments behave toward investors and exercise their regulatory powers can be a first element in their strategy.

Second, countries can strengthen the legal framework that protects investors and its enforcement, including by:

- Concluding international investment agreements with strong investor guarantees.
- Signing major international conventions that foreign investors view favorably.[3]
- Strengthening the domestic judicial system, realizing that arbitration is not a panacea and that functioning judicial systems are indispensable attributes of the rule of law.

While some of the above actions specifically target FDI, strengthening the judicial system can benefit all investors, foreign and domestic, and should not be overlooked.

Third, states can implement an "Investor Grievance Management" mechanism to detect investor grievances at an early stage and resolve them proactively by empowering a lead agency within the government, using a range of techniques (including connecting the agency causing the grievance and the investor to facilitate a solution).[4] A best-practice example of such a mechanism is the Office of the Foreign Investor Ombudsman in the Republic of Korea. A well implemented Investor Grievance Management mechanism can prevent grievances from turning into full-fledged disputes between states and investors.[5] As disputes almost inevitably lead to the departure of investors,[6] this can help retain FDI long-term, which will help generate the most FDI benefits for host economies. The World Bank Group's advisory work supports developing economies to, at the same time, strengthen their investor protection framework and implement Investor Grievance Management mechanisms.

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[1] A broad definition of political risk views such risk as the probability that MNE operations will be disrupted by political forces or events. A narrower definition (used by the political risk-insurance industry) focuses on specific "insurable risks", e.g., currency convertibility, transfer restrictions and expropriation. Our team and this note use the latter definition.

[2] These findings emerged from two WBG surveys: the MIGA-EIU surveys (2009-2013) and the Global Investment Competitiveness (GIC) survey, 2017. PRI cover is narrow; for instance, adverse regulatory changes are usually not covered, unless changes amount to expropriation or transfer restrictions.

[3] Such as the MIGA, New York and ICSID Conventions.

[4] A forthcoming WBG publication will address how this can help minimize risks and retain investment.

[5] The IGM can complement, and even be part of, the general aftercare programs that many investment promotion agencies offer.
[6] Often, the mechanism will focus on more serious grievances (e.g., government conduct that could be interpreted as violating core investor guarantees), precisely because the risk of disputes is higher, with more severe consequences than other grievances or investment-climate issues.

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