“So foul a sky clears not without a storm.”

King John (William Shakespeare)

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Hayfin’s Chief Risk Officer discusses the limitations of traditional risk analysis when companies and economies are facing political uncertainty

So, it’s back. By which I mean no-deal Brexit rather than coronavirus.

That we are still talking about the prospects of no deal less than three months before the end of the transition period, and nearly four and half years after the EU referendum, is a political failure of colossal scale, on both sides.

I have discussed the reasons for this failure elsewhere. As I have the long-term benefits of Brexit – for both the EU and the UK.

However, whether you agree with my views on Brexit or not, what I wanted to do here was use the Brexit negotiations, as well as some aspects of the response to the coronavirus crisis, to illustrate certain issues around the unintended or unforeseen consequences of political events and their possible analysis.

It is obvious that no deal, a skinny deal or even a late deal (after 31 December 2020) will increase the friction costs of Britain’s exit from the EU, irrespective of the long-term benefits.

As a firm, we have analysed these costs at length – across the portfolios and for new investments. And we have done so many times, practically continuously, since before the referendum in 2016 through to the last-minute scramble in 2019 to put in place the Withdrawal Agreement (and the transition period) and up to today. So, it is no co-incidence that our exposure to the direct effects of Brexit[1] is small.

However, the unintended consequences of no deal are more difficult to analyse.

Take the British government’s Internal Market Bill. This is the proposed legislation dealing with the return of powers to the UK now that it is leaving the EU single market so as to ensure seamless internal trade between England, Scotland, Wales and Northern Ireland.

Much of the recent media excitement is focused on its breach of the Irish Protocol to the Withdrawal Agreement. I would suggest that the real risks of a problem at the Irish border are low. The issues are well known, analysable and both the UK and Ireland are strongly motivated to resolve any difficulties that might arise. Arguably, the introduction of the offending safeguards in the Internal Market Bill arose because the government recognised the implications of the EU imposing a hard border between Northern Ireland and Great Britain and that this was considered as great a threat to the peace process as the possibility of a hard border between Northern Ireland and the Republic. The concerns which apply to one border apply equally to the other, albeit that at the Irish border they are of more focus to nationalists and at the Irish Sea they are of more focus to the unionists.

The real risks of the Internal Market Bill – and of no-deal Brexit - lie elsewhere.

One is that they play to narratives of Scottish grievances against England and the case for independence. With the Internal Market Bill, the Scottish government claims it cuts across the devolution settlement, giving powers to Westminster that should be held within the devolved administrations (“Scots told what they can eat by England”). A similar grievance applies to Brexit itself – particularly if there is economic disruption following no deal – since a majority of Scots voted to Remain (“Scotland taken out of the EU against its will”). Also, since health is a devolved competence, the coronavirus pandemic has allowed Nicola Sturgeon, the Scottish National Party’s First Minister of Scotland, to present herself as a credible head of government leading her people through a crisis. The result is a very significantly increased chance of a second referendum on Scottish independence in the near future, especially if the outcome of the elections to the Scottish Parliament in May 2021 is a large SNP majority.

[1] Volatile £/EUR exchange rate, disruption to trade flows, impact of tariffs reducing margins and of regulatory obstacles to sell products or services

What do we make of this? For an investment firm, the risks of the direct consequences of Scottish Independence are analysable and can be mitigated. We have looked at it before, in 2014, the year of the first referendum. The heightened risk of another is why we continue to be cautious on financing businesses with significant exposure to illiquid sterling assets in Scotland and why we have very little of this exposure in any of the portfolios today.

What could be other unforeseen consequences of no deal?

Take fishing for example. It is not hard to imagine violent clashes between continental and British fishermen in UK waters, perhaps even deaths, and that the situation could quickly escalate, to clumsy enforcement action by the Royal Navy or to blockades of channel ports by French fishermen.

How do we analyse the impact of these? I have no idea.

Were we in a better position in relation to the coronavirus? Not really. This time last year we had not even heard of it. So, we had never assessed the performance of our credits or potential investments against the risk of a pandemic or, more accurately, the possibility that governments around the world would shut down their economies in response to it.

Now that we have seen what a coronavirus pandemic involves, we have become adept at analysing its direct consequences: which credits are immune or benefit from it, which are adversely affected and, of those, the scale of their cash burn/releveraging from lock down, the potential earnings' recovery curves which might materialise, our level of conviction in them and our consequential view of investibility.

Many of the unintended consequences of government responses to the crisis however are still too difficult to assess. For example, the real threat to the rule of law in Britain is probably not the Internal Market Bill but the arbitrary criminalisation of normally law-abiding citizens for spending time with their own families. This has become government by diktat, without any parliamentary scrutiny, and could lead to a systemic break down of law and order. Can we analyse that? No.

Each major political event then can be broken down into three categories.

First an analysis of its direct effects – every conscientious asset manager should be able to do that and articulate both an analytical framework and its results.

Second, you should think through possible unintended or unforeseen consequences of the event. Some of those risks are analysable and the investment process can take account of them (minimising exposure or pricing in the risk appropriately).

Some, the third category, are not analysable.

This should be no surprise. Stefan Zweig, that titan of 20th century European literature, observed that it is an iron law of history that those who will be caught up in the great movements determining the course of their own times always fail to recognise them in their early stages.

Which means it will not be possible to tell what kind of storm will clear the foul skies above us now.

King John's storm began with the death of his mother, the Plantagenet matriarch, Eleanor of Aquitaine. It could start for us in any number of ways. A small-scale military confrontation between Britain and France overfishing. The break-up of the UK or Spain. A terrorist incident. The re-emergence of the migration crisis. No one knows.

The only thing you can do as a creditor to protect yourself against these unforeseen events is to structure your deals with ample headroom against underperformance, strong documents and a proper security package.

This is why we always run a material downside on each potential investment, starting the day after the relevant purchase date, to provide high conviction in capital preservation in the reasonable worst-case scenario. The particulars of the downside don't matter; it is only the recovery of capital in those dire circumstances that does.

And that is how risk officers sleep at night.

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