Business strategy and political risk

Llewellyn D. Howell

Llewellyn D. Howell *is senior research fellow at the Pacific Asia Management Institute and director of the Vietnam Executive MBA program for the College of Business Administration, University of Hawaii at Manoa. He manages the UH EMBA program in Hanoi, Vietnam. He is also professor emeritus of international management at Thunderbird. A senior advisor for The PRS Group, he consults widely on political risk for investors, foreign policy issues and investment in southeast Asia. He was a Fulbright lecturer at the Malaysian National Institute of Public Administration, the civil service training arm of the prime minister's office. Howell is president and senior analyst of his own management consulting company Howell International Inc. He has authored numerous books and articles on the subject of political risk analysis, foreign policy and Southeast Asian studies, and is international affairs editor for USA Today Magazine. He received his Ph.D. in political science from Syracuse University, with related studies at the University of Michigan and Cornell University. He may be reached through his website www.political-risk.net.*

Too many businesses go into foreign countries knowing little or nothing about the political risk that exists or that may develop, said Professor Llewellyn Howell in his address to the Global Executive Forum.

"People know political, they know risk, they know assessment, so they think they know what political risk assessment is and what political risk analysis is," said Howell. "What I find is that people really don't have a clue as to how this all occurs and how it's used."

By itself, political risk is a broad term that doesn't begin to cover the variables that are incorporated into sophisticated forecasting models. In fact, there is a whole industry working on the ground in foreign countries, using time-tested methodologies to categorize weight and rate the different factors that comprise a risk forecast. Analysts make assessments based on historical and current data in each category and subcategory and how they interconnect in order to draw a picture of what the business environment is apt to look like in the short- and long term.

"There's no prediction here. We're always talking in probabilities."

The client company gets something like a weather report. "If a meteorologist tells you there's an 80 percent chance of rain tomorrow, you better take an umbrella. And that's what we try to do with our forecasts. What we're going to tell the client is that there's an 80 percent probability of civil strife in the area where you are operating with some chance of damage to your company. Therefore, you better take your umbrella."

Political risk insurance comes under that "umbrella." But, said Howell, "you have to understand what a political risk is before you can determine what your insurance needs are. You don't get just political risk insurance; you have to buy a specific type. For example, you need to know the situation well enough to know if you need civil strife insurance or if you need war insurance."

Political risk assessment is a big business and there are some well-known companies in the field, including The PRS Group, Business Environment Risk Intelligence (BERI), the Economist Intelligence Unit (EIU), and the International Country Risk Guide (ICRG).

"Corporations pay these companies to do assessments for them and to advise them on what action they need to take relating to the assessment. Do they need physical protection? Do they need to make political alliances? Do they need help negotiating with local tribes? Do they need insurance? If so, what kind, how much and how much should they be willing to pay for it? Or do they need to pass on a particular location altogether because the probabilities are that they will lose their investment?"

The point of political risk assessment is to make investments in emerging countries more feasible and more profitable. What the host countries get out of it is economic development, job creation and technology transfer.

"These governments want the investments. They want investors to feel safe and to be successful, and they try to shield them from some of the problems they're likely to face. They often will pay the cost of political risk insurance to woo a company to their shores."

OPIC, MIGA

Long term political and social stability in developing countries is an objective of OPIC - the Overseas Private Investment Corporation (see sidebar), and of MIGA - the Multilateral Investment Guarantee Agency of the World Bank (see sidebar next page).

Both agencies insure against currency inconvertibility, expropriation, and political violence. In addition MIGA insures against breach of contract should a corporation's profits be damaged due to a government unilaterally changing the terms of the contract.

OPIC has the power of the United States behind it, while MIGA's strength comes from the World Bank. "The real advantage of getting insurance from these two agencies is that foreign governments are reluctant to expropriate or act against properties they have insured for fear of the consequences."

Howell refers to this as impact insurance which is distinct from compensatory insurance. "The idea is that you don't want to get reimbursed at 90 percent of your equity. You want those local governments to leave you alone."

Assessment models

Although the goal is the same, there are differences in the risk forecasting models used by companies engaged in political risk assessment. ICRG, one of the best known, uses an attribute model that relies on characteristics of the government and the society to determine the level of danger to foreign investors. Each of the components is weighted in relation to its importance in the total attributes that contribute to risk.

Government Attributes

Government stability	12 pts
Investment profile	12 pts
Democratic accountability	6 pts
Law and order	6 pts
Military in politics	6 pts
Religion in politics	6 pts
Bureaucracy quality	4 pts

Business strategy and political risk

Llewellyn D. Howell

Societal Attributes

Internal conflict	12 pts
Corruption	6 pts
Ethnic tensions	6 pts
Socioeconomic conditions	12 pts

International Environment

External conflict 12 pts

The lower the score a country receives, the higher the probability of risk:

Very high risk	00.0-49.9%
High risk	50.0-59.9%
Moderate risk	60.0-69.9%
Low risk	70.0-79.9%
Very low risk	80.0-100%

At the end of 2002, The United States has a score of 76 on this model; China, 66; Costa Rica, 76, and Denmark, 90.5.

There are similarities among all the models, said Howell. "All of them have corruption, civil strife damage, ethnic tension and religion.

"The biggest area of payment is civil strife damage. The world has divided up into tribes since the end of the Cold War and they're all fighting each other. At any given time, there are 20-30 wars going on around the world. Almost all of them are internal, between two tribes, religions, or racial groups."

A country might not have many problems of its own but will lose points if it has a bad neighbor. "Israel is a trouble spot; therefore, neighboring countries are at risk. Proximity to a super power also is a bad-neighbor situation, and it doesn't matter which super power it is. Super powers think they need to control their backyards, sometimes through invasion."

Generally, companies have the wrong system for deciding where they're going to invest. "In most cases, the person who gets to scope out the territory is the vice president. He stays at a five star hotel, speaks English, eats at the hotel restaurants and doesn't learn a thing about the country. Then he comes back and gives the project a green light."

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Llewellyn D. Howell

Pirates, kidnappers the tough side of political risk

The "tough" side of political risk is piracy and kidnapping, said Howell. And law enforcement is weak in those parts of the world where the threats are highest.

Southeast Asia is one of three problem areas for piracy. "There are tens of thousands of pirates and thousands of pirate ships in the South China Sea and around through the Straight of Malacca and out into the Indian Ocean."

The other two areas are the east coast of Somalia, and the coast of Brazil.

Often, the men aboard pirated ships are killed, the women raped. But the pirates, if they are caught, are likely to get a free pass home. In one case Howell talked about, the oil tanker Petro Ranger was pirated and taken to a port off the coast of China. The pirates off-loaded the oil into smaller tankers and were refitting the ship to disguise it when they were discovered by port police.

"The Chinese eventually sent the pirates back to Indonesia because they didn't know what to do with them, and they never, to my knowledge, suffered any consequences."

What does this do to the cost of insurance?

"It drives it up. Any operation of any size ship that goes through these areas now has this added cost of insurance. So it's clearly an issue and it's a big problem."

South America is fertile ground for kidnappings, said Howell, "averaging about 200 to 300 a year if Colombia is excluded from the statistics.

"In Colombia the kidnappings average about 3,000 per year, with the main target being business executives who, when the ransom is paid, are worth their weight in weapons. So the kidnappings are political in that sense.

"At one point, the Colombian government was refusing to allow businesses to insure their executives against kidnappings because they said it was the same as having it written across your forehead: I'm paid for, kidnap me.

"I understand they're allowing it again, but I also understand the concern a government might have about anything that might encourage kidnapping."

OPIC - Overseas Private Investment Corporation.

An agency of the U.S. government, OPIC's mission is to facilitate U.S. private sector investment in the economies of less developed nations as part of U.S. foreign policy. To do this, OPIC provides political risk insurance up to $200 million, loans and loan guaranties, and financing of private equity funds. It also advocates for the interests of the American business community overseas.

Established more than 35 years ago, the agency is self-sustaining, funding its operations through fees paid on its insurance and financing products. OPIC produces a profit each year and reserves currently stand at more than $4 billion.

MIGA - Multilateral Investment Guarantee Agency of the World Bank.

MIGA was created in 1988 by the World Bank to promote foreign direct investment into emerging economies. To do this MIGA offers political risk insurance up to $200 million to investors and lenders, thus helping developing countries attract and retain private investment. As an international organization, MIGA acts as an umbrella of deterrence against government actions that could disrupt investments. The agency uses its legal services to further smooth possible impediments to investment. Through its dispute mediation program, MIGA helps governments and investors resolve their differences and ultimately improve a country's investment climate.