

BSM939

Risk and Uncertainty in Business

Lectures 7 & 8
Political and regulatory risk

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Political risk

Why does it matter?

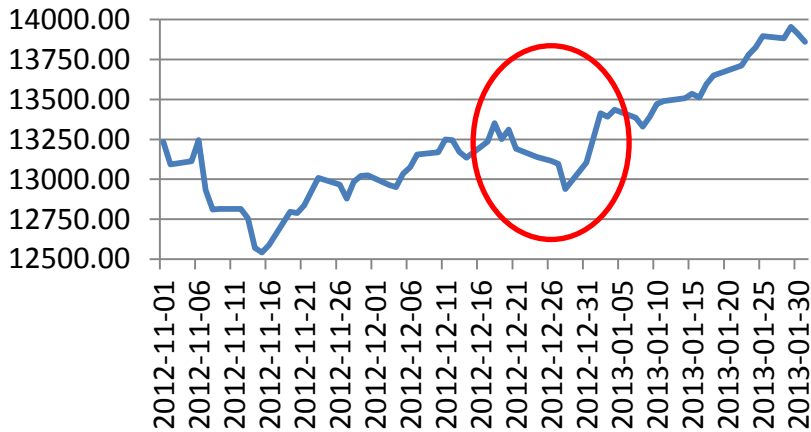
- Interconnected global markets
- Interventionist military and other policies
- Off-shoring and global supply chains
- Increasing dependence on energy

Examples

- “Venezuela will nationalize a fleet of oil rigs belonging to U.S. company Helmerich and Payne, the latest takeover in a push to socialism as President Hugo Chavez struggles with lower oil output and a recession.”
 - Reuters, June 24, 2010
- “Senate leaders and the White House struck a last-minute deal to avert the feared fiscal cliff Monday night, with Vice President Joe Biden headed to the Capitol Hill to pitch the plan to fellow Democrats. But the House of Representatives went home long before midnight, meaning nothing will get through Congress before the combination of tax increases and spending cuts lawmakers have been scrambling to head off starts to kick in, at least on paper.”
 - CNN, January 1, 2013
- “[Georgian Prime Minister Bidzina] Ivanishvili’s victory was the latest setback in the former Soviet Union for the U.S. And the EU, which backed [President Mikhail] Saakashvili’s Rose Revolution in 2003. Georgia, which borders Russia, Armenia, Turkey and Azerbaijan, hosts the BP Plc-managed Baku-Tsiblisi-Ceyhan and the Baku-Supsa oil pipelines as well as the Baku-Tsiblisi-Erzurum gas link.”
 - Bloomberg, January 31, 2013

Impact

Dow Jones Industrial Average



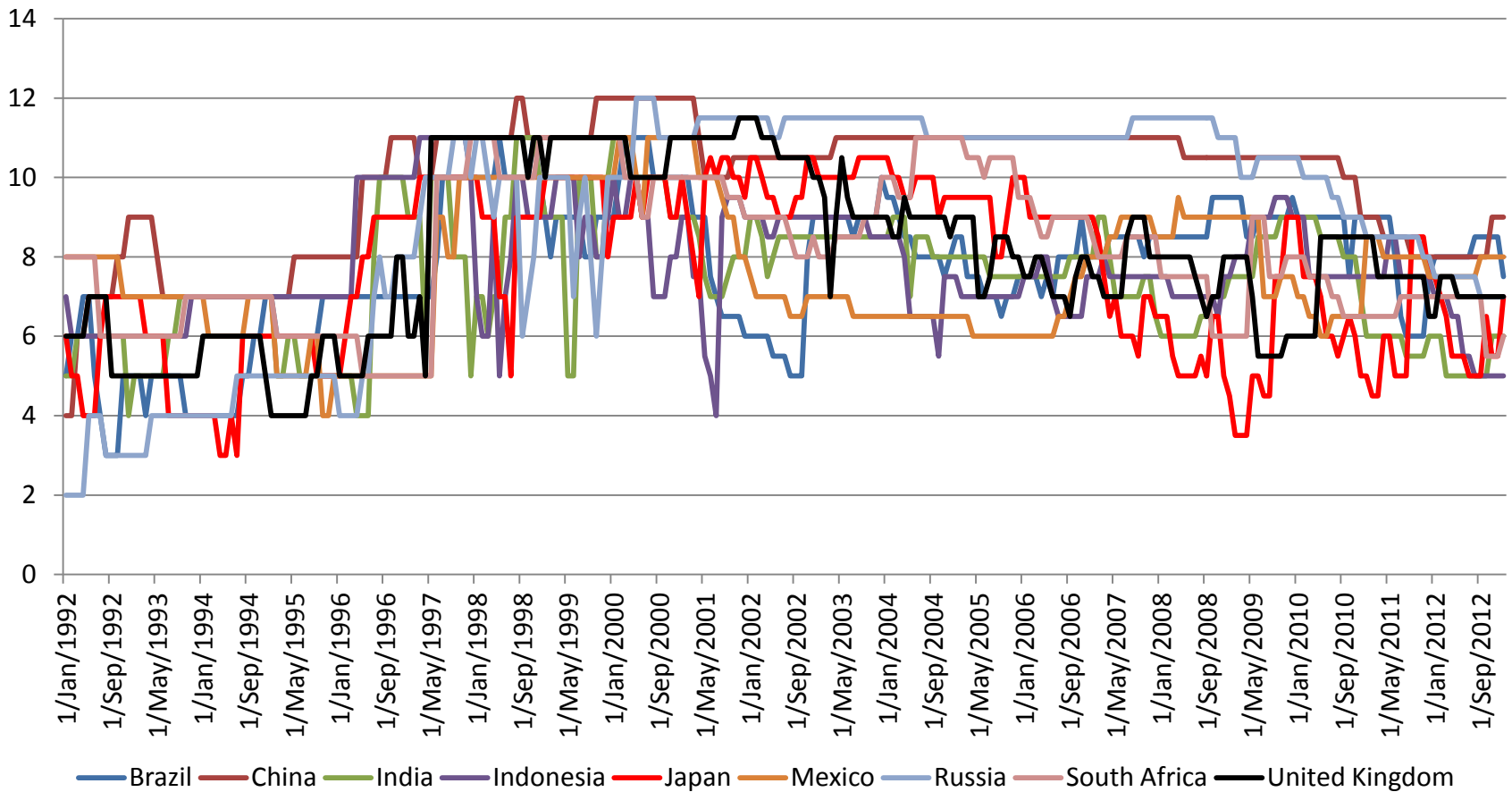
← Fiscal cliff in the USA

→ Trouble over land acquisition for Nano

Tata Motors

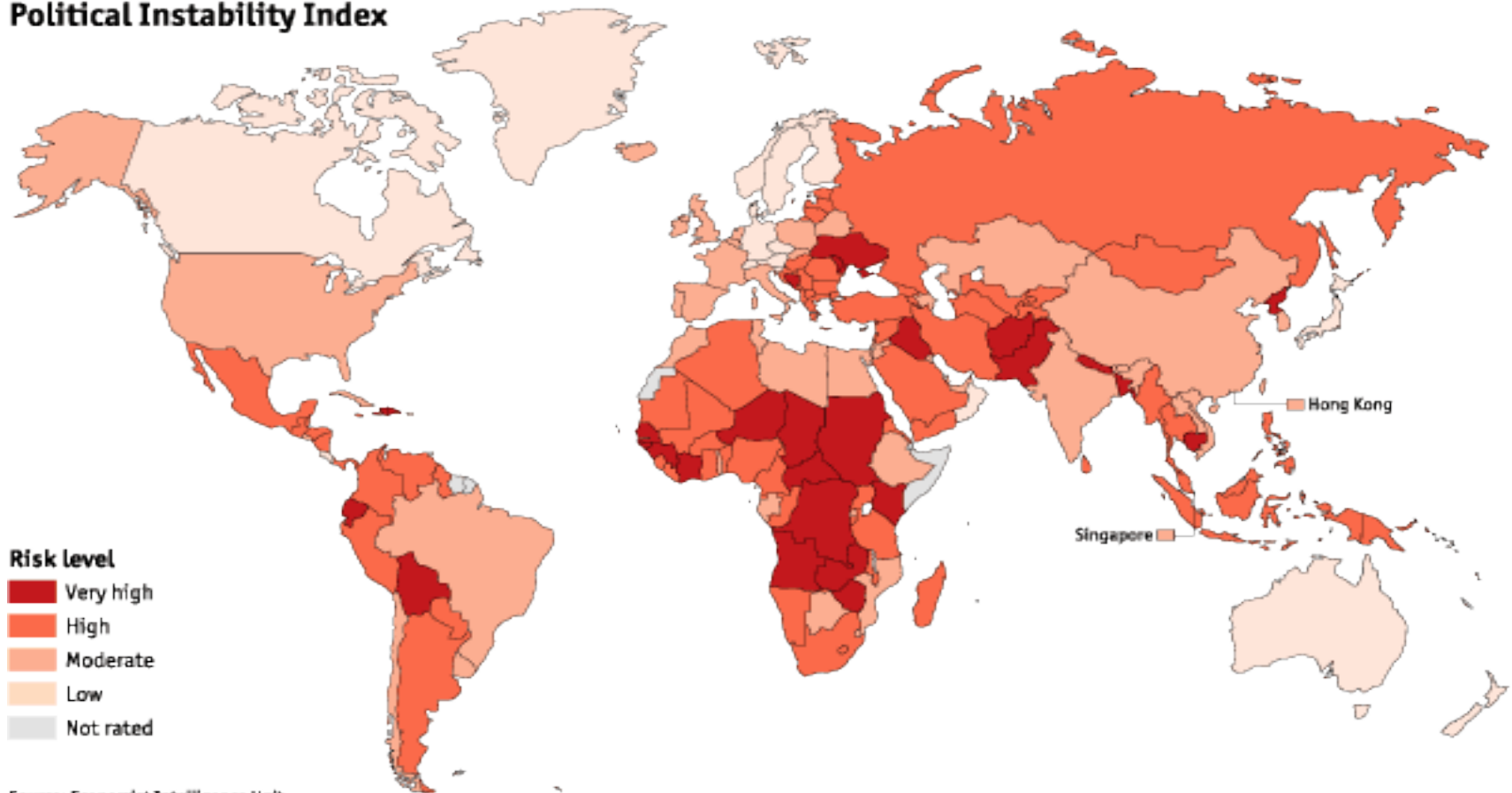


Dimension – government stability



Dimension – threat of social unrest (2009-10)

Political Instability Index



Source: Economist Intelligence Unit.

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http://viewswire.eiu.com/site_info.asp?info_name=instability_map&page=noads.

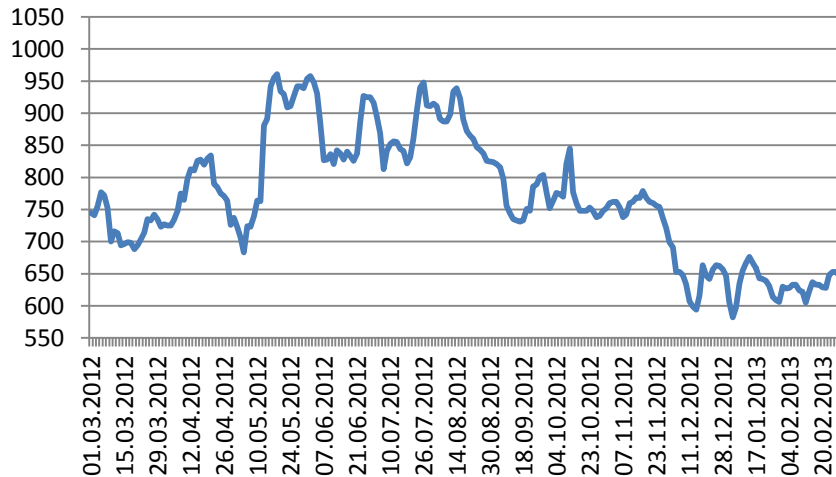
Threat – risk ignorance

- “Imagine a conversation. “So, your company is expanding its operations in country x, but I hear there is a lot of frustration among young people about unemployment. Are you worried about the possibility of political upheaval?” And the investor responds, “We’re not very worried about any instability. The current government has been in power for decades and we’re very well connected, so if there are any problems, we’ll be protected.” Without naming names, we can think about how this approach to risk management may have failed investors as of late, but such reversals of fortune predate the days of Twitter and Facebook – take the fall of the Suharto regime in Indonesia. At MIGA’s recent discussion this attitude toward risk was aptly labeled “risk myopia.” “
- “So, how are investors and advisors looking at risk more broadly? Two important indicators that risk- management specialists in the World Bank Group are now keeping an eye on are youth unemployment and the percentage of household income spent on food. Although it seems very obvious in hindsight, no matter how stable a country may be perceived on the world stage, a country’s underlying socioeconomic factors should be key elements in any country risk-rating model.”

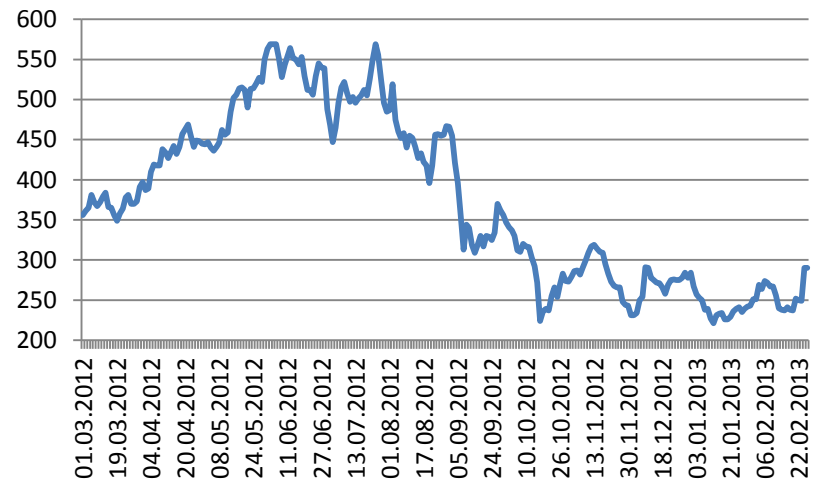
Mitigating political risk

Tracking political risk – market

Venezuela: CDS spread

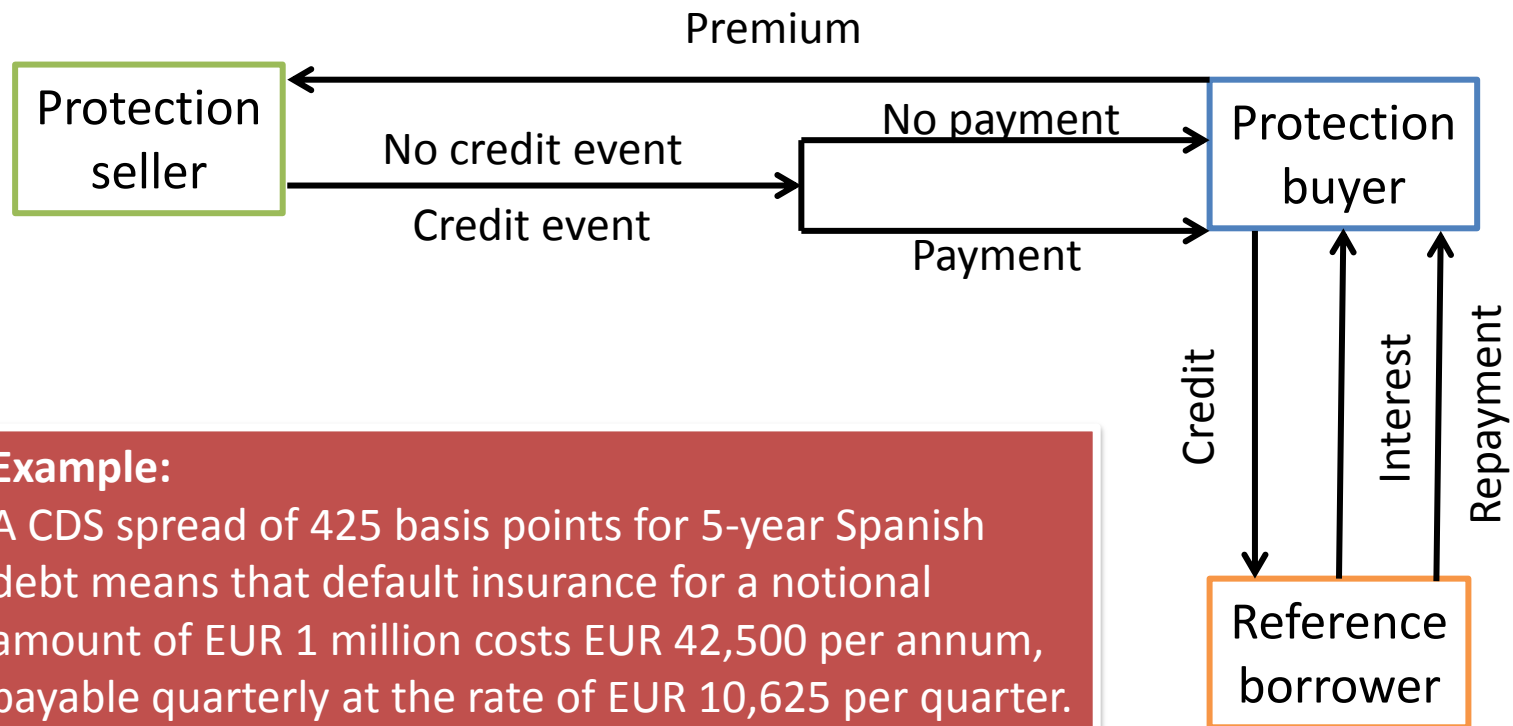


Italy: CDS spreads



Digression

Credit default swap



Example:

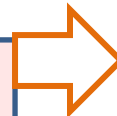
A CDS spread of 425 basis points for 5-year Spanish debt means that default insurance for a notional amount of EUR 1 million costs EUR 42,500 per annum, payable quarterly at the rate of EUR 10,625 per quarter.

Tracking political risk – internal

FACTORS AFFECTING STABILITY	STABILITY SCORES (0 - 100)			COMMENTS
	Jan 2005	Feb 2005	Mar 2005	
GOVERNMENT (such as strength of current government, rule of law, and level of corruption)	67	64	62	Political missteps by the government led to poor performance in state elections and strengthened opposition parties.
SOCIETY (such as social tension, youth disaffection, and health, education and other services)	58	58	58	Low per capita income and literacy lead to a low human development index. Simmering social tensions keep the society score low.
SECURITY (such as level of globalization, geostrategic condition, and emergencies and disasters)	53	48	48	Peace talks with Pakistan and China have eased security fears. But a Maoist insurgency in Nepal and continuing Kashmir violence keep the score low.
ECONOMY (such as fiscal condition, growth and investment, and external sector and debt)	75	75	76	Economic growth and expanding trade keep the numbers healthy. The fiscal deficit remains a worry.
Cumulative National Stability Score	63	61	62	

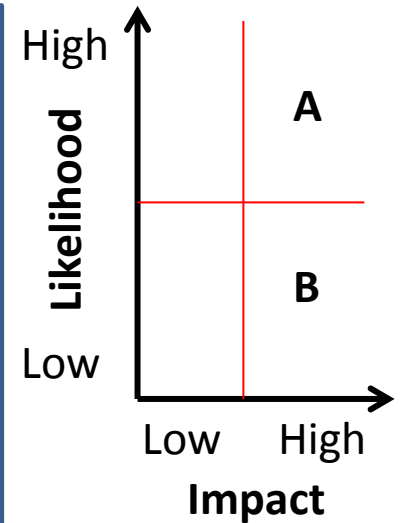
Process for stress testing corporate strategies

Trigger events	World
<ul style="list-style-type: none"> ◆ Upward revaluation of Chinese RMB ◆ Social unrest in China ◆ Skilled labour shortages increase 	China's growth slows down
<ul style="list-style-type: none"> ◆ US invasion of Iran ◆ Political turmoil in Russia 	High oil price
<ul style="list-style-type: none"> ◆ Avian flu 	Health pandemic



Translate each state of the world into a set of economic forecasts

- Description of the world
- Likelihood
- Policy responses
- Economic impact
- Impact on company



A: Model and quantify impact
B: Assess risks and prepare contingency plan

Source: Davis, N. et al. (2008). Shaping strategy in a highly uncertain macro-economic environment, McKinsey working papers on risk no. 8; Exhibit 3, pp. 5.

Risks and mitigation

Top 6 political risks of most concern to investors in developing countries

- Adverse regulatory changes
- Breach of contract
- Transfer and convertibility restrictions
- Civil disturbance
- Non-honouring of government guarantees
- Expropriation/nationalisation

Top 5 risk mitigation strategies by foreign investors

- Use of joint venture or alliance with local company
- Political/economic risk analysis
- Invested gradually while developing familiarity with the local environment
- Use of third-party consultants
- Scenario planning

Risk mitigation strategy

Entry mode choice by multinationals

	Greenfield	Acquisition	Joint Venture
Institutional quality	0.22 (NR)	0.13 (96%)	- 0.34 (NR)
Intangible asset need	- 0.26 (92%)	0.02 (99%)	0.25 (92%)
Tangible asset need	- 0.22 (91%)	0.01 (NR)	0.22 (91%)

Sample hypothesis: Institutional quality has no impact on choice of entry mode

Source: Meyer, Estrin, Bhaumik and Peng (Strategic Management Journal, 2009)

Entry mode choice	Costs
Greenfield	Search cost and cost of negotiating implicit and explicit contracts will suppliers, distributors , bureaucrats, etc.
Acquisition	Cost of renegotiating contracts with existing stakeholders
Joint venture	Cost of negotiating and enforcing contract with local partner

Predicting the likelihood of “political” events

Thought experiment

- Consider a country with 10 people. For each person, we have a score, a number that tells us how many people would have to join a revolution before he joins in himself. For example, if a person has the score 2, it means that 2 people will have to join in a revolution before he joins in.
- Scenario 1:
 - The country has the distribution $\{1, 1, 1, 1, 1, 1, 1, 2, 2, 2\}$
 - Will there be a revolution?
- Scenario 2:
 - The country has the distribution $\{0, 1, 2, 3, 4, 5, 6, 7, 8, 9\}$
 - Will there be a revolution?

Risk mitigation strategies

Case – Beiersdorf

- Holding and protecting property rights abroad
 - In the aftermath of WW-I, Beiersdorf started affiliate firms in Switzerland and Netherlands, countries that were neutral during the war. The main purpose was to retrieve trade marks from Britain which German firms would not have been allowed to repurchase.
- Use of overseas affiliates to evade certain jurisdictions
 - There was mutual lending between foreign affiliates, independent of German regulations. The main purpose was to evade the currency restrictions that were imposed by Germany in the summer of 1931.
- “Cloaking”
 - In response to the prevailing sentiments in Nazi Germany, Warburg held shares were converted into common stock and Jewish employees were transferred to the Dutch subsidiary in Amsterdam.