Managing Political Risk
- A contextual approach

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Abstract
Background: The world is turning into a global market place and multinational enterprises are as a consequence exposed to more and more risks of various kinds. One of these risks is political risk, which implicates the risk of negative effects for a company due to political actions. Even though it is possible that the political risk is managed differently depending on contextual factors, there is, as far as we know, little research conducted with the purpose of investigating this relationship. We would therefore like to compare a number of companies and situations in order to distinguish a pattern concerning what elements influence their political risk management and in what way.

Purpose: The purpose of this thesis is to investigate why companies manage political risk in a certain way as well as to determine how contextual factors influence the political risk management.

Method: We have investigated and compared the political risk management in ABB, Saab, Scania and Skanska. This has been done through interviews with one political risk manager and one project manager in each company.

Result: The risk management is greatly influenced by various contextual factors, such as the risk attitude of the company and the characteristics of the project.

Keyword
Political, risk, management, identification, analysis, response, contextual, politisk, risk, hantering

Table of Contents

1 Introduction

In the early nineties, Scania had sold and delivered a number of trucks to a Yugoslavian buyer, but before the company had received payment, the outbreak of war was a fact. Since the company was not reimbursed, the intention was to take the vehicles back. Unfortunately there was no registry system working in the country and the trucks could not be located. Scania contacted their insurance company who found out that the trucks were being used to transport ammunition from Eastern European countries to Belgrade. The cost of hiring Europool to find and take possession of the trucks would be larger than the profit. Instead, the insurance company chose to compensate Scania for their outstanding claim and the only loss for Scania came from extra administrative work.[1]

1.1 Background

The world is turning into a global market place. The internationalisation process began more than a century ago, but the development has accelerated during the last decades. For a small open economy, as Sweden, exports are especially important. Many Swedish companies would not survive without access to the large foreign market. As a consequence of the internationalisation, investors seek opportunities in new regions and markets. This is supported by the fact that world-wide private capital flows targeted at markets in developing countries more than quintupled from BUSD 44 in 1990 to BUSD 256 in 1997.[2]

At the same time as internationalisation and investments in emerging markets have increased, multinational enterprises are as a consequence exposed to more and more risks of various kinds.[3] One of these risks is political risk. It implicates the risk of negative effects for a company due to political actions. For investments and projects in third world countries, that often have instability and democracy problems, the political risk is often more important than for activities in the western civilisation. There is, however, political risk in almost all investments. Many companies do for example worry about projects in France, since the risk for strikes is considerable. Political risk can originate from a variety of different sources. Expropriation, currency controls, requirements for additional

[1] Interview, Political Risk Analyst, Saab
[2] Moran, 1998
[3] Oetzel et al., 2001

local production are just a few examples of political risk.[4] For example, shifts in political-economic ideology following an election may result in expropriation of foreign-owned firms, as was the case in Cuba in 1959 and in Chile in 1971.[5] Other examples of political risk include war, kidnapping, confiscation and trade embargoes.[6]

There are many factors that make it very hard to assess the probability of a political event. For example, not very many people had predicted the outbreak of war in Yugoslavia or in Kuwait. It is possible to statistically calculate the probability of a fire in a house, but there is no way to measure the exact chance of someone making a military coup d'état and what consequences that would have on a company's investments. This is one reason why political risk is different and harder to manage than most other forms of risk. Not only is the probability of a political event very uncertain, but the potential loss is also significant since the company might lose all their possessions and receivables.

1.2 Problem area

Due to the increased activity in developing countries, the process of risk management has become more important the last years. In order to evaluate the profitability of a project, it is of vital importance to take the risk factor under consideration. One definition of the term risk management is presented below.

> *"Risk management is a multidiscipline involving the identification and valuation of risks as well as controlling and financing any risk which is threatening life and property."*
>
> Hamilton, 1988, p.5

Risk management is consequently the entire process from identifying the risks and assessing them to actually respond to the various risks in one way or another. For a project in a third world country, the political risk is a major part of the total risk.

Political risk management is fundamental to the success of a project, but the variations in risk management practices are important.[7] One reason

[4] Shapiro, 1992
[5] Kobrin, 1982
[6] Hamilton, 1988
[7] Baker et al., 1999

for these variations is that political risk is hard to quantify and the evaluation of it is thus made in a more or less subjective manner. In fact, several surveys indicate that there are still a significant number of firms, which do not rely on any systematic means of assessing political risk.[8] The perception of the political environment is influenced by personal or organisational factors such as background and experience.[9] Often the political risk assessment is also affected by the upper-management's attitudes toward certain countries. Their opinions can be based on factors depending on the situation or context, including historic reasons and unpleasant business experiences. Even though it is possible that the political risk is managed differently depending on contextual factors, there is, as far as we know, little research conducted with the purpose of investigating this relationship. We would therefore like to compare a number of companies and situations in order to distinguish a pattern concerning what elements influence their political risk management and in what way.

Political risk can be dealt with in several ways. A company can hedge it either partially or completely, actively or passively monitor it, or not bother to hedge or monitor it at all.[10] The easiest way to manage political risk is through insurance companies specialised in the area. There are, however, alternative ways to protect a company against political risk, for example through risk preventive- and loss-limitation measures.[11] Another method is to form a partnership with one or several parties. Despite all these different methods of responding to political risk, many companies do not feel well protected against it. While more than 85% of the Fortune 1000 companies, surveyed by AM Best Company Inc in 2001, felt that they were well protected from most risks, such as property and general liability risks, only 21% considered themselves to be well protected from losses occurred by political events.[12] We would therefore like to investigate why companies manage political risk the way they do.

[8] de Mortanges & Allers, 1996
[9] Kobrin, 1982
[10] Political Risk Creates Need to Choose Strategy, 1998
[11] Hamilton, 1988
[12] AON Model Helps Determine Political Risk Exposures, 2001

From the discussion in this chapter we have identified two questions that we would like to answer:

- What contextual factors determine how the political risk is managed?

- How do different contextual factors affect the way companies manage their political risk?

1.3 Purpose

The purpose of this thesis is to investigate why companies manage political risk in a certain way as well as to determine how contextual factors influence the political risk management.

1.4 Research scope

This study will investigate political risk management in large Swedish companies. The reason for limiting the research to Swedish companies is that there might be cultural aspects influencing the political risk management. For example Harnett and Cummings found that Scandinavian, Central European and Greek managers were risk averse at the same time as American managers were the most risk taking.[13] Several other authors, such as Hofstede[14], have found that national culture can affect decisions in different situations.

Smaller companies are probably just as exposed to political risk, but we exclude these from this study since we estimate that they do not have the resources to work as actively with the political risk management as large multinational corporations. The study is further limited by the exclusion of political risk that the companies are exposed to in the home country. Interaction by the Swedish government can obviously affect the outcome of a foreign project run by a Swedish company.

We will investigate political risk in projects as opposed to operational activities. Based on inputs from Christensen & Kreiner, we define projects as: a temporary activity that has a specific goal to attain and a pre-determined date of termination for the accomplishment. Furthermore, the

[13] Harnett & Cummings (1980) in Bromiley & Curley, 1992
[14] Hofstede, 1980

role of a project does not involve a regular standard function in the company, but a specific situation.[15] The reason for the project approach is that operations through a subsidiary in a foreign country, which is an alternative to projects, implies different exposure to political risk. Costs and revenues are generated in local currency, which implies that there is no transfer risk. Furthermore, it is very hard to insure local subsidiaries against political risk.[16] It must, however, be pointed out that creating, for example a joint venture, can be considered a project if it has the necessary characteristics in terms of limitations in its time frame.

[15] Christensen & Kreiner, 1997
[16] Interview, Political Risk Manager, ABB

1.5 Readers guide

This guide is created to provide the reader with a structural overview of the thesis.

In ***chapter 1***, the reader is introduced to the background and problem investigated in this thesis, followed by the purpose and scope.

Chapter 2 is dedicated to an explanation of the methodology and scientific approach we used when writing the thesis. The chosen method is also evaluated in this chapter.

In ***chapter 3***, we present the concept of political risk. The section is structured using the risk management cycle.

Chapter 4, serves as an aid to the reader's pre-understanding providing information about various facts that the case companies refer to.

In ***chapter 5,*** the data gathered from empirical studies of the four case companies is presented.

In ***chapter 6,*** an analysis of the empirical data and the theoretical information is made using a structure based on chapter 3.

In ***chapter 7***, we conclude what was found in the analysis and provide an answer to the purpose.

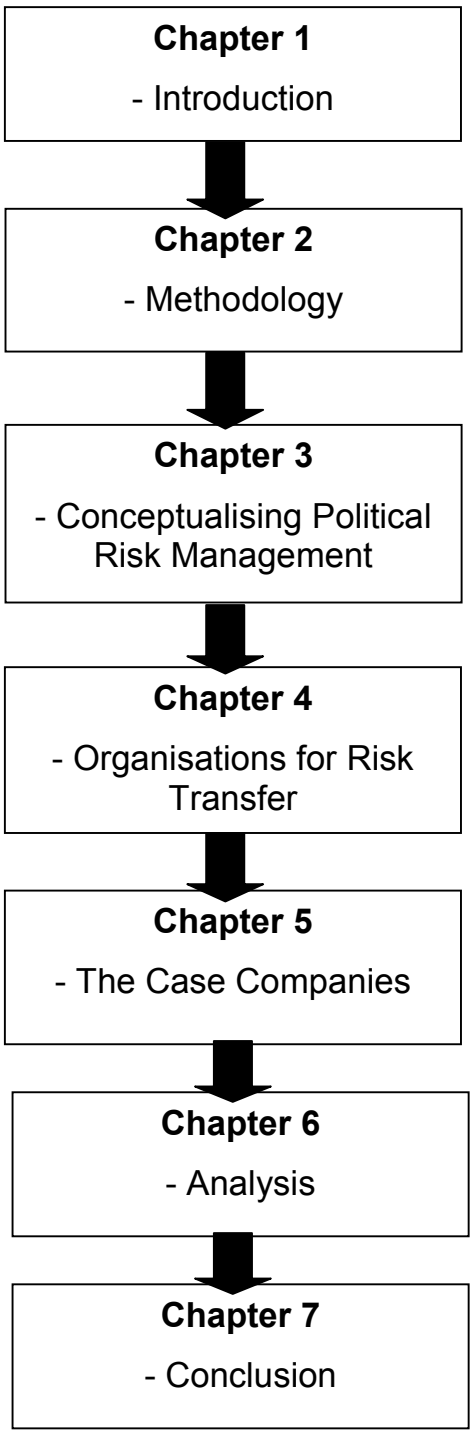

Figure 1.1 *Chapter Overview*

2 Methodology

In this chapter we describe how the problems defined in chapter 1.3 were approached. For the credibility of the thesis, it is necessary that there is a transparency in how the work has been carried through. Explaining the research method is important since it provides the reader with the possibility to understand how the data was collected and a justification to why we proceeded the way we did. We end this chapter by evaluating our choice of method and point out the strengths and weaknesses of using case studies as research approach.

2.1 Methodological approach

Methodology is an action plan for collecting, organising and integrating data in order to arrive at the result of the research. The choice of method is determined by the nature of the problem and the end-result that is wanted.[17] The goal of our research was to answer how and why companies use a certain way of managing political risk. The study was thus, per definition, made subjectively with interpretations based on our experience and pre-understanding. Through the interpretations we gain new knowledge which changes our perception of reality and thereby our pre-understanding. This phenomenon is known as the *hermeneutic circle*.[18] Another way to look at the process of understanding is to compare it with puzzle solving like Ödman. He claims that a puzzle cannot be solved unless you have an idea of the totality as well as the parts to make it up.[19]

Holme & Solvang emphasise the importance of choosing the method that corresponds the best to the purpose or problem of the investigation.[20] The problem we wanted to investigate, i.e. why companies manage their political risk in a certain way, was complex and required much flexibility when collecting data. It was not possible to find the information needed in previously published material and we did not judge it feasible to acquire all the information from a quantitative survey. We would not have understood the political risk management process in the investigated organisations without the possibility of interactivity and asking follow up questions. We therefore chose a qualitative method for our research. Qualitative research is by Strauss & Corbin described as "*findings not*

[17] Merriam, 1988
[18] Patel & Tebelius, 1987
[19] Ödman, 1991
[20] Holme & Solvang, 1991

arrived at by statistical procedures or other means of quantification"[21]. According to Holme & Solvang, a main advantage of the qualitative method is its ability to show a totality of various variables and therefore give increased understanding of contexts and relations.[22] This corresponds well to how our problem is formulated since it requires an understanding of how a large amount of variables interrelates.

2.2 Case studies

Our research bears many of the characteristics of what Strauss & Corbin calls a "grounded theory" approach, in the sense that we attempt to build rather than test theory. We have been systematic and creative simultaneously and we have identified, developed and related the concepts that constitute the building blocks of theory.[23] We do, however, refer to our study as being a case study since it is the terminology used by most of our references. Furthermore, according to Stake:

> *"Custom is not so strong that researchers (other than graduate students) will get into trouble by calling anything they please a case study."*
>
> Stake, 1994, p.237

We are however aware of the fact that our study does not correspond fully to the demands of a case study, concerning the depth and length of the investigation, but it does still bear many characteristics of such a study. Yin defines a case study as:

> *"an empirical inquiry that investigates a contemporary phenomenon with its real-life context, especially when the boundaries between phenomenon and context are not clearly evident"*.
>
> Yin, 1994, p.13

Case studies should not be confused with qualitative research. The reason is that case studies can be based on qualitative and/ or quantitative data.[24] Our thesis is, however, limited to the use of qualitative

[21] Strauss & Corbin, 1998, p.10-11
[22] Holme & Solvang 1991
[23] Strauss & Corbin, 1998
[24] Yin, 1994

evidence. Zikmund claims that the purpose of a case study approach is to obtain information about multiple variables from a few situations that are similar to the researcher's problem area.[25] Since our problem was multidimensional, requiring a number of variables to be understood and explained, this reinforced our conception that a case study was the most appropriate research strategy for us. We had no pre-defined limits to the number of parameters we wanted to investigate, but tried to take in all the variables that we found affected the risk management process. We wanted to describe the reasons for the design of our companies' political risk management process and to explain the interaction of the variables. Typical for qualitative case studies is the discovery of new understanding and concepts. Traditional quantitative studies are on the contrary focused on verifying predetermined hypothesises. Our purpose was not to test a theory, but to investigate how the political risk is actually managed and the reasoning behind the procedure. We therefore had to start with the information obtained from the study and try to produce a theory from that information. This signifies that we used a method that bears similarities to the inductive principle, which implies that generalisations, concepts and hypothesis arise from the information obtained in a study.[26]The intention of our study was to investigate why companies manage the political risk in a certain way and how different contextual factors affect the management. The most important reason for us to relate our investigation to the principles of case studies, is that both Saunders et al.[27] and Yin[28] claim that it is a suitable approach to answer the questions "why", "what" and "how". The two latter can sometimes be answered by a survey rather than interviews. In our case, it would however not have been possible to answer how contextual factors affect the political risk management using a survey since we did not know which factors would be relevant to evaluate. These arguments partially explain why we based our data collection on interviews.

Conducting interviews was the most natural way for us to obtain enough understanding of the problems to understand how different variables interact with each other. Empirical evidence has to a dominant extent been gathered by interviewing a limited number of representatives from the Swedish export-oriented industry. The nature of the research problem

[25] Zikmund, 2000
[26] Merriam, 1988
[27] Saunders et al. , 2000
[28] Yin, 1994

was somewhat complex since we wanted to answer why the political risk is managed a certain way and there was an important amount of influential variables. We consequently needed the flexibility and interactivity that interviews allow for. The ability to complement questions with explanations, observations or discussions proved invaluable in our study. The problem also required that the companies were willing to share sensitive information with the writers. We found that the best way to get our hands on the required information was by gaining the confidence of the selected companies. Trust has been built on close communication with the host companies through the establishment of personal contacts. This is also an important reason why we chose to use interviews as our principal tool for collecting empirical data. Trust can not be obtained as effectively by survey investigations where the personal interaction is kept at a minimum.

2.2.1 Sampling

How many cases are needed for an investigation is according to Yin, a subjective judgement since case studies do not require the same sampling logic, as do quantitative surveys.[29] Our thesis is built on, what Yin refers to as, a multiple case study where several Swedish companies each have served as individual cases. We have chosen to investigate four companies. Multiple case studies obviously require much time and resources, which are major issues in almost all research and the most delimiting factors for our study.[30] The reason to look into several companies was to find patterns or differences in order to better understand why companies manage political risk in a certain way. We had no intention to make a statistical sampling, but chose from the companies we believed would have a formal process for managing political risk, which corresponds to what Glaser & Strauss[31] refer to as theoretical sampling. According to Strauss and Corbin, theoretical sampling is suitable when investigating new or unexplored areas, since it improves the possibility of comparing data in order to identify similarities and differences, which simplifies a categorisation of the material.[32]

In qualitative case studies, the selection of cases and interviewees is very important as it determines the value of the information received and

[29] Yin, 1994
[30] Yin, 1994
[31] Glaser & Strauss (1968) in Eisenhart, 1989
[32] Strauss & Corbin, 1998

serves as a foundation for the understanding of the phenomena being studied. The selection of case companies should therefore not be made randomly but systematically, depending on certain pre-determined criteria.[33] However, the researcher has to make a selection of what aspects to study since it is practically impossible to observe everything. Schatzman & Strauss claim that selective sampling is a practical necessity and even mandatory from a theoretical perspective. The sample is determined by a number of issues, including the time available, the background and interests of the researchers and restrictions from the selected cases.[34]

2.2.2 Theoretical contribution

Keating classifies case studies into three categories depending on the objective and nature of the study. *Theory discovery studies* have an open-ended character and are appropriate when the aim of the investigation is to look for new perspectives on existing theories or describe phenomena that have not previously been theorised. Such a study should somehow point out where the gaps are in the current knowledge and how the own research relates to the existing research programs. *Theory refinement* comes in two different flavours: either as illustrative studies looking at a phenomenon in a new or better way or as theory specification seeking a refinement of an existing theory. *Theory refutation* cases aim at proving theories wrong, based on evidence from the chosen case .[35] According to Keating's classification, our method is best described as a theory discovery case study. What we want to achieve with this thesis is to create new understanding of why political risk is managed in a certain way. We hope that our findings will stimulate others to carry on the research even further. As far as we know this is an area that has not previously been investigated and our study would therefore contribute with novel material to the creation of new theories. These are all arguments corresponding to what Keating considers to be characteristics of a theory discovery study.

2.3 Practical procedure

Data for case studies can originate from six different sources: documents, archival records, interviews, direct observations, participant observations

[33] Holme & Solvang, 1991
[34] Schatzman & Strauss, 1973
[35] Keating, 1995

and physical artefacts.[36] For practical reasons we have limited our data collection to two methods, using interviews and document studies.

2.3.1 Choice of companies

The companies were chosen with help from several academics at the University of Linköping. The main criteria we had when choosing companies was that they have projects in third world countries and that they are large enough to have developed a method for handling the political risk affecting each project. The companies chosen were ABB, Saab, Scania and Skanska. These companies represent a wide variety of Swedish export-oriented companies. Our intention was, however, not to draw any general conclusions but to explain the patterns we saw in the process of risk management in the chosen companies. Our objective was to obtain thorough, in depth information from the selected companies and not to talk to as many companies as possible. We changed our sampling strategy during the process of writing this thesis. From the beginning we wanted to concentrate solely on the strategic perspective of political risk management. Having finished the collection of relevant data we found it necessary to put it into perspective with a more operational view of political risk, since we wanted to cover a large number of variables and obtain input of different perspectives within the companies. We therefore made supplementary interviews with all of our case companies. Our sampling procedure is similar to what Strauss & Corbin refer to as theoretical sampling. Theoretical sampling means that the sampling is not predetermined but evolves during the research process. The purpose of this technique is to take advantage of the possibilities of comparing data in order to see how it varies depending on properties and dimensions. Theoretical sampling is cumulative as events sampled add to the previous data and analysis. It demands a certain flexibility in order to be able to take advantage of emerging events during the research. Before the investigation starts, the researcher can reason about the likelihood of finding relevant information in a certain company and make the sampling accordingly. [37]

Furthermore, we interviewed an employee at the Swedish Export Credits Guarantee Board, EKN. The reason for the interview was that EKN is the largest organisation for political risk insurance in Sweden and all of the case companies use EKN as a means of responding to political risk.

[36] Yin, 1994
[37] Strauss & Corbin, 1998

Beside the specialised insurance companies, banks are the market players who work the most with political risk issues. We were told by several of our case companies that SEB has the most developed process of political risk management and we therefore chose to interview them as well. It should be pointed out that EKN and SEB are not case companies, but only provided us with information about political risk and the different possibilities to handle it.

2.3.2 Choice of interviewees

In total we have conducted ten interviews with representatives from six different companies. We chose the first interviewee in each company simply by calling the company and asking for the person in charge of the political risk management. Even though we had to spend much time on the phone before being connected to the appropriate extension, this method worked very well since there is, in most companies, only one person who works primarily with political risk. It turned out that the political risk manager in most cases works at the finance or treasury department. In one case, there were a few people who worked with political risk and we then chose to interview the manager of the department, presuming that he was the most involved in the reasons for the company's political risk management method. All the interviews were held in Swedish and we later translated the information to English. As was previously mentioned, we eventually realised that we needed additional information from a second source. We then got back to the interviewees for suggestions on whom to speak to. Our intention was to hear about the political risk from another angle than the financial one and we therefore wanted to talk to a project manager or someone who had another view of the risk management. This way we could assess the companies' view on political risk both from a strategic and a more operational perspective. At EKN, we got in touch with an expert on country risk assessment in third world countries. Concerning SEB, we were fortunate enough to be granted an interview with the senior country analyst, a man who many of our interviewees claimed to be the leading Swedish expert in this area. We only held one interview concerning each of these two companies, since the purpose of the interviews was primarily meant to improve the understanding of different methods of responding to political risk.

2.3.3 Realisation of the interviews

A few days before the interviews, we sent the interviewees a guide of the general questions we wanted to treat. This worked out well since it allowed them to prepare and think through aspects such as why the political risk management is made in a certain way. The same question template was used for all interviews in order to obtain comparable information (for the treated topics see appendix 1). Most of our questions were fairly general and served as a base for discussion. Our interviews were semi-structured, since the interviewees were given much freedom to interpret the questions depending on his own opinions, experiences etc. An interview is highly structured if the interviewee is not given any room for interpreting the questions.[38] The order of which the questions were answered varied greatly, since many questions were answered without us having to ask them. The precise formulation of the questions also changed slightly from one interview to another, since most of our questions were meant as a base for discussion and did not require us to formulate them identically in each case. Consequently, our interviews had a rather low degree of standardisation. The standardisation depends on the extent to which the interviewer is free to decide the composition of the questions and in which order they are asked.[39]

With permission from the interviewees, we taped all the interviews so that we would be able to type them and, if required, listen to them again. This procedure also helped us to be more alert during the interviews, since we were not forced to take extensive notes. Furthermore it is almost a prerequisite to have taped an interview if one later wants to cite a response. During all interviews both of the authors were present, even though one had the main responsibility for asking questions. Five of the interviews were conducted face to face and the other five were made from a conference phone. There were two reasons why five were not done face to face. Some of the interviewees preferred a telephone interview and some of the interviewees simply were to far away for our resources regarding time and money. The length of each interview varied from 30 to 90 minutes, depending on the talkativeness and knowledge of the interviewee. A general observation was that the interviews conducted on the phone were shorter than the ones conducted face to face. Before publishing our thesis, we sent the interviewees the parts of the thesis that were based on their interviews. They were asked to confirm that we had

[38] Lekvall &Wahlbin, 1993
[39] Lekvall &Wahlbin, 1993

correctly interpreted their responses and could also withdraw information that they did not want published, although none of the interviewees exercised this option. We always asked each interviewee for permission to quote him or her and also if we could refer to the case company by its actual name. Given the sensitive nature of some of the information we got, most of our interviewees saw it as a prerequisite to be allowed to proof-read the material.

2.3.4 Secondary sources

Even though our main source of empirical data has been interviews, secondary sources have played an important part as well. From the companies investigated we have for example received various published and unpublished material such as corporate policies and annual reports. Secondary data has further served as a basis for our understanding of the investigated problems as well as a source of inspiration throughout the work. The secondary data used in this thesis does to a large extent origin from the article databases supplied by the university library in Linköping. We have also borrowed books from the same library and from several other university libraries in Sweden and Norway, when the resources in Linköping were not satisfying.

2.4 Evaluation of method

It has of course been our intention to only write accurate facts in the thesis, but we have been forced to take many method decisions and there could have been better ways to do parts of our study. There is no such thing as a perfect choice of methodology. For this study we are quite certain that it has been most appropriate to work with case studies, but at the same time it has some downsides. One of the main drawbacks of case studies is that they can over-simplify or over-estimate variables in a given situation, which consequently affects the reader's possibility to draw conclusions from the study.[40]

Case studies are sometimes criticised for not providing a real basis for scientific generalisation.[41] We do not see our case companies as representing a sample of a population, nor do we consider the results of the study to be statistical generalisations about an objective reality. Our

[40] Merriam, 1988
[41] Yin, 1994

contribution lies in the enhancement of the theories concerning a specific phenomenon.

2.4.1 Validity

Validity is a measurement method's ability to measure what it is meant to do.[42] It implicates that the observations reflect the variables that are of interest for the research.[43] The theories we have based our analysis on are mainly American. They can not be totally independent of the cultural context and may therefore have influenced our understanding of the topic political risk management. Another reason to question the validity of the study is that a large proportion of the literature, on which it is based, is more than 20 years old. The world has changed since then and so has consequently the political risk situation. Furthermore, it is possible that the information we obtained from the interviews was biased or incorrect. This possibility is however reduced by the fact that we interviewed two people at each case company and that we sent them a transcript of the interview for revision.

Strauss & Corbin claim that a researcher has to continue to sample until each of the studied categories are saturated, or else the theory will be lacking density and precision.[44] We are quite aware of the fact that we have not been able to reach far enough in our research to achieve real saturation and did therefore not meet the demands for a complete theoretical sampling. Given the nature of our problem together with the time and resources we have had at our disposal, it has not been a realistic target for us. For each additional interview we have made, the amount of novel information has, however, decreased significantly and the purpose of our research does not require us to go further.

2.4.2 Reliability

Reliability has to do with the degree of precision of the measurement. The same measurement, performed at a different time or by a different investigator, should not vary if reliability should be considered as high.[45] This is more easily achieved for quantitative studies and we have to agree with Strauss & Corbin when they claim that it is virtually impossible

[42] Widersheim Paul & Eriksson, 1997
[43] Kvale, 1997
[44] Strauss & Corbin, 1998
[45] Carlsson, 1991

to reproduce social phenomena because of the difficulty of controlling all the variables and replicate the original conditions. [46]

Merriam has identified three main issues affecting the reliability of an investigation based on interviews: the personality and skills of the person conducting the interview, the respondent and the interview-situation in itself.[47] We interviewed two people in each case company and, even though there are not very many people working with political risk in each company, it is possible that their answers did not fully correspond to the reality. For different reasons, the interviewees may have kept data for themselves or distorted information. Another reason to question the reliability of our study is that five of the interviews were conducted over the phone. This is not as good as interviewing face to face, since it is not possible to see the other person. It is therefore possible that we would have acquired additional and more accurate information if we had conducted all the interviews face to face.

Qualitative case studies are by nature exposed to the subjectivity of the researcher. Guba & Lincoln even claim that an unethical researcher can choose among available qualitative data to arrive at practically any result he wants.[48] Since there are no clear-cut procedures of how qualitative data should be analysed, the result depends on the sensitivity and experience of the person conducting the study.[49] Our interpretations when interviewing and reading material, may have been influenced by our backgrounds, opinions and values and we can consequently identify ourselves with the hermeneutic Habermas who claims that there is no such thing as an objective social science, free from valuations. According to him, scientific work has to be coloured by the norms or values that it is built from and that the importance lies in identifying them and defining the affects they will have on the study.[50] The authors have a common background that has previously introduced us to the concept of risk and risk management. Our pre-understanding of the concept has, however, changed significantly during the period of gathering empirical data. Our changing pre-understanding has obviously influenced us both in our choice of related literature and in the choice of case companies, which could potentially lower the quality of the analysis. Since we are coloured

[46] Strauss & Corbin, 1998
[47] Merriam, 1988
[48] Guba & Lincoln (1981) in Merriam, 1988
[49] Merriam, 1988
[50] Holme & Solvang, 1991

by our business studies, it is possible that we have searched for economical explanations where others would have focused on different aspects.

3 Conceptualising Political Risk Management

In this chapter we describe the theories and models that will be used to analyse the political risk management process of the chosen case companies. We describe different views on the term political risk and the process of political risk management. We will use the risk management cycle in order to provide a structure to the chapter and the thesis.

3.1 Risk

Companies face various risks in their daily business. There can be physical dangers like fires or accidents, but also risks that are harder to measure such as lawsuits or raised taxes. One considerable risk when investing abroad, and especially if the investment takes place in a developing country, is the political risk. In this section we attempt to clarify several risk expressions. First the difference between risk and uncertainty will be treated, then risk attitude and finally the concept of political risk will be dealt with.

3.1.1 The risk and uncertainty concepts

Risk and uncertainty are abstract concepts that are difficult to measure with precision. Raftery provides the following definition:

> *"Risk and uncertainty characterise situations where the actual outcome for a particular event or activity is likely to deviate from the estimate or forecast value"*.
>
> Raftery, 1994, p.5

To be able to clarify our use of the expression "political risk", it is necessary that a distinction is made between risk and uncertainty. A decision is called *risky* when the probability that an event will occur in the future is precisely known, for example in a fair roulette game. In contrast, a decision is called *uncertain* when the probability is not precisely known. Examples of such situations, are the outcomes of sports events, elections or most real investments. Decisions under risk can be seen as a special case of decisions under uncertainty with precisely known probabilities. Risk and uncertainty can be distinguished by the degree with which probabilities are known. In case of uncertainty, probabilities are not precisely known but people can form more or less vague beliefs about

them. [51] Uncertainty thus indicates a greater unknown than risk.[52] Thunell claims that uncertainty exists when a decision-maker does not know the objective probabilities for all possible outcomes of an event as opposed to risk. He further states that with the exemption of the simplest decisions, it is always uncertainty that is at hand.[53]

Risk can be defined as the probability that an outcome will be unfavourable.[54] There are sceptics who claim that the word risk is too associated with negative effects. Many definitions only consider risk to cover the possible negative outcome, such as:

> *" 'Risk' means the danger that a random event will affect negatively the possibility of attaining the desired goal."*
>
> Hamilton, 1988, p.10

Miller & Lessard give a more neutral definition, claiming that

> *"Risk is the possibility that events, their resulting impacts and dynamic interactions may turn out differently than anticipated".*
>
> Miller & Lessard, 2001, p.438

Risk is considered to be of a more quantitative nature than uncertainty. Raftery describes risk as the occurrence of a certain event that it is possible to statistically assess the probability of. This quantification can be illustrated with a simple formula: *Risk = Probability of event * Magnitude of loss/gain.*[55]*.* We will use the expression "risk exposure" when referring to the maximum magnitude of loss for an individual company.

The probability of the occurrence of a political event is not possible to calculate statistically, due to its unsystematic nature. It would therefore be logical to call this concept uncertainty instead of risk. On the other hand, political risk has become a well-known expression for this phenomenon. We have consequently chosen to use the term political risk even though it is impossible to calculate a credible statistical probability. Furthermore, we will only discuss the possible negative effects of political events in

[51] Herring, 1983
[52] Raftery, 1994
[53] Thunell, 1977
[54] Clark & Marois, 1996
[55] Raftery, 1994

accordance with many definitions of the risk concept. The reason is that focus in risk management lies on minimising unfavourable outcome of events.

3.1.2 Risk attitude

One important factor that contributes to form the attitudes of individuals or organisations towards risk, is the perception of risk and benefit of a decision.[56] *"Any decision about risk will be affected by the attitude of the person or organisation making the decision."*[57] It is therefore of great interest for a company to direct its staff to make decisions which are consistent with the risk attitude of the firm.[58] Even though the risk attitude is very important when making decisions, few decision-making techniques take this into account.

> *"The evidence strongly supports a conclusion that risk taking varies across populations and situations, but as yet does not give us strong guides as to how it varies".*
>
> Bromiley & Curley, 1992, p.121

In practice, most monetary decisions involve a combination of influence from direct factors and attitude preference. The direct factors being for example to choose the cheapest out of two alternatives with all other factors being equal.[59] Flanagan & Norman classify firms into three groups: Risk loving, risk averse and risk neutral. Risk loving implies a person or organisation that takes on much risk on the expectation of higher return and risk averse is the contrary. A risk neutral person or organisation is one who treats risk and reward on an equal basis.[60]

Raftery states that a large proportion of business people is highly risk averse.[61] There are many different factors that can influence the risk attitude in a company. Harnett and Cummings studied 550 managers from Europe and USA in 1980. As was previously explained, they found that Scandinavian, Central European and Greek managers were risk averse at the same time as American managers were the most risk-

[56] Dyer & Sarin, 1986
[57] Flanagan & Norman, 1993, p.46
[58] Raftery, 1994
[59] Flanagan & Norman, 1993
[60] Flanagan & Norman, 1993
[61] Raftery, 1994

taking.[62] Another influencing factor that was studied by Laughhunn, Payne and Crum is the occupational differences. For example, airlines and food chains were the most risk seeking, with banks far down the list.[63]

3.1.3 Defining political risk

Robock was one of the first to address the issue of political risk in 1971.[64] Since then, political risk has been debated in the management literature as well as in scientific journals. In spite of the fairly large number of articles and books published treating the subject, there is no clear-cut definition of political risk. Robock does for example consider political risk to exist when *"discontinuities occur in the business environment, when they are difficult to anticipate, and when they result from political change"*.[65] This definition does not clearly state that social factors such as strikes, riots and boycotts are included in the political risk.

In its most simple definition, political risk refers to the possibility that political decisions, conditions, or events in a country will affect the business climate in such a way that investors will lose money or not make as much money as they expected when the investment was made.[66] Many of the earlier works on political risk (Aliber (1975), Baglini (1969), Carlson (1978), Channon (1978), Greene (1974) and Lloyd (1976)) defined political risk as government interference with business operations.[67] Shapiro has published a more recent work with a similar view. He sees political risk as any *"government intervention into the workings of the economy that affects, for good or ill, the value of the firm"*.[68] Most of the later definitions of political risk involve many more aspects than only the government interference.

One of the most important types of political risk is the risk for a government turnover and the effects such an event could have on a company. A number of variables can influence an irregular turnover in government. Many authors claim that the main influencing factor is the

[62] Harnett & Cummings (1980) in Bromiley & Curley, 1992
[63] Laughhunn, Payne & Crum (1980) in Bromiley & Curley, 1992
[64] Robock (1971) in Clark & Marois, 1996
[65] Robock (1971) in Clark & Marois, 1996, p.53
[66] Kobrin, 1982
[67] Kobrin, 1982
[68] Shapiro, 1992, p.503

type of political system, but other examples are ethnic/ religious conflicts, foreign government intervention and economic stress.[69]

The definition of Kennedy provides some more concrete examples of factors included in political risk:

> *"Political risk can be defined as the risk of a strategic, financial, or personnel loss for a firm because of such nonmarket factors as macroeconomic and social policies (fiscal, monetary, trade, investment, industrial, income, labour, and developmental), or events related to political instability (terrorism, riots, coups, civil war, and insurrection)."*
>
> Kennedy, 1988, p.27

Robock was first to make the now common division of political risk into macro-risks and micro-risks.[70] Macro-risks are also referred to as country risks and include all events that are likely to have an effect on foreign investments in general. [71] The micro approach is a response to the simplified assumption that the degree of political risk exposure is the same for all firms in a country.[72] The micro approach also indicates the need for company managers to pay attention to changes in industry-specific conditions and not only radical changes in government. According to Kobrin, most politically generated contingencies present micro and not macro risks.[73]

In addition to the macro/ micro categorisation of political risk, actions and policies can be distinguished as internally- or externally based events.[74] Simon further divides influencing variables into social-related and government-related risk. The purpose with all these distinctions is to help identify the origin of the various types of political risk.[75]

[69] Simon, 1982
[70] Simon, 1982
[71] Clark & Marois, 1996
[72] Shapiro, 1992
[73] Kobrin, 1982
[74] Dunn, 1983
[75] Simon, 1982

Below is a chart that shows examples of political risk in each category and how they fit into the different expressions.

		External	Internal
Macro	Societal-	• Cross-national guerrilla warfare • International terrorism • World public opinion • Disinvestment pressure	• Revolution • Coup d'etats • Civil war • Factional conflict • Ethnic/ religious turmoil • Widespread riots/ terrorism • Nationwide strikes/ boycotts • Shifts in public opinion • Union activism
	Governmental-	• Nuclear war • Conventional war • Border conflicts • Alliance shifts • Embargoes/ International boycotts • High external debt/ service ratio • International economic instability	• Nationalization/ expropriation • Creeping nationalization • Repatriation restrictions • Leadership struggle • Radical regime change • High inflation • High interest rates • Bureaucratic politics
Micro	Societal-	• International activist groups • Foreign MNE competition • Selective international terrorism • International boycott of firm	• Selective terrorism • Selective strikes • Selective protests • National boycott of firm
	Governmental-	• Diplomatic pressure • Bilateral trade agreements • Import/ export restriction • Foreign government interference	• Selective nationalisation/ expropriation • Discriminatory taxes • Local content/ hiring laws • Industry specific regulations • Breach of contract • Subsidisation of local competition • Price controls

Figure 3.1 *A general Framework for Political Risk Assessment*
Source: Modified Simon, 1982 p.67

In this thesis, in order to maintain a stringency in the use of the term political risk, we follow Simon's definition, which we summarise as: *the risk that an event, due to societal or government related actions, will bring about negative consequences for the affected companies' assets.*

3.2 Risk management process

Risk management aims at protecting the company against damage and loss. Many different ideas exist on how to divide and name the different aspects of risk management. There are a couple of authors who only see two steps in the process. Hamilton states that the classic risk management functions could be classified into: risk analysis and risk control[76]. Buchan[77] and Raftery[78] find that the risk management cycle has three main phases: risk identification, risk analysis and risk response. Other authors have identified four or five steps in this cycle such as Flanagan & Norman, adding a risk classification- and a risk attitude step to Raftery's model[79]. It has to be highlighted that there are also authors (for example: Moran[80] and Ting[81]) who call the response phase for risk management. This can be confusing since our definition of the whole process with all its steps has the same name.

We believe that it is most common to divide the process into three steps. We are further of the opinion that the most commonly used, and therefore most appropriate names of each of the steps are: *identification, analysis* and *response*. We will therefore use the following model when structuring the rest of this thesis.

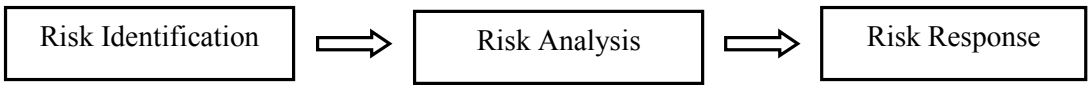

Figure 3.2 *The Risk Management Cycle*
Source: Modified Raftery, 1994, p.18

3.3 Risk identification

Risk identification is a crucial step in the risk management process. Flanagan & Norman even consider that *"an identified risk is not a risk, it is a management problem"*[82]. The risk identification answers the question: what risks do we have?

[76] Hamilton, 1988
[77] Buchan (1994) in Baker et al., 1999
[78] Raftery, 1994
[79] Flanagan & Norman, 1993
[80] Moran, 1998
[81] Ting, 1988
[82] Flanagan & Norman, 1993, p.47

When managing risk in general the following information sources are used [83]

- The company's own *statistics*, which provide information about previous experiences.
- Interviews with the *employees* and inspections in order to show the current position.
- The *management*, which is the main source of information for judging tomorrow's risk.

Flanagan & Norman see the initial step as identifying the sources and types of risks that exist. They suggest a mapping procedure where the source and effect of the risk is categorised as controllable/uncontrollable and dependent/independent. A proper risk categorisation is necessary because poor knowledge of risk will breed further risk.[84]

Political risk can be identified by looking at historical political circumstances that have damaged a company in one way or another. Employees working in the country have often heard rumours and can sometimes identify risks. They usually know much about the specific conditions for the company in the country. In many companies management has the responsibility for identifying the political risk, but they can also receive help externally from different experts and consultants.[85]

3.4 Risk analysis

Risk analysis can also be referred to as risk assessment (Ting[86] and Samset[87]). It has to be pointed out that some authors also make a distinction between the two expressions. In this thesis, the expressions will however be used with identical implications. The purpose of risk assessment is according to Samset to identify and make rough estimations of the probability of major uncertainties and consider the effects they can have on a project.[88] Haendel says that the risk assessment should serve the company with a basis for better corporate

[83] Hamilton, 1988
[84] Flanagan & Norman, 1993
[85] Hamilton, 1988
[86] Ting, 1988
[87] Samset, 1998
[88] Samset, 1998

decision making.[89] The primary end use of political risk assessment is according to Kobrin, investment decision-making and strategic planning.[90] Ting makes a further refinement by claiming that the risk assessment is used differently depending on what industry the company is operating in. Banks use it to determine exposure-limits on international credits, while exporters use it to decide whether or not to export and what amount of insurance coverage is needed.[91] How companies chose to assess the political risk varies significantly from case to case. Worth to point out is, however, that many companies do not have a systematic approach for analysing political risk. The methods used vary from guesses and rule-of-thumb procedures to external forecasting and formalised staff functions.[92] According to Hamilton, companies often set a probability for the occurrence of a harmful political event in a certain country, but do not apply it for the specific project. The characteristics of the individual project do, in those cases, not influence the political risk analysis.[93]

> *"Even today, some companies have yet to discover the importance of political risk forecasting, In these companies risk is often assessed by prevailing upper-management attitudes toward certain countries, shaped by dubious factors like historic reasons, unfamiliar customs, or unpleasant business experiences.*
>
> de Mortanges & Allers, 1996, p.306

Other factors that influence decisions unduly are dramatic events like student riots, kidnappings, government coups etc. Investors who are overly influenced by periodic surges of optimism and pessimism are sometimes said to suffer from the "the odd-lot syndrome". The consequence of this phenomenon can be that companies miss opportunities due to perception of more than actual political risk.[94] Other times the political risk is underestimated or even unidentified.[95] There are multiple ways of classifying the risk assessment. Aguilar makes a division of four scanning methods: *informal-* and *formal search* and *undirected-*

[89] Haendel, 1979
[90] Kobrin, 1982
[91] Ting, 1988
[92] Ting, 1988
[93] Hamilton, 1988
[94] de Mortanges & Allers, 1996
[95] Ting, 1988

and *conditioned viewing*[96]. We will in this thesis use de Mortanges & Allers division of deliberate assessment methods of political risk, which is the following:[97]

- Qualitative unstructured methods
- Qualitative structured methods
- Quantitative methods

3.4.1 Qualitative unstructured methods

Qualitative unstructured methods can be divided into two principal variants relying either on the competence of internal managers or external experts. [98]

Judgement and intuition of managers [99]

One method of assessing the political risk is to simply have the managers evaluate the risk. Aguilar found in his study that this was the single most important source of information about external environments.[100] The managers base their evaluation on intuition and knowledge of the country. The "grand tour approach" is a well-known qualitative judgement method. First the company does some preliminary research in the country where the project is running or is being considered. Secondly the company sends an executive or a team of executives for further investigation. Their work will mainly consist of meetings with government officials and local business people. When the representatives return home, they inform top management of their experiences.[101] The main advantage of this method is that the decision-makers get an intimate and intuitive feel for the actual operational environment. A disadvantage is obviously the cost of travelling, which might not be justified by the information that is received. A brief visit might not either give an in-depth view of the host country.[102] A second alternative is available if the company already has activities in place in the host country. The employees at these facilities are a valuable resource when it comes to scanning the political environment.[103]

[96] Aguilar (1967) in Kobrin, 1982
[97] de Mortanges & Allers, 1996
[98] de Mortanges & Allers, 1996
[99] de Mortanges & Allers, 1996, when nothing else is mentioned
[100] Aguilar (1967) in Kobrin, 1982
[101] de Mortanges & Allers, 1996
[102] Ting, 1988
[103] Kobrin, 1982

This type of investigation sometimes only contains selective information, which does not take into account factors that could be disastrous for the company. An example could be if a manager retains negative information in order to not risk his position. It is also very hard to use the outcome of such an investigation to make cross-country comparisons and to integrate the results in the process of decision making. A team of executives can still be very useful, but de Mortanges & Allers. stress that *"…it is advisable to supplement this method with other less subjective methods*"[104]. There are, according to Kobrin, inherent sources of bias when relying on internal sources. The reason is that there can often be conflict of interests. The worst case is when the same business unit does both the business recommendations and the environmental scanning.[105]

Experts' opinions[106]

Expert opinions can also be referred to as *specialised external sources*. To rely on experts is a rather unstructured method also known as the "old hand" approach. This approach provides a valuable source of information, especially concerning macro political risks, even though it should be combined with other assessment methods for optimum effectiveness.[107] In this method, companies acquire information and advice from outside consultants who are experts of a certain area or country. Examples of sources can be: advisory councils of foreign business people, banks, local government officials, academics, former politicians, seasoned educators and journalists. Haendel[108] and Kobrin[109] considers multinational banks to be in a particularly advantageous position to deal with political risk since they are in contact with both governments and corporations and are likely to have many sources of information. There are also government agencies, such as embassies (or trade and export councils), that can provide primary information.

Obviously, even experts make mistakes and do not always predict actions very well. There can also occur conscious and unconscious biases of experts. These biases can be due to personal relations or financial interests. The expert could also have personal reasons for encouraging

[104] de Mortanges & Allers, 1996, p.307
[105] Kobrin, 1982
[106] de Mortanges & Allers, 1996, when nothing else is mentioned
[107] Ting, 1988
[108] Haendel, 1979
[109] Kobrin, 1982

direct investment and improving the national economy or he could even be bribed.

3.4.2 Qualitative structured methods[110]

There are a number of risk assessment methods referred to as qualitative structured. Three of the most commonly used methods are: Delphi technique, standardised checklists and scenario analysis.

Delphi technique

The Delphi technique could be considered a more systematic and thorough version of the expert- or "old-hands" approach. This method includes a group of experts who is called upon to give their opinion on factors that affect the political environment of a country such as: political stability, attitude towards foreign investors etc. The questions given to the experts are identical and they remain anonymous to each other throughout the process.[111] The responses are then collected and a statistical distribution of the opinions is produced. This statistical distribution is then shown to the experts in order to allow them to change their initial opinions. The process is repeated several times, but in the final round an average opinion of the expert group is created.[112]

Compared to the "old-hands approach", this method is usually more correct than the initial individual opinion, since information and knowledge is taken from many different sources through a systematic generation of multiple experts' knowledge during the process.[113]

Standardised checklists

Another structured approach for both identification and analysis of risk is the use of checklists. These can include different factors, but the idea is for the manager to systematically review the items in the list.[114] According to Ting, checklists or other simple ranking methods are frequently used methods for an initial screening of a potential host country.[115]

[110] de Mortanges & Allers, 1996, when nothing else is mentioned
[111] Clark & Marois, 1996
[112] Shubik, 1983
[113] Ting, 1988
[114] de Mortanges & Allers, 1996
[115] Ting, 1988

Scenarios

Scenarios can be used in order to evaluate the effects of different outcomes and can be made using both quantitative and qualitative data. This approach is based on the formulation of a number of possible scenarios for a certain country. An example of a scenario can be the arrival in power of a political group, and the scenario would be built according to the groups attitude toward foreign investment. Next, probabilities can be given to the alternatives in order to provide the management with a base for decision. A common approach is to make three different scenarios representing a pessimistic an optimistic and a most likely outcome.[116]

3.4.3 Quantitative methods[117]

Lately, companies have begun to use quantitative methods to provide a figure for the political risk. Some companies find that quantitative methods reduce the subjectivity bias of the qualitative methods. It is, however, important to underline the fact that a quantitative approach is not necessarily objective since even subjective opinions can be quantified.[118] Ting defines quantitative approaches to risk assessment as:

> *"any analytical procedure that is based on data that can theoretically lend themselves to statistical or mathematical operations"*.
>
> Ting, 1988, p.145

This implies that the range of available methods is very large. There is a number of different quantitative methods and even more variants of each of these methods. The most common approach is to predict a probability for the occurrence of a certain event through the use of a number of measurable factors that work as leading indicators. For example, a low balance on current account of a country might indicate an increased probability for restraints on transfer of currency.

Multiple discrimination analysis is an example of a method that can be used for political risk data and it provides a powerful tool for risk forecasting. These techniques are based on regression philosophy, taking into account a large number of attributes for a country that is classified

[116] Flanagan & Norman, 1993
[117] de Mortanges & Allers, 1996, when nothing else is mentioned
[118] Ting, 1988

progressively following a discrimination principle.[119] First the countries with the least risk are excluded from further consideration, thereafter the countries in the next risk class etc. With this technique, the occurrence of certain dependent risk variables (such as expropriation or currency controls) are provided with a probability through a set of independent variables (for example inflation or current account balance/ gross domestic product). Multi discrimination methods or other optimisation models can be used as forecasting tools by entering current or projected data as independent variables.[120]

In order for a quantitative method to be effective, the data has to be reliable and sophisticated computer programs are usually required. It is also of vital importance to have experts who can carefully interpret the results. Ting even suggests that a forced use of quantitative methods can undermine the validity of the risk forecast, since a lot of data is almost impossible to quantify.[121]

A main drawback to quantitative methods is the accuracy of the data applied to the analysis. External environments change quickly, but the data of governmental agencies and international organisations often require a period of time before being updated. The best way to solve this problem is to have the management's intuition work hand in hand with the statistical program.[122]

3.5 Risk response

Good risk assessment does not eliminate risk but it does provide a fair base for managing it.[123] Once risk has been identified and, if possible, given an estimated probability, the company must decide what to do with it. The actions taken to respond to the risk are aimed at improving the profitability of a foreign investment opportunity. Ting argues that risk strategy and risk orientation in international operations are very company specific depending on the perception of risk and risk taking behaviour of a firm. Variables such as size, experience and management philosophy can be underlying reasons for these differences.[124] However, Ting does not

[119] Doumpos et al., 2001
[120] Ting, 1988
[121] Ting, 1988
[122] de Mortanges & Allers, 1996
[123] Irwin, 1998
[124] Ting, 1988

suggest which management method is the most suitable for each company characteristic.

Raftery has identified four techniques to respond to risk: *retention, reduction, transfer* and *avoidance*[125], an approach also suggested by Flanagan & Norman[126]. Haendel divides the available risk management tools into six general categories: *avoidance, transfer, diversification, prevention, insurance* and *retention.*[127] Ting has divided risk management strategies in seven categories: *avoidance, retention, pooling, diversification, loss prevention, loss control* and *risk transfer*. The difference between the various definitions lies in their degree of specification. The three approaches described above are contextually the same. We will treat all seven of Ting's categories, but we will use the classification of Raftery to structure the description.

Ting divides the various risk management techniques into defensive and integrative methods. Risk avoidance, insurance, and diversification are considered as defensive risk management referring to their risk reducing nature, protecting the company from financial loss following negative government interactions in the host country. In its most simple definition, defensive risk management is any measure taken to reduce the risk exposure of the company independently of its natural activities. Integrative risk management is on the other hand directly linked to the activities of the company in the host country and can be seen as preventive, risk-reducing actions. The principal argument for integrative risk management is that it reduces the probability of the host government taking adverse actions against the company. The logic behind this reasoning is that the company makes itself indispensable for the host country in one way or another. One example is to introduce new technology to a country or pursuing social responsibility goals. Ting argues that it is not sufficient to manage political risk simply by taking insurance. An optimum risk management strategy requires a balance between both defensive and integrative techniques.[128] In most cases the risk is managed through a number of methods. For example, it is logical to try to reduce the political risk before buying insurance, in order to keep the price down.

[125] Raftery,1994
[126] Flanagan & Norman, 1993
[127] Haendel, 1979
[128] Ting, 1988

3.5.1 Retention[129]

The significance of risk retention is that the risk is partially or fully withheld by the company. Risk retention can be made either intentionally or unintentionally.

When risk retention is made intentionally, it is called self-insurance and means that the company keeps the risk in their own books. This can for example be achieved by creating a subsidiary as a captive insurance company taking on the risk or by establishing a reserve fund to cover for a potential loss. The motives behind risk retention are often economic. By taking on part of the risk, a company can significantly lower the cost of insurance. This can be compared to people only insuring their cars for third party damages and theft instead of a complete insurance.[130] Risk retention can also take place for more practical reasons when the potential losses are considered to be insignificant or when the cost of insurance can not be justified by the risk exposure.

Unplanned or unintentional risk retention is often caused by a company's unawareness or ignorance of a potential danger. Ting does, however, highlight the fact that most companies are today so aware of political risk that risk retention to a very large extent is made intentionally.

3.5.2 Reduction

Reduction of the political risk can be done in two ways. It can either be by loss prevention, which signifies actions taken in order to reduce the probability of a damage. The second alternative is loss control (also referred to as loss protection), meaning actions taken to minimise or at least reduce the consequences or impact of a political event.[131]

A somewhat complicated risk reduction strategy is to determine a country exposure limit. This exercise requires estimating probabilities and using mean-variance. The strategy has serious downsides, since it is very hard or even impossible to estimate the probabilities and mean-variances. It is also very difficult to implement and monitor the changes in exposure, probabilities and mean-variances from day to day.[132]

[129] Ting, 1988, when nothing else is mentioned
[130] Flanagan & Norman, 1993
[131] Ting, 1988
[132] Marois & Clark, 1996

Diversification is a very effective way of spreading risk based on the ancient knowledge that "all eggs should not be put in the same basket". For political risk management, a diversification strategy can be used to offset country risk against each other for example through exposure in multiple countries. In other words, balancing multiple investments in different countries, where some are less risky than others, is a way to compensate for possible losses. The risk is still kept within the company, but diversification can also be seen as a reduction of the political risk, since it is more unlikely that any one event will have as great an impact as would be the case if all projects were in the same country.[133]

3.5.3 Transfer

Risk transferring is one of the most popular and effective ways to manage risk. The logic behind risk transfer lies in shifting the risk to an outside entity.[134] It can be defined as the reduction of risk exposure by sharing the risk with a third party.[135] This is by Marois & Clark referred to as using external hedging techniques.[136] For political risk, the risk transfer can basically be achieved in three ways. The most common way to deal with political risk today is through insurance. There is an increasing market for more speculative risk insurance, which now constitutes a very important tool for the management of political risk. Using that alternative, the physical property is retained but the "financial part" of the risk is transferred. A similar option is to hedge the risk through a bank or other financial institution.[137] The third alternative is to transfer the activity or activity exposed to the risk through different forms of unbundling.[138] The latter signifies contractual arrangements such as joint ventures, franchising and various forms of counter trade, shifting part of the risk to an outside entity.[139]

Insurance

The concept of insurance is built on the principle of pooling a large number of individual risks to give a better predictability of the occurrence of an event. Theoretically, the probability of loss can be more accurately predicted if a sufficiently large number of units, exposed to the same risk,

[133] Ting, 1988
[134] Ting, 1988
[135] Halman & Van der Weijden, 1997
[136] Marois & Clark, 1996
[137] Marois & Clark, 1996
[138] Baker et al, 1999
[139] Ting, 1988

are grouped together.[140] This is also known as the actuarial method of estimating potential loss. The principle is thus built on statistics that make it possible to calculate how much of the total cost each participant in the risk pool should carry. Insurance serves as a risk-reductive tool spreading the economic burden of the risk to the exposure units proportionally.[141]

Ting claims that reinsurance is of outmost importance when it, as for political risk, is not possible to accurately estimate the probability of the insured risk. Political risk is, however, not quantifiable statistically in the same way as traditional risks, such as accidents or fires due to the dynamic interaction between the foreign enterprise and the host country. Consequently, political risk is less predictable and the underwriting of it can not be done on an actuarial basis. Due to the difficulties of quantifying the risk, there is a strong reluctance to cover for it.[142] Most large transactions, such as the sale of a power station, are financed through buyer credit. This implies that banks (for a significant price) bear the potential risk of default (the risk that the buyer will not pay). Banks can obtain protection against this risk through public insurance contracts and transform their loans into public guaranteed credits. In those cases, the final risk is taken by non-profit state agencies like EKN for Swedish companies (this will be further explained in 4.1).[143] Companies can also insure directly from the public insurance company[144] or from a private insurance company such as Lloyd's in London (which is the most well known insurance company handling political risk). A major problem with political risk is their unpredictability, i.e. that the probability of an event can not be estimated with any accuracy. *"Risks that are unpredictable are very costly to insure if they are traded at all on the market"*.[145]

Letters of credit

Letter of credit is a frequently used means for an exporter to transfer risk to a financial institution. The principle is that a bank undertakes to guarantee the payment of an importer. The exporter receives payment by presenting proof of fulfilment of his part of the deal to the bank having issued the guarantee. This way the risk that the buyer will not have the means or the possibility to meet his engagements is eliminated, since the

[140] Skipper, 1996
[141] Skoog, 1998
[142] Markwick, 1998
[143] Marois & Clark, 1996
[144] Kunreuter & Kleindorfer, 1983
[145] Skoog, 1998, p.249

claim is on the bank, not on the importer.[146] The exporter only needs to worry about the creditworthiness of the issuing bank and the degree of uncertainty is therefore considerably lower. The main disadvantage with the letters of credit is the high cost, especially for third world countries.[147]

Contractual arrangements

Mutual risk sharing can be done through joint ventures and collective ownership of risky enterprises.[148] One way to transfer the risk to another party is to join a number of others in a consortia. This response method is very common for firms in the raw material industries. Basically, the consortium spreads the political risk among the companies in question. The partner companies can either be foreign or local. The reason behind a joint venture or consortium is normally to reduce the risk. In some cases there could also be other reasons such as government requirements and the counterpart's knowledge or legal qualifications.[149]

Another way to transfer political risk is through pooling, which is a method that could also be seen as risk reduction. Risk-pooling can be done as a mutual guarantee, where the pool members engage to cover each other's losses. Each members risk is thereby transferred to a common pool with more or less diversified risk. Compared to insurance there are several positive aspects with pooling. Pre-payment is not necessary for agreements of mutually sharing each other's losses. Therefore, less information is required for pooling than for insuring. If the pooling is not done through a third party company, the price of handling the risk should also be less important since the insurance company normally has the objective to make profit out of the business. One of the problems with creating a risk-sharing pool is that the parties have to accept the presumption that they all face the same risk. This could be handled through the terms of the contract, but sometimes an agreement could need a lot of negotiation. An important aspect when using this method is that the pool must be large enough to diversify the risk effectively. If the pool only consists of a few companies, or parties with similar risk exposure, much of the benefit is lost.[150]

[146] Marois & Clark, 1996
[147] Shapiro, 1992
[148] Skoog, 1996
[149] Vernon, 1983
[150] Skoog, 1998

3.5.4 Avoidance

Risk avoidance (also called risk elimination) is according to Ting, probably the most commonly practised risk management strategy. The meaning of this concept is to avoid exposure to personal, property or liability risks by not entering a certain field of business or activity.[151] By only doing business with the safest countries the probability of a harmful event will decrease, but unfortunately this strategy eliminates many countries with good trade potential.[152]

Risk avoidance can occur pre-entry as well as post entry where the former is the choice to not undertake an investment or deal, while the latter is to divest. Both are techniques used to avert probable expected losses and they are a result of forecasts made either internally or externally. Baker et al points out the fact that there are alternative ways to avoid risk for example by tendering a very high bid, placing conditions on the bid or not bidding on the high risk portions of a bid.[153] Risk elimination is a way to decrease a company's exposure to political risk by not taking a risk at all and the use of it is therefore very dependent on the risk attitude of the decision-makers.[154]

[151] Ting, 1988
[152] Marois & Clark, 1996
[153] Baker et al, 1999
[154] Ting, 1988

4 Organisations for Risk Transfer

In this section we will describe how EKN and SEB work with the political risk management. The reason for including this chapter in the thesis is that the case companies all refer to these organisations when describing their political risk management. The chapter can therefore be seen as an important pre-understanding for the reader. The information is later used in the analysis as a means of comparison.

4.1 EKN[155]

The Swedish export credits guarantee board (EKN) is subordinated the Ministry for foreign affairs. Their aim is to promote Swedish export by issuing guarantees. The activity of EKN shall be financially self-supportive, but there is no intention to make a long run profit. The guarantee from EKN functions as an insurance policy where the Swedish government assumes certain risks, such as the political risk.[156] It is impossible to insure equity in foreign subsidiaries, which signifies that the insurance only covers exports and not the affairs of a subsidiary in a certain country. At the end of the year 2000, the total guarantee offer and risk exposure of EKN reached SEK 136,5 billion.[157] The Swedish government stands as guarantor of EKN, which gives the institute a very good credit ranking if they need to borrow money. There are organisations like EKN in all OECD countries. They are called Export Credit Agencies (in the future referred to as ECAs) and they all work together by sharing information.

4.1.1 Definition of political risk

> "*Political events are related to buyer country. These may involve war, natural catastrophe, confiscation, nationalisation etc or, the most common form of political event: foreign currency shortage in buyer country (transfer constraints).*"
>
> www.ekn.se, 011124

Exporters go to EKN in order to buy political and/ or commercial insurance. Political insurance cover up to 100% of a damage inflicted by a

[155] Interview, Country Risk Analyst, EKN, when nothing else is mentioned
[156] www.ekn.se
[157] Annual report of EKN, 2000

political event, but commercial insurance only covers up to 90% of a loss. The commercial risk is basically the risk of a customer bankruptcy. EKN can take much larger risk on short term affairs, since the risk for war and other problems are easier to predict and less likely to occur.

The most common political risk is that an authority restrains the transfer of money, normally called the transfer risk. Devaluation is the result of a political decision, but EKN considers that as a commercial and not political risk. Most companies use other instruments, such as futures or forwards, in order to protect themselves against the devaluation risk and do not need such insurance from EKN. A Swedish company can be affected if their customer goes bankrupt as a consequence to the devaluation, but as described above, that risk is considered commercial and not political.

4.1.2 Risk identification

EKN uses a very large number of sources for acquiring information about political risk. They have access to several sources that private actors do not have, for example the data of IMF and many authorities of the OECD countries. Therefore, the evaluation of EKN should theoretically be better than the one of private insurance companies. Furthermore, EKN trades information with other ECAs, acquires information from the ministry for foreign affairs, travels around the world in order to make their own observations and discusses with analysts, exporters and central banks. EKN also uses several news services and acquire information from specialised analysts such as “Oxford Analytica”, an organisation that consists of a number of Oxford professors writing articles on political risk.

4.1.3 Pricing

EKN’s classification is divided into two parts. First they analyse the political risk for each country. Thereafter they look at the foreign customer and the specifics of each project. For evaluating the political risk of a country, EKN investigates a number of important factors. The political risk is classified into seven categories. For every class of 1-7, the political risk is further divided into A-G, depending on the credit worthiness of the buyer, and placed in an appropriate price category. “A” signifies the best buyer in the country, which is often a central bank and the cost for insuring such an affair is the lowest. The premium is based on the maximum sum that EKN can lose, which is normally the total value of the export. A client can decrease the premium of EKN by sharing risk with

banks or other companies through for example letters of credit. The prices of EKN can also be improved by risk preventive actions from the company.

The minimum class (1-7) for each country is set by OECD, with the intention that no countries should be able to compete by having their companies pay lower commissions. The political risk analysts of the OECD countries meet four times a year. An econometric model is then used in order to judge the minimum price an institution may set on an insurance premium. The model gives a significant amount of importance to the financial and the economic situation of the country.

EKN's analysis of the political risk in each country is based on OECD's classified econometric model, but they also consider factors that are not part of the model. Examples of such variables are a coming election, the effectiveness of the bank sector etc. EKN is allowed to put countries in a higher and thus more expensive risk class than OECD, but never lower. What is the most difficult for EKN is actually not to choose between for example classification five or seven, but to choose whether or not to insure exports to the country at all. Some countries are not at all possible to insure through EKN even if they are fairly good according to the econometric model. EKN considers one of the most important factors for evaluating the political risk to be the earlier experience of the payment behaviour. A bad reputation affects a country for a very long time even if they improve their payment behaviour.

A company can to a certain extent influence the cost of insuring through EKN. It is possible to exclude certain risks from the insurance agreement and only insure against for example expropriation, but this is quite unusual. In some cases the companies chose to take the political risk in their own books and spread the risk internally, but most of the time they use EKN. The cost of insuring is often not even perceived as a real cost, since it in many cases is transferred directly to the customer. Naturally insurance against the political risk also brings benefits such as better conditions from the banks and sometimes insurance is even a requirement from the banks if there is a project finance agreement.

4.2 SEB[158]

SEB is one of the major Swedish commercial banks. Their merchant banking department helps export oriented companies with financial solutions and risk management.[159] SEB see themselves as a complement to EKN and not a substitute, since they are on the market under different conditions. Whereas EKN functions as an insurance company and takes on risk against a premium, SEB's risk management is part of a financial solution. A bank demands shorter credit terms than an ECA since the latter is not obliged to make any profit and is even backed up financially by a government. Banks further have to make reservations eating up the profit when taking risk in their own books. When asked to describe what role the bank plays for the political risk management of our case companies, SEB consider themselves to have two functions. First of all they can effectively identify and analyse the risk through their superior access to information as well as to relevant expertise. Secondly they serve as a transfer unit onto which the companies can lay their political risk against financial compensation.

4.2.1 Definition of political risk

SEB defines political risk somewhat differently than the other companies we have interviewed. They use the term country risk when referring to risk caused by political events. This definition is of a more financial nature than the one used by most of our sources that see negative effects on the transfer of money as the major source of risk. They do for example not consider destruction or personal damages due to a civil war as a country risk. According to the definition of SEB, a country is not a state or a nation, it is an area in which a currency is used. The reason is that they consider the risk to be tied to the currency not to the country itself. This means that for example the countries in EMU are seen as one and thus fall into the same risk category. The senior country risk analyst explains that one example of where the benefits of such a classification are obvious is China, where Hong Kong can be seen as a separate risk entity since they have their own currency.

4.2.2 Risk identification

The senior country risk analyst at SEB, has developed a tool, based on his own empirical studies, which is used for the identification and

[158] Interview, Senior Country Risk Analyst, SEB, when nothing else mentioned
[159] www.seb.se

classification of country risk. The bank has used it since the beginning of the 90s to make evaluations of countries' credit worthiness and to classify them according to the likelihood of harmful political events that they entail. The idea behind the model is to use political-, financial- and macroeconomic inputs and make an analysis resulting in 30 specific issues that make up the basis for the risk classification process.

One third of the variables are so called "soft" judgements based on evaluations made more or less subjectively and two thirds are "hard", quantifiable variables expressed in numbers. One example of a soft variable is the cultural aspect. The president of the central bank of India made an interesting remark when he was asked about the extreme measures he took to be able to make repayments of a credit in time:

> *"You know, as a Hindu, if I don't fulfil my obligations in this life it will haunt me in my next…"*
>
> Interview, Senior Country Risk Analyst, SEB

For each of the hard variables, the investigated country is appointed one of three grades ranging from "failed" to "passed with distinction". These grades are translated into points and the country can receive between one and sixty points in total. Depending on their total score, the countries are categorised in ten classes. An important detail is that the classification is not strictly controlled by the score achieved in the model but can be re-evaluated for example due to a bad balance between the "soft" and "hard" variables. The country classification serves as a way of setting limits on how much exposure can be taken on each country and how long credits that can be granted.

The bank has an extensive budget put aside for gaining access to inputs needed for the identification and classification of potential political risk. The information budget is currently 1,7 MSEK per year and is justified by the fact that the bank is very dependent on the possibility to quickly assess information about any country in the world. Examples of the services they use include "Oxford Analytica", "Institute of international finance" and "Economist Intelligence". Added to this comes the extensive experience and knowledge of the internal specialists working in the bank.

4.2.3 Risk response

Even though we have presented the bank as a means for the case companies to transfer their political risk, SEB are themselves forced to respond to the risk. The most drastic (and currently most common) way to do so, is to simply avoid the risk by not engaging in new credits. The bank was quite severely struck by the financial crisis in Indonesia and Russia in the late 90s and has since then lowered their exposure significantly. An outstanding exposure of 36 BSEK in 1998 has now (in the last quarter of 2001) decreased to approximately 10 BSEK partially because of the perception of an increased political risk. A similar method is to increase restrictions in the length of the commitments. The country classification model previously described, determines both the exposure limit and the length of the credits.

SEB, like any other company, has the choice between transferring the risk or to take it in their own books. The most common way to transfer the risk is to take insurance through EKN either by themselves or indirectly by requiring that the company they grant a credit has such insurance. If they take the risk on themselves, part of the amount at stake has to be reserved. The size of the amount varies between 25% and 100% depending on how significant the risk is considered to be.

5 The Case Companies

In this chapter the reader is presented information concerning the political risk management process in the four case companies that have been investigated. Two people have been interviewed in each company and as long as they both agreed on an issue, we will not specify which one gave us each piece of information.

> *"The capitalist himself is a practical man, who, it is true, does not always reflect on what he says outside his office, but who always knows what he does inside the latter."*
>
> Karl Marx

5.1 ABB

ABB is a global actor in the automation, manufacturing and power industry. The company has 160,000 employees in more than 100 countries.[160] The basic strategy of ABB is to "Offer more value for customers while building a leaner organisation."[161] Total revenues reached around 23,000 MUSD in 2000.[162]

5.1.1 Political risk

> *"ABB defines political risk as everything that affects our activities in a negative way due to politics. In principle ABB sticks to the definition of the insurance market even though it is not made explicitly."*
>
> *Interview, Political Risk Manager, ABB*

The cost of responding to political risk is not an overhead cost in ABB, but is added directly to the project costs and thereby affects the profitability of the project. The projects of ABB are often very large, run over a long period of time and have a government involved as a buyer. It is the project manager who has the responsibility to take actions in order to respond to the political risk.

The whole organisation does probably not take the political risk with the same seriousness according to the political risk manager at ABB.

[160] www.abb.com
[161] www.abb.com
[162] ABB group annual report 2000

Salespeople look at other factors before the political risk and their primary concern is to generate more sales. Since the company has suffered from political events several times throughout the years, the risk awareness is still fairly high.

5.1.2 Identification

Identification of political risk is principally based on the creditworthiness of the country, since ABB believes that most risks are related to this factor. The company uses several external sources to identify and define the creditworthiness, such as Moody's and EKN, but they also rely on their own analytical capability to a major extent.

> *"The reason behind our thorough risk identification process is to create awareness within the company of the importance of political risk in different countries and therefore take on a more critical approach when entering a country with high risk."*
>
> *Interview, Political Risk Manager, ABB*

There are also initial project briefings where the specific political risk of the project is identified. This process of identifying risks before making an offer is called a "bid-no-bid procedure". In principal, no offers are made without identifying the risks and knowing how much it would cost to buy insurance from EKN.

5.1.3 Analysis

ABB classifies all countries into five categories depending on the political risk. In the lowest class there is no perceived political risk. The exposure is therefore not measured and nothing is done to respond to the political risk. Examples of these countries are northern Europe and North America. In the other categories actions have to be taken to manage the risk.

In ABB, a case scenario is usually made before a project starts in order to calculate the effects that various actions would have on the result. The idea is to find out how much the company can lose, in the worst case, if no actions are taken to deal with the different risks. The next step is to judge how much can be dealt with through insurance or other risk mitigating actions and which risks are left to be taken in the own books.

5.1.4 Response

ABB's response strategy for political risk is to transfer as much risk as possible for countries over a certain risk level. The shorter and the simpler a project is, the less suited are the insurance instruments available. *"A two million cash sale to Chile is not worth the bother of insuring, since the paper work cost more than it is worth."*[163] Therefore the risk is more often kept internally for those projects. When the risk is kept internally it is necessary to reserve up to 75% of the project value, which signifies that the money is set aside and can not be used for anything else. The reason for this is to increase the awareness of the political risk management and to maintain a high discipline. Most parts of the responses to political risk are regulated by policies and the only way to go around such a policy is to acquire approval from further up in the organisation. If the company chooses to take the risk in their own books, approval is needed from top management.

In terms of volume, EKN is by far the dominating partner for ABB when it comes to political risk insurance. This is the case especially for long projects expanding over more than two years as well as for large projects where the total project value is significant. The political risk manager of ABB believes that the company recuperates as much from EKN as they pay for the insurance premiums. He further explains that EKN does not make a profit in the long run and that the fluctuations even out. Smaller projects can sometimes be dealt with on the private insurance market. On the private market, the most frequently used alternatives are the London based insurance company Lloyd's and the internal ABB subsidiary Sirius. If the internal company is used, they buy reinsurance so that all the risk is not kept internally. EKN and the other insurance options are actually not totally comparable, since the private industry sees much more to the specifics of each project whereas EKN focus on the country itself. Furthermore, the private companies usually do not offer insurance for more than two years. It can be very costly to transfer the political risk to a private insurance company. There is for example one case where ABB had to pay 15% of the project value in insurance fees to get acceptable coverage for the political risk. Normally this cost is handed over to the customer, but sometimes it is not possible. Reasons for this can be that their customer is a government that refuses to see any political risk in their country.

[163] Interview, Political Risk Manager, ABB

Risk is also mitigated through awareness of the exposure on different markets. There are internal policies for how much exposure and risk can be taken for each country. The decision of whether or not to increase exposure in a country is taken higher up in the hierarchy the riskier the country is considered. The principle of all sales-projects is that the risk should be insured and the price for this insurance should be a part of the price the customer has to pay. To lower the risk exposure, the company also works with the terms of payment.

> *"ABB emphasises on the prevention of risk exposure. Strong and clear-cut conditions in the agreements are of outmost importance if something would go wrong. It increases the chances of getting paid."*
>
> *Interview, Political Risk Manager, ABB*

The terms of payment can for example be improved by the use of letters of credit where a bank takes on most of the risk of non-payment. The risk can also be eliminated and transferred to the buyer by having him pay early (i.e. a short credit time). This is, however, not very common as a consequence of the large sizes of most projects. Furthermore, the quality of the payment conditions is also considered to be very important for the insurance companies. ABB occasionally uses non-financial measures for risk prevention, for example by working together with the local union.

Risk-pooling is another way to transfer the risk and it has actually been considered by the political risk manager. The problem with the concept is according to him that there is often a problem of defining the risks. Risk-pooling is feasible with the most easily defined risks, but the reasons behind most events are a combination of political and commercial influences and it is very hard to determine the cause of an incident. There is always a question of whether it was the fault of the customer, the selling company or the political environment. ABB has discussed risk-pooling with several other Swedish companies a number of times, but the definition problem has always been impossible to overcome. Despite the thoughts about pooling risk with other companies, ABB does not think in the terms of internal pooling when choosing which projects to go through with. Each project is evaluated from its own values and whether or not it is on a market that is over- or underrepresented in the total risk exposure is not decisive. If the risk is too high and there are no profitable methods

to deal with it, ABB simply turns the affair down – something that is not at all unusual.

When ABB insures at EKN they feel well protected for political events according to both of the interviewees. As long as ABB has part of the risk in their own books, there is however uncertainty. According to a representative from the sales force, the most common reason for suffering from a political event is when an offer has been made and the conditions of the country change. ABB can then be bound to the offer even though they now find the political risk to be too large.[164] Unfortunately it is basically impossible to be protected for events like this.

5.1.5 Follow-up

The updates of the political risk situation are primarily done when deciding if a project shall be carried through or not, but during the life of a project the risk is followed up quite regularly. Every quarter there is a project briefing where the risk status is discussed. The total exposure is also measured for the group in each and every market. If the exposure becomes too high in a report, headquarters tell the risk managers to increase the insurance coverage or to back out of the project.

5.1.6 Summary

ABB principally follows the political risk definition of the insurance market. ABB believes that most of the political risk has a relation to the credit worthiness of the country. External sources and ABB's own analytical capability are the main resources for identifying factors that influence the credit worthiness. Thereafter, the risks that are specific for each project are identified at initial project briefings. Identification of political risk is always done prior to making an offer. The offer is partly constituted by EKN's price of insurance, since this cost is often passed on to the customer.

ABB classifies the countries into five categories depending on the political risk. A worst-case scenario is thereafter used for each project in order to evaluate the possible impact of political events. ABB basically transfers all risk for countries over a certain risk level, mostly by EKN insurance. However, the shorter and smaller the project, the less suited are the insurance instruments available. For these projects, the risk is often kept internally, but with a certain percentage of the exposure reserved for

possible problems. There are internal exposure policies for each country and much risk is prevented by conditions in the contracts. If the exposure becomes too high in a report, headquarters tell the risk managers to acquire more insurance or back out of the project. Furthermore, ABB has discussed risk-pooling with other Swedish companies, but the problem with defining which factors are behind a specific event has been impossible to overcome. ABB does not feel well protected against all political events, since conditions may change drastically for example after an offer is made.

5.2 Saab

The operations of Saab are focused on defence, aviation and space. The group has a total number of 15,000 employees and total annual sales of approximately 18 BSEK.[165] The whole world is seen as the market, but most production and research is done in Sweden.

Saab sees the less developed (and consequently more risky) countries as the most interesting alternatives for the future. Today the sales are not very high in these countries. Out of Saabs total sales, about 20% go to third world countries, but especially south-eastern Asia looks very interesting the coming years. The effect of this is that the political risk exposure will increase in the future. Saab operates under certain regulations, which make their market conditions somewhat different from other export-oriented companies. Being in the defence industry, their clients are always governments or states. The Swedish government also restricts their export possibilities since a buyer must be approved before a deal can take place.

5.2.1 Political risk

> *"I do not know if the company has a formal definition of political risk. Personally, I believe that the political risk is primarily tied to the transfer risk, that is the possibility to attain currency."*
>
> Interview, Export Credit Manager, Saab

According to their political risk analyst, almost all the risk is political since the customers are always governments. This gives Saab a wider definition of political risk than the one used by EKN. For practical reasons,

[165] www.saab.se/node966.asp

they do however use the definition given by EKN as a reference in order to know how much of the risk that can be transferred.

The cost for responding to the political risk through insurance or other measures is put directly on the result of the project. Each project has a manager with profit and loss responsibility who is also responsible for the political risk management. The political risk management function in the company has a consulting role. It is always the responsible of the project who decides what risk response actions to take and who thereby has the final responsibility.

As was previously mentioned, Saab operates under quite particular conditions due to the nature of their activities. Consequently, their view on political risk management is somewhat special. According to the export credit manager of Saab, the most important political risks are budget deficits, debts of the country or that political instability will make the country refuse to acknowledge that they have debts.

One important factor when assessing the political risk is if the country has kept their agreements earlier.

> *"The historical perspective is very important. For example Hungary has been very good at paying their bills for 500 years. For them this has to do with honour and it is a part of their culture."*
>
> Interview, Political Risk Analyst, Saab

On the other hand there are countries with the opposite culture and reputation. Saab explains that even if governments and political systems change, the willingness to pay is often the same.

The possibility of war is evidently a political risk that is important for Saab. Since the company is not allowed to sell any products to countries engaged in armed conflicts, a war would not only mean a risk for non-payment, but also that Saab is not allowed to deliver spare parts etc. New agreements can not be signed after the problem has arisen, with the consequence that deals always have to be made well on beforehand to counter the fact that Saab could not otherwise make any follow up deliveries.

5.2.2 Identification

> *"It is necessary to learn a great deal about a country and to understand the political risk and how it varies."*
>
> Interview, Political Risk Analyst, Saab

Saab has an internal checklist that was first introduced when Saab started their co-operation with British Aerospace. It has been modified to Saabs conditions and is a quite powerful tool for identifying the political risk in a country. It is a method for picturing the economy of the country, but also social factors such as strikes are taken into consideration. Saab uses this checklist to identify which of the factors are of importance in each particular project. The export credit manager emphasises on the fact that one of the most important instruments for identifying political risk is the common sense and knowledge of the employees at Saab. One method for Saab to identify the political risk is to recruit local people when they enter countries where they have no presence beforehand. It is necessary to understand the local political culture in order to minimise the risk once they are in the country. Furthermore, much of the identification-work is moved to the insurer, since the policy is to insure against all political risk.

5.2.3 Analysis

Saab does not produce a classification of the political risk in each country as do most banks and insurance companies. The classification system does not fit Saab, where the interviewees claim that they have to take other aspects into account, which are not shown in the country risk classifications. Instead they identify and assess the political risk for each and every project in case scenarios with three different outcomes. Sometimes there can be several different projects going on in the same country and there will thus be several different processes for identifying, assessing and responding to the political risk. The project managers have meetings and speak to each other, but their risk management is totally separate from that of their colleagues.

Saab uses two models for producing a rough quantitative estimate of the political risk. These models measure the economic status of the buyer, taking into account variables such as budgets, growth, political stability and projects characteristics. Thereafter, Saab takes other non-economic factors into account, but this is done subjectively without a quantified

result. An interviewee explains that it is not very important for Saab to know the exact political risk. It is enough to know if the risk is low, average or high, since most risk will be dealt with through EKN or another insurance company.

Saab also uses the knowledge of external experts about a country's specifics to measure the risk. They rely on inputs from a variety of sources, but are most dependent on information from the people who are directly involved in the affairs, such as banks and insurance companies. Furthermore, Saab often hires experts on a certain subject to investigate an identified political risk. An example is when the company hired an historian to investigate the traditions and history of payments in Hungary before entering a project. One of the interviewees explains that the company can never employ enough people to know everything and is therefore often better off with expert consultants in the aspect of cost as well as quality of information.

5.2.4 Response

> *"Saab's policy is principally to not take any risks. Everything that is possible to insure shall be insured. Western Europe and North America are basically the only areas where we can accept doing business without insuring the political risk."*
>
> Interview, Export Credit Manager, Saab

Saab does not have a fixed limit for risk exposure in each area or country. Instead they try to keep an eye on the total risk exposure and if the risk becomes too high in a country, they have to take measures. There are no fixed rules concerning when Saab buys insurance and when they respond to the risk in another way, but corporate policy is to minimise the risk withheld internally. There is an individual set up of the response in every case and the design varies greatly. The credit risk manager explains that the four most common ways for Saab to respond to political risk are to: 1) take EKN insurance, 2) negotiate other conditions with the customer such as payment through letter of credit, 3) take the risk in the own books and 4) to turn the proposal down. The risk can also be balanced through consortia, risk sharing with partners, private insurance coverage etc.

According to one of the interviewees, it will be worth the cost of insuring the political risk, when an influential event one day takes place. The

company normally tries to transfer the cost of insurance and often, at the end of the day, it is the customer who pays for the premium. All competitors have the same reasoning and therefore Saab does not perceive it is a competitive disadvantage to let the customer pay the insurance premium. Some countries are sceptical about the insurance, since they consider themselves to be more secure, trustworthy and stabile than EKN does. Saab tries to use EKN as much as possible and if such insurance is not an available option for an affair, they have to secure the payment in some other manner.

It has occurred that Saab did not enter a country due to the political risk. The normal situation is, however, that Saab creates a proposal and tries to manoeuvre the deal into feasibility by lowering the risk. This can for example be done through contractual agreements, such as terms of payment. One of the interviewees states that if one does not take any risk it is impossible to do affairs *and "it is not very much fun to deny affairs when there are not that many"*. The same interviewee further explains that the key is to have enough money in reserve to be able to pay oneself out if a problem arises. It is necessary for Saab to have enough durability and therefore not burn all the reserves at the same time.

There are ways to manage the risk without taking insurance. Sometimes affairs are done together with other companies in joint ventures. For example, Saab does almost always run projects in developing countries together with at least one other company. Risk-pooling is not used by Saab, since it is not considered to be in their line of business. As a last alternative, risk can be taken in the own books. Small affairs of for example 20 million SEK can sometimes be retained without insurance, since the benefit of transferring such a small potential loss is not considered to be in proportion with the administrative work it requires. When the risk is kept internally, the exposure is always reserved in the balance sheet.

The interviewees from Saab consider themselves to be fairly well protected against political risk, when using EKN's definition. The reason is the policy to always transfer as much risk as possible in almost every situation. When the political risk is not insured, but taken in the own books, the case is well thought-through and accepted from senior management. In such occasions, the credit payment time is kept short. Normally Saab sees to it that the buyer has to pay before he gets the

products delivered. There is still a risk, since Saab commits a lot of money and other resources in order to manufacture the goods, but the incentive for the buyer to pay is considerably increased.

Saab further explains that it is difficult for the company to reduce the exposure to political risk by other than financial means. It would for example hardly be feasible to get a contact in the local government working as an early warning system to the political risk. One important factor that is not possible to cover by insurance, is all the work and money (often several million dollars) involved in making an offer to a country. An example is the cost of transporting several JAS- fighter planes to Brazil in order to demonstrate their performance to a potential buyer. No identification or management of political risk is done before this process is started and all the money can be lost if the affair does not take place as a consequence of political events. The export credit manager feels that Saab could be much more restrictive concerning which countries to market the company towards and make offers to.

5.2.5 Follow-up

Saab's deals are often very long (the one in South Africa is close to 30 years) and nobody knows how the political situation will change over such a long period of time. This has made Saab aware of the fact that they have to keep a continuous follow-up process and solve the situation step by step. Three to four times a year, the political risk manager makes a presentation for the management team of Saab concerning the current political risk exposure. Furthermore, the responsible project leaders gather information from other sources and can sometimes know more than the political risk management group.

5.2.6 Summary

Saab does not have an official definition of political risk, but use the definition of EKN as a reference. On the other hand, the political risk manager states that all the risk of Saab can be seen as political. They use an internal checklist to identify the political risk for each project in a country. No country classification is done, since every project is analysed independently. Saab further explains that much of the identification-work is moved to the insurer, since the policy is to insure against all political risk. The company has two quantitative models that provide rough estimates of the political risk related to the country's economy. Thereafter non-economic factors are taken into account, without a quantified result.

When further information is needed, Saab hires experts and talk to banks and insurance companies.

Saab's policy is to minimise the risk in the third world and only take on political risk for low risk countries. The company does not have a fixed risk exposure limit for each country, but balance the risk that can not be insured by EKN through consortia and risk-sharing with partners. One important factor that can not be insured is the work and money invested in making an offer. Saab considers themselves to be well protected against political risk as it is defined by EKN.

5.3 Scania

Scania's core competence is the development, production and marketing of trucks for heavy transport and for buses and coaches for more than 30 passengers.[166] 95% of Scania's outputs are sold outside Sweden, in more than 100 countries.[167] In the year 2000, the company's sales amounted to 54 BSEK.[168]

The credit controller of Scania thinks that the political risk exposure will increase in the years to come. One market that looks very interesting for the future is Asia. Today the sales are not very large in this part of the world, but Scania will work on improving their market share over the coming years.

5.3.1 Political risk

The credit risk of Scania is divided into political risk and commercial risk (the risk that a counterpart can not fulfil its commitments for other reasons than those defined under political risk). Political risk is defined as:

> *"The risk that a counterpart can not fulfil its obligations due to a political event, including war, revolution, confiscation etc., as well as moratorium by governments or public sector entities."*
>
> Internal material, 011105

[166] www.scania.com/au/
[167] www.scania.com/au/au03.htm
[168] www.scania.com/ir/ir07.htm

The credit controller however highlights that:

> *"It is not us in Scania who actually decide what political risk is, but it is the insurance companies who set the definition".*
>
> Interview, Credit Controller, Scania

One of the interviewees explains that it is convenient to use the definitions of the insurance industry, since insurances are an important part of Scania's risk management. Unfortunately, these definitions are not always clear. If for example EKN is asked the question if something is defined as political risk, the answer is according to one of the interviewees most often that "it will have to be taken to trial".

The finance department's objective is to counsel the market divisions who are the ones that see the business opportunities. Usually the company tries to find a way to get rid of the political risk through insurance or other measures and thereby allow the project. New markets and new projects signify that the finance department has to co-operate even more with the people working closer to the customers. The market department does not take the political risk under consideration when the employees see an opportunity, they only make a market oriented evaluation of the business opportunity. The credit controller believes that one reason for this could be that most people working close to the market are engineers and they do neither have the same inputs nor the same background as the people in the financial department.

5.3.2 Identification

For the identification of political risk, Scania relies on inputs from sources such as various analysts and the Swedish Trade Council. The latter works closely together with the embassies in most foreign countries and does for instance provide Swedish companies with daily newsletters concerning the business climate in different countries. Scania uses this service as an initial source of information if something is going on in the country. Other important sources of information are inputs from employees, partners and local authorities.

5.3.3 Analysis

It is stated in the finance policy of Scania that all countries in which the company has exposure shall be rated on a scale from 1-5 (where five is the highest risk class). For example western European countries are

rated 1 and most of Africa is rated 5. In order to set this rate, Scania looks at three different credit- and political risk analysis institutes and weights their rates with 1/3 each. The institutes can change, but currently Scania uses EKN, Dun & Bradstreet and Euromoney. This classification is controlled and designed by Scania's financial policy and does not leave room for subjective judgements by the credit controller. If Scania acquires initial input of something going on in a country from another source (for example an employee), the company uses additional resources in order to acquire information about the turn of events.

Scania's evaluation of political risk does not consider who the customer is. A government is considered to have the same political risk as a private company (even though Scania most of the time sells to a distributor). Furthermore, Scania does not assess the size of each specified political risk. They calculate a total risk and if there is a change in the environment of the country, the company has to learn more about the conditions, which is often accomplished with the help from EKN or a bank. The argument for not further specifying the political risk is the fact that such a procedure serves no real purpose, since the objective is to transfer all of the risk through insurance anyway. Scania does, however, occasionally create case scenarios, based on country specific variables, for the high risk countries where the company is exposed.

5.3.4 Response

In Scania, the countries with a rating of 2-5 shall be appointed a land limit expressed in monetary terms. This is the total amount of political risk exposure the company may have in a country and it is suggested by the credit risk management and signed by the chief financial officer (CFO) of the company. The exposure equals the total possible magnitude of loss minus the political insurance. The credit controller sets the exposure limit subjectively, influenced by the rate of the country and the size of the budgeted projects.

The limits are re-evaluated if new projects appear during the year or other circumstances make the existing limits questionable.

> *"It is regulated in the finance policy of Scania what has to be insured and what doesn't. In most cases, Scania insures the risks in the high-risk countries, with a few exceptions I can think of. I imagine that all risk isn't always insured, but only a part of the risk. Furthermore, despite the insurance policy stating something else, we have in a few occasions taken the risk in our own books, but in those cases an approval is necessary."*
>
> Interview, Credit Controller, Scania

When a salesperson is asked about the response to political risk, he states that ris*k* is something that has always been avoided: *"It is the old Wallenberg-spirit that everything should be safe."* For example, when a country is risk class four or five, Scania has to take EKN insurance according to their finance policy. He also claims that the project characteristics do not influence the response in Scania. The reason for this is that the different projects are so similar.

Insurance is often used together with customer financing and in those cases it is the customer who pays for the insurance at the end of the day. At the same time, the credit controller claims that the high cost of political risk insurance is a problem for Scania, since it takes away a large part of their margin. One of the interviewees says that *"we pay much much more than we get back".* The explanation that follows is that the premiums are much larger than the funds recuperated from the insurance companies. He further says that EKN's justification of their prices is that if something happens, it will most likely have a large effect and cost a lot of money. If EKN is unwilling to insure an affair and Scania has to turn to private actors, the price is usually much higher. In those cases, one of the interviewees explains that it might not be profitable to go through with the affair. Therefore the question, if EKN can not insure, is often not whether to use a private insurance company, but rather whether to turn down the proposal or to retain the risk. As a general rule, in the cases when the risk is kept in the company, the turnover of the deal is not significant. It is mostly a question of maintaining the market position in a country where Scania does not have much activity. The company normally reserves the retained exposure when running a project in a country in class four or five.

The market side of Scania in general and the sales force in particular consider that it would be more economical not to insure and instead take the risk on themselves. Since the company is divisionalised, the insurance price affects the result of each division and they are not very happy about this large cost. The finance department looks at this with a more global view. The credit institutes who lend money to Scania have a good insight in their business and insurance affects the credit rating of the company.

There are practically no countries where Scania has a policy not to be represented because of the political risk. If EKN is not willing to take on the risk, Scania uses another solution. Often there is an international bank represented in the country, which opens the possibility to make a deal between a Swedish bank and the international counterpart in order to secure the payment. Scania has a very conservative approach to the payment-procedure. In general all customers that are not regular counterparts have to pay through letter of credit. Such a procedure implies that money is secured and the political risk of the sale is therefore non-existing.

Risk-pooling is something that Scania has never used. The reason for this is according to the credit controller that even if they for example divided half the risk with another part, there would still remain risk in their own books. Since this is against Scania's finance policy it is not an option.

Scania does, even though they are very risk averse, not feel fully protected against political risk.

> *"It is hard to predict what is going to happen and one can never be fully protected. Precaution together with the short transaction periods has kept Scania from serious problems. There are, however, investments that can never be insured."*
>
> Interview, Sales Manager Asia, Scania

Since the definition of EKN is not clear enough, Scania feels uncertainty of whether or not they are covered against various events. In cases of extreme political uncertainty, the company has at some occasions even decided to freeze all activities and wait for a better time to act.

5.3.5 Follow-up

Scania continuously updates the applicable exposure rates and the risk classification of the countries when changes in the political risk situation take place. Furthermore, the credit controller reports the total exposure in each country once every three months. This report is sent out to the organisation so that people get a feeling of the risk and exposure in the different countries.

The local sales people can be seen as an early warning system. They are situated in the concerned countries and provide the political risk managers with most of the input on a change in the environment. At the same time, this information has to be treated with scepticism, since the locals are influenced by being in the country and can be biased by wanting to generate as much sales as possible.

5.3.6 Summary

Scania has a formal definition of political risk, but they still use the definition of the insurance companies for practical reasons. In order to identify the political risk, Scania relies on inputs from analysts, the Swedish trade council, employees, partners and local authorities. As the project goes on, the local salespeople can be seen as an early warning system that provides the political risk managers with most of the input about a change in the environment. The evaluation of political risk is country specific and does not consider who the customer is. All countries are rated in a scale from 1-5, by weighing the risk classification of three different credit- and political risk analysis institutes. Countries with a rating of 2-5 are appointed a land exposure limit. This limit is set subjectively and is affected by the risk classification, but also by the budgeted projects. The limit can be re-evaluated if new opportunities appear or the limit is surpassed.

Scania normally insures all the risk in high-risk countries through EKN. If the ECA is not willing to insure an affair, private insurance companies can sometimes be used. All customers who are not regular counterparts have to pay through letter of credit, which eliminates all political risk. Scania does not feel fully protected against political risk. One reason is that the unclear definition of EKN creates uncertainty as to whether a possible event is covered by the insurance or not.

5.4 Skanska

Skanska operates in the area of construction-related services and project development. The company has around 85,000 employees in more than 60 countries. The mission of Skanska is to develop, build and service the physical environment for living, working and travelling. Total sales amounted to SEK 108 billion in 2000.[169]

5.4.1 Political risk

> *"Skanska does not have a definition of political risk. We tried to make one long ago, but arrived at the conclusion that there was no point in having a definition."*
>
> Interview, President Financial Services, Skanska

Instead Skanska looks at all the risk of a project. One interviewee states that the risk with having a strict definition is that the company may become too tied to the definition and not see the whole picture. Furthermore, both interviewees state that the political risk is taken seriously in the whole organisation.

5.4.2 Identification

Skanska has a corporate specific model for identifying and assessing risk. The model is called ORA: Operational Risk Assessment. This model includes all risks in a project, such as technical, juridical, financial and environmental. ORA is a checklist used to identify and analyse the risks in each specific project.

The inputs of Skanska mainly come from the own experience of the region and public information from sources like the ministry for foreign affairs and other authorities. When need arises, experts are also hired in order to complement the information in a specific area.

5.4.3 Analysis

When the identification is done, the next stage of the ORA is to assess the risk. Often, the projects are situated in countries where the company already has activity or at least has established contacts. In these cases, much information is already at hand. If Skanska is entering a new market, excessive research is done about the risk in the country for the specific

[169] www.skanska.com

project in question. Skanska often purchases supplementary information from consultants acting in the specific region, but they do not categorise countries according to the perceived risk, as EKN and many other institutes do. Skanska quantifies the total risk of every project without separating the political risk.

The risk evaluation is mainly influenced by the project characteristics even though some factors are the same for all activity in a certain country.

> *"Every imaginable aspect is taken into account and quantified. What does it signify for us and what will the consequences be? We try to evaluate the effects of a worst-case scenario, a probable outcome and the costs for each scenario. It does probably not differ very much from what others do, but we have developed our own parameters and content."*
>
> Interview, President Financial Services, Skanska

5.4.4 Response

Skanska does not set limits for the risk exposure in a country. At the same time, the main essence of the risk policy of Skanska is to minimise risk. Political risk can be minimised through several measures. The one extreme is that the risk is too high and the project is rejected. The other is that the effect of a worst-case scenario is calculated and is thereafter reserved in the company's own books. Most of Skanska's affairs are insured through EKN and some through private actors, but it is often the customer who pays the premium in the end. They also try to transfer as much risk as possible to counter parties, customers, partners etc. From time to time the company also works in joint ventures, but not with the objective to decrease the political risk. Instead, the reason for running a joint venture is often that additional technical competency, experience and/ or resources are needed. Skanska uses many different techniques for securing payments. For example, letters of credit and other means of transferring the political risk to another party are used occasionally.

Skanska's activities are very diversified with more than 15,000 projects going on, but they do not use diversification as a systematic method of responding to political risk. Risk-pooling has never been used in Skanska, because of the practical constraints.

> *"Risk-pooling signifies that we would take somebody else's risks and Skanska is a construction company, not an insurance company."*
>
> Interview, President Financial Services, Skanska

Project characteristics influence the risk response to a large extent. The response depends on the individual project, but the interviewees are not able to tell any specific factors that lead to a certain method of response. Skanska has run projects in regions where they do not believe any competitor would have gone. The reason is that all influencing factors have to be fitted together. Skanska carried through a very large project in Kashmir despite great technical and political problems, but it was feasible thanks to help from the customer and the local authorities. Furthermore, Skanska has had projects going on in Somalia during the civil war and they have been in both Kosovo and Colombia when the climate was not very calm. The only countries where Skanska does not have any activity by principle are the ones with UN sanctions. Otherwise each project is analysed even though the country may be very unstable. Sometimes Skanska makes the judgment that a project can not be done during certain circumstances. In most cases the alternative is to wait and see. An example of such an occasion can be when an election is about to be held in a less developed country. Sometimes project proposals can also be turned down as a consequence of political instability. If the risk level is too high and it can not be dealt with, the project is rejected.

Even though Skanska participate in projects in several politically unstable countries, Skanska feels well protected against political risk.

> *"A thorough risk analysis is always done for all activities and we only go through with a project if we feel able to deal with the situation."*
>
> Interview, President Financial Services, Skanska

5.4.5 Follow-up

When asked about the identification of new risk once a project is running, an interviewee answered:

> *"We live in and with the country and follow the development from first row. Furthermore, the headquarters has a continual, almost daily contact with the managers in place in the country."*

Interview, President Financial Services, Skanska

Another method, used by Skanska, for acquiring information is to try to establish more or less close contacts with the authorities in order to get a better view of the future political development of the country.

Sometimes, Skanska pulls out of countries where the political risk has become too great, but it does not happen very often. For example, the company put a project on ice in Baghdad in 1980, when the war between Iran and Iraq was going on. The only time a project has been totally abandoned was in 1971 when Eastern Pakistan became Bangladesh. It has been known to happen that the insurance market changes its view of the risk in a country (without Skanska necessarily perceiving any change in the environment) and therefore accepts to insure in a country where the political risk was previously not possible to insure. In these cases, Skanska may take the opportunity to transfer some risk externally.

5.4.6 Summary

Skanska has chosen not to define political risk, since they do not want to limit their ability to see the whole picture. To identify and analyse all various kinds of risk, an extensive checklist, called ORA, is used. Skanska's sources of inputs concerning the political environment are mainly their own experience of the region and public information, sometimes complemented with information from external consultants. Each individual risk factor is quantified through an internal model providing a result used for deciding how to respond to the risk. Skanska does not set limits for the maximum risk exposure in each country, but they try to minimise the exposure. EKN is sometimes used for insuring against political risk, but also other insurance companies. Other methods used for dealing with risk are to transfer risk to other counterparts, to engage in joint ventures and to simply take the risk in their own books. Project characteristics influence the response to a large extent, but all influencing factors are fitted together before making a decision and no separate influences are distinguished. The president of financial services feels that Skanska is well protected against political risk, with the motivation that the company only goes on with a project if they feel able to deal with the situation.

6 Analysis

In this chapter we analyse our empirical information with support from the theories in chapter 3. We begin with a short analysis of the different definitions, since such differences can have importance for the way the political risk is managed, followed by a discussion about risk attitude. Finally we look at each part of the political risk management cycle and discuss why it is designed and used in a certain way.

6.1 Definition of political risk

The definition of political risk varies greatly in literature (as discussed in 3.1.3). The case companies all have their own view on the expression political risk, but in practice they all basically follow the definition of EKN. This illustrates how companies can see political risk differently than the insurance companies, but conform to the established practice. The reason for using the definition of EKN is that most projects are insured through them. Naturally it is important for companies to know what is covered by the insurance. However, a problem for the case companies is the uncertainty caused by vague definitions of political risk. Scania points out that EKN often can not, even themselves, answer whether a certain risk is political or not. This is a problem for exporting companies since they do not know to what extent they are covered and can thus not make an appropriate evaluation of their risk exposure. Even though not clearly expressed, the other three case companies probably have the same difficulties. EKN could clarify this by simply establishing more comprehensible and unambiguous terms. The problem with the political risk definition is that many occurrences, when companies suffer from a political event, are unique. Therefore, political events are hard to categorise in advance and waterproof terms are difficult to formulate.

6.2 Risk attitude

Political risk is taken seriously in all of the case companies. This can be deduced from the fact that the case companies, in most occasions, take actions in order to minimise the political risk. Having such strict corporate policies regarding the management of political risk, witness of awareness of the hazards as well as a risk averse attitude in general. This signifies that, even with the possibility of higher profit, they do not want to retain

much risk internally.[170] The companies have justified the risk aversion by explaining that their line of business is not to handle risk and that they prefer doing what they are good at. Insurance companies should be better at pricing risk than actors in other lines of business and consequently well suited to deal with the risk.

We perceive the three old Wallenberg companies: ABB, SAAB and Scania to be slightly more reluctant to risk exposure than Skanska. The Wallenberg companies have rules concerning which risks shall be dealt with in a certain way. For example, Scania has to take EKN insurance for projects in countries that have the classification four or five. ABB and Saab also have strong corporate policies in order to minimise the consequences of political events. One of the interviewees saw this as a traditional Wallenberg philosophy that has affected the company for a very long period of time through the business culture. Skanska also insures most of the political risk, but they use a more analytical approach where the cost of a response method is weighed against the benefit and might therefore be considered less risk averse than the other studied companies.

The risk averse attitudes of the four case companies can also be seen as a phenomena tied to the general management culture in Sweden. This is supported by Harnett's & Cummings' study from 1980 pointing out Scandinavian managers among the most risk averse in the world. It is important to highlight the fact that political risk is not necessarily comparable with other risk, since the probability of political events, unlike many others', is very difficult to calculate. This can, at least partially, explain why much precaution is taken in order to get rid of the politically related risk.

The risk attitude affects the whole risk management cycle. If a company insures every part of a project, the incentive for a careful identification, analysis and follow-up is much less important. However, the risk attitude affects the response method the most. It decides how much risk should be retained and how much should be eliminated in one way or another. The more risk taking the company, the more risk can be retained.

[170] Flanagan & Norman, 1993

6.3 Risk identification

All case companies consider comprehension of the political risk situation to be important, since risk exposure creates vulnerability. They seem to agree with Flanagan & Norman[171], who claim that poor knowledge of what risks the company is exposed to breeds further risk, thus creating a vicious circle.

We found that risk identification is carried through in a similar way in all four case companies with help of several methods. The use of external sources in general and of EKN in particular is a common and fairly simple approach. We have repeatedly heard the argument that there is no need to question the expertise of EKN since they have access to supplementary information as well as superior experience. Using EKN is also a cost-effective approach since at least part of the information, used for their country classification, is public and therefore accessible free of charge. Furthermore, it is quite expensive for companies to employ more people to work with risk management (especially since there are so few experts in this area).

Risk identification does however take place internally as well. Both theoreticians and interviewees at our case companies point out the know-how of the personnel as a natural starting point to the risk identification process. For the case companies it is standard procedure to initially collect the first hand inputs that can be received from the employees already in place, if multiple projects take place in the same country. They experience the political climate themselves and might therefore be able to report things that are unknown to external analysts, who might rely more on theories than on actual first hand experiences. Saab explains that hiring local people is an important method for learning about countries where they are not previously engaged. ABB, on the other hand, uses the credit worthiness of a specific country to make a first attempt to identify the political risk. They claim that most risks at the end of the day originate from this variable. Scania uses a similar approach, weighing country classifications from three different sources. We agree that there are some advantages of using such an approach. The information is easily accessible at a reasonable cost, even though it might not be adapted for the conditions of a specific project. It is obviously an oversimplification of reality to base the identification process, of such a complex matter as

[171] Flanagan & Norman, 1993

political risk, on only one variable and they consequently use supplementary methods for the risk identification. It is hard to explain why ABB sees all political risk as originating from the credit risk, while the other companies do not have the same view. One reason could be that ABB often has governments as customers and that the credit risk of the country therefore includes most relevant information. On the other hand, Saab and Skanska also have large sales to governments and they do not have the same approach. A possible explanation for the divergent approaches could be differences concerning managers or business culture.

Besides the risk associated with a country, the so called macro risk, there is also project-specific risk that has to be taken into account. The latter corresponds to what Robock calls micro risk[172]. To identify the political risk that is specific to a certain project it is important to have the competence to do so in-house. The reason is that most external sources, such as rating institutes and analysts, work primarily with macro risk, thus seeing the risk from a wider perspective.[173] The relevance of the information retrieved from these sources is thus somewhat limited, since additional data is needed to give an accurate picture of the total political risk. Different lines of business and project characteristics such as location in the country may also affect the political risk. Three of the four case companies mentioned that a more thorough risk evaluation process normally takes place before they even start bidding on a deal. The risk evaluation takes into account both micro and macro factors sourced externally as well as internally. On the other hand, Saab does not have such a procedure and much money can be lost if an affair does not take place as a consequence of a political event. The export credit manager of Saab is aware of the problem and explains that the company could be much more restrictive concerning offers and marketing in certain countries. The reason for not being more restrictive is probably that Saab does not get many requests for proposal and each project is therefore important for them.

A tool used by Saab and Skanska, for political risk identification on both micro and macro level, are checklists where a large number of variables are examined in order to picture the conditions under which the project will take place. Checklists are a way to accomplish what Flanagan &

[172] Simon, 1982
[173] Simon, 1982

Norman call a mapping procedure, identifying the source of risk and what specific type of risk it is.[174] For the companies using checklists, risk identification becomes a somewhat standardised procedure. It is thus less probable that aspects will be forgotten and the results of the identification are comparable since the mapping is always done the same manner. In this way, it is more likely that they will manage to identify the risks and thereby take on a more selective and critical approach to each project. A drawback with this method is, however, that the risk identification becomes static and erroneous measures may not be replaced. This could explain the fact that ABB and Scania do not use checklists for risk identification. It can be noted that Saab and Skanska, who base their identification and analysis on the project, also use checklists. This could be a mere coincidence, but an explanation could be that they need a standardised procedure. Since they do not use a country classification, it would be very expensive to start from scratch for every new project.

In theory, one of the most effective techniques of identifying political risk is to establish contacts in the government of the host country.[175] This way, a company can receive primary information early. Only one of the case companies, Skanska, did however say that they occasionally use contacts in local authorities. Why none of the others use the method could probably be explained by the difficulty of establishing the necessary contacts in practice, but there is also a possibility that the companies do not openly want to admit the use of a somewhat controversial approach. Contacts in governments or authorities could be associated with corruption and therefore produce bad publicity.

We have the impression that political risk identification in the different case companies is associated with previous corporate traditions in risk management. Many companies have corporate policies, forcing the managers to minimise the risk when dealing with politically unstable countries. It is therefore natural that a large part of the risk identification responsibility has been put on the external sources through which the risk is transferred.

[174] Flanagan & Norman, 1993
[175] de Mortanges & Allers, 1996

6.4 Risk analysis

6.4.1 Approaches

The political risk assessment is, like the identification process, dependent on two variables: the risk associated with the host country and the risk associated with the project. It is therefore not enough to decide the risk category for a country, but maybe even more important is to find how the political environment will affect the individual project. The case companies differ in how they approach the political risk. In most risk management theories, the analysis departs from the country where the project is taking place. The normal procedure is in that case to make a country classification, as ABB and Scania do, or to accept an external classification, such as the one made by EKN. The next step for the companies is to determine what additional risks can occur depending on the characteristics of the project. Scania does however not, unlike ABB, take into consideration who the buyer is when determining the political risk. The reason could be that they see this risk as commercial and not political.

Both Scania and ABB make a country classification of 1-5 where the “fives” are the riskiest countries and the “ones” are countries where the political risk is considered insignificant. The countries in the lowest category are treated as exceptions since there is no active risk assessment being done and there are no limits on how much exposure the company is allowed to have in such countries. The identification and analysis is here equal to the observation that the country is in the lowest risk class. In those cases, corporate policy states that no further actions have to be taken to manage the political risk. The techniques used in order to make up the country classification differ somewhat between the companies. Scania uses a model where inputs from three different analysts are weighted equally to give a risk class. This could be seen as a simplified Delphi technique since several sources independent of each other produce forecasts of the same phenomena. Also ABB uses country classification for their risk analysis. The difference is that they do not employ a mathematical model, but make a more subjective evaluation. The benefit with Scania’s model is the low cost and almost inexistent work required for the country classification. On the other hand, they oversimplify reality and do not take account of the special conditions for their line of business and their company. ABB has a different approach,

requiring more resources, but with a result more accurate for the company.

Alternatively, the analysis can depart from the project instead of the country. Saab and Skanska do not even make a country classification, since they emphasise on evaluating the political risk associated with each project. The advantage of such a procedure is that only variables relevant to the project make up the foundation for the analysis. From an interview at Skanska it was revealed that they have projects going on in countries engaged in war, since the risk for the specific projects is not at all significant. Had they only based their evaluation on the risk associated with the country it is very unlikely that these projects would have been carried through. A disadvantage departing from the specific project is the amount of resources needed for the procedure. When running more than one project in a country, the companies need to make separate evaluations instead of just one. An interviewee at Saab further explains that for them it is not necessary to calculate the exact political risk in a country. It is enough to know whether it is low, average or high since their policy is to transfer as much of the risk as possible. If the risk is transferred to an outside party, a more precise evaluation is of no use. The situation is slightly different for Saab than the other case companies since there are government restrictions regulating whether or not they are allowed to sell to different countries. Even though Saab makes a risk assessment based on project-specific criteria, a high country-specific risk can very well be enough for the Swedish government to ban the project, which would also have consequences on follow-up deliveries etc.

The reason for ABB and Scania to make country classifications is that it facilitates the risk management. This is especially apparent for Scania, who claim to not be influenced by project characteristics. They do, however, admit to treat new customers different than old ones so there are some exceptions. The reason for Scania not to emphasise on the project characteristics is that all their projects are fairly similar and not very complex, as opposed to our other three case companies. The other three companies have different starting points, but they all take project characteristics into account for their political risk analysis. The difference in approach of ABB, as opposed to Saab and Skanska, is probably mainly due to company traditions and the end result should be fairly similar. Since Hamilton[176] claims that the characteristics of the individual project

[176] Hamilton, 1988

do usually not influence the political risk analysis, a majority of our case companies have a more thorough risk management process than what the literature claims is normal. The reason for this could be our sampling, since we investigated companies likely to have a well-developed risk management.

6.4.2 Evaluation

When assessing the political risk, there are several techniques being used by the case companies. As a matter of fact, the companies use almost all of the available risk analysis techniques presented in chapter 3. There is, however, a strong tendency to rely on so called qualitative methods, but Skanska and to some extent Scania and Saab also quantify some inputs for their risk analysis. The reason why quantitative methods are not used more extensively is, as argued both by scholars and several case companies, that political risk is almost impossible to calculate using traditional statistical methods. The reason is, as previously mentioned, the difficulty of determining probabilities of political events. Common characteristics when making risk classifications in our case companies are the use of both externally and internally generated inputs as well as both quantitative and qualitative data. The single most practised risk assessment method is what de Mortanges & Allers call the "old hand approach"[177], which means the use of opinions given by external experts. All the case companies receive inputs from a wide variety of sources including rating institutes such as Moody's and Standard & Poor's, specialised political risk analysts and various public institutions such as embassies, the Swedish trade council, the department of foreign affairs and EKN. Saab even hired an historian to investigate Hungary's traditions of paying debts, before going into negotiations with the country. This rather unorthodox approach highlights the fact that there are ways to minimise the risk exposure by creativity. The logic behind this reasoning is that the more that is known, the better the risk can be responded to. When the political risk is transferred to an external party, the need for the case companies to make an extensive analysis of the risk picture should not be crucial. Additional inputs are equal to additional costs and it is therefore necessary to find some kind of break-even point where supplementary information does not justify the expenditure.

Aguilar puts a lot of trust in the capability of managers to assess the risk, claiming they are the most important source of information concerning

[177] de Mortanges & Allers, 1996

external environments.[178] Our case companies agree that the internal managers are a valuable resource since they often have primary information available at a low cost. Several companies have, however, mentioned that an advantage with information generated externally is that it is more objective, which is also supported by Kobrin[179]. There is often a conflict of interests between the person wanting to generate a sale and the manager working to keep the risk exposure at a certain level. External experts may also be influenced by bias and therefore not totally objective.[180] What this implies is that an optimum risk management procedure should contain inputs from a variety of sources. This corresponds well to our case companies who all, as already mentioned, use both external and internal sources of various kind for political risk analysis.

ABB, Saab and Skanska all mention the use of thorough case scenarios to analyse the risks involved in a project. The political risk is only one out of many variables that make up the scenario. By making a worst-case scenario, it is possible to assess the maximum damage that can be done to the company in a project. To make up such a scenario, risks have to be identified and the potential impact has to be analysed. A case scenario can therefore serve two purposes, both as a tool for identifying risks and as a tool for analysing the effects of them. Scania uses case scenarios to a smaller extent than the other companies. A drawback with this technique, which might explain why Scania does not use it as much as the others, is the amount of resources it requires to construct a credible and comprehensive case scenario. Since Scania's projects are fairly small and not very complex, the need for comprehensive case scenarios might not be very large. A difference in the scenario approaches is that Scania makes country specific scenarios, while the other three case companies make a scenario for each project. This is probably explained by the fact that most of Scanias projects are fairly similar. More precise information for each project is simply not worth the extra cost.

[178] Aguilar (1967) in Kobrin, 1982
[179] Kobrin, 1982
[180] de Mortanges & Allers, 1996

6.5 Response

The risk management methods by Ting[181] described as defensive appear to be the most used by our case companies for responding to political risk. In our study, it is only ABB that has mentioned the use of integrative risk management, since they for example sometimes work together with the local union in order to reduce the political risk. It is, however, possible that the other companies also use integrative risk management, but that our interviewees are not aware of this. It is more probable that the personnel in place in the countries take integrative risk management measures, without the need of consulting with the Swedish managers. Skanska and ABB should have the strongest incentives for integrative risk management. The reason is that they do much of the work at place and are therefore very dependent on the local opinions of the activities in the host country. Scania and Saab, on the other hand, often deliver physical products made somewhere else and are therefore not as vulnerable as Skanska and ABB.

6.5.1 Retention

Risk retention implies that a company intentionally or unintentionally keeps the risk within the company.[182] All four of the investigated companies sometimes keep at least part of the risk intentionally, which they refer to as keeping the risk in their own books. The main reason for keeping the risk is that the benefit of transferring a small potential loss is not perceived to be in proportion with the administrative work and is therefore considered insignificant. It must be stressed that what is considered to be significant varies greatly between companies. For example, Saab does not find 20 MSEK to be significant, while many other companies would probably do so. The perceived significance is naturally closely tied to the size and current well being of the organisation as well as the size of the projects they are normally engaged in. Saab does obviously not take the same precautions when selling spare parts to rocket launchers as when they sell fighter planes worth 500 MSEK a piece. The significance might also be affected by the amount of work a company puts into choosing which way to respond to a risk. For example, Scania can, thanks to the company's analysis approach, determine how to respond without much effort. They may therefore consider smaller

[181] Ting, 1988
[182] Ting, 1988

projects to be worth responding to than the companies having a more complex process.

One reason to, at least partially, withhold the political risk is that the insurance cost may be significantly reduced. A company can either choose to not include certain risks in the insurance or not cover the entire value of the affair. Short affairs are also better suited to be retained. The risk is in those cases, as already explained, much less important and more easily predicted. In which country the project takes place is also a determining factor of whether the risk is retained or not. In Western countries, where the political risk is usually fairly low, most of it is retained. As was previously mentioned, the perceived probability is not high enough to justify neither the risk nor the work required for a different response.

When ABB keeps the risk in the company, up to 75% of the total value (i.e. the total risk exposure) is kept as a reserve fund in order to cover a potential loss. The reason to do this is, according to an interviewee, to increase the awareness of political risk management and to maintain high discipline. The awareness of political risk is probably greatly improved when the project manager has to reserve as much as 75% of the value, which signifies that the wanted outcome is achieved. The high discipline is obviously maintained since most of the exposure is already in a fund if something would occur and the money would be needed. Skanska and Saab have similar approaches as ABB and can reserve up to 100 % of the outcome of a worst-case scenario. Scania reserves the exposure of most affairs for projects in risk class four or five. We have the impression that the other three companies reserve more often than Scania, who does not reserve retained exposure in other than the most risky countries. The reason could be that Scania does not feel the same concern about liquidity as the other companies, since the retained affairs are so small that the company would not suffer from liquidity problems due to a political event.

Self-insurance is not popular among the four case companies. ABB has an internal insurance subsidiary, but at the rare occasions that they take on political risk, the risk is re-insured through an external party. The reason for not self-insuring is that the companies, as far as possible, do not want to keep political risk internally, even if done under a subsidiary. They all have corporate policies stating that as much of the political risk

as possible should be dealt with in some manner, in order to minimise the actual risk kept by the company itself. The logic behind minimising the internally kept risk is argued to be that the companies want to focus on their core competencies. Their primary line of business does not include calculating probabilities of political events and judging whether it would be more economical to keep the risk instead of for example insuring.

As earlier stated, risk can also be retained unintentionally. It is hard to determine how much of the political risk that is not perceived or identified by the companies. The fact that they all have strict policies regarding the management of the political risk suggests that unintentional risk retention is rare. This is further supported by the statement made by Ting[183] and a majority of the interviewees concerning the high awareness of risk that exists in companies. As discussed in 6.1, there are differences and questions concerning the definitions of political risk. Companies might very well believe that they have insurance for an event that actually falls outside EKN's or a private insurance company's definition. The consequence is sometimes that they are not covered by the insurance and the risk is not transferred, which Ting[184] refers to as unintentional retention. Unintentional retention can give unpleasant surprises leading to important losses, since no preparative work, such as an action plan, has been made to deal with the eventuality. This once again indicates that it is sometimes not the harmful event itself that causes the greatest danger for the companies, but rather the uncertainty of whether or not they have transferred the risk.

6.5.2 Reduction

Political risk can be reduced by affecting the probability of damage (loss prevention) or by reducing the consequences of an event (loss control).[185] A loss control tactic, used primarily by Scania, is to determine an exposure limit for each country.

Scania is the only case company that uses formal exposure limits regarding how much risk can be taken for individual countries, even though they are used primarily as a method for monitoring the size of the current exposure and not as a loss control tactic. The limits are set based on which risk category the country is in. The classification can also serve

[183] Ting, 1988
[184] Ting, 1988
[185] Ting, 1988

as a basis for how much attention has to be paid to respond to their risk in the country. Scania has a rather strict policy forcing them to set a country exposure limit if the class is two or higher and to buy insurance when dealing with a country in class four or five. The advantage of such a policy is that it can standardise the procedures linked to the political risk management and thereby save time on discussions concerning whether or not to act in a certain way. As was previously explained, Scania has projects that are smaller and less complex than the other companies' and might therefore be better suited for standardised procedures, such as exposure limits. The disadvantage with exposure limits is that the risk management might become inflexible. A consequence could be that market opportunities are missed because the limit for a certain country is reached or that unnecessary measures are taken to eliminate a risk that is not significant for the project. These reasons seem to provide the most plausible explanation for the other companies to not set exposure limits. In Scania, the exposure limit constitutes a warning system, alerting the managers of the risk situation. Scania does, however, emphasise on the fact that the country limits first of all serve as guidelines and can be extended if new proposals are received or if there is a change in the political situation. ABB regulates their political risk exposure through policies specific for each country, which practically work as limits. Even when exposure limits are quite flexible, they still serve as an obstacle to precipitated actions giving increased control to top management of both ABB and Scania. The reason is that surpassing the exposure limit always requires approval from further up in the hierarchy.

Skanska and Saab do not employ exposure limits at all, even though additional insurance or other measures can be taken if there is overrepresentation in a country. This does not mean that exposure is ignored, only that it is controlled in a more flexible manner. Skanska and Saab keep track of the total exposure in each country in order to judge if it is too high. The reason for not using exposure limits is that they evaluate each project individually. Furthermore, as all case companies, they do not want to turn down proposals simply because they already have several projects running in that particular country. Since Scania's exposure limits are fairly easily extended and ABB's policies are flexible, the four companies work similarly. They do not want to be too tied to limits if new business opportunities arise, but keep track of the total exposure to avoid becoming excessively affected by events in one single country.

Diversification is another risk reduction method, providing loss control. A company with projects in many different countries would not suffer as greatly of one single event as if the company only ran projects in the country where the event took place. All the cases we have investigated are large multi-national companies and are therefore more or less diversified through their presence on multiple markets. On the other hand, none of the case companies do primarily look at the political risk exposure in order to choose which project to accept. The loss control by diversification can therefore be seen as a consequence of their investments, but not as a purpose behind them. Nevertheless, the risk is still reduced, since the companies have a diversified country exposure. Having exposure limits, as Scania, is a way for the company to more actively make sure all eggs are not put in the same basket. These limits encourage diversification, since it forces the project managers to actively spread the risk between different markets. Scania should therefore be less vulnerable than they would have been without country limits. However, without more information it is not possible to determine whether or not they are more diversified than the other case companies. What can be seen is that Saab is probably the least diversified of the case companies. The company has fairly few projects, most of relatively significant size, going on in a limited number of countries.

6.5.3 Transfer

Insurance

Today the most common way to deal with political risk is through insurance. As was earlier explained in chapter 3, political risk is not quantifiable statistically in the same way as traditional risks such as car accidents or robberies. The quantification difficulties have made the private insurance companies reluctant to cover political risk.[186] Our interviewees claim that private insurance is usually very expensive and that it does not cover political risk for more than two years. It is probably most common for our case companies to turn to private actors when running a project in a country where EKN does not provide insurance. According to an interviewee at Scania, the main question in most such cases is not whether to insure or not, but whether to reject the project or to take the risk in their own books. Another reason to insure through a private actor is when certain special circumstances make it cheaper, due to the stiff bureaucracy of EKN. The organisation focuses on the risk

[186] Markwick, 1998

associated with each country and does not analyse the specific project, except concerning who the buyer is. Private actors are more willing to make separate customised solutions for each case and do not have as strict rules as EKN. Special conditions can make the political risk much less important than normally for a given country and some such conditions are not possible to take into account according to the regulations of EKN.

Our case companies all claim that the most common way to respond to political risk is to insure at EKN. In order to answer why the most common way to respond to political risk is to insure at EKN, we have identified three competitive advantages for export credit agencies:

1. The ECAs are *non-profit organisations*. While other private actors have an owner demanding a certain profit, EKN and its colleagues do not have the requirement to make such a profit. The ECAs can therefore offer a lower price than the private alternatives and with everything else equal, the logical choice is always to choose the cheapest alternative.

2. Thanks to their *information and know-how advantages*, the ECAs can make a better judgment of the political risk in a country. It should therefore, theoretically, be less probable for them to price incorrectly. Since probability of a specific political event is impossible to calculate exactly, the ECAs will not always be right, but with the help of their supplementary information they should be able to price better than the private actors. The same advantages also make the ECAs better at judging in which countries insurance should be provided. Losses on insurance for some countries have to be covered by pricing others higher. Therefore, at the end of the day, the closing down of high-risk countries leads to a lower price for the insurance of projects in other countries.

3. The third factor benefiting the ECAs is that they have the *state backing them up*. If an ECA needs to borrow money, they receive the same interest rates as other state departments. This lowers the cost for the ECAs and therefore also decreases the price for customers to insure. Furthermore, an ECA can not go into bankruptcy. This is part of the explanation for them being able to borrow at such a low interest rate, but it can also be assuring for a large company buying insurance.

> Many affairs done by our case companies are simply so large that a private insurance company could not take on the risk without transferring most of it to other parties. The administration of such an affair would probably be very costly, but if the insurance company kept the whole risk in their account, default would cause bankruptcy, which would make the insurance worthless. Consequently, a company might very well prefer to buy insurance from an ECA rather than a private actor, even if the price was the same.

The outcome of all this is that EKN has a considerable competitive advantage, which enables them to price the insurance lower than the private actors. Consequently, all our case companies claim that their main resort for dealing with a political risk is EKN. The price of EKN is simply so low that there are normally no other methods that can compete with their insurance, except for the few exceptions discussed in this chapter. A downside of political risk insurance is that much time has to be spent on negotiations and administrative work before any funds can be recovered. There is also an important time lag before being reimbursed, when the capital could have been invested elsewhere. Furthermore, there is always a risk that a political event occurs before the insurance is bought, having a devastating effect on preparatory work.

One of our interviewees at Scania claims that the company pays much higher premiums than the sums they recuperate. Since EKN does not have a long run profit, the reason has to be that Scania has been lucky enough to not be exposed in the countries where Swedish companies have suffered from political events lately. Understandably, the same interviewee at Scania says that the sales force of Scania would prefer to take the risk internally instead of paying such high insurance premiums affecting the results of their projects negatively. On the other hand, the interviewee explains that not insuring would affect the company's credit rating negatively. Therefore, the loans would become much more expensive and thus not at all give such a large saving impact on a hypothetical approach of not insuring against political risk. An interviewee at Saab further claims that even if the premiums are high, the insurance will be worth the cost if an influential event one day takes place. The reason is that most projects are simply so large that a default would seriously affect the solvency and result of the company. An interviewee at ABB claims that the company recuperates about as much as they pay in premiums. This seems as a logical outcome of a large and well-diversified

business buying insurance from a non-profit agency. Saab and Skanska could, however, not estimate the recuperation rate of their companies. Scania's situation of paying much higher premiums than they recover ought to be rare. If Scania is correct in their statement, there must be other companies that earn as much from insuring as Scania and others lose.

Buying insurance is expensive even when it's done through an ECA. However, all companies state that the premium price can often be transferred onto the buyer and that most competitors have similar insurance premiums included in their offers. In such cases the insurance cost is not a competitive disadvantage. Even if the price is quite high, there are no other alternatives for the customer than to pay for the insurance. At the same time, several interviewees have mentioned problems concerning relational issues especially when having a government as customer. It is not always taken well when asking them to pay for insurance indicating that there is no confidence for the country. In most cases the competitors do, however, have the same demand and it is then not a competitive disadvantage. It can also be mentioned that governments often are considered less risky, and the insurance premiums are thus priced lower, than when dealing with private companies.

At the end of the day, all of the companies give a lot of attention to the country classification made by EKN. The reason is that it is the decisive factor on whether or not the political risk can be insured by EKN and how high the premium in that case will be. Since EKN is normally the cheapest alternative, their premium can serve as a base of comparison when analysing the political risk and the price for responding to it. ABB, Saab and Skanska even include the EKN premium in their offers, with the implication that they must know the exact EKN price before making an offer. Scania's situation is slightly different, since the company's affairs are short and fairly small. In their line of business, as opposed to the one of the other case companies, it is often favorable to use letters of credit instead of EKN insurance. Since Scania's competitors do not always use ECA insurance, it can sometimes be a competitive disadvantage to include such a large supplementary cost in the offer.

Risk transfer through financial measures

A very effective way of reducing a company's risk exposure is to make sure that the time, during which a harmful event can take place, is kept as brief as possible. The logic is obviously that once payment is received, the risk is eliminated. As explained by a case company, the perfect scenario would be to always get paid in advance.

Letters of credit are alternatives and/or complements to political risk insurance. One interviewee even states that there is no risk involved when using letters of credit, since these agreements do not only eliminate the financial aspects of political risk but also the commercial risk associated with every project. Letters of credit are therefore especially well suited for affairs with new, unfamiliar customers.

The statement about total risk elimination is unfortunately not entirely true, since there is still a risk that the bank having issued the guarantee will not be able to fulfil its commitments.[187] There are also other non-financial risk aspects not covered by a letter of credit, such as physical damage inflicted to property and personnel. There are, however, two major reasons why our case companies do not use letters of credit more often than they do. First of all it is an expensive way of transferring risk. Even more important are the practical constraints that limit the usefulness of them. Given the nature of the projects our case companies are engaged in, credit time is normally very long and it is unrealistic to make deals, sometimes worth hundreds of millions, without providing long term customer finance. One alternative is to construct a solution where the customer pays in several different letters of credit over the project's lifetime. However, payment through letter of credit is more or less comparable to cash payment. Few customers want to pay in advance and terms of payment can very well be a means of competing against another exporter. This limits the usefulness of letters of credit. It should also be mentioned that using letters of credit can be more advantageous for some companies than others. Scania sells trucks and therefore delivers a fairly standardised physical product on a specific date (as does Saab in some cases). It is easier to set up a payment through a letter of credit if there is a specific date of delivery and a product that is handed over. ABB and Skanska mostly work in projects running over a long period of time and it is harder to judge when a product is delivered. At the same time, the customer will probably not have any benefit of the work before the entire

[187] Clark & Marois, 1996

project is completed. Therefore these companies do not use letters of credit very often. As a contrast, the trucks of Scania can be used from the day they are delivered.

Another issue limiting the use of letters of credit is that banks have become more reluctant to cover for political risk. For example SEB, that has been the Swedish bank taking on the most political risk, has decreased its exposure from 36 BSEK to 10 BSEK during the last three years. The consequence of this development is that exporting companies have become even more dependent on the insurance industry.

Other contractual arrangements

Contractual arrangements exist in form of joint ventures, franchising and various kinds of counter trade, shifting part of the risk to an outside entity. Joint venture is a method for decreasing the political risk that is used by ABB, Saab and Skanska, but not by Scania. The reason for Saab to make affairs through joint ventures is not only to decrease the political risk, but perhaps mostly to be able to provide a better deal. Saab may deliver missiles, while other companies deliver complementing military equipment. In the defence industry, most large affairs are also backed up with counter affairs from the government, which can be improved if coming from several different countries. The interviewees at Skanska explain that their reasons for working through joint ventures vary. One reason could be to decrease the political risk, but more practical advantages are often at least as important. For example to increase the know-how in the project or that more resources are needed. The projects of ABB are similar in the way that they are complicated, large and often run over a long period of time, which implies that ABB should have similar reasons for using joint ventures. Scania, on the other hand, does not use joint ventures, since their line of business involves fairly simple and small affairs. Three of the case companies use joint ventures from time to time, but the main reasons seem to be practical and commercial and not to transfer risk. Joint ventures are therefore not seen as an important method of responding to political risk, even though they result in a decreased exposure.

Risk-pooling is another contractual arrangement, where the pool members engage to cover each other's losses.[188] This method is not at all used by our case companies. Scania and Skanska have not even thought

[188] Skoog, 1998

seriously about the method. They claim the reason to be the practical difficulties with such a solution although their views on these difficulties are not the same. Scania has a finance policy that forces them to minimise risk and they can consequently not take even a part of the risk in their own books. Saab and Skanska, on the other hand, are more concerned about taking on part of the risk of another company. They explain that their line of business is construction and not insurance, wherefore they do not want to take on other companies' risk, which risk-pooling would imply. ABB has actually discussed risk-pooling with other Swedish companies. There are many advantages with risk-pooling, such as not needing to calculate a probability of an event's occurrence and not having to pay a premium in advance as for insurance.[189] Despite these advantages, ABB found that it was not feasible to use risk-pooling. The main reason was the difficulty to define what caused the harmful event. Often very many factors interact to produce an event and it is very hard to judge which factor caused an event and thus if the factor was included in a risk-pooling agreement.

Risk-pooling is an unfamiliar concept for Saab, Scania and Skanska. It is therefore likely that personal opinions are expressed and not the companies'. Since ABB is the only company that has considered the use of risk-pooling, it is probable that their argument can best explain why it is not being used in practice.

6.5.4 Avoidance

The meaning of risk avoidance is to eliminate company exposure to personnel, property or liability risks by not entering a certain field of business or activity. Risk avoidance can occur pre-entry as well as post entry. Since risk avoidance signifies that a project is not taken on at all, the extent to which risk avoidance is used, depends much on the risk attitude of the decision makers and the company. [190] ABB, Scania and Skanska sometimes avoid political risk by turning down proposals, because the political risk is too high and not possible to eliminate. Furthermore, the insurance might be too expensive to make the affair profitable, which may for example happen if EKN does not insure a country and private actors have to be used. Saab sometimes turns down proposals, but normally tries to make an affair negotiating conditions that decrease both the probability and potential damage of an event as much

[189] Skoog, 1998
[190] Ting, 1988

as possible. As mentioned in 6.3, the reason for Saab not to turn down many affairs is that they simply do not get very many orders and that each project is important for them. From the interviews, we learned that Saab is the company that acquires the least requests for proposal. A deduction could be that the more requests for proposal the case companies obtain, the more restrictive they are concerning which to accept. This is dangerous, since the companies with few large projects, such as Saab, are the least diversified and the most exposed in a single project. The effect is that the potential impact of a single political event is very large.

All our case companies have claimed that they sometimes temporarily withdraw from projects if a country, for one reason or another, becomes too dangerous. In this matter we did not see any differences between our four case companies. A temporary withdrawal may imply that the company loses much of the resources left in the country, but at least the personnel is safe and the project often can be continued when the environment has cooled down in the country. The reason for withdrawal is often not associated with financial risk, but personnel. The companies only withdraw when the risk for the employees is great enough to justify the loss created by lost possessions and lost time, even though it is very hard to calculate if a withdrawal is justified economically.

6.6 Follow-up

The risk management model used in chapter 3 did not include a follow-up stage. After speaking to the case companies, we could identify a fourth stage, taking place after the risk response. This stage could be seen as renewed risk identification, but it is often slightly different, since it evaluates the change in political risk from day to day during the project. Risk identification on the other hand, is more of a once per project procedure. A follow-up is done by all the case companies, but not as systematically as the identification. A general observation is that all the case companies use a similar follow-up process. The political risk is looked over continuously during the project and there is a project or country briefing quarterly. The daily changes in the political situation are the responsibility of each project manager. The managers can have different procedures, but most often a new political risk is identified only if an employee perceives a change in the environment and suspects that an influential event might occur. The political risk manager may then be

contacted to acquire more information. In those cases inputs are retrieved from ordinary sources, such as experts, analysts, information from authorities etc. The reason for companies to use this method of identifying new political risk is most likely monetary. Many changes in the political environment can be identified by the personnel in a certain country. The cost for a more regular structured and detailed political risk identification would simply be higher than the gain.

The reason behind having a follow-up stage is that companies could be greatly affected by a political event. As described in 6.5.1, intentional and unintentional risk retention imply that the companies are not fully protected against political risk. One reason, for companies not being protected against all political risk, is that many factors can not be responded to. For example, much work often goes into making a proposal. The money spent on such work is not possible to insure against the risk that a political event makes the affair impossible, even though there are alternatives, such as joint ventures, that can reduce the risk. Saab spend many MSEK on marketing and making proposals and consider a rejection as a political risk, since the potential buyer is a state or a government. A proposal being turned down is consequently caused by a political decision. ABB worries about environmental factors changing after the offer is made. The company is then tied to the offer, but the price for eliminating or at least reducing the political risk may have grown considerably between the offer and the acceptance. Another reason for not being fully protected against political risk is that time and money will be lost if a harmful event occurs, even if the project is insured. The reasons are the time lag for recuperating the funds and the required administrative work. Other aspects making the follow-up stage important are the safety of the employees and the risk of a delayed progress in the project. Even if the insurance would reimburse all lost funds, bad-will from a delayed project can not be compensated. Neither could the, even more serious, case of injured employees and the impact such an event would have on the moral of the workers. Since the global political situation is far from static, changes in the risk picture can occur rapidly. A country considered as safe at one moment can in the next become a company's worst nightmare, if proper actions are not taken well on beforehand. When projects are not fully insured, the follow-up and update in exposure may have the consequence that more insurance is bought if the risk increases. If the risk is too high, the company may even withdraw from the project temporarily or definitively.

7 Conclusion

Based on the empirical data we have gathered, we have found that the original risk management cycle is slightly modified in our case companies.

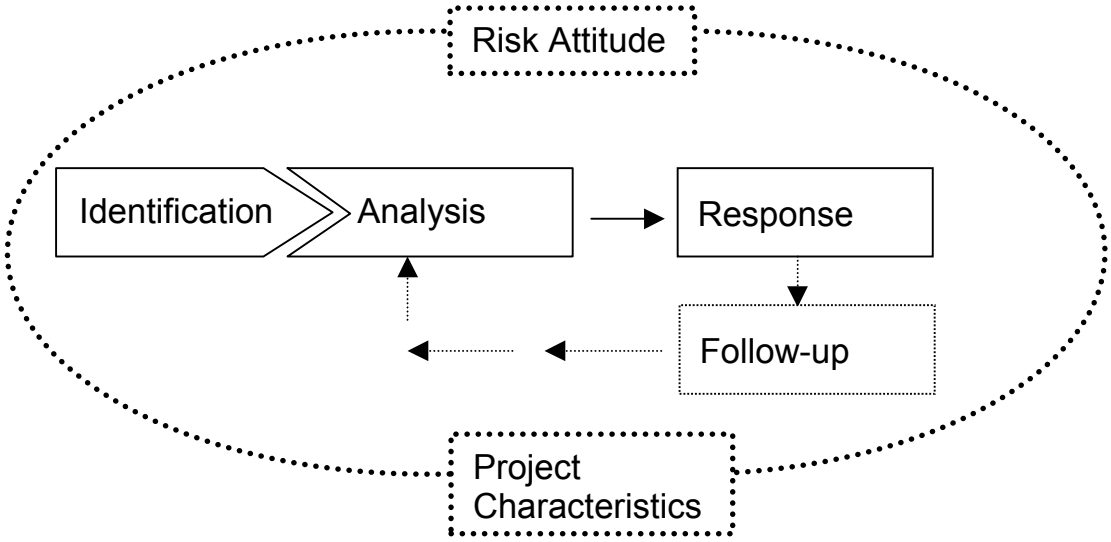

Figure: 7.1 *Case companies' Risk Management Cycle*

In the model above, we illustrate how the ***risk attitude*** is an important aspect affecting the procedure in every step of the cycle and therefore constitutes the frame within which the management takes place. Even though it is today quite rare that the companies suffer from political events, most of them have a strict policy forcing them to limit the political risk exposure and transfer the risk, even though the costs of doing so can be high. One reason to have such policies is the averse attitude towards risk. This attitude is, to a certain extent, explained by the management philosophy in Swedish companies in general and in Wallenberg controlled companies in particular. The risk aversion is simply part of their business culture. Skanska's response is not governed by policies, but they evaluate if the benefit of a response is worth the cost. This clearly shows how their attitude leans more towards risk neutral than do the other case companies'.

Missing in the original model was also an explanation of how ***project characteristics*** affect the risk management. Even though neglected in theory, we have within the case companies found a link between project characteristics and every step in the cycle, wherefore this factor should also be seen as a frame of the risk management. For example, in the companies making a country classification, the risk in projects in the

lowest risk class is not further dealt with once the risk class has been established. The main reason is probably to simplify the process through standardisation and save time and money.

There are also a number of factors that only influence the method of response. Characteristics, such as size, length and geographical location, can determine whether the risk is insured, taken in the own books or dealt with in another way. In figure 7.2, the reader is shown how a number of factors influence companies' response to political risk.

Response:	Size	Customer	Length	Country	Complexity
EKN	Large		Long	Poor	Simple
Private insurance	Small		Short	Poor	Complex
Joint venture	Large		Long		Complex
Retain	Small	Old	Short	Rich	
Letter of Credit		New	Short	Poor	Simple

Figure 7.2 *Response depending on project characteristics*

The political risk ***identification*** is fairly similar in our case companies. A difference in the identification and analysis of political risk lies in the starting point of the different companies. Scania and ABB start by identifying the general political risk associated with a country, while Skanska and Saab look at the political risk from a project specific view. The method of the two latter companies is more expensive, since the whole process has to be made for every project, but they also generate more relevant data. ABB does, unlike Scania, take the project characteristics into account after considering the country risk. The reasons we have found for the differences are that companies with short, small and standardised projects do not need the extra information provided by a project specific approach. Culture and preferences may also affect the choice of approach.

The ***analysis*** of political risk in the case companies is made in connection with the identification process. A difference from the original political risk management model is that the first two steps of the cycle are in reality so closely linked to each other that they can in fact be seen as a single process. It shall also be mentioned that, since most of the companies have policies forcing them to transfer the political risk, the political risk is supposedly already covered for and the incentive for a thorough risk analysis is partly lost. The reason to still have an

identification and analysis process is that awareness and understanding or the environment is a prerequisite to be able to handle the risk in one way or another.

In all the case companies, both the identification and analysis of political risk is made, with the help of a variety of tools and methods, using both internal and external resources. External experts are very good at analysing the general risk in a country, but they do not take special consideration to project and company characteristics. Employees, on the other hand, are more familiar with the specifics of each project, but may be influenced by such factors as desire of generating sales. It is consequently important to collect inputs from a variety of sources in order to obtain all necessary information and minimise the bias.

The most common political risk ***response*** is clearly to insure through EKN, since it is the cheapest way to transfer the political risk. The case companies, influenced by their risk attitude, basically try to minimise the exposure to political risk. To do this they choose the cheapest available method, which is closely related to the project characteristics. If the price is clearly excessive, or no transfer alternatives are available, the risk is sometimes retained in the company.

By adding of a fourth step, called ***follow-up,*** risk management can be seen as a circular process, The follow-up serves as a new identification- and analysis process, leading to new insight on how to respond to a changing situation. Inputs to the follow-up stage are mainly collected from employees in place in the country, since this is an effective and fairly cheap method of obtaining information. The additional step is a consequence of the importance that all case companies attach to actively update the exposure of political risk in their projects. A company can never be fully protected against issues such as the security of employees and the cost of administrative work required for insurance reimbursement.

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Appendix 1

1. **How does your company define political risk?**

2. **How is political risk identified? Why?**

3. **How is political risk measured? Why?**

4. **How is political risk dealt with? Why?**

5. **When does the company try to avoid taking political risk? How is this done?**

6. **Does the company take measures to prevent political risk? Are there risk reduction strategies?**

7. **How does the company deal with political risk when EKN can not insure it?**
   - Is there in those cases political risk that can not be avoided? Examples?

8. **Does the projects characteristics (size, length etc.) influence the response to political risk?**

9. **Are there any examples of when the company has suffered because of political events?**

10. **Do you feel well protected against political risk? Why?**