# SAMPLE WORKSHOP NOTES

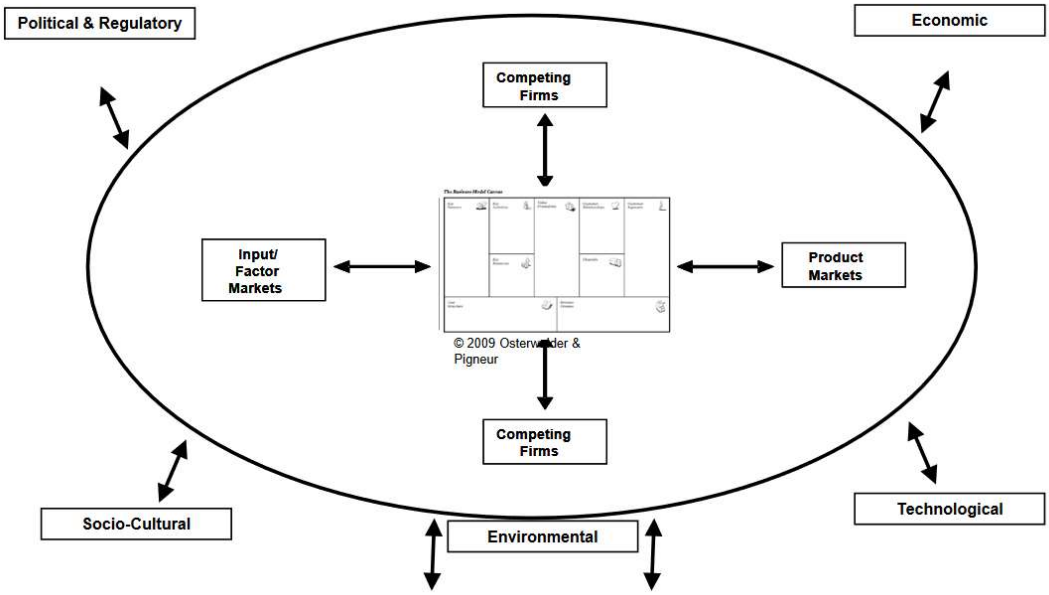
**Workshop Three: Political / Regulatory Environment**
**Problems Associated with Psychology:**

- Test Your Awareness: Do The Test Youtube: 'Easy to miss something you're not looking for.'
- Multi-tasking means you may miss a lot of things - this class you will look at risk of missing things.
- Tversky and Kahnerman (1974) [Nobel Prize for *Illusion of Validity* - Heuristic and Biases]:
  - These affect our judgement.
  - *Heuristic* is a mental shortcut
    - e.g. red is blood, danger, heat; blue is associated with cold; water is blue but actually a lot of times its brown; etc.
    - Get these sort of thinking from experiences and learnings!
  - *Bias* is a tendency to think in a particular way
    - e.g. Lotto tickets people buy a dream and possibility
  - *Systems of thinking:*
    - System 1 - fast instantaneous thinking e.g. 1+1=2 - respond to danger, etc.
    - System 2 - slow deliberate type of thinking - e.g. pause and think about it first - may cause paralysis in decision making!
    - Now, note we start with System 2 thinking for risk management skills and then we do it so much it becomes system 1 risk management brain! Similar to firemen processing data on how fire spreads deliberately using System 2 thinking in training then with experience becomes second nature System 1 thinking!

**Understanding Regulatory Risk**

- Regulatory risk refers to the uncertainty due to laws and regulations enforced by different governments
- MNC are profit, market and resource seeking entities while governments protect national interests (citizens, consumers, industries, identity). These two have competing interests creating challenges!
  - So why do some MNEs look out into the world in search of resources, opportunities, advantages, etc.? Because some countries endowed with more of certain resources than others e.g. Indonesia endowed with Malacca Islands spices!
  - *Obsolescing Bargain (Vernon 1971)*: "A **model** of interaction between a multinational enterprise and a host country government, which initially reach a **bargain** that favors the MNE but where, over time as the MNE's fixed assets in the country increase, the **bargaining** power shifts to the government"
- Government use policies and regulations to make it difficult and expensive for MNCs to operate in foreign country (instruments of trade policy). Examples of instruments of trade:
  - *Tariffs*: taxes imposed on particular products or services as they enter or exit a particular country
  - *Subsidies*: financial assistance governments give to their own industries in order to rescue them from financial stress or make them more competitive
  - *Import quotas*: impose limits to quantity of a good/service allowed to enter/exit country
  - *Local content requirement*: require foreign companies to buy raw materials, services, components from locals or partner with locals
  - *Administrative policies* that foreign companies must comply with including registration rules, corporate codes of conduct, reporting requirements.
  - *Country specific compliance* defining what company is allowed / not allowed to do!

- Risk identification -> analysis -> management -> evaluation & monitoring
- How do they impact the Business Model e.g. how do tariffs etc. make an impact on Business Model Canvas? they could make an impact on the price that they need to sell (and hence revenue streams) or import of inputs from partners may increase the costs for a business, etc.




**Understanding Political Risk**

- Difference from regulatory risk is that political risk refers to uncertainty stemming from political parties, such as change in government, revolutions or lobbying (as opposed to risk from policy).
- Want to predict political problems to manage this risk, so we have Simon's framework!

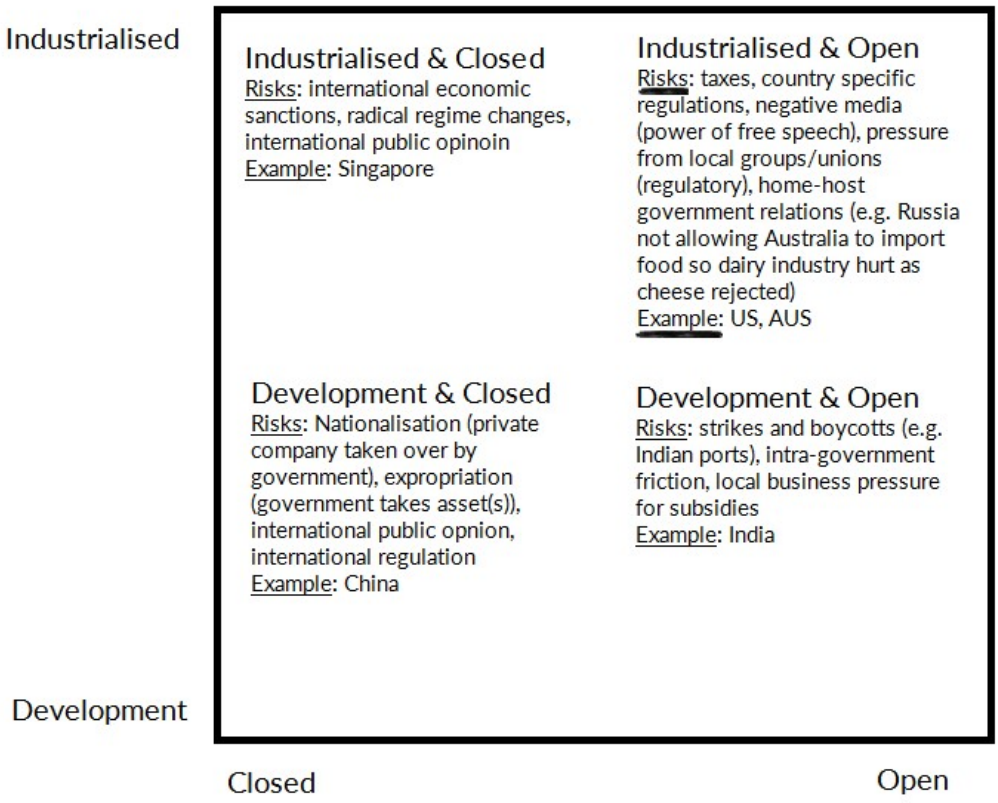
***Simon's (1984) Political Risk Framework***

Simon says we need to look at two things to assess and predict the level of political risk of a country:

- Actually looks at regulatory risk as well (we need to separate the two in our head!)

1. Level of economic development:
    - e.g. UAE is rich but not economically developed (it has concentrated wealth from oil, yet no oil industry because country doesn't have domestic industries that are actually capable of digging)
    - This criterion deals with industrial infrastructure and development - India, China, Brazil are not strong in this area!
2. How open the political system is in the country
    - This is as judged by free speech. Just like level of economic development, it is not black and white, it is a spectrum!

From this, we can predict the level of political risks of a country via the matrix below:




**Multilateralism (Multilateral Agreement)**

- Obligation have free movement of goods and services AS WELL AS people across every other country in the group!
- *Problems*: 'want to open doors to one country in agreement, but not another - yet you are obliged and cannot choose'
- For example, EU (located top-right of Simon's matrix) has political and economic integration through institutions, only in EU is there a perfectly free movement of people between 27-28 countries, common migration policy, etc. - this is why UK pulled away!
    - From a risk management perspective, Brexit for UK means tariffs as no independent trade deals have been negotiated!

**Risk Measurement**

*Introduction: Monty Python Problem*

- If you have 3 doors and 1 has prize inside, you choose door 1 and someone tells you door 3 does not have the prize inside, do you switch your choice to door 2 or not?
    - If do not switch then you will have 33% chance of winning
    - If you switch you get conditional probability of 66%
    - SWITCH!
- Pascal's Wager on reward/punishment of living a good / bad life conditional on existence of heaven / hell:
    - Risk associated with living a good life: punishment = 0, reward = infinite, with 50/50 chance
    - Risk associated with living a bad life: punishment = - infinity, reward = 0, with 50/50 chance

**RISK = P(negative future occurrences, factors or events) x Expected Consequences**

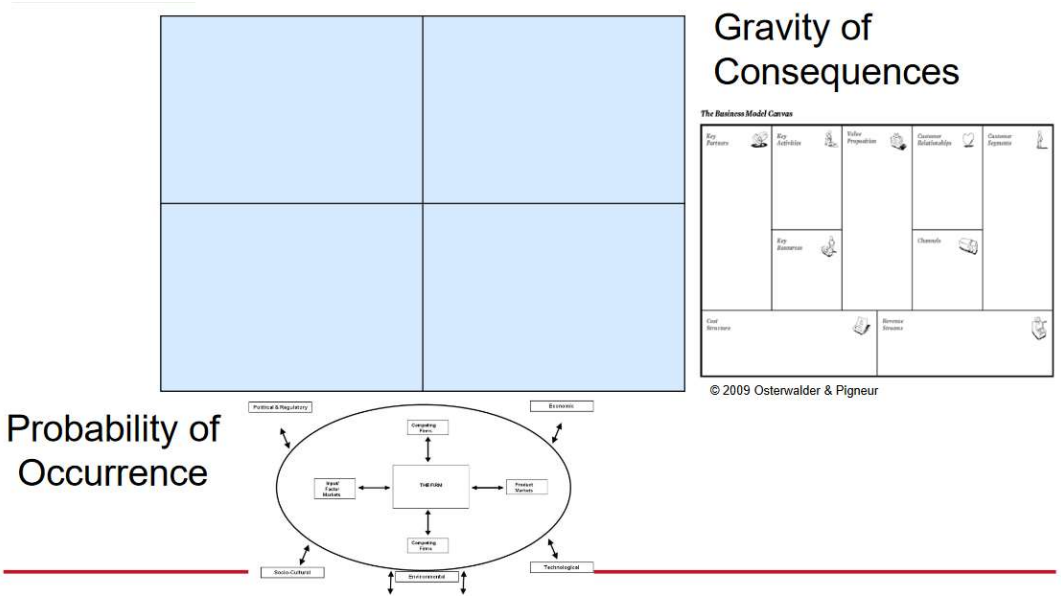
*Key challenge is not finding the probability, but finding the consequences.*

*Example: Failing Class Twice*

- Financial consequences of: 1500 + 1500 (uni fees) + time 50/hr x 3 contact hrs / wk x 13wk x 2 fails = 1960 x 2 (opportunity cost of working) + 20/wk x 13 wks (transport) + 300/wk x 13 (rent) = 3900 = $15,220
- Failure Rate at University is 36.8%
- Risk = 36.8% x $15,220 = $5,600.96

**Risk matrix brings together company Business Model and Environment**

- You can see which part of the company is important via the risk management and then you can assign numbers to the business canvas model!
- Example: left of BM = cost increase, right of BM = revenue loss, numbers that can capture specific risk!
- *Using Simon's Risk Framework*: for example, probability of nationalism is low then you can assign probability to very specific types of risks that affect the BM



# SAMPLE READINGS

**Week 2 Readings**

**Miller, Kent D. 1992, *A Framework for Integrated Risk Management in International Business*, Journal of International Business Studies, 23:2, 311- 331.**

*Summary*:

- Paper provides an integrated framework categorising uncertainties faced by firms in international context and offers both strategic and corporate risk management responses
- Risk defined in this paper as "unpredictability in corporate outcome variables" (consistent with finance)
- Three categories of uncertainty:
    - General environmental
        - Factors affecting business context across industries
        - Example: political instability, government policy instability, macroeconomic uncertainty, natural uncertainties, social uncertainties
    - Industry
        - Input market uncertainty:
            - Uncertainties around acquisition of adequate quantities and qualities of inputs in production processes
            - Usually affected by supply and demand shifts
            - In international environment, closely related to general environmental uncertainties - e.g. multilateral trade agreement uncertainties can influence input market uncertainties
        - Product market uncertainty:
            - Unexpected changes in demand for industry's output
            - Influenced by consumer tastes as well as foreign policies e.g. in regulating importing and foreign trading, etc.
        - Competitive uncertainty:
            - Uncertainties associated with rivalry among existing firms and potential entrants into the industry
            - Inability to predict the type and amount of goods in product market - from tech uncertainty or innovations!
            - Porter (1980) provides analysis of how to gain competitive advantage in an industry
    - Firm-Specific
        - Operating uncertainty:
            - Labour uncertainty
                - e.g. productivity
                - Safe workplace reduces labour uncertainties
            - Firm-specific input supply uncertainty
                - e.g. raw material or spare part shortages
                - Input supply uncertainty greatest when you have a single supplier to crucial input for firm
            - Production uncertainty:
                - Variation in output due to machine failure and other random factors that disturb production process e.g. accidents
        - Liability uncertainty:
            - Unanticipated harmful effects due to the production or consumption of a company's products (leading to legal action against firm)
        - R&D uncertainty:
            - Lack of certainty in foresight between R&D expenditure and actual introduction of new product/process - timeline unclear!
        - Credit uncertainty:

        - Uncertainties with collectibles!
    - Behavioural uncertainty:
        - These are agency relationship uncertainties where managers seek personal welfare at expense of firm's owners
- Financial and strategic responses to uncertainties:
    - Financial risk management reduces exposure to risks w/o changing firm's strategy
        - Forward or future contracts
        - Insurance
            - e.g. hedge/insure against FOREX or commodity movements
            - No financial risk management responses help against firm-specific uncertainties!
            - Sometimes, premiums too expensive and lack of market development for future/forwards to hedge the risk means need to turn to strategic responses
    - Strategic responses generally impact firm's exposure across wide range of environmental uncertainties
        - Five generic responses to general environmental uncertainties below:
            - Avoidance (of uncertainty):
                - Divest, delay new market entry, go to low uncertainty niches
            - Control (environmental uncertainties):
                - Political activities (lobbying), gain market power (deter new entrants), exchange of threats (so competitors are more predictable), vertical integration (input and supply certainty), horizontal M&A (competitive uncertainty)
            - Cooperation (multilateral agreements as opposed to unilateral control above):
                - Contractual agreements, voluntary restraint of competition, JV / SA, franchising, etc.
            - Imitation (of rival organisation strategies to reduce uncertainty)
                - Industry leader can predict response of rival because their actions are just a lagged imitation of own strategic moves!
            - Flexibility:
                - Adapt to substantial, uncertain and fast-occurring environmental changes that have a meaningful impact on organisational performance
                - This leaves predictability of external factors unchanged, but increases internal responsiveness
                - Example include product and geographic diversification, operational flexibility (input sourcing, work force size/skills, plant/equipment, multinational production).
- Implication of integrated risk management perspective (this paper):
    - <u>Uncertainty tradeoff</u>:
        - Sometimes, reducing uncertainty of one factor will increase exposure to another!
        - Example, increasing R&D uncertainty, may allow for reducing exposure to competition uncertainty by becoming more competitive!
        - As uncertainties are interrelated, need to consider a corporate level integrated risk management response over functional/divisional responses due to recognise the uncertainty tradeoffs
    - <u>Managerial response</u>: clearly, financial/strategic decision-making should be taken by managers if marginal benefit of reducing uncertainty outweighs marginal costs. Assess and respond!

**Week 7 Readings**

Reinhardt et al 2000. Mastering risk / Volume One (excerpts, pp.255-268)

**Summary:**

**Tensions in the Environment**

- Environmental risk:
  - *Government regulators and environmental activist perspective*: risk of damage to ecosystems or public health arising from some man-made environmental offense [risk to environment]
  - *Managers perspective*: understand environmental risk arises from social concern about environment
    - often it is not the environmental damage but the public concern about the environment that creates the risk to private cash flows and corporate asset values
  - *Management exposed to following costs*:
    - Lose customers
    - 'Toxic torts' in courts
    - Government impose increasing operating costs or ban company from operating
  - *Note - they are not the same and can exist without the other e.g. company can be at risk financially but cause negligible physical environmental risk; and vice-versa*
- Environmental risk is **asymmetric** - no short-term upside (like war / kidnapping, unlike economic risk), but may have long-term benefits
- *Need to figure how much risk to transfer, how much to invest in risk reduction and how much risk to carry. But many realise they need to invest into here to ensure long term survival preventing cataclysm.*
- **Tools to reducing environmental risk**:
  - Purchase insurance against risk
    - e.g. contingent liability from waste disposal
  - Use internal command-and-control regulations - safety procedures employees to follow to reduce enviro. risk
  - 'Soft tools' e.g. management evaluation and promotion system, corporate culture - if leadership is environmentally conscious the rest will follow suit
  - *Choice of tools depend on robustness of risk information*
    - More robust (less likely to change magnitude and probability) then more likely to use price-based tools like insurance contracts
    - Less robust, more likely to use non-price based tools like command-and-control regulation
- Environmental risk more likely complicated in future as economic output increases worldwide with increasingly affluence societies also simultaneously demanding higher standards e.g. climate change
- As information improves, they can start comparing enviro risks to other risks in the company and assess payoff.
- **Incentives for risk management for managers:**
  - Managerial performance based off business-unit profits mean incentives need to pay attention to reducing costs that do not create short-term gains --> therefore, managers impose command-and-control regulations
  - Violation of environmental laws lead to individual civil or criminal liability for managers
  - Enhance own status in community or self-worth
- **Generally,** there is tension between risk to environment and environmental risk to company: choose to comply and damage profits, or not comply and damage long term environment

- Some exceptions: e.g. Chevron pesticide clean up - they complied to minimise risk to environment and at the same time reduce long term environmental risk to the company as less red tape!

**Seeking succour from the rising costs of catastrophe**

- Cost of natural disasters increasing in size and publicity, but don't receive any notice until immediate aftermath!
  - Due to property development in hazardous areas
- Emerging economies have suffered more from natural disasters comparatively to developed because the loss is proportionately larger compared to their GDP
- Require cost-effective loss-prevention/reduction measures as well as complementary adequacy in financial protection following disaster
- Reasons why people don't put in effective 'loss-prevention' measures:
  - The 'it won't happen to me' mentality
    - Low probability disasters means limited personal experience and don't regard probability as significant
  - Natural disasters may not even be considered until after they have occurred
    - Difficult to obtain risk estimates until now
  - Requires $$$ w/o guaranteed return
    - (even though best return on insurance is no return!)
    - e.g. mitigation by building stronger houses, people don't care if short time horizon
- New developments in assessing risk via IT more quickly allow persuasion of business / property owners to mitigate risk
- 'Reinsurance' for insurance companies,(insurance for insurers) to avoid possibility of insolvency / significant surplus loss
  - Still, insurance sector's capacity to bear large catastrophe is still low according to Wharton study.
- Best insurance solution:
  - Combination of private and public initiatives:
    - Risk management economic incentive by private sector - reduce costs of premium if owner is safer and gives plant earthquake protection for e.g.
    - Strongly enforced building codes (so less damage and insurers pay less for 'Act of God' bond towards reinsurer, and businesses less for insurance) by public sector

**The Essentials of Crisis Management**

- General framework for managing major crises: a composite of 'best practices' for companies to compare their current crisis management capabilities
  - Consists of crisis types, mechanisms, systems and stakeholders as per below
- Crisis types
  - Economic, informational, physical, human resource, reputational, psychopathic and natural disaster crises
  - Natural disaster means don't need to assign blame
  - *c. Need to prepare for outside their direct operating experience (i.e. don't look at individual crises in isolation, but how it relates to overall system)*
- Crisis mechanisms
  a. Proactive not reactive
  b. Signal-detection mechanisms
     i. e.g. increased graffiti in factory walls may indicate employee unrest and potential workplace violence
  c. Damage containment - don't allow crisis to spread e.g. oil spillage containment have firewalls etc.
  d. Post-mortems - assessing crises after they occur

- Crisis systems
    - Determine crises management capabilities: Technology, organisational structure, human factors, culture and psychology of senior management
        - These are the five components to understanding any complex organisation
        - Generally, orgs use Freudian defense mechanisms to deny their vulnerability to crises
        - Understanding these systems and aligning them are essential to crisis management
- Crisis stakeholders (internal and external)
    - Employers, employees, emergency services, insurance companies
    - Need to cooperate, share and be trained in crisis plans