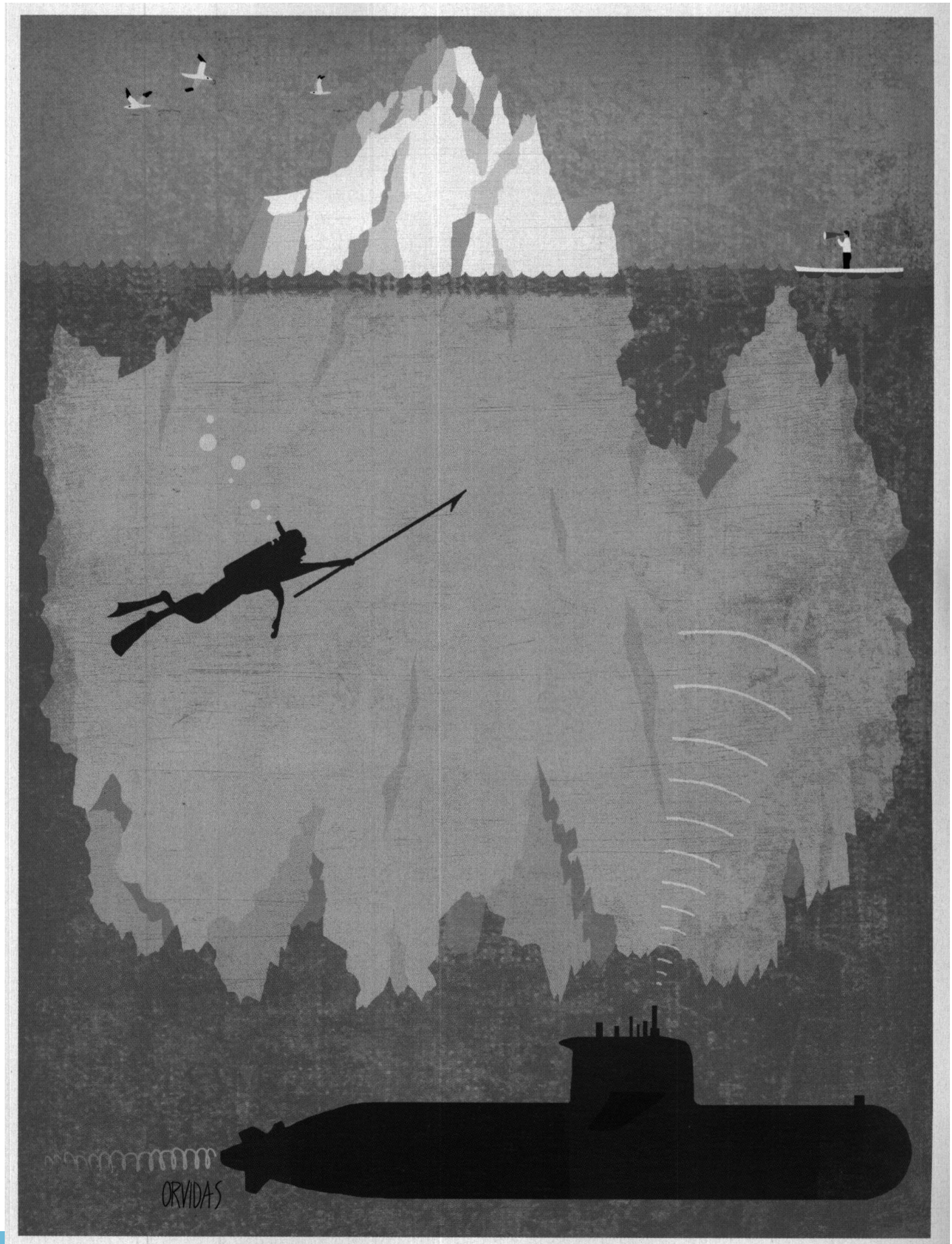
# MEASURING AND MANAGING SOCIAL and POLITICAL RISK

BY TAMARA BEKEFI AND MARC J. EPSTEIN

Sustainability and corporate social responsibility are increasingly becoming mainstream business practices. For many companies, the discussion is no longer whether to be more sensitive to stakeholder impacts and needs, but how to do that in a complex, profit-oriented enterprise.

Some companies focus primarily on minimizing risks related to pollution, product quality, safety, and unacceptable actions by suppliers in foreign factories. Others, like The Home Depot, with its Eco Options line, and GE, with its commitment to "Ecomagination," seek new opportunities inspired by these risks.

Managing social, environmental, and political risk is challenging for any company. But rigorously incorporating innovative practices into a wider risk management and strategy framework can mean the difference between devastating loss and as-yet-unrecognized opportunities.

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These risks are too often ignored, partly because of the complexities of measuring and integrating them into operational and capital investment decision making. Social, political, and environmental risks are often relegated to the footnotes, which aren't included in financial calculations. Reporting these risks in monetary terms is an important step toward integrating them into financial planning and corporate strategy. In so doing, they climb from their current position as footnotes to the financial calculation to a position that accurately reflects the devastating impact they can have.

**The failure to integrate social, environmental, and political risks into investment decisions in a meaningful way leaves critical elements out of current resource allocation.**

Until now, financial managers have lacked a suitable methodology to explicitly measure and integrate these risks into existing capital resource allocation approaches, including return on investment (ROI). But transforming the discussion of political and social risk from a largely qualitative to a quantitative one emphasizes their relevance.

## A NEW, COMPLEX REALITY

Let's look at some of the extensive social, political, and environmental risks that companies face. U.S. companies that emit large amounts of greenhouse gases face potential taxation under the Lieberman-Warner bill, now in the Senate. International toy companies and local retailers are grappling with falling sales resulting from lead contamination in playthings produced in China. Small and large companies face the specter of nationalization or forced partnership in Venezuela, Bolivia, and other areas as parts of Latin America drift farther to the left.

A changed international political landscape heralded by September 11, 2001, and followed by bombings in London, Madrid, and Mumbai; technological leaps creating rapid communications networks; Hurricane Katrina and other natural disasters; and corporate scandals have all broadened the scope of what can now be classified as corporate risk. This new climate includes challenges such as terrorism, anti-globalization, technologically savvy advocacy groups, amplified scrutiny of labor issues and increased litigation, as well as the Sarbanes-Oxley Act and the London Stock Exchange's "Combined Code."

Relegating risks to the footnotes effectively places zero value on them, even though they can have a devastating impact on earnings, shareholder value, and brand value. According to a recent poll by the American Institute of Certified Public Accountants (AICPA), 84% of companies don't formally integrate social and political risks in financial calculations. Often, therefore, companies make decisions about social, environmental, and political risks based on personal biases, or they arbitrarily assign higher risk premiums to projects in unfamiliar locations and thereby fail to focus management's attention on reducing risk.

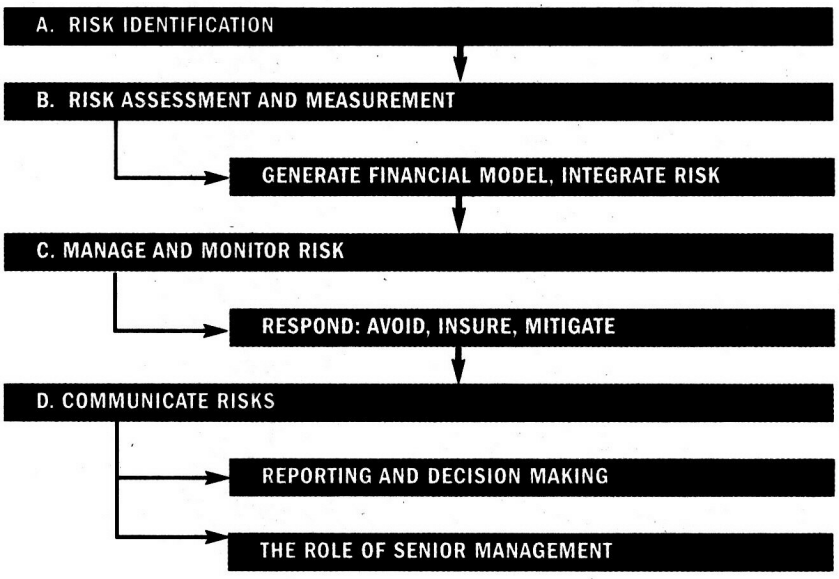
There are many reasons why. One is that capital investment decision making relies heavily on reliable and verifiable financial information, but social and political risks are generally thought to be immeasurable. (Yet adequate disclosures of risk assessments provide significantly more and better information regarding the quality of the data, and the range and reliability of the estimates, than is often provided for other projections.) Another reason is that explicit recognition of these issues is done in narrative form, which is often ignored or not fully considered.

Current yet inadequate practices to address social and political risks include country risk scorecards that are too general to be useful, statistical analyses that produce nonmonetary results, and adjusted discount rates and cost of capital often based on overly broad data.

The failure to integrate social, environmental, and political risks into investment decisions in a meaningful way leaves critical elements out of current resource allocation. Even when companies have invested in increasingly risky ventures (including diversification into significantly more complex locations), they haven't used available tools to analyze their alternatives more rigorously. But thanks to recent developments—information technology that facilitates collecting and analyzing large amounts of data, systems that include nonfinancial measures of organizational performance, and risk management systems that organize complex data for more rigorous analysis—failing to integrate social and political risk into management decisions should be considered unacceptable.

With only 16% of companies formally integrating social and political risks into investment decisions, a

**Figure 1:** Social and Political Risk Integration Model




practical and rigorous approach is required. As we've said, better forecasting of potential changes in the social and political environment can lead to improved decision making. Our approach (which integrates social and political risk into a modified ROI calculation that can include real options) provides a practical method that's sensitive to balancing the costs of management time and the significant cost of ignoring major risks.

## INTEGRATING RISK MEASUREMENT

Risk is generally described as any event or action that would adversely affect an organization's ability to achieve its business objectives and execute its strategies successfully. More specifically, risk relates to the probability that exposure to a hazard will lead to a negative consequence.

Social risks are societal matters. Ongoing social challenges may include diseases that impact the workforce, environmental issues that create tension within local communities or prompt penalties, infringement on human rights that can lead to reputation damage or litigation, and challenges by stakeholders due to perception of business practices.

Political risk is the exertion of political power in such a way that it threatens a company's value. The distinction between social and political risk, however, is often blurred; issues can be experienced differently by different sectors in varied locations.

Effective risk management involves recognizing the socio-political and corporate environments that might create risk, then identifying, evaluating, measuring, analyzing, resolving, and monitoring them. Calculations can be applied to decisions in both day-to-day operations and capital investment planning, such as choices about plant location (see Figure 1).

## DEGREES OF RISK

Different businesses are prone to and exposed to social and political risks in unique ways. This can depend on:

- Location of facilities,
- Product and customer characteristics,
- Nature of employment relationships, and
- Industry characteristics.

Well-known examples of companies such as Nike, Wal-Mart, and Shell recall the notorious social risks related to industries such as mining, footwear, apparel, toys, petroleum, and chemicals. Nike, for example, was accused of using child labor to produce soccer balls in Pakistan and was boycotted as a result. Wal-Mart has been accused of paying its workers less than minimum wage, forcing them to work off the clock, and violating child labor laws. The well-known dispute about environmental impacts of disposing of the Brent Spar oil platform in the North Sea had significant costs for Shell, and it still reverberates.

There are varying social and political risks—and degrees of risk—related to locating in specific countries or regions. So it's vital that the evaluation and calculation of social and political risk be company and project specific. Integrating these risks into a modified ROI calculation

enables managers to better understand the full range of risks they face and the costs they may incur. It also helps clarify thinking about potential mitigation strategies.

## NEW STRATEGIES

The first step to integrating social and political risks into financial calculations is identifying the most relevant issues. This can be done in a variety of ways, including:

- Learning from the past,
- Learning from others, and
- Scenario planning.

**Learning from the Past:** While past experience can't necessarily be a predictor of future performance, ignored signals, missed opportunities, and surprises can provide insight into organizational blind spots. Some suggest beginning a few decades back and systematically listing the social, technological, economic, environmental, and political changes in and around your industry.

**Learning from Others:** The adage "A wise person learns from experience, but a wiser person learns from the experience of others" holds as true in business as it does in life. The report "To Err Is Human" (released in 1999 by the Institute of Medicine, an arm of the National Academies) estimated that 98,000 patients die annually from preventable medical errors. This wake-up call resounded throughout the healthcare community and led to a realization that the majority of adverse events in U.S. healthcare are the result of human error, particularly failures in communication, leadership, and decision making.

A few top managers recognized the similarity between the structures of medical and aviation teams, as well as the causes for medical errors and plane crashes. As a result, many healthcare organizations began to innovate around patient safety with guidance from the aviation industry, which has a similar structure of captain (surgeon) and crew (nurses and anesthesiologist). This process of learning from another industry allows healthcare providers to efficiently address a major risk and save costs by quickly honing in on solutions for patient safety.

**Scenario Planning:** Once mainly the domain of crisis management teams, scenario planning is a powerful tool. Identifying the factors that could weaken or decimate your business allows for early action to avert catastrophe and create well-thought-through action plans. This can lead to innovative thinking that generates new ideas.

Social, political, and environmental risks must be measured and monetized. Like other estimates used in financial analysis, they are often imprecise. But with proper estimation techniques and disclosure, they certainly aid decision making and are relevant for management discussions.

Often, decision makers will estimate ranges of costs and choose a point estimate for use in the analysis. The ranges, along with measurement techniques for the ROI analysis, would then be included as a footnote or appendix. Discussion of these ranges and decisions to determine a certain point estimate assist personnel in thinking about and communicating these often-neglected risks.

While these estimations are important, ultimately just as critical is the process of deciding on the appropriate issues, their associated costs, and the probabilities of occurrence. In the end, it's the board, the CEO, or CFO who must decide on the appropriate metric. The quantitative analysis, ranges, point estimates, and ensuing discussion are critical elements of the decision-making process. Therefore, the assumptions, decisions, and measurement techniques that lead to quantification of social and political risks must be included as a footnote or appendix to the ROI analysis.

## MEASURING RISK

Measuring social and political risk for inclusion in ROI calculations is a nine-step process:

1. Generate options using "real options thinking";
2. Calculate benefits of each risk;
3. Calculate potential costs, including reputation;
4. Estimate probability;
5. Calculate expected value of each risk;
6. Calculate net present value (NPV) of each risk;
7. Aggregate NPVs of social risks;
8. Aggregate NPVs of political risks;
9. Calculate expected value ROI.

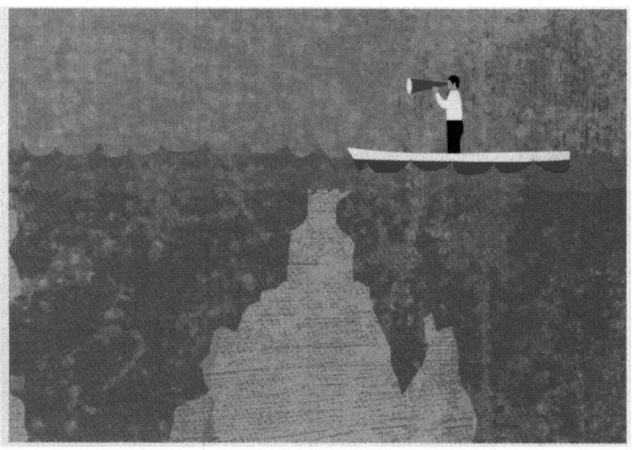
**Step 1:** Real options thinking forces decision makers to explicitly consider the value of a new investment and the options it creates. It also allows for an initial investment with a longer time horizon for a return on the investment, and it builds in the possibility of a variety of outcomes and responses to this information as it unfolds. But, because they are complicated, real options calculations aren't being used other than in financial settings and stock option calculations. When real options thinking is included in general business decisions, it is often done using ranges or as a discussion of underlying assumptions rather than by including point estimates.

Real options thinking incorporates financial insights at the strategic stage of project planning rather than as afterthoughts. The first step in a modified ROI calculation that includes social and political risks is thinking about the various options (such as investment in a range

of countries, including a range of suppliers in the supply chain, etc.) that could potentially minimize risk. This helps clarify where risks lie and what the potential impact could be.

An option is a right, but not an obligation, to take an action—such as buying, expanding, or deferring—at a predetermined price for a predetermined period of time. Real options embed an option value in otherwise static NPV calculations and thereby add the necessary flexibility. Real options allow for the uncertainty and continuous learning inherent in project planning and successful business strategy.

**The biggest cost of social and political risk is usually in reputation and lost sales due to consumer boycotts or protests.**



Though real options thinking is very helpful to the analysis of social and political risk and should be included in decision making, the formal submissions for capital resource allocation approval continue to be based on ROI or NPV analyses. Return on investment is the most popular approach in corporate performance measurement because ROI is the approach that CEOs and CFOs are most familiar with. If built on a foundation of real options thinking, it can provide a comprehensive approach that integrates these difficult-to-measure risks, and it can improve decisions.

To make such analysis more complete and improve operational and capital investment decisions, political and social risks must be included in the conventional ROI calculation, making it more explicit and relevant.

**Step 2:** Monetizing the savings and costs associated with each issue that could generate social and political risks is the second step. If a corporation considered employing child labor (which we do *not* advocate), the savings would be calculated by measuring the wage rate difference between paying an adult and a child. The *issue benefit*, which is generally assigned a positive value, would be the savings.

The reputations of industries, especially clothing and shoe manufacturing, have been seriously damaged by the use of child labor, and some companies have attempted to stop the practice. The chocolate industry largely ignored the issue until newspapers began publishing stories of kidnappings and forced child labor on cocoa plantations in West Africa.

After calculating the risk of child labor, then each potential cost associated with it, such as the public discovering it, should be calculated. These costs could include:

- Lost sales and other reputation impacts,
- A consumer boycott,
- Diminished brand value, and
- Negative impact on recruiting potential employees.

The process is the same for political and social risk: pinpointing general issues and those specific to the firm, product, and operation location. Third-party polling firms, surveys, a public relations team, and information from other companies can help determine which stakeholders view particular social and political issues negatively. (These stakeholders can include customers, distributors, employees, the general public, lenders, local communities, stockholders, suppliers, social activist groups, and the media.)

The biggest cost of social and political risk is usually in reputation and lost sales due to consumer boycotts or protests. This can be measured through lost sales minus the cost of producing the goods, or the *lost net profit*. *Share price* and *market share decline* are two other potential issues.

The professional services and insurance firm Marsh & McLennan Companies, Inc., experienced a 40% drop in its stock price when accusations of bid-rigging activity made the news in November 2004. In addition to its debt being downgraded by credit rating agencies because of its deteriorating reputation, Marsh & McLennan cut 5% of its workforce that year on predictions of a 94% decline in its third-quarter profits.

Where possible, the impacts of share-price and market-

## Table 1: Integrating Social and Political Risk Costs in ROI Calculations

**1. Calculate the Monetary Benefits of the Project**

| OUTPUT | REVENUES | NPV |
|---|---|---|
| New product | Added revenue stream | $..... |
| | Labor cost savings | $..... |
| | New customer base | $..... |
| | **Total Benefits** | $..... |

**2. Calculate the Total Costs of the Project**

| COSTS | | NPV |
|---|---|---|
| Shipping | Transport rates, import duty, transporting goods from port to factory | $..... |
| Raw materials | | $..... |
| Labor | | $..... |
| Total Social Risk costs | See Schedule A | $..... |
| Total Political Risk costs | See Schedule B | $..... |
| | **Total Costs** | $..... |

**3. Calculate the Project ROI**

$$ROI = \frac{\text{Total Benefits} - \text{Total Costs}}{\text{Capital Costs (Investment)}} * 100$$

**Schedules A** (Table 2) **and B** (Table 3) provide a sample list of social and political risks to give a sense of potentially relevant issues. Schedule A lists possible risks for a business operating in an unstable region, such as an extractive company. Some issues, such as civil unrest near the site, would likely not present any benefits. Others, such as operating on indigenous lands, can present a short-term savings because of low land prices.

share decline should be calculated as potential long-term losses. Include the costs of managing stakeholders in the medium to long term either through additional personnel or other strategies. In most cases, reputation risk is associated with particular social and political risks. They are simply another cost and probability, albeit often large ones, to be calculated when thinking through the impacts of certain issues.

**Step 3:** Each of these costs is assigned a value to get *risk costs*.

**Step 4:** After calculating the potential costs of each risk, approximate the potential likelihood, in percent, that each risk would occur. This is the *estimated probability*, or the likelihood that the event will occur and damage the company. You can include a footnote in the ROI analysis that demonstrates that these numbers are midpoints and most likely will settle within a range. Assign an estimated probability to each risk you identified.

**Step 5:** Once you've approximated the potential likelihood that each risk will emerge, calculate its *expected value* by multiplying the *estimated cost* of the risk by the percent *estimated probability* of an occurrence.

**Step 6:** Calculate the net present value of each issue. Note that each issue has risks that emerge at different times. NPV calculations for social and political risk are determined in the same manner as traditional NPV calculations. Discount back using a set discount rate in the traditional manner. Carry out these calculations for each social and political risk.

**Steps 7 and 8:** After calculating all NPVs for social and political risks, add together the social risk NPVs and then the political risk NPVs. Insert them as line items in the normal ROI calculation. Provide schedules that show the calculations of benefit, expected value, likelihood, and cost of social and political risk (see Tables 1, 2, and 3). This enables senior management to see both the output and process.

## Table 2: Schedule A—Costs of Social Risks

| RISK | BENEFIT | COST TYPES (EXAMPLES) | COSTS | LIKELIHOOD | EXPECTED VALUE |
|---|---|---|---|---|---|
| **Civil unrest surrounding site** | $..... | Engaging employees skilled in negotiating with protesters | $..... | ..... % | $..... |
| | | Extra security personnel | $..... | | |
| | | **REPUTATION-RELATED:** | | | |
| | | Hiring community relations manager | $..... | | |
| | | Managing activist nongovernmental (NGO) relations | $..... | | |
| **Prostitution near site** | $..... | Health education for workers to teach about sexually transmitted diseases (to avoid costs related to HIV infection) | $..... | ..... % | $..... |
| **Child labor** | $..... | **REPUTATION RELATED:** | | ..... % | $..... |
| | | Reputation damage | $..... | | |
| | | Managing boycotts when information reaches activist consumers | $..... | | |
| | | Hiring NGO-relations manager | $..... | | |
| **Infringement on indigenous lands** | $..... | Litigation in international courts | $..... | ..... % | $..... |
| | | Remunerating population | $..... | | |
| | | Work stoppages due to local strike, reputation damage, community protests, work stoppages | $..... | | |
| | | **REPUTATION-RELATED:** | | | |
| | | Hiring community relations manager | $..... | | |
| | | Managing activist NGO relations | $..... | | |
| **Reputation costs, including lost sales and profits** | | | | | $..... |
| | | | | **NPV** | $..... |

Most underlying causes of political risks don't present any savings. While there can be benefits and costs related to entering a country with political instability, the risks posed by anti-business legislative changes, policy changes, or contract renegotiation are of little to no benefit. Favorable policy or legislative changes wouldn't be considered political risks.

Reputation costs are included as a separate line item because they represent a large component of social and political risk. In addition to the methods mentioned previously, reputation costs can be listed as lost sales and profits.

**Step 9:** Integrate the results into traditional ROI calculations.

## MANAGING, MONITORING, REPORTING

Identifying, measuring, and integrating social and political risks into ROI calculations allow a new understanding of the full spectrum of risks and provide the foundation for managing them. While financial risk might be shared or transferred, this is often impossible with social and political risks. Companies operate in a setting where they are often held liable for the misdemeanors of their suppliers or related businesses with the same moniker.

Managing political, social, and reputation risk includes devising policies and programs to identify, measure, monitor, respond to, and report on risk and using this information to avoid or mitigate those risks.

Responding to social and political risk can occur in four ways:

- Insuring against risk when possible,
- Avoiding risk,
- Mitigating risk, or
- A combination.

As the hazards faced by businesses continue to proliferate in scope and complexity, it becomes critical that corporate risk management practices integrate social, environmental, and political risks in order to effectively manage companies' real risks, improve their resource allocation processes, and capture corporate social opportunities.

## Table 3: Schedule B—Costs of Political Risks

| RISK | BENEFIT | COST TYPES (EXAMPLES) | COSTS | LIKELIHOOD | EXPECTED VALUE |
|---|---|---|---|---|---|
| **New legislation that changes the rules of the game** | $..... | Lost revenues | $..... | ..... % | ..... % |
| | | Increased taxes and tariffs | $..... | | |
| **Forced contract renegotiation with host government** | $..... | Lost profits | $..... | | |
| | | Lost investment | $..... | ..... % | ..... % |
| **Armed insurrection** | $..... | Hiring private security | $..... | ..... % | $..... |
| | | Training local police/military to prevent human rights abuses (if required to use these forces by contract) | $..... | | |
| **Associated reputation risk** | $..... | Incentive packages to attract workers to location | $..... | ..... % | $..... |
| | | Protests, etc. due to potential linkages with human rights abuses | $..... | | |
| **Endemic corruption** | $..... | Payoffs and bribes | $..... | ..... % | $..... |
| | | Potential lawsuits | $..... | | |
| | | Lost contracts for refusing to participate | $..... | | |
| **Targeted criminal activity** | $..... | Protecting personnel, including reinforcing security at private homes, and providing security training to employees and families | $..... | ..... % | $..... |
| | | Increased pay, time off, and hardship bonuses to attract workers | $..... | | |
| | | Increased security to protect facility | $..... | | |
| | | Potential work stoppages | $..... | | |
| **Terrorism** | $..... | Reinforcing infrastructure | $..... | ..... % | $..... |
| | | Hiring additional security personnel | $..... | | |
| | | Rebuilding | $..... | | |
| **Reputation costs, including lost sales and profits** | | | | | $..... |
| | | | | **NPV** | $..... |

Though quantifying these risks is often imprecise, it's the first step to integrating a wider set of hazards into calculations that will more accurately reflect the true nature of risk in an increasingly challenging business environment. Measurement also enables decision makers to formulate mitigation strategies, sometimes preemptively, that can represent significant cost savings.

We too often think about risk only as a hazard. But if managed well, the risk coin has a flip side: Innovative ideas can capture and manage the opportunities for increased growth. Next month, we discuss the measurement of the opportunities that can emanate from these risks if they are managed effectively. ■

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**Risk management is a topic at IMA's Annual Conference, June 14–18, 2008, in Tampa, Fla. For information, visit www.imaconference.org.**