

POLITICAL RISK FACTORS IN SOUTH AFRICA: SOURCES, ANALYSIS AND INSURANCE FLEXIBILITY

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Abstract

Political risk factors are of prime importance to business operations around the world, as they may impact negatively on the financial performance thereof and may even lead to the financial failure of enterprises and industries. As political risk factors are often abundant in developing countries with emerging market economies, this study is undertaken in South Africa which is classified accordingly. The objective of this research focuses on the improvement of financial decision-making concerning the sources, analysis and insurance flexibility of political risk factors. To achieve the objective of the paper, a literature study and an empirical survey, involving the agents of political risk insurance in South Africa, were undertaken. Due attention is paid to identifying the most important sources of political risk factors, as well as the analysis of the political risk factors by the underwriters concerned. The importance of flexibility concerning the various aspects of political risk insurance is also addressed. The perceptions of the agents of political risk insurance in South Africa provide a valuable contribution to the empirical results and conclusions of this paper.

Keywords: Analysis of Political Risk Factors, Insurance Flexibility, Political Risk Factors, Political Risk Insurance, Sources of Political Risk Factors

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1 Introduction and objective of research

Although various definitions of political risk are available, the following definition provided by Brink will be applied in this paper, which defines political risk as "... the probability that business will ... suffer losses ... as a result of stakeholders within a political system's (in)actions or reactions to events, decisions and policies..." (2004:18). Brink (2004:2) identified 103 political risk factors which are the actual areas or spheres where political risk may occur. Political risk factors are of prime importance to the business environment as they may impact negatively on the financial operations thereof and may eventually lead to the insolvency of the enterprises.

South Africa is classified as a developing country, as well as one of the 21 emerging market economies of the world (MSCI Barra, 2010). It is also well-known that South Africa recently became a member of the BRICS countries (SouthAfrica.info, 2011). This study focuses on the sources and analysis of political risk factors which are apparent in the BRICS countries according to Essel (2012:126-132).

The flexibility of political risk insurance is also addressed in this paper to effectively manage these risks. The proper management of political risk factors may signify the difference between a financially feasible enterprise and an unsuccessful firm.

The objective of this research embodies the improvement of financial decision-making concerning the sources, analysis and insurance flexibility of political risk factors. This objective is achieved by focusing on the literature concerning the various sources of political risk factors, the analysis of the political risk factors and the manners according to which insurance flexibility of political risk factors can be achieved.

An empirical study was conducted thereafter to determine the various sources of the political risk factors in South Africa, whether the political risk factors are properly analysed in the country, as well as the importance of flexibility concerning various aspects of political risk insurance, as perceived by the respondents. The responses of South African agents who are occupied in underwriting political risk factors are employed in this regard. The results of this

research should also be valuable to enterprises in other emerging market economies as South Africa is classified accordingly.

2 The classification of the sources of political risk factors

The sources of political risk factors can be classified in two manners, viz. the internal versus the external sources of political risk factors, as well as the government-related versus the society-related sources of political risk factors (Essel, 2012:30-33). The classifications are discussed in the following sections.

2.1 The internal versus the external sources of political risk factors

When political risk factors originate within the country itself, they are known as internal sources of political risk factors. Civil wars, nationalisation, expropriation and riots are examples of such political risk factors. The internal sources of political risk factors may originate from government and other pressure groups in the social environment. According to Brink (2004:87) it is probable that when a country has a poor bureaucracy, more radical changes may be experienced when a new government takes over the rule of a country. The institutional strength and quality of a bureaucracy are determining factors of how dramatic changes will be when a new government comes to power (The Political Risk Services Group, 2010). It is interesting to note that a close relationship was concluded between the strength of a country's bureaucracy and its institutional strength (Busse & Hefeker, 2005:3).

In the case when political risk factors are caused from outside a country, they are known as external sources of political risk factors. International terrorism and war are examples of external sources of political risk factors (Alon & Martin, 1998:12). The importance of external sources of political risk factors should not be underestimated as a foreign government and other foreign societies may impact negatively on the business operations of a country by causing political risk factors (Howard, 1993:42).

The government-related versus the society-related sources of political risk factors

The sources of political risk factors may also be classified as government-related versus society-related. Riots and terrorism may be classified as society-related sources of political risk factors as they are caused by the society instead of the government. The government may, on the other hand, be the source of political risk factors when expropriation and nationalisation occurs (Bremmer & Keat, 2009:88).

Regulatory changes may cause three types of government-related sources of political risk factors which may be economically or ideologically motivated, namely:

Transfer risks originate when government regulations impact on the capability of an enterprise to transfer funds. This may apply to the transfer of funds between various locations or between local and foreign currencies.

Operational risks impact negatively on the financial operations of an enterprise. This may imply that the regulations are explicitly detrimental or that they are so vague that uncertainty exists concerning their current and future applications.

Ownership-control risks which have the change of ownership of subject-matter in mind which may involve expropriation or nationalisation by government.

Government-related sources of political risk factors focus mainly on confiscation, price and technology controls, currency inconvertibility, devaluation, tax regulations, as well as repatriation, import, employment and operational restrictions (Lewis, 1979:222). Society-related sources of political risk factors may have a detrimental impact on a government's actions or may bring political tension along when society's demands for stability, security, respect and dignity are not met. Society-related sources of political risk factors may include unemployment, poverty and consumer distrust (The Political Risk Services Group, 2010). When societies are reasonably satisfied with the economic, political and socio-cultural situations in a country, society-related political risk factors should occur less often than in countries where dissatisfaction prevails amongst the population.

3 Analysis of political risk factors

The analysis of political risk factors addresses a process to determine the probability and severity that political risk factors may cause. By identifying the various underlying indicators of political risk factors, the situations which may lead to political risk factors can be anticipated. Poverty, as an underlying indicator, may, for example, lead to the political risk factors of civil unrest and riots. The analysis of political risk factors enables two important aspects, viz. the anticipation of the possible occurrence of political risk factors, as well as the proper management thereof (Brink, 2004:4).

The analysis of political risk factors is an ongoing process, as the underlying indicators of political risk factors are constantly changing. Due to the human nature of political risk factors, they cannot easily be anticipated on a statistical basis (Venter, 1998:6). The effectiveness of the political system, socio-economic conditions, conflict, and religion should, amongst others, be taken into account when analysing political risk factors (Alon & Martin, 1998:11; Brink, 2004:80-88; Control Risks, 2009(a)).

The importance of making a distinction between open and closed political systems when analysing political risk factors in a country is emphasised by

Simon (1984:130). The reason why the degree of openness in a society is important, is that it indicates the capability of non-governmental parties to impact on the events which occur in a country. The openness of a society may be an important facilitator of political risk factors, as actions such as protests and boycotts of a non-violent nature could easily take place in an open political system. Violent activities are more probable to occur in a closed political system according to Simon (1984:130-134). The extent of a country's democracy may also contribute to the degree of political risk according to Jensen (2008:1041-1042). It is expected that political risks may be high during the recovery phase of an economic cycle, when the expectations of the population are not met in a democratic society. The probability of some political risk factors may however be lowered when the population's expectations are met (Control Risks, 2009(b); Groth & Roberts, 2001:302-304).

It was already mentioned that South Africa has an emerging market economy, which may be more risky than developed market economies in terms of political risks (Bilson, Brailsford & Hooper, 2002:14; Diamonte, Liew & Stevens, 1996:72). Economic conditions, such as poverty and unemployment, may play an important role in this regard and may impact on political risk factors. It was found that 57% of emerging market economies have a medium or even higher political risk rating (Control Risks, 2007). Although political instability is more likely to occur in emerging and less developed market economies compared to developed market economies (Kouznetsov, 2009:378; Nakata & Sivakumar, 1997:469), it should be emphasised that political risk factors are not limited to emerging market economies (Berlin, Berlin & Vrooman, 2003:2). Political risk factors may also occur in developed market economies, for example in the manifestation of corruption or detrimental trade regulations (Brink, 2004:29).

4 Flexibility concerning political risk insurance

The management of political risks can be done in a number of manners, including risk retention, risk reduction, risk avoidance and risk transfer. Political risk insurance is part of risk transfer and is considered to be the most effective strategy for handling political risk factors. Political risk insurance issued by a political risk insurer should be an efficient source of protection against the related risks. The political risk insurance industry therefore provides a more stable business and investment environment relating to political risk factors (Nel, 2009:112). Business operations in foreign as well as domestic countries can benefit from the cover provided by political risk insurance. There are various aspects of a political risk insurance policy which can be utilised to customise the policy contract in order to suit the needs of the

insurer and the enterprise. The flexibility concerning political risk insurance can be obtained in various manners, viz.:

The general conditions of the insurance policy contract can be adjusted, taking the needs of a particular insurer, insureds or industry into account.

Special endorsements can be provided in the insurance policy contract for an extraordinary insured.

The extent of the cover can be set according to the needs of the insurer and/or insured.

The definition of political risks can be adjusted to acknowledge particular political risk factors which are important for a specified business situation.

The level of premiums can be determined by the insurer on an ad hoc basis taking the level of political risk into consideration.

No-claim bonuses can be provided by the insurer to acknowledge the good claims history of an insured.

By employing the preceding aspects of a political risk insurance policy, the flexibility thereof can be achieved to the satisfaction of both the insurer and the insured. The empirical section of this paper will, amongst others, pay attention to the flexibility concerning these various aspects of political risk insurance.

5 Research methodology

The objective of this research was already formulated as the improvement of financial decision-making concerning the sources, analysis and insurance flexibility of political risk factors. The perceptions of the underwriting agents of political risk insurance in South Africa are therefore of prime importance to support the literature study which was done. The empirical survey consisted of personal interviews which were conducted with the agents that underwrite political risk insurance in South Africa, known as Sasria insurance. The questionnaire, which was used as an aide-mémoire during the personal interviews, was based on the literature study. After special efforts were undertaken, 32 of the available 54 agents participated in the empirical survey. The empirical results appear in the following sections.

6 Empirical results

The empirical results of this paper focus on the sources of political risk factors in South Africa, the analysis of political risk factors by the respondents, as well as the insurance flexibility of political risk factors based on the perceptions of the underwriting agents (Essel, 2012:122-132). The following section addresses the sources of political risk factors.

6.1 Sources of political risk factors

Table 1 contains the most important sources of political risk factors in South Africa during the past

five years and the next five years, according to the perceptions of the respondents.

Table 1. Most important sources of political risk factors in South Africa during the past five years and the next five years, as perceived by the respondents

Source	Past five years		Next five years	
	Number of respondents	Percentage of respondents	Number of respondents	Percentage of respondents
Local governments	5	26	5	26
Provincial governments	0	0	0	0
National government	1	5	0	0
Foreign governments	0	0	0	0
Local labour unions	2	11	3	16
Other local societies	0	0	0	0
Provincial labour unions	1	5	2	11
Other provincial societies	0	0	0	0
National labour unions	10	53	9	47
Other national societies	0	0	0	0
Foreign labour unions	0	0	0	0
Other foreign societies	0	0	0	0
Number of valid responses = 19				

Table 2. Most important sources of political risk factors in South Africa, classified according to government-related and society-related sources for the past five years and the next five years, as perceived by the respondents

Category	Source	Past five years		Next five years	
		Identified	Category number	Identified	Category number
Government-related	Local governments	5	6	5	5
	Provincial governments	0		0	
	National government	1		0	
	Foreign governments	0		0	
Society-related (labour unions)	Local labour unions	2	13	3	14
	Provincial labour unions	1		2	
	National labour unions	10		9	
	Foreign labour unions	0		0	
Society-related (other than labour unions)	Other local societies	0	0	0	0
	Other provincial societies	0		0	
	Other national societies	0		0	
	Other foreign societies	0		0	
Number of valid responses = 19					

The empirical results indicate that 53% of the respondents perceived that national labour unions was the most important source of political risk factors during the past five years and that 47% of the respondents were of the opinion that the same source will be the most important source of political risk factors during the next five years. The second largest percentage of respondents indicated local governments as the most important source of political risk factors during the past five years and during the next five years. When the empirical results of Table 1 are classified according to government-related and society-related sources of political risk factors, the depiction of the following table is obtained.

The society-related source of political risk factors, which focuses on the role of national, provincial and local labour unions, was mentioned by the majority of respondents as the most important source of political risk factors for the past five years as well as the next five years. A minority of the respondents indicated

that the government-related source of political risk factors was the most important source of political risk factors. All the identified sources of political risk factors were domestic (internal) as no foreign (external) sources were indicated by the respondents.

The two preceding tables lead to the conclusion that the majority of respondents regarded the social-related source of political risk factors, which focuses on labour unions, as the most important source concerned during the past five years and the next five years. The emphasis is especially on the impact of labour unions which operate on national level. The next section addresses the analysis of political risk factors.

6.2 Analysis of political risk factors

The following table indicates whether the respondents conduct political risk analysis and if so, which methods are applied.

Table 3. Whether the respondents conduct political risk analysis in South Africa, and if so, which methods are applied

	Not conducting own political risk analysis	Applying quantitative methods only	Applying qualitative methods only	Applying both qualitative methods and quantitative methods
Number of respondents	24	2	0	5
Percentage of respondents	77	7	0	16
Number of valid responses = 31				

It is an alarming result that 77% of the respondents do not conduct any analysis of political risk factors, as they are in fact the agents who underwrite political risk insurance in South Africa. Only seven of the 31 respondents conduct any analysis of political risk factors, of which about 70% employ both qualitative and quantitative methods and the remaining two respondents apply quantitative methods only. This empirical result emphasises an important gap in the analysing process of political risk factors in South Africa. Although the vast majority of respondents indicated that they do not conduct some form of political risk analysis themselves, many of them pointed out that they often obtain such information from other enterprises which specialise in

political risk analysis or from related publications. The next section focuses on insurance flexibility of political risk factors.

6.3 Insurance flexibility of political risk factors

Table 4 depicts the importance of flexibility concerning the various aspects of political risk insurance in South Africa, as perceived by the respondents. A five-point Likert interval scale was employed to classify the perceptions of the respondents.

Table 4. Importance of flexibility concerning the various aspects of political risk insurance in South Africa, as perceived by the respondents

Aspect of political risk insurance	Extremely important	Highly important	Moderately important	Little important	Not important
General conditions of cover	6	13	8	3	2
Availability of special endorsements for specific insureds	7	14	6	5	0
Extent of cover provided	10	10	10	2	0
More leniency in acknowledging political risk factors	10	10	10	1	1
Level of premiums on an ad hoc basis	5	12	9	5	1
Availability of no-claim bonuses to all insureds	6	9	2	10	5
Number of valid responses = 32					

As it was stated explicitly during the personal interviews and on the questionnaire that the five-point Likert interval scale forms a continuum, it was

possible to assign weights to the answers (Albright, Winston & Zappe, 2002:224-229 & 245). The answers of the respondents received the following weights:

Answers of the respondents:	Weights assigned:
Extremely important	5
Highly important	4
Moderately important	3
Little important	2
Not important	1

The total weighted scores calculated for the importance of flexibility concerning the various aspects of political risk insurance appear in Table 5.

Table 5. The weighted responses on the importance of flexibility concerning the various aspects of political risk insurance in South Africa, as perceived by the respondents

Total weighted score calculated	Declining order of importance	Various aspects of political risk insurance
124	1	Extent of cover provided
123	2	More leniency in acknowledging political risk factors
119	3	Availability of special endorsements for specific insureds
114	4	General conditions of cover
111	5	Level of premiums on an ad hoc basis
97	6	Availability of no-claim bonuses to all insureds

The extent of cover provided to the insured is regarded by the respondents as the most important aspect of flexible political risk insurance as it has the highest total weighted score calculated. The aspect of political risk insurance focusing on more leniency in acknowledging political risk factors is almost as important as the preceding aspect according to the total weighted score based on the perceptions of the

respondents. It should be clear that these two aspects of political risk insurance address the core of any type of short-term insurance, namely the extent of cover and the specific factors which will be covered by the insurer.

The aspect of flexible political risk insurance which received the third highest total weighted score calculated, refers to the availability of special

endorsements for specific insureds who need tailor-made insurance policies for their particular circumstances. This aspect of flexible political risk insurance places the emphasis on an insured, compared to the fourth important aspect of flexible political risk insurance which relates to the general conditions of coverage applicable to all insureds.

The fifth most important aspects of flexible political risk insurance, viz. the fixing of the level of premiums on an ad hoc basis, should, amongst others, take the insured's line of business, the geographical region, the nature of the industry concerned and the claims history of each insured into account. The least important aspect of flexible political risk insurance

which refers to the availability of no-claim bonuses to all insureds, is also important. It must be realised that even this aspect still has a total weighted score calculated of more than 60% of a possible maximum score of 160 (which equals 32 respondents times a weight of 5).

The weighted mean value was calculated by dividing the total weighted score calculated for each aspect of flexible political risk insurance by the number of valid responses (namely 32). The descriptive statistics on the importance of flexibility concerning the various aspects of political risk insurance in South Africa are depicted in the following table.

Table 6. Descriptive statistics on the importance of flexibility concerning the various aspects of political risk insurance in South Africa, according to the respondents

Aspect of political risk insurance	Weighted mean value	Median value	Standard deviation
Extent of cover provided	3.88	4.0	0.94
More leniency in acknowledging political risk factors	3.84	4.0	1.02
Availability of special endorsements for specific insureds	3.72	4.0	0.99
General conditions of cover	3.56	4.0	1.11
Level of premiums on an ad hoc basis	3.47	4.0	1.05
Availability of no-claim bonuses to all insureds	3.03	3.0	1.43

The descriptive statistics of the preceding table indicate that the weighted mean value of each aspect of political risk insurance is very similar to the median value of its responses (according to Table 4). Based on the standard deviations, the respective responses did not vary much from the weighted mean value. It can therefore be concluded that the six aspects of political risk insurance (which are mentioned in the preceding table) are moderately to highly important for the insurance flexibility of political risk factors.

7 Conclusions

The objective of this research was initially formulated as the improvement of financial decision-making concerning the sources, analysis and insurance flexibility of political risk factors. The following important conclusions were made in this paper, based on the literature study and the subsequent empirical survey, which should improve financial decision-making in developing countries with emerging market economies:

(1) It was concluded that the majority of respondents regarded the social-related source of political risk factors, which focuses on labour unions, as the most important source concerned during the past five years and the next five years. The emphasis is especially on the impact of labour unions which operate on national level. This conclusion makes sense against the background of emerging market

economies. All the identified sources of political risk factors were domestic (internal), as no foreign (external) sources were indicated by the respondents.

(2) It is an alarming result that the majority of the respondents do not conduct any analysis of political risk factors, as they are in fact the agents who underwrite political risk insurance in South Africa. Only a small number of respondents conduct any analysis of political risk factors, of which about 70% employ both qualitative and quantitative methods and the remaining respondents apply quantitative methods only. This empirical result emphasises an important gap in the analysing process of political risk factors in South Africa. Although the vast majority of respondents indicated that they do not conduct some form of political risk analysis themselves, many of them pointed out that they often obtain such information from other enterprises which specialise in political risk analysis or from related publications.

(3) It was concluded that the following six aspects of political risk insurance are moderately to highly important for the insurance flexibility of political risk factors, where they are listed in a declining order of importance, according to the perceptions of the respondents:

- The extent of cover provided to the insureds;
- Providing more leniency in acknowledging political risk factors;
- The availability of special endorsements for specific insureds;

The general conditions of cover;
The fixing of the level of premiums on an ad hoc basis; and
The availability of no-claim bonuses to all insureds.

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