International Journal of Academic Research in Accounting, Finance and Management Sciences
Volume 2, Special Issue 1 (2012), pp. 89-95
ISSN: 2225-8329

Risk Types in International Business Relations

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ABSTRACT *Risk analysis and knowledge of diversity in the world of international transactions has a great practical importance, because it allows business people to identify the tools and policies to reduce / eliminate the risk and the damage they cause. Given the unpredictable nature of risks is necessary to know them very well in order to say that it is possible to eliminate unwanted effects. When concluding an international economic transaction, the more fully aware of the uncertainty in the action, the more prepared we are to limit the possibility of random events that could cause an unfavorable turn of the transaction.*

KEY WORDS *Risk, business, analysis, knowledge, transaction*

JEL CODES D8

1. Introduction

Risk is the possibility of an event happening. Risk is often associated with negative outcomes; although there are some beneficial possibilities too, people generally connote risk with loss or damage. We normally take the insurance and everyday life custom of linking risk automatically with an unpleasant event. It is necessary to consider recapping on our views of risk within a multi-step process:

- Hazard – the risk of an outcome or event;
- Danger or risk catalyst that allowed this risk to occur;
- Impact of the event upon your group;
- Risk management – the process in which you can limit or avoid the potential damage.

There are four risk types that we wish to examine in depth within this book.

1. Reputation risk
2. Market risk
3. Credit risk
4. Operational risk

These last three are the same major risk types outlined in the latest Basel II banking regulations[1].

2. Reputation risk

The time-worn way to avoid risk was the tactic of keeping silent ("there is no danger, keep shut"), or hiring a big name with a good reputation to reduce your investment risk.

[1] "New capital accord – an explanatory note", Basel Committee on Banking Supervision, January 2001.

Thus, taking on the services of the top Wall Street or London City investment banks, lawyers, accountants and specialists was a sure way or reducing risk because they were "safe" business partners. One of the drawbacks of this method is that we are relying on heuristics that are either unfounded or out of date. The rule of thumb: "prestigious reputation = great service".

CASE STUDY: EQUITABLE LIFE

The notion that a large, old and well-established firm means a "good risk" took a bit of a knock after the Queen's bank (Barings) of England went down after the Leeson disaster.
History repeats itself when we are faced with a respected company founded in the 18th century facing a struggle for survival. It seems to have been a case of damage by acting in a risk-ignorant and not by intention or criminal act. Damage limitation provided by the UK life insurance company Equitable Life shows us where risk management often comes in after a risk hazard surfaces, not before.

1. The damage from the mis-selling scandal was quite severe, many funds found culpable of selling inappropriate pensions to the public.
2. Most funds were enamored of the guaranteed annual repayment whereby the funds essentially bet that they could assure the policy-holder of a fixed amount each year upon retirement.

The stock-market slump threatened their ability to pay out to customers, plus it jeopardized the capital adequacy base.
The new management went on a damage-limitation exercise. This eventually succeeded in keeping the company afloat, despite hard knocks to its former prestige. It is a process of reputation risk recovery, which could not have been conducted by a low-level risk management exercise. In this case, top management:

- Recognized the hazards;
- Evaluated the impact of the risks;
- Allocated vast resources to damage control;
- Set about retrieving reputation and clients' trust;
- Put in procedures to limit further similar damage in the future.

A better use of communication and efficient PR could have triumphed over mechanistic risk management. Equitable Life was under such financial pressure that it dropped 50 000 pensioners from its schemes. Pay-outs fall, the number of lives insured decreases and the number of satisfied policy-holders have shriveled to almost zero. If only they had known beforehand. Equitable Life struggles on, but survives. We can just regret that these damage limitation measures were not done before, but post facto (see Figure 1)[2].

[2] *Financial Times*, 16 November 2002.

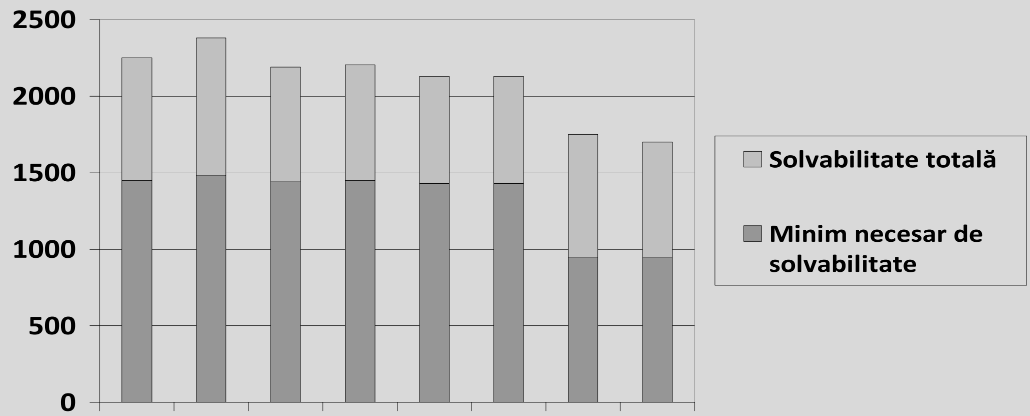

Figure 1. Equitable Life monthly solvency Dec 2001 – July 2002

3. Credit risk

Credit risk is the ancient hazard of suffering loss because of not being able to extract the promised return from a business partner. We also include counterparty and country risk within this category. Various examples exist: sovereign risk on issue of bonds and debt default such as the Russian economic crisis of 1998, or the Argentinean debt crisis in 2002.

Few banks only lend to one sector but actively diversify their portfolio. A modern bank (Commerzbank, 2001) shows how it makes arrangements for the projected level of domestic bad debt. See Table 1.

4. Market risk

Market risk is the loss in value of the bank or fund's portfolio caused by changes in price (or price-related) factors. Currency rate, interest rate, equity price levels, volatility levels are changes or risks that come under this heading. A bond-dealing desk taking positions is a typical example of a portfolio under market risk. The large foreign exchange market trading feeds of these risks for good and bad where those who estimate the market risk well benefit, whilst those who calculate market risk wrongly generally fail.

Table 1. Credit risk

Total 100% of banking sources for credit risk		
Services and other industries	**Manufacturing, construction, distributive trades**	**Other retail customers**
59,2%	26,8%	14,0%

Source: "Provisioning for borrower risks by customer group – 'Commerzbank in 2000'," Annual report, 2001.

5. Operational risk

This is a wide-embracing term that refers to the danger of losses from business system or process failure. This can include mechanical and human operations, faults in procedural design and system function. The Basel Committee on Banking Supervision adopts a narrower definition: "…the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events[3]."

It includes legal risk and all errors from trading and settlement not previously covered in the above categories, to the criminal/fraudulent actions, up to the IT and system failures from human and external changes. Strategic, systemic and reputational risks are excluded. These are the categories of risk that are often said to be the hardest to model and predict – the human side.

When we have redesigned bank business processes, created dealing operations, or inspected fund managers, we work in a complex network of people and their varying skills. Some of these skills and experience are not really definable in numerical terms, but involve an element of intuition. Thus, investment risk management is an art, and not a science in many ways.

Risk management used to be a staid and reactive exercise, where the auditors would be called in after a company crashed or suffered loss. Now, it has become a specialist field in its own right encompassing several disciplines geared towards a proactive stance to mitigate against risk consequences.

Formerly, risk management was just like an optional feature that you could choose to buy later. Lately, risk management is becoming an inherent part of the processes of wealth creation and a sought-after skill. We include some of the essential skills for modern risk management.

The variety of risk is so wide and potential damage so deep, that risk management has become high profile in itself. Directors are less able to pay lip-service to operational risk because of the high impact when the hazards happen. Compliance was such a boring and low-key event that companies devoted fewer resources to it. Now the regulators are devising stricter rules, and the public wants to see that these are met by the company, that directors do not wish to face the reputation risk of being known as inept or hiding something disastrous when it comes to complying with the disclosure regulations.

Risk management skills often involve a combination of financial training and an intuitive sense to sniff out suspect investment opportunities or partners. It has a strong mathematical foundation, but recently, some of this modeling has demonstrated weak underpinning. So, we come back to having a good "nose" for business – intuition and experience, instead of paper qualifications.

Then, we define where we come into the grey area that calls for the artistic gift of subjective interpretation. The Andersen–Enron–WorldCom (AEW) cases demonstrate where confusion led to crooked chicanery. Then, we define where we come into the nebulous area that calls for the artistic gift of subjective interpretation. Yet, we can hover above the company risk horizon and see dangers surrounding us.

The concept of an AEW risk-alert system would work in the same way as AEW (airborne early warning) radar detects potential enemy action. It is tempting to point the finger at Andersen's accounting arm and try to fix the fault just there. Risk management is truly concerned with the

[3] "Sound practices for the management and supervision of operational risk", Basel Committee for Banking Supervision

fundamental source of errors and lack of control in modern corporate business, not just the symptom. The post-Enron quick-fixes and assurances must offer superficial comfort.

6. Risk and damage

The fact is that although financial regulatory procedures for protecting the investor are well documented, financial redress and net loss are less well recorded. This means that even when the stock exchange and the regulatory organizations have given a good-housekeeping seal of approval to large numbers of listed companies, some records of company operations and the more truthful balance sheets take an opposite view. The imperfect relay of information, or interpretation by the investors, shows a divorce between extant risk and likely damage.

The finance industry wallowed in a "If it ain't broke, don't fix it" mentality for decades. Mistakes were made partly because of lack of proper execution in planning for extreme events, matched to negative impact. Every business builds a risk register with relative probability and associated impact. See Figure 2.

The different risk impacts and frequencies need to be dealt with by different people with various risk management skills. This varies from company to company, and from risk culture to risk culture. Where losses occur, these should be recorded in the loss database.

Insurance and fund managers form a highly organized risk-seeking profession that aims to share these risks for profit. It tries not to take on too much risk, or even too much risk that it does not understand. Otherwise, it stands the risk of dying as a business.

Insurance, even with its avowed expertise in risk management, is just as likely to face insolvency, as the crashes in their stock-market portfolios have revealed. Because banks, insurance companies and pension funds have a large slice of the entire stock market capitalization, corporate inadequacy can force a sell-off of shares in their portfolios. This can create a systemic or pro-cyclical risk where continued selling destroys the stock-market value[4].

	Low frequency, high impact risk Catastrophes to building safety – fires, electric power-outs, floods ret.	**High frequency, high impact risk** Loss of key staff to competitor. Death of CEO.
Impact	**Low frequency, low impact risk** Lateness in share register delivery. Lateness in filling month compliance report	**High frequency, low impact risk** Lateness because of transportation problems. IT minor system crashes.

Frequency

Source: marsh.com

Figure 2. The risk registers (frequency vs. impact)

The threat of stock-market crash or some terrorist activity after September 11th may seem so uninsurable that some clients opt-out or go for self-insurance (bear the risk burden yourself).

[4] "New capital accord – an explanatory note", Basel Committee on Banking Supervision, January 2001.

Otherwise, pay higher insurance premiums. A large corporation can retain a large risk because of the size and strength of its balance sheets.

Risk retention or self-insurance is troubling the insurance industry. Insurers' efforts to cope with loss of business have tried to offer alternative products or to cut premiums – both carry considerable risk. Cutting premiums or guaranteeing the pay-outs endangers the very same insurance companies that are meant to protect investors. Risk retention is also a prospect that troubles some investors – there is a tacit admission that they take a bet on an extremely low-frequency, high-impact risk. This means that their company can go bust, with little compensation for the investor. Business looks more like a gamble at the horse races.

7. Viable alternatives

There are loop-holes when we seek to protect ourselves through the financial regulators, the legal system, accounting or insurance. The validity of auditing and due diligence can be called into question. Rushed business diagnoses are superficial, and their foundations for defining a business conclusion are clearly limited.

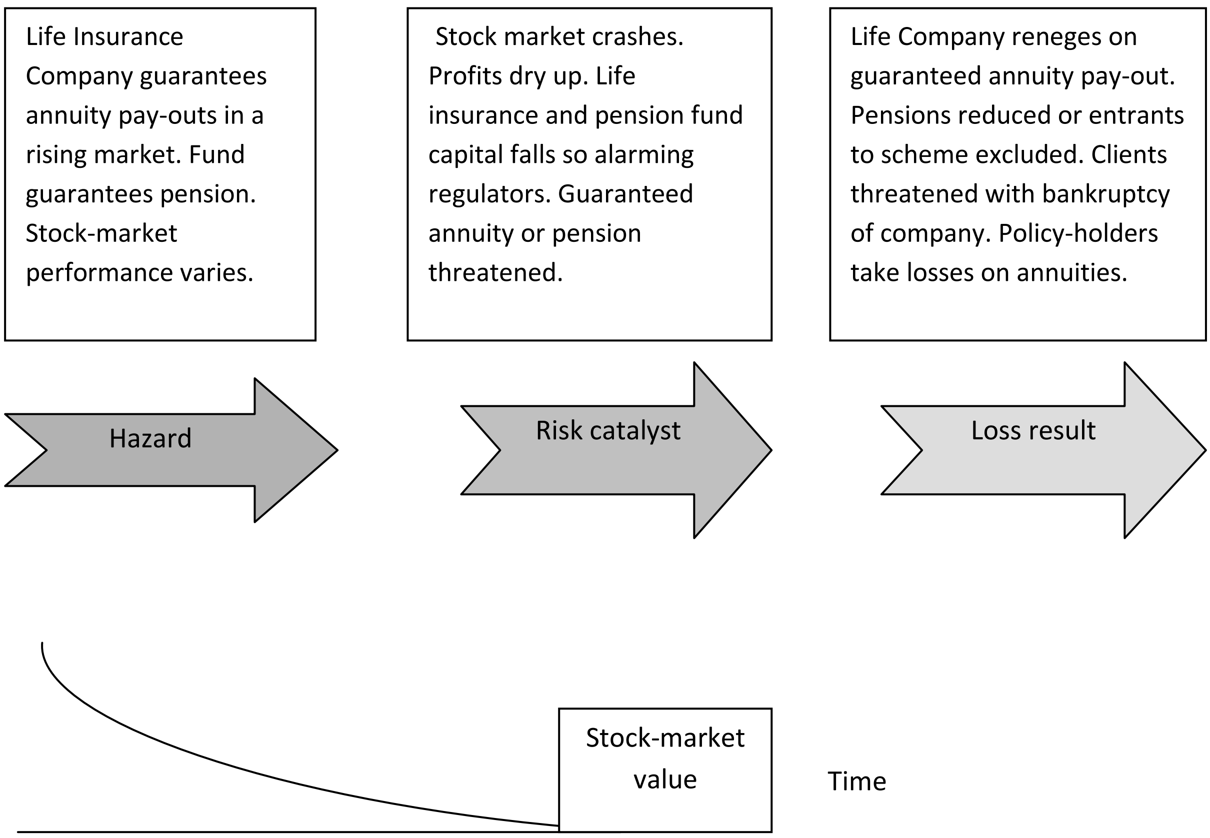

Figure 3. Risk in a life insurance company or pension fund

These severely reduce the effectiveness of traditional risk management avenues. The growing feeling among investors is that prevention is better, and cheaper, than a cure.

Accumulating a pool of corporate information might come in very useful. These avenues are explored in further depth in the following chapters. Some are:

- Traditional sources of corporate news in current events coverage.
- Prior company case studies and relevant industrial experiences from media sources logged in a "risk register".
- A deeper investigation of performance track-record of key company staff, counter-parties and business partners under detective and forensic accounting initiatives.
- Additional company reports filed under the Basel II new banking regulations.
- Procedure for early warning (AEW).

Those who have suffered enough from previous investments understand that reputation risk means perceived corporate value becomes rapidly uncoupled from real worth. We can now attempt to detect and discard undesirable business elements from our future plans using these data sources. One of the ways we can help to achieve this is to use an investment risk methodology. This is outlined in succeeding chapters within a view of a methodology for an investor's closed-end project, i.e. a launch and a desired end. So, when it comes to investing or building a portfolio, the increasing feeling is to do everything yourself.

8. Conclusions

Risks of economic activity mainly result from the inability of the company to continuously adapt their cost (in decreasing terms) and to adapt to the economic environment.

Business risk can be addressed either in terms of internal activity of the company, either in terms of external environment in which it evolves.

Risk occurs in the environment in which business operates:

a. Reputational risk - is the risk of loss or failure to achieve record profits estimated, due to lack of public confidence in the integrity of a bank. Reputational risk management plans to ensure continuous positive image, untrue, square, in front of customers;

b. Market risk - is related to uncertainty about future income due to adverse changes in prices and rates in different markets;

c. Credit risk - the possibility that borrowers or issuers of securities must not honor their obligations at maturity, due to degradation of their financial situation, which can be determined by the borrower or business conditions overall economic situation;

d. Operational risk - directly or indirectly is the risk of loss resulting from inadequate way of managing internal processes, people, systems inadequate or external events (economic conditions, changes in banking, technological etc.).

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